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Economic Background – April 2020

From a distance[1]

As we all adjust to new ways of living and working, the spread of the Covid-19 has impacted people's health, businesses and markets around the globe. The scale and reach of the virus is unprecedented and it is obvious that no country/government was fully prepared for this eventuality.

The social distancing measures in place have altered normal life causing whole sectors of the global economy stop, in particular the hospitality and leisure sector. In the UK large hotel chains are not taking any bookings until June at the earliest, shops are closed and leisure facilities lay dormant.

Impact

The speed of decline in markets has been unprecedented. The S&P500 took only 16 trading days to fall 20%. During the Great Depression of 1929 it took 30 days to fall 20% and in the Great Financial Crisis it took 188 trading days to fall this far. The S&P500 has fallen 30% on 8 previous occasions. It has taken the S&P500 only 22 trading days to fall 30% this year. The next closest in terms of time was in the Great Depression when it took 31 trading days.

Covid-19 is having a huge impact on the credit market. Fund managers whose investment objectives only allow them to invest in investment grade corporate debt are having to sell bonds into a falling market. According to Deutsche Bank $90 billion of corporate bonds were de-rated to 'Junk' in March. Index providers have taken out the likes of Ford and Macy's from their investment grade indices. Carnival, the cruise line holiday operator came to the bond market looking to raise $6 billion, whilst offering a 12% yield. Ratings agencies are downgrading the credit worthiness of many businesses, but Carnival is still currently considered investment grade and the bond was oversubscribed. As recently as October last year Carnival was able to raise $600 million for a 10 year bond paying 1%.

Oil majors have raised $32billion in debt over the past weeks. The drop in the Brent Crude oil price in the month from $53 (per barrel) fell to $21.7 (per barrel) a price last seen in 2003. With the world on lockdown, demand for oil has collapsed exacerbated by Saudi Arabia and Russia increasing supply.

[1] Bette Midler, From a distance, 1990.

Selling in the first 3 weeks of March was quite indiscriminate. The panic in the market meant that defensive stocks fell alongside cyclicals. Some company share prices will have fallen more than their prospects would warrant and those that were more sensitive to the crisis fell precipitously. We spoke to all of our key fund managers and a common theme was their focus on ensuring that the balance sheet and cash flow resilience was in place. Some were taking the opportunity to add new names into their portfolios as the market dislocation had provided opportunities at prices not seen in a while.

Faced with this uncertainty companies are trying to raise cash, shore up balance sheets and cut costs. HSBC estimates that there will be $300bn of lost inflows into US stocks due to companies suspending buybacks. This has been one of the main driver of US stocks over recent years. We have to remember that we came into this period with prices paid for US companies whilst not at record highs, were elevated.

Change in Earnings Per Share (EPS) growth estimates for each quarter in 2020 since January 2019

Date	1Q20E EPS Growth	2Q20E EPS Growth	3Q20E EPS Growth	4Q20E EPS Growth
10/1/2019	7.23%	7.33%	12.97%	14.85%
11/1/2019	5.68%	6.11%	9.94%	14.76%
12/1/2019	4.25%	5.57%	8.83%	14.72%
1/1/2020	3.68%	5.34%	8.46%	14.35%
2/1/2020	2.45%	4.64%	8.36%	11.36%
3/1/2020	-0.55%	3.48%	7.98%	8.84%
4/1/2020	-6.60%	-10.25%	-2.19%	2.46%
4/6/2020	-8.35%	-13.29%	-4.71%	0.70%

Going Lower

2020 EPS estimates will continue to drop as America and the world close businesses to prevent the spread of COVID-19.

Source: The Earnings Scout

After the recent rally in equity markets the S&P500 US market is only 5% lower than it was 12 month ago. US earnings are set to deteriorate significantly over the coming quarters, will the high multiples that the US has experienced remain, given this is likely to be one of the worst earnings contractions in living memory? However the markets move in the short term, eventually companies will be valued on their longer term outlook, balance sheet and cash flow strength.

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In the coming months we will get more information as to how much bad debt there is and how much long term damage has been done. Furloughing of staff has undoubtedly helped in the UK. It is important jobs are retained through this period, so there isn't a self-fulfilling effect of a downward spiral.

Unemployment

However, despite massive fiscal packages in part to help businesses retain staff the unemployment data has weakened considerably. The US data is extraordinary.

US weekly initial unemployment claims since 1967

> *The loss of employment in leisure and hospitality has been the largest: They represent almost 3% of the employed workers in the industry and 65% of the overall reduction in payroll employment. Restaurants and bars are either exclusively offering take-out or temporarily shutting down, so some decline was expected.*
>
> *St. Louis Federal Reserve*

Investment banks predict that the unemployment rate in the US is expected to be greater than 10% (10%-16%) in the summer, before returning to mid-single digits over the subsequent 18 months. As recently as February the unemployment rate was 3.5%. Economists from major Banks are forecasting anything from a 10%-40% drop in GDP in the second quarter, with a member of the US Federal Reserve commentating that a GDP fall of 50% is possible from the shutdown. The US has not experienced a double digit decline in GDP since WWII.

Response

The speed and scale of the monetary and fiscal response has been massive. With economists quantifying it as 9-10% of global gross domestic product (GDP). Based on current pledges central bank Quantitative easing (QE) in 2020 will amount to $5.5 trillion. Central banks and governments are hoping that shock and awe tactics early will provide the ammunition of the economy to stabilise and recover as quick as the slowdown

When the US underwent its second phase of QE in 2010/11 it took the US Federal Reserve 30 weeks to purchase $800bn. During this round of QE (QE4) it took 1 week. According to reports it has purchasing assets at a rate of $1 million per second over the last two weeks. They have been assisting the ETF market too by buying Investment Grade Corporate Bonds ETF's with a duration of less than 5 years.

There are tentative signs that the social distancing measures China took are working, with the first day of no reported fatalities from the virus, 54 days since the peak in the number of cases. From anecdotal evidence from our fund managers and the country's coal consumption and traffic congestion data, China is slowly getting back to work. However Chinese personal consumption is still well below where we were at the end of last year.

> *"Less encouraging are signals from consumers more broadly, who now drive the majority of China's growth. A Morgan Stanley online survey of 2019 consumers in 19 provinces last week found that while most respondents—86%—were leaving the house for work, most were still reluctant to go out to shop, eat or socialize. And 69% said they would go out for essentials only, down from 75% in early March—still extremely high.*

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> *That level of caution may be hard to overcome as long as both citizens and the government remain worried about a secondary outbreak. Last Friday, Beijing ordered all of the nation's movie theaters to close again after a handful reopened. And a small county in Henan province Tuesday found itself locked down again due to fears about a renewed outbreak."*
>
> *Wall Street Journal.*

Recovery

Over the last few weeks the rate of new cases of Covid-19 has fallen, with Italy dropping in absolute terms. It is expected that the UK and US daily infection numbers will peak in the coming week. Without being too gloomy, there are 3 differing scenarios for the recovery. Economists describe them in letters, 'V', 'U' and 'W' or UU'.

