ISGAM

Manager's Report

QUARTER TO 30 JUNE 2020

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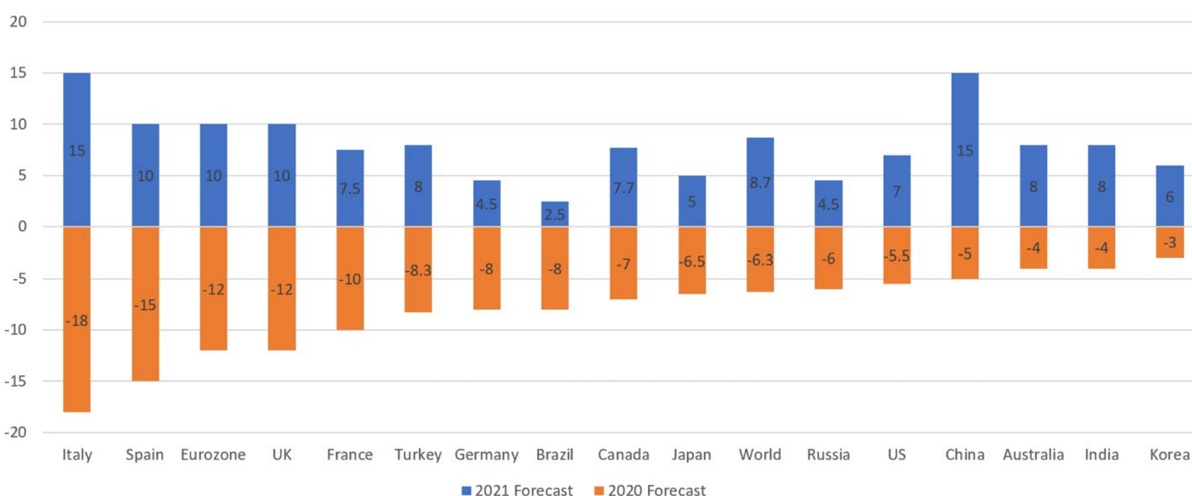
The second quarter of 2020 has seen the worst decline in real global GDP since the Second World War as economies "locked down" to lessen the spread of the deadly new Corona Virus. At the same time, seemingly paradoxically, risky assets rallied, recovering part of the losses sustained in the first quarter.

As usual the stock market looks forward, past the current reality of terrible economic numbers and sharply reduced company earnings, to a future where the virus is contained (hopefully through a vaccine) or at least manageable without closing most economic activity.

The "fair value" of stock prices is derived from expected future cashflows, discounted at a "discount rate" which is anchored in government bond yields. Thus the prospect of an economic rebound coupled with very low interest rates means current stock prices are not as divorced from reality as some commentators suggest.

The initial rebound of activity in economies that have been partially able to reopen has been stronger than expected, in many cases approaching a "V shape".

