



Investment Letter – Q1 2020

First and foremost, I hope that you and your family are as safe and well as you can be during these truly difficult times.

“There are decades where nothing happens, and there are weeks where decades happen.” Vladimir Lenin

Even if it does feel like a long time ago, I will start by saying that we entered the year with a relatively sanguine view on the global economy, following a decisive election result in the UK and an apparent thawing of US-China trade hostilities, both providing support to broadly steady economic data. However, with valuations towards the top of their historic ranges in many developed equity markets, we had a preference for actively managed funds, focusing on companies with robust balance sheets. This constructive growth outlook was upended by the outbreak of COVID-19.

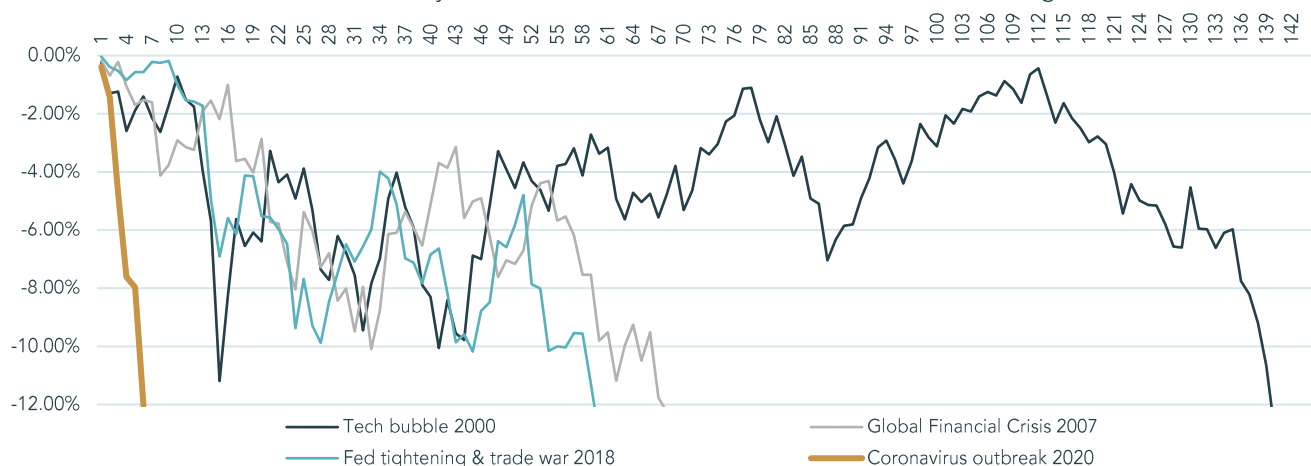
In late January, global markets appeared to be marching higher, without pricing any disruption from the virus as cases started to be recorded outside of China. Without having any superior epidemiological insight into how the virus would develop, we heeded the advice of Angela Merkel in handling a crisis: “Fahren auf Sicht” or “adjust your speed to the visibility”, reducing equity exposure in portfolios. Initially, we reduced exposure in Japan, Europe and the UK, and then in February as Chinese equities quickly rebounded following their initial coronavirus-related sell-off, we also took the opportunity to sell our passive exposure in China. We then entered a period of heightened volatility with elevated cash positions in client portfolios. With hindsight, we clearly wish we had taken off more risk as this was not enough to shelter portfolios from the severe market downturn that followed.

Volatility certainly ensued in March, as Russia declined to sign an agreement between OPEC and its allies to lower oil output. The three-year-old agreement to curb oil supply was aimed at supporting the oil price and its re-signing was expected by many to be a formality. With Russia deciding to break ranks, both Riyadh and Moscow then separately announced that they would flood the market with oil which, against the backdrop of a collapse in demand due to the coronavirus pandemic, caused the oil price to fall to multi-year lows. Equity markets reacted negatively to this supply shock, with oil-dependent markets such as Russia and the UK suffering particularly large selling pressure.

As the virus spread, governments were forced into taking disruptive action and it was clear that there was potential for strain on the credit market, particularly for businesses vulnerable to falling oil prices. Consequently, in early March, we reduced our exposure to high yield bonds. Given the strength of the US Dollar in times of crisis and the oil-dependence of many emerging economies, we also felt it prudent to trim our exposure to emerging market bonds at this time, whilst maintaining a positive long-term view on the asset class.

This combination of factors caused extreme market moves throughout Q1 as markets tried to price in the economic impact of the virus, with the FTSE 100 finishing down 25%, the Euro Stoxx 50 down 26% and the S&P 500 down 20%. Alongside this quarterly decline, the volatility in daily market moves skyrocketed. To put this into historical context, there were 5 days during 2016 when the FTSE 100 Index moved $\pm 3\%$; 0 days in 2017, 1 day in each of 2018 and 2019, and 9 days in March 2020 alone. Not only have equity markets fallen, but the severity and speed of the daily market moves this quarter were substantial. The chart below highlights the speed of Q1’s correction in the US equity market, which was not only the fastest in history, but the fastest by some margin.