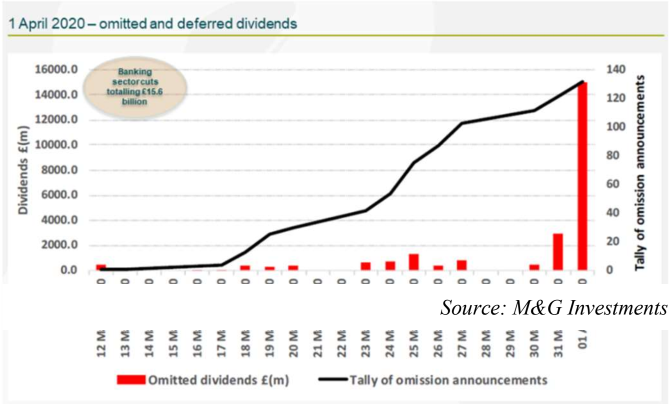
1. A 'V' shaped recovery. This was the most hoped for when Covid-19 was merely an epidemic. The longer the lockdown, the more unlikely this scenario will occur. Particularly since the US as one of the biggest drivers of global growth has yet to stem the rate of flow of new cases.
2. The second and most favoured shape of recovery is the 'U' shape, however debate will be had as to how long the trough of the U will last. Once the world has slowed the growth of the virus and lockdowns are lifted, businesses and economies can start to reopen.
3. The 'W' shape or double U, 'UU' is the third and potentially most distressing outlook. Here we see a recovery in quarter 3 this year, but with the onset of winter and without vaccinations, Covid-19 reappears and takes economies into another trough, before eventually recovering.

Investor sentiment has improved since the panic in mid March. As companies start to report earnings over the coming weeks, we will get a clearer picture of what short term damage has been done and whether that will affect the long term prospects. It is a concern the magnitude of the unemployment figures and cost cutting by companies may spiral out of control.

Whilst many will try to predict that the worst of the economic damage is behind us, we simply don't know yet. There is no historical comparison to the fall in demand we are experiencing. We do know that a sharp rise in unemployment does alter consumer behaviour, spending is halted and saving increased. We don't know how long this pandemic will last or in fact what society will look like once we get back to 'normal'.

Dividends

For UK investors the market turmoil has impacted company's ability to pay dividends to shareholders. Payments from UK companies could fall by 53% in 2020 (£28.2 billion) according to a worst case forecast by Link Group. The dividend cuts, postponements or suspensions have come across the sectoral spectrum. The banking sector alone has had £15.6 billion in dividend cuts and since this chart was produced insurance companies (RSA, Aviva, Direct Line & Hiscox) have cancelled the final dividend payment due in the coming weeks and for the rest of 2020.



Source: M&G Investments

There is debate as to whether the dividend cuts to the banks and insurance companies were entirely necessary, but perhaps driven by prudence. Whether the Banks were going to undertake the exercise or not the Bank of England (through the regulatory body the Prudential Regulation Authority) seemingly put enough pressure on the company boards to conserve cash at this point in time. The capital reserves of the banks are certainly stronger than they were leading into the Global Financial Crisis, but the decision also takes into account that paying dividends at time when customers and borrowers face hardship is not great optically

However, not all companies are taking the same attitude and some are not experiencing any ill effects:

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- Tesco, who is receiving a reported £585 million in rate relief this year has announced an increase to its dividend for 2019. The final payment of 6.5p per share is an increase from the 4.10p per share a year earlier.
- Imperial Brands which is widely held in our funds, reported that Covid-19 had no material effect on its trading so far and they expected their year-end numbers to be in line with previous expectations. The stock currently has a dividend yield of 13%.

> *"What will be key over the next few months is striking the right balance between those companies with a good chance of maintaining their dividend, those which present valuation opportunities and those that will recover post the crisis and be the high-yielding UK stocks of the future."*
>
> *M&G Investment*

It is too early to quantify the effect that the dividend cuts will have on your portfolio at this stage, however we do expect it to be less than the market. In general, we have a low exposure to Banks, Housebuilders, Miners, Leisure and Hospitality businesses. Our fund managers focus on the financial strength of a company, the balance sheet and cash flow, as this is how you avoid permanent loss of capital. When the economy recovers, the strong will emerge stronger.

We know from previous crises that markets will turn before the economic data gets better. It is impossible to time the bottom, but history reminds us that the best returns are achieved in the days immediately post the bottom. Even though we do not know what earnings are going to be like in the short term, fund managers can make an assessment as to what markets are pricing in and whether that is likely or not. Of course prices can fall lower and sentiment can change in the short term, but for a long term investor there will be opportunity over the coming weeks and months.

Chris Davis
Chief Investment Officer

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