Chart 1) Capital Economics Forecast of Real GDP Growth in 2020 and 2021

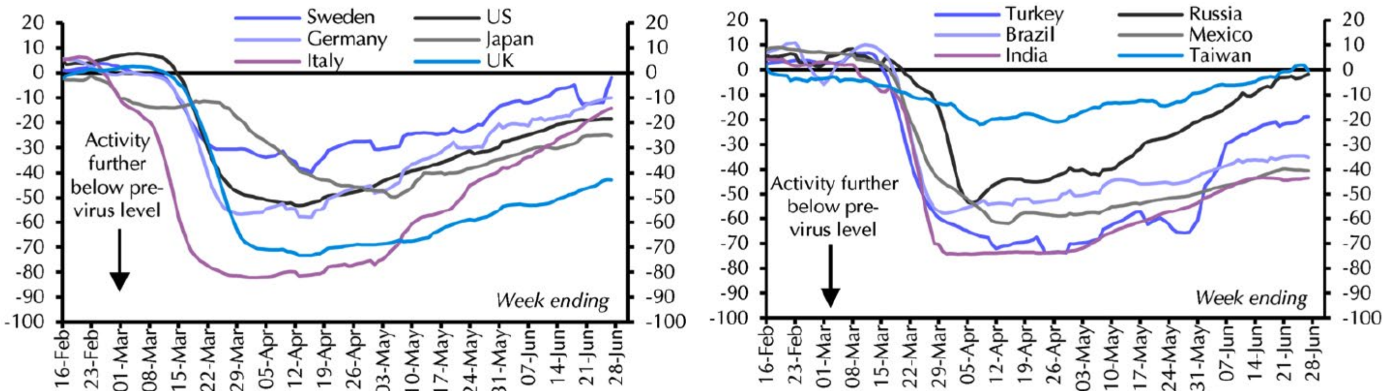


Source: Capital Economics

In order to capture real time data many economists are currently turning to alternative, high frequency data such as Apple and Google map location requests, restaurant visits, etc. Capital Economics graphs these data below, for both developed and developing economies.

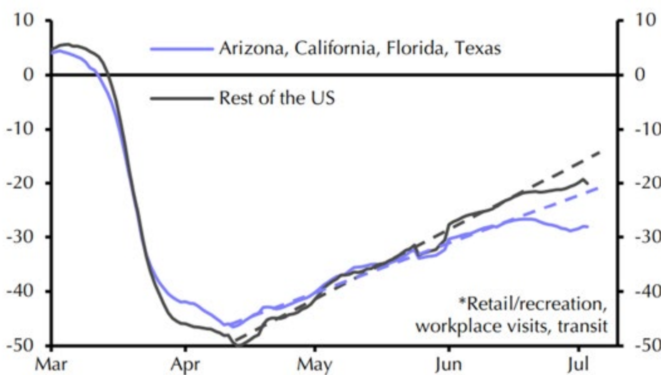
In countries that have reopened to a greater extent activity is not far below pre-crisis levels; some have not been as successful in containing the disease when it first started (like the UK) or are currently suffering a surge in infections (eg India, Brazil) and activity remains depressed.

Chart 2) Capital Economics COVID Recovery Trackers (activity as % of pre-virus level)



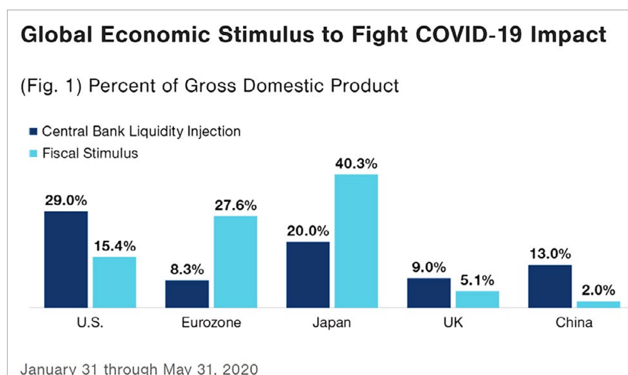
Source: Capital Economics, Google, Apple, Moovit

Chart 3) Capital Economics COVID Recovery Trackers USA (activity as % of pre-virus level)



Source: Capital Economics

Chart 4) The Combination of Monetary and Fiscal Response to this Crisis has been Unprecedented in Size and Speed



Source: T Rowe Price

The US is currently experiencing a renewed increase in infections in several large states which appears to be having a dampening effect on consumer sentiment; the activity rebound is levelling off for now. Overall, after a stronger than expected initial recovery in economic activity further normalization could become more uneven as consumers remain cautious, though large scale lockdowns are unlikely to be repeated and containment measures will probably be more targeted and localized.

The monetary and fiscal response to the crisis should not be under-estimated and is playing a large part in the economic as well as the market rebound.