Number of days for the S&P 500 Index to fall 12% from historical high

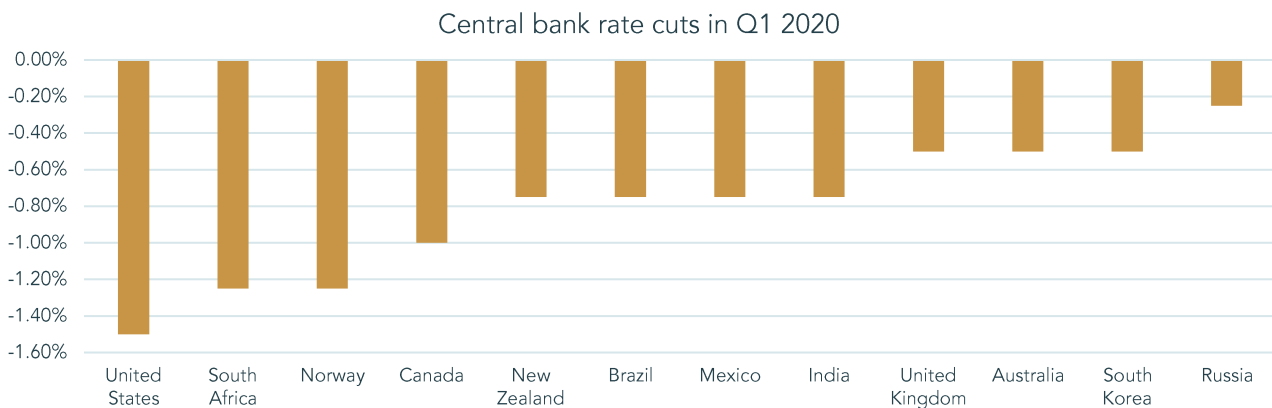


Source: Bloomberg LLP, 2020



No doubt you are all too familiar with the extreme measures which governments have been forced to take in order to deal with the virus. The quarantines and isolations are already taking their toll on economic data, with the US posting 6.65 million new jobless claims in the last week of March, a record weekly increase. Closer to home, the UK Purchasing Managers' Index reading, a measure of economic activity, fell to its lowest level since it was first measured in 1998. We can expect a slew of exceptionally poor data in the coming weeks, given the lagging nature of many of these readings.

The extent of the economic damage is still unclear, with several mitigating factors at play. Alongside the imposed social interventions, governments and central banks have stepped in to provide their economies with unprecedented levels of monetary and fiscal support. In March alone, we saw the US Congress ratify a \$2 trillion fiscal support package for the US economy, equivalent to just under 10% of GDP and significantly larger than the \$800 billion response to the 2008 financial crisis. Other governments are offering similar levels of fiscal support, whilst many central banks have reduced interest rates and launched significant bond purchasing programmes. The chart below shows the scale of global interest rate cuts across major economies, with the Bank of England and the US Federal Reserve cutting rates to historic low levels of 0.1% and 0%-0.25% respectively.



Source: HSBC, Refinitiv Datastream, 2020

Late in March, we made our first steps in buying back some of the equity exposure we sold in January and February. Multiple technical indicators suggested that global equity markets were entering oversold territory, which presented an opportunity to deploy a small proportion of the cash we had raised into US and Japanese equities. Given the ever-changing nature of the pandemic situation, we elected to do this via two highly liquid passive funds which provide us with maximum flexibility in the event the outlook changes again. In the medium term, we see some of these passive positions being redeployed into actively managed funds as the situation stabilises. Our active funds place balance sheet analysis at the forefront of their stock selection process which should put their portfolio companies in the best position to survive the current economic climate and prosper once it has passed.

At this juncture, there are a number of commentators with extreme views. Pessimists believe we are in a long and protracted battle with COVID-19 which will inevitably lead to a deep recession and a materially larger fall in markets in the future, whilst optimists believe the virus will be controlled and the global economy will restart itself without any lasting damage. I suspect we are somewhere in the middle; confident that we will emerge from this crisis, but conscious that the damage done could be more severe than the market has reflected to date. This latter concern has kept us slightly more cautious than usual, restraining us from putting more of the liquidity in portfolios back to work as yet.

We are extremely disappointed to have to report falls in the value of portfolios and are aware of how unsettling the most recent moves in markets have been. We firmly believe that this period, like other financial crises, will pass and we will look back and be grateful to have maintained our investment composure, because it is often in the moments of greatest uncertainty that the best opportunities can be found.

Wishing you and your family well during this period.

Fred Hervey
Chief Investment Officer