Market Update

6th May 2020

With the FTSE 100 standing at around 6,000, Square Mile has said that the market feels somewhat overvalued. What are the signs that you are looking for to enable you to buy in on weakness?

It is fair to say that at Square Mile we do not just look at market valuations. While these measures do receive a lot of attention, the question for us really is one of when to re-risk across the portfolios, through both equities and fixed income. However, it is first worth adding some context. The FTSE 100 is back up to 6,000, representing a 20% rally from its lowest point during this crisis. Since then, it has been announced that 30 million people have been confirmed unemployed in the United States, that is one in five of the working age population. $14 trillion of economic stimulus has been pumped into markets globally, whilst in the UK dividend cuts, actual or forecast, look to be between 30% and 50%. And yet, despite all this news, we have seen a market rally of 20% from the trough. While we cannot say for certain whether this is just an over speculative market recovery, if you look back at the market crashes over the last century, there is on average three bounces of more than 10% per recovery, before normal business resumes.

However, let's get back to the original question on valuations and for the sake of argument, we will focus on the US as it is the largest market globally. If we were to simply assume a constant future long-term growth rate of 6%, with the value of the S&P at around 2,800, as it currently stands, that would imply a return of about 9% per annum (based on a dividend discount model) which seems unlikely given the market environment. Indeed, it is over 1.5% ahead of the long-term capital assumptions suggested by our corporate providers. Of course, the problem with this estimated return figure is that it assumes a *"constant growth"* rate of 6% in perpetuity, which is clearly something we are not going to see over the next four or so years. What we can expect to see is a significant fall in earnings and dividends per share until things return to normality, although no one can be sure what that normality will then look like. A recent article in the Economist suggests that we might expect an economy running at 90% in three to four years, and even then, there will be certain sections of the economy that will still not be fully operational.

In the context of valuing a market, we need to apply and work through differing scenarios. For instance, if we see a 40% cut in dividends next year, and for the sake of argument, the following year they come back from that low by 15% and then another 10% the next year, and then we assume a constant growth rate of 6%, the S&P still looks expensive at today's level. So when would we start to buy into it? It will have to be at a level somewhat lower than it is today but as we all know, things are moving very quickly, new information is becoming available all the time, and the underlying assumptions and therefore market entry levels could change.

What sectors, UK or globally, do you see both surviving and prospering through this current crisis, and how do you access them via open-ended funds?

It is clear that the investable landscape in future is going to look very different from how it does now. The component parts that make up the UK market, which is the market we are arguably most familiar with, is likely to alter fundamentally and therefore any fund that tracks the UK market will look very different in the future. Clearly the sectors which will face significant challenges until life returns to normality are those associated with hospitality, the likes of pubs and restaurants, as well as the aviation industry, of course, which will take a long time to recover from this crisis. These sectors will face the greatest headwinds and will possibly require the silver bullet of an effective vaccine to enable people to resume the lives they led three months ago.

Conversely, tech stocks are likely to prosper, although investors need to look beyond the big names. For instance, we are conducting this video call though Zoom teleconferencing, a technology that we are likely to be using more regularly for the foreseeable future. However, when looking at FAANG (Facebook, Apple, Amazon, Netflix and Google) stocks, it is worth considering their differing business models. While Amazon and Netflix are benefiting, Google with its parent company Alphabet have not fared as well since much of their revenue derives from advertising. Nonetheless, tech stocks are definitely an area of interest and we are considering how best to get exposure across the portfolios, bearing in mind the high levels of market volatility and the fact that tech stocks in the UK tend to be more midcap focussed.

Square Mile have consistently been strong advocates of a blend of value and growth. Do you see the portfolios maintaining this balance as we come out of the other side of this crisis?

The value allocation within our equity portfolio has not kept up with the broader market and in particular, has lagged the growth element of the portfolio. This is something we are reviewing very carefully. However, as value-orientated strategies have historically performed well on the way out of a recession we want to ensure that we do not miss out on any upside. Having felt the pain, we want to avoid readjusting the balance of the portfolio at the wrong time. We are looking at other parts of the portfolio and are considering building more of a quality bias into the portfolios. In doing this, we will dilute some of the value-orientated strategies.

The case for passive strategies is also weaker. Under current market conditions, investors should prefer to set their own asset allocation as much as possible rather than be driven by the fortunes of the underlying components of an index. However, on the subject of passives, iShares recently published some interesting statistics which show that value-orientated strategies have begun to attract inflows over the last couple of weeks relative to all other equity factor orientated strategies.

Chris Fleming, Investment Services Director