Market Update

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PARK HALL
Financial Services Limited

SQUARE MILE
INVESTMENT SERVICES

MARKET UPDATE

Review of Markets

The spread of Covid-19 has had a profound impact on the global economy and financial markets. Initial hopes that the disