

Overview

The first quarter of 2020 saw a sharp set-back in world equity markets as the coronavirus Covid-19 took an increasing toll both on human and economic life. Governments and central banks provided substantial support to offset the significant disruption to companies and individuals, while an optimistic view on the speed of the recovery enabled markets to rally from their lows.

Investor confidence was rattled early in January by events in the Gulf region, when the US assassination of the Iranian general Qassem Suleimani raised concerns that the disputes in a volatile area would escalate, although the reprisal from the Iranian regime was relatively subdued. The price of oil rose sharply then subsided, before coming under pressure as did wider markets on concerns over the potential impact on the global economy of the coronavirus that emanated from Wuhan in China. Markets saw initial sharp falls in February as investors reacted to the extent that the virus had taken hold elsewhere, in Italy, in Iran and in South Korea especially. There was still a misplaced hope that Covid-19 would have a similarly limited impact as did the SARS outbreak in 2002-3 which caused 774 deaths, even though China then accounted for only 4% of global GDP compared to 16% in 2019 and that it was then less connected to the world. The exceptional month of March was entirely dominated by the realisation that this was too optimistic a view and by the increasing impact of the coronavirus. A striking element was the collapse in the oil price, driven by the drastic drop in demand for transportation in particular but compounded by a refusal between Russia and Saudi Arabia to agree production cuts. Liquidity was an important factor in the period, too, for property funds again but also for money-market ones.

Political issues have remained prominent, including a shift in the possible outcome for the US presidential election and a move to more authoritarian measures in certain countries. The coronavirus has eclipsed Brexit in all aspects yet this is still a consideration for the UK in 2020.

Central banks have made unprecedented moves to support economies as have governments to help businesses and individuals, although many will still suffer. The new Chancellor of the Exchequer announced successive measures while the Bank of England cut interest rates twice in March, first to 0.25% and then to their lowest level in history at 0.1%, if unlikely to stimulate demand in the short-term given the restrictions in place. The US Federal Reserve also cut rates twice to near-zero and the Trump administration agreed a stimulus package of up to \$2trn, while the authorities are expected to deliver 'helicopter money' by making direct payments of cash to citizens. The European Central Bank and Bank of Japan were among others to introduce more radical measures.

Outlook

As before, an assessment of the outlook is based on the virus itself, on its economic impact and on how markets factor in developments, as they tend to anticipate a recovery. We face the constraint that this is a particularly challenging time to be making forecasts, but we can still retain conviction in our approach as well as the flexibility to adapt - after all, it had seemed all too easy to expect that markets would continue their positive momentum into 2020. Perhaps it needed a black swan event, a pandemic if not the Black Death, to shake off complacency and to add renewed complexity.

Most people will have a view on the virus, its origin, its likely extent and the solution. It does appear that the key will be tough restrictions and extensive, repeated testing while a new drug will still take time, even with impressively-accelerated trials, while the virus is likely to mutate over time so as to make tackling it more complex.

It does also seem likely that the lock-downs will continue in some form for some time, as in the extensions seen in India and Italy, even as governments look to relax the restrictions for some sectors to avoid a protracted economic slump that will in itself have serious adverse consequences for the health of individuals as well as a country's GDP. Even in Wuhan, where the Chinese authorities have lifted the strict quarantine, there are logistical challenges and demand seems a little fragile.

We have moved from an expectation of reasonable economic growth around the world, a little better than in 2019 if lower than the average in the last decade, and from a range of gradual adjustments to radical shifts in forecasts that encompass a sharp recession. The UK economy is expected to contract by a fifth in the second quarter, when a typical recession might see GDP down by 1 to 2%. For the US JP Morgan, for example, has estimated a drop in GDP of 10% in the first quarter followed by one of 25% in the second as the lock-down there takes hold. The quantum of the fall is hard to quantify, and we can only be sure that we have seen the end of the protracted period of economic expansion since the financial crisis over a decade earlier, and earlier than most had forecast. It will surely be some time before the full extent of the impact becomes clear, especially if lock-downs are extended, as businesses start to fend for themselves without government support and as public companies return to reporting results and to managing a consensus on earnings. The focus is more on the trajectory of the recovery, which may yet be a sharp V-shape, or a more gradual U- or perhaps W-shape if the enforced restrictions on economies persist or need to be re-imposed.