It has been much larger in size than in the immediate aftermath of the Great Financial Crisis and deployed much more rapidly. Also, during the GFC much of the fiscal measures (like TARP) and the liquidity injections from the Central Banks disappeared into the Reserves of the banks, which had to repair their balance sheets – rather than being pushed out into the real economy, which continued to suffer for years as banks remained unable or unwilling to lend. The current wave of liquidity and fiscal support has largely ended up on consumers' bank accounts, in the form of direct payments (from the US government, under the CARES act) or via companies' "furlough schemes" supported by European governments (to prevent the link between employers and workers being severed), or via government and Central Bank backed loans to companies, either directly or through the banks (which are currently in a much stronger position to lend than in 2009.)

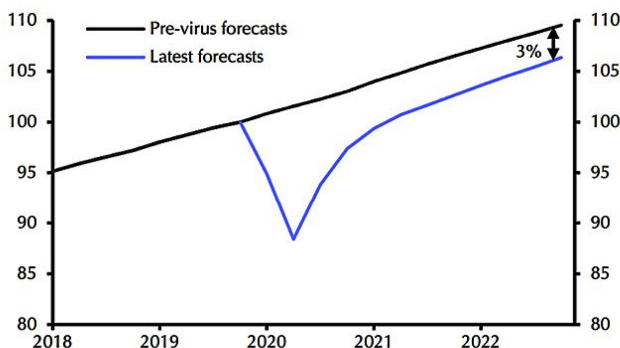
It is worth a mention that the European Union's fiscal response to the pandemic has been starkly different from its austerity focused one 2008; some call it Europe's "Hamilton Moment". Though the EU is still far from having a unified debt market, the first "baby steps" have been made by its members agreeing to jointly issue Euros 750 bn worth of bonds to combat the economic effects of the epidemic. Negotiations are in process about the details of the plan and which "strings" will be attached to its deployment. Under Angela Merkel's leadership Germany seems to be easing away from its stringent balanced budget policy, in favour of fiscal stimulus that will benefit all members of the bloc.

Part of the funds will be targeted at stimulating new industries, jobs and infrastructure in a push for a "Green New Deal". The ECB, which has already been "doing what it takes" to enable the smooth transition of easy monetary policy across the eurozone, is finally seeing its calls heeded that politicians also step up to the plate.

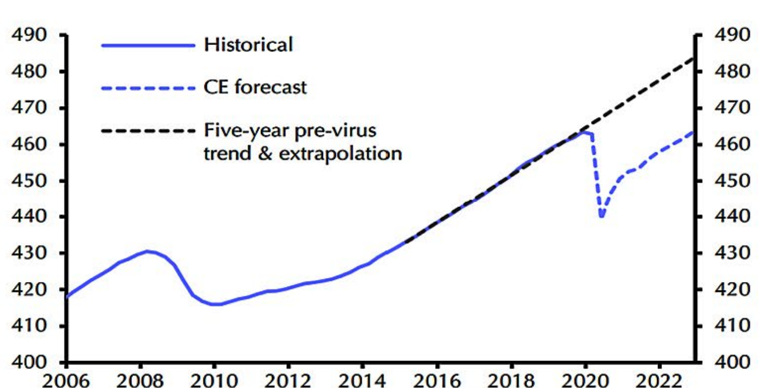
Most economists expect the further normalization of economic activity to resemble a "Nike Swoosh" shape from here – with Global GDP some 3% lower, at the end of 2022, than it would have been without the pandemic, and employment somewhat lower as well.

Chart 5) Further economic recovery expected to resemble a "Nike Swoosh", after the initial VTrackers USA (activity as % of pre-virus level)

World Real GDP – (Q4 2019 = 100)



Employment in Developed Markets Economies (millions)