Such sharp falls in GDP have been a feature in developing economies but not in developed ones: data from the World Bank indicates that since 1960 there have been only thirteen instances in which there have been declines of at least 5% with only three of those over 7% (Finland in 2009 then Greece in 2011-12). Even going back to 1870, as did the University of Groningen, there have only been forty-seven instances across eighteen developed economies of a decline in output of over 10%, usually at a time of war or in the Great Depression - and if you want a depressing statistic, shares in the US did not regain their previous high of 1929 until 1954. Economies do recover sharply from a difficult war-time or war-like collapse but the average time taken since 1870 has been five years, while it has been four years on average for smaller declines of 5% since 1960 - and while it is a great country in many ways the Italian economy had still not regained its pre-financial crisis level of real output before the latest one hit. Much will depend on any lasting damage to socio-economic institutions and also to the structure of global trade, which had been under some pressure from the tariff disputes in 2019 and will see a shift in sourcing as well as to greater self-reliance.

Also key will be collective action. Amidst an unprecedented use of the word, there is no doubt that central banks, governments and international institutions are doing whatever they can, if with some trepidation. Since the end of March the US Federal Reserve has provided an additional loan package worth \$2.3trn and finance ministers in the eurozone agreed a €500bn rescue package, if with some opposition from Rome. The G20 and the US added their support to an agreement by the wider OPEC+ group, led by Saudi Arabia and Russia, to cut oil production by a record 10m barrels per day in May and June, with their own cuts in supplies and an agreement to build emergency reserves. Yet even reductions of 15m barrels

per day in total might not offset the pressure from an estimated drop of 30% in typical daily demand of 100m barrels.

The numbers for corporate earnings are arguably more important for equity markets. The expectation is that they may fall by half in many countries, which suggests that markets are pricing in a lesser fall, a faster recovery or a more sustained re-rating than looks appropriate, especially in the US, admittedly a market that can confound sceptics. It is also true that with further cuts in interest rates and with a further re-pricing in bonds the relative appeal of equities remains and the basis for their rating off bond yields offers some support.

The traditional support from dividend yields is less evident. Companies have been quick to cut payments or at least to defer them, so as to preserve cash at a time when business has changed abruptly, or they have been directed to do so as in the UK banking sector. The more dire current forecasts predict a cut by half in UK dividends for 2020; this compares to a reduction of 14% in dividend payments in 2008-09 when earnings fell by a little over 40%.

Then there are the longer-term trends that this crisis will accelerate. There had already been a migration in the US to the warmer climates of the south and west, made more palatable by air conditioning but still contributing to an apparent decline in productivity, as does the shift to services. Large technology firms have been a driving force in recent years, their business models and cash generation offer resilience, and there will be more demand from remote working in particular. The crisis should enhance a previous focus on the climate and the benefits of lower pollution, as well as a concern that pandemics may become commonplace if we do not find an improved balance to life and society. This will add to the substantial demand for companies and funds committed to a positive impact.

And there are the problems this crisis might bring: increased social inequality given higher unemployment; a set-back to progress in developing countries; and mutual antagonism or a blame-game that will militate against a global approach whether in manufacturing or research or recreation. Governments will be more indebted and with limited inflation to erode debt levels taxes will be higher, which will also pay for the increased role of the state (including some overdue wage increases in the health sector). The returns from savings will be lower especially if they are depleted by the severity of the recession.

Asset allocation

Our short-term call, and the conclusion of our latest quarterly investment committee, is that equity markets are likely to see further volatility as the encouraging news from successful containment of the virus in some countries is offset by the continued restrictions in place and by their increasing economic impact. There will clearly be variations by sector and by region, and our focus will for now be on companies that can prove resilient as well as regions that may be less troubled, such as northern Asia. For companies our concern will be on those that have been heavily indebted and especially those that were due to repay their debt in the near term, which would also suggest some caution on the credit quality of corporate debt. The yields on government and high-grade corporate debt are minimal and point to challenges ahead, but for now those stocks offer relative stability. For alternatives we shall keep an exposure to gold and to other sectors. We need also to pay attention to currency, for which we are less inclined to keep in place hedging of some overseas assets even as Sterling looks low on the basis of purchasing power parity, as it may stay under pressure.

Cash can provide a buffer against future falls and be the wherewithal to profit from an array of likely opportunities, although it feels a burden when markets rally.

Asset returns

The total return from the FTSE UK Gilts All-Stocks Index was 6.3% in first quarter of 2020, which reversed the weakness in the fourth quarter of 2019 as ten-year yields moved from 0.82% at the end of December to 0.36% at the end March. In the US ten-year yields also fell sharply in the period, dropping from 1.92% to 0.67% while those on two-year debt closed at 0.25%. In Germany yields again turned more negative at -0.47% against -0.19%, although in Italy and Spain they rose a little given pressures there. US Treasuries with a duration of 7-10 years saw a total return Sterling terms in the quarter of 10.3%, helped by the strength of the US\$, whereas emerging market debt in local currency and higher-yield debt were notably weak given their perceived vulnerability.

In equity markets the FTSE 100 fell by 24.8% in the first quarter which took the index from 7,542 to 5,672 even after a rally from a low point below 5,000 in the month. The FTSE 250 Index of mid-sized companies fell further with a drop of 31% over the quarter as did the FTSE SmallCap Index with one of 28.4%, although both indices also saw a greater rally from their lows; for the AIM market the quarterly loss was 28.8%. The FTSE All-Share had a total return including income of -25.1% for the quarter.

In the US the S&P 500 index fell 20% while the concentrated Dow Jones index saw a loss of 23.2% in the quarter. Although its orientation to technology provided some resilience to the NASDAQ index it still dropped 14.2% while the Russell 2000 index of smaller companies fell by 30.9% in the quarter. This was the fastest market crash on record, due in part to the role of computer trading.

In Europe the EURO STOXX 50 fell by 25.6% over the three months to March whereas in that region at least smaller companies, as per the Euromoney index, outperformed a little if with a loss of 23.7%. In Japan the Nikkei 225 fell by 20% in the quarter.

The MSCI Emerging Markets index in US\$ was 23.9% lower over the quarter, in spite of some cushioning from the Chinese component, reflecting previous weakness and the first indications of a recovery in output; the Hang Seng index in Hong Kong was down 16.3%. The MSCI Frontier Markets index lost 27.7% in the period and even Vietnam struggled, off 31%.

Sterling's strength in the fourth quarter of 2019 was offset by weakness in the first period of 2020, especially against the US\$ which as with the Japanese Yen benefitted from a flight to the most liquid currencies. Sterling ended the period down 6.3% against the US\$ to close at a rate of \$1.24:£, having reached in March the lowest level since the 1980s, while against the euro Sterling was 4.8% weaker at €1.13:£. Oil-sensitive currencies such as the Norwegian krone were also under pressure in the period.

This reflected a slump in the price of oil with the spot price for a barrel of Brent falling by 68% in the first quarter to \$22, before a rally off its lows. The price of gold managed a gain of a further 4% to close at \$1577 per troy ounce, although it also saw a period of weakness which seemed to have been driven by forced sellers. The major metal prices were all lower in the quarter, save palladium although even its price fell in March. Agricultural commodity prices were mostly lower in the quarter. The substantial increase in volatility in the period saw the Vix index for the US equity market record a nearly threefold rise.

UK

- Testing time for domestic economy as for the world
- Brexit off the agenda for now but still an issue by end of 2020
- Some yield support if with dividend cuts, and Sterling a factor

The UK economy was hardly robust even before the crisis took hold although there had been renewed confidence following the decisive Conservative victory at the general election in December with the indications of increased government spending on education and infrastructure as part of an end to austerity. The coronavirus crisis brings that to an end and will bring a sharp recession, as yet unquantifiable, together with a rise in unemployment even with the government's proposed furloughing policy. Wage inflation will dissipate even with another government contribution in the latest increase in the national living wage for those over 25 to £8.72. Rishi Sunak in his new role as Chancellor of the Exchequer in effect introduced three budgets in nine days, following the first with two rounds of emergency stimulus. The Bank of England cut interest rates to 0.25% then 0.1%, giving its new governor in Andrew Bailey a similar baptism.

In January the UK left the European Union forty-seven years after joining the Common Market, with a focus still on agreeing the right approach on trade come 31st December. The deadline holds for now although the coronavirus has provided an element of dislocation and may yet prompt a degree of compromise as both the UK and the EU will want to minimise any further disruption to economic life, while most other countries will have little appetite for signing new trade deals.

The UK market had seemed to offer attractive value coming into 2020 when the aggregate dividend payments for the FTSE 100 were forecast at £91.1bn, a new record level if barely a 2% increase on 2019 while dividend cover remained tight at around 1.7x. Now it is not just housebuilders that will have limited cover as earnings evaporate and there is still some concentration risk: the largest ten payers have accounted for over half of total dividends, a group that includes two banks and two oil companies. With a drop in dividends of half and with the fall in markets the yield on the All-Share is below 4%, from which level it has historically produced decent returns in the subsequent two years. The drop in dividend income is a challenge for investors, as would be the impact from a recovery in Sterling on income from overseas assets.

Continental Europe

- Sharp set-back as elsewhere if variable by country
- ECB wanting to do more but limited options
- Potential political pressures to emerge

The mainland European economy had looked set for an improvement this year from a recovery in manufacturing even as Ireland too in particular faced concerns over the impact of Brexit, yet it too has been hit hard by the impact of the virus. There has been a significant impact from the shut-down imposed in Italy, Spain and France even if Germany, with the benefit of greater investment and efficiency, avoided the same death-rate from the disease. The Scandinavian countries took a varying approach, with Denmark early into a lock-down

(and now ready to edge out of it), Sweden more concerned with keeping the economy and social life ticking over (so a place where you would find a restaurant open) and Norway hit by the drop in energy prices (even as it pioneered a move away from dependence on fossil fuels). There has been no concerted political approach as a Continent.

Christine Lagarde, another person relatively new to her role as president of the European Central Bank, had seemed wary of following her predecessor Mario Draghi's policy of doing whatever it takes, in part as she had initiated a first review in two decades of the ECB's strategy for its monetary policy, but the central bank did make substantial offers of support: the ECB has extended its policy of asset purchases and maintained a negative deposit facility rate for bank funds overnight of 0.5%. The eurozone's wealthy countries with a low deficit, notably Germany and the Netherlands, have now been inclined to spend more to provide a stimulus but they are still understandably wary of financing what they see as lax lifestyles on the Mediterranean, one aspect of increased tension in the currency bloc.

The political landscape remains complex. In Germany Angela Merkel has shown what they will miss in a leader at a time of crisis, while her intended successor Annegret Kramp-Karrenbauer resigned in February. In Spain the minority coalition between the Socialists and the populist Podemos remains fragile while in France President Macron has a number of challenges, even as his authority has been enhanced for now by the crisis. The further grab for power by Viktor Orban in Hungary has highlighted different perceptions of democracy, while Greece and the EU as a whole faces a threat in a renewed surge of migrants from Turkey as politics and armed intervention in Syria play out.

North America

- Economy slowed by shut-down but likely to recover quickly
- Federal Reserve still active in cutting interest rates and asset purchases
- Presidential election campaign more open than before

The data on the US economy has become much more mixed as the country copes with the pandemic and a gradual shut-down, imposed by states rather than on a national basis. The evidence has come in a sharp rise in unemployment, with more than 6.6m seeking benefits by early April which put into perspective the previous relatively minor changes in non-farm payrolls and reflecting the speed with which US companies can shed staff, and take them back.

The Federal Reserve moved to adjust its new strategy with cuts in interest rates and drastic measures of support, as did the federal government even in the face of continued antipathy between Republicans and Democrats.

One consequence of the crisis has been a shift in the basis of the campaign for the next presidential elections in November. Donald Trump saw a slump in his popularity, which has been closely linked to the level of the stock market, while the Democratic primaries moved from an element of farce amidst an array of contenders to a sole candidate in Joe Biden after Bernie Sanders dropped out, removing the spectre of a more radical economic approach.

US markets have been helped by the significance of technology shares and leading consumer companies, whose business models have been more robust. They also still reflect confidence: nearly one thousand US executives bought \$1.1trn of shares in their own companies in March, the highest level since October 2013.

Japan, north-east Asia and Australasia

- Japan challenged with no boost from Olympics
- Trade wars followed by trade disruption
- Recovery in China likely to be a positive factor

In Japan consumers have been a key part of demand in what has been a sluggish economy overall and the increase in consumption tax last year, from 8% to 10% on 1st October, did after all have an impact. Combined with the disruptive effect of a typhoon, the tax contributed to an annualised fall of 6% in the economy in the final quarter of 2019. This is one reason why the government declined to lock down society, encouraging its citizens to stay at home instead. Its elderly population is a challenge, its clever technology an advantage, its stronger currency (a feature of market crises) a headwind for its exporting companies. With the postponement of the Olympics from the summer has gone a potential boost to spending (although the decision to keep the name Tokyo 2020 is a boon to mug-makers and future quiz-masters). The Bank of Japan provided its own massive stimulus and for now elevated debt levels are not a concern.

Tariff wars had dampened growth in the region and then came the impact of the virus on South Korea and Taiwan, although they at least showed how extensive prompt testing can be as an effective way to counter its potential spread.

Australia's exceptional period of continuous economic growth, which resisted even the effect of the financial crisis, is set to end; while the recovery in Chinese production will be a benefit to its commodity exports it cannot offset the full impact, even if helping a fair recovery.

China, India and Emerging Markets

- Chinese economy starting to pick up from shut-down
- India in lock-down but helped by low oil price
- Risk of high human and economic cost in many countries

China remains a pivotal consideration. As the source of the virus it is also an exemplar of the way in which a strict quarantine can seem to control it, as in Wuhan which limited its spread outside of Hubei province (as the epidemic eased, some 65,000 cases there in a population of 59m with a fatality rate of 2.9% compared to 13,000 with a fatality rate of 0.4% amongst the other 1.3bn in the country). The region also gives an early indication of the economic impact (a drop of 10% in GDP in the first quarter of 2020 over the previous quarter), of the speed by which normality can return (with some restrictions still in place and consumer demand a little slow to recover) and of the risks of re-infection (mainly from Chinese nationals returning from abroad). The Chinese authorities may have been typically slow to be fully forthright over the outbreak but they did then mobilise the full resources of the state. At the time of the financial crisis and at other times they have provided a stimulus that has helped to restore stability in world demand, although this time their approach might be complicated by an economy that was already maturing and by the potential adjustment to global trade.

In India the positive factors of a good monsoon and of lower energy prices for an importing country have been offset by the extended lock-down in the country.

Other emerging economies and emerging markets such as South Africa seem particularly vulnerable in both human terms and from the shift in global dynamics.

Property, commodities and other alternatives

- Property hit by drop in rental income and illiquidity
- Oil price sharply lower with reduced demand and slow production cuts
- Gold helped by uncertainty and hedging strategies mostly doing their job

The UK's commercial property market soon lost the signs of increased confidence that arose from the election as transactions halted and open-ended funds were suspended on the basis of a material uncertainty in valuations. The crisis is likely to accelerate the demise of operators in poor sectors such as retail, especially with debt, but it will also provide opportunities from a shift in working patterns and a move to remote or online delivery of services and goods.

The price of oil fell dramatically given the drop in demand and the initial approach from the Saudis and Russians, although it has rallied from its low; the likelihood is that prices will be materially higher rather than lower in the medium-term, although longer-term trends may now accelerate a shift to renewable energy. Gold retains its allure at a time of great uncertainty and of ballooning balance sheets at central banks, which puts pressure on fiat currencies, as well as negative real interest rates.

The performance of real assets has been mixed as some income flows have been disrupted and indebted structures have looked vulnerable, although resilient long-term revenues have helped many funds. Hedging strategies which generate little income look much more attractive when they do serve to preserve capital, and they remain an option as long as their liquidity is good.

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