Source: Capital Economics

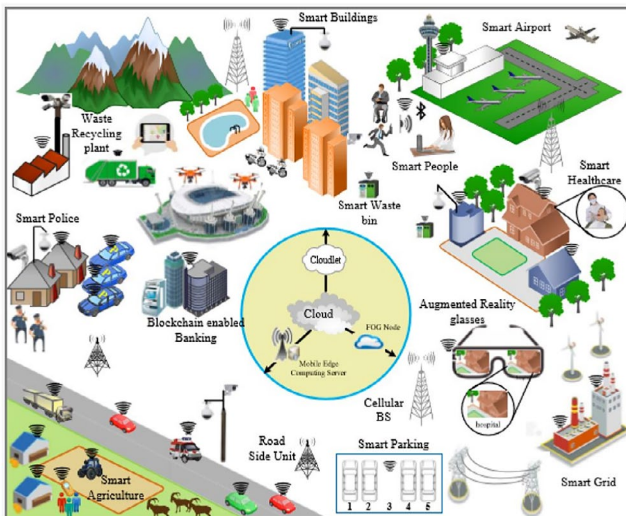
Likewise, company earnings are likely to have troughed in the second quarter (Q2 2020 earnings estimates in most markets are roughly 50% below last year's) and recover from here, albeit with large differences between sectors and companies; the bifurcation between companies on the "right" and the "wrong" side of change has rarely been wider.

Broadly speaking, many companies in the technology, healthcare and consumer staples sectors have not seen negative effects on their business and earnings; some even positive effects. People working from home, students learning virtually and entertainment becoming home based has boosted demand for technology, bandwidth and web-based services.

The current crisis has fast forwarded a number of trends that were already in place. It remains to be seen how much the pandemic will permanently alter consumers' behaviour, but increased use of e-commerce, e-learning, increased working from home and replacing some business travel with virtual meetings will probably last. As will a renewed focus on protection of the environment, security of supply chains, sustainability of the food chain, and the speeding up of replacing cheap labour with robotics. Many manufacturing companies have had a dismal first half of the year as they were largely forced to halt production and supply chains were disrupted, but those involved in areas such as Robotics or Clean Energy have seen strong rebounds in their share prices as investors are looking past the current dip to strong secular growth trends.

The roll-out of 5G, which has lower latency and much greater bandwidth than 4G, and increased deployment of cloud-based services will accelerate the development of "the internet of things" where robots, devices, monitoring equipment etc. will work together to create "smart cities" with more efficient and sustainable use of resources.

Chart 6) New Business Opportunities with the Rollout of 5G



Source: IEEE study "Edge Computing Enabled Smart Cities: A Comprehensive Survey"

Among healthcare companies, those focusing on developing a viable cure, vaccine or test for the novel virus have seen earnings estimates and share prices rise while those involved in more elective treatments such as knee replacements have suffered a temporary setback as these procedures are crowded out by hospitalization needs of corona virus patients.

Among consumer staples companies those providing basic grocery and home cooking needs are doing well while those based on restaurant visits and pub demand are suffering. Within the retail sector, Amazon's business is booming and has gained a large number of "newly converted" clients for their service, while traditional and mall-based retailers are struggling to survive. As Amazon makes up over 25% of the market capitalization of the "consumer discretionary" subsector in the S&P 500 index, the gain in its share price has actually helped the sector to a gain year to date, in spite of dismal performances from other companies in its sector such as the car makers and department stores.

Some of the worst performing stocks this year can be found in the financial, energy, airline, leisure and traditional retail industry. Stock selection is more important than ever when sifting through possible bargains among the "losers" and gauging which of the "winners" still represent decent long-term value.

What changes have we made to portfolios in the second quarter?

We had entered the year being 5% underweight to clients' "neutral" equity levels. Also, in early February we had somewhat scaled back our high beta equity sectors in favour of quality, and reduced high yield bond exposure. This gave the opportunity to move opportunistically in early April, when we felt stocks and corporate bonds represented compelling value in spite of the considerable uncertainties, given the fact that 1) humanity and the global economy has eventually bounced back from many crises of similar or greater magnitude and 2) governments and central banks are united in responding rapidly and adequately.

We shifted some cash, mainly from low risk, low yielding bonds to bring the equity section of portfolios back to a neutral weight.

This cash was invested in funds that focus on investing in global growth trends in healthcare, technology, cloud based services, robotics, etc. In bond portfolios we increased the allocation to high yield and emerging market bonds as spreads had become compelling compared to cash and government bonds; it is likely that we have seen the generational lows in long term developed market government bond yields.

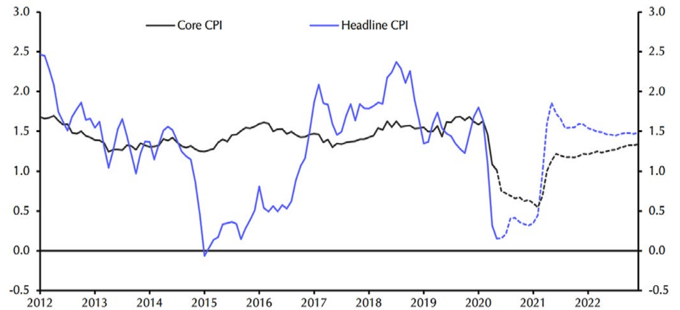
We have held back a bit of "dry powder" to add to equities should the markets see a sizeable correction in the coming months. Although we do not think the March lows will be revisited, there are a number of factors that could cause volatility, such as a possible "second wave" of infections and necessity for renewed lock downs, hesitation by governments to extend extraordinary measures, disappointing company earnings reports, and the as yet unknown outcome of the US election this fall.

Besides the acceleration in certain technological and consumer trends described above, the pandemic has laid bare some societal trends that have been long in the making.

Chart 7) Wealth Inequality has Grown

Source: Pew Research Centre

Chart 8) CPI Inflation in Advanced Economies



Source: Capital Economics

Average hourly wages, when adjusted for inflation, have barely moved over the past 60 years, partly due to increased globalization and competition from low wage emerging markets. The chart above shows average hourly US wages but similar charts can be compiled for most developed countries. Meanwhile, the combination of the resulting low inflation, plus the series of financial crises since 2000 that caused major central banks to suppress interest rates and bond yields, has enabled decent returns on invested capital, while suppressing interest income for small savers and pensioners.

The increasing wealth gap has been causing a growing rumble of discontent, protest and "populism" in many countries. The recent pandemic has also served to highlight inequality, including racial inequality. Comorbidities exacerbate mortality rates, and communities with less access to decent healthcare have been hit extra hard.

We think that, whatever the outcome of upcoming elections in the US or Europe, there is likely to be increased pressure for affordable healthcare, affordable housing, affordable (re-)education of people whose jobs are displaced by robots, very possibly increased regulation and taxation of large, quasi monopolistic companies (including large tech), and lower profit margins for companies (which recently reached an all time high as % of GDP). We incorporate these themes when analysing and choosing investments.

Looking ahead, we expect Central Banks are likely to continue suppressing interest rates. Given the deflationary nature of the current crisis, coupled with demographic and secular trends that were already deflationary, we expect this to be the case for the next few years without the threat of inflation.

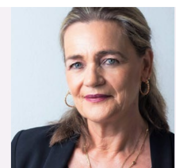
Low interest rates will mean the increased debt currently taken on by governments to fight the Covid crisis will not be a problem – the interest burden will be sustainable plus Central Banks will be ready to buy much of the newly issued bonds through their QE programs. We do not see how any developed government would advocate austerity measures in the current environment – the voter back lash would be too big. The massive amounts of liquidity pumped into the system are currently not inflationary as people remain wary to spend; thus the "velocity" of this money (the speed at which it moves through the system) is not high.

Further in the future, if Central Banks maintain easy policy, inflation could pick up – a reason to keep a decent exposure to stocks, especially stocks of companies with pricing power. Government bonds, with yields close to 0, probably have the lowest total return potential of any asset class. In conclusion, we plan use any new volatility this summer to add somewhat to stock investments.

As always, please do not hesitate to contact us if you have any questions or comments, about the contents of this report or your portfolio in general.

Stay safe. **Portfolio Management Team ISGAM AG**

Marianne
Rameau ASIP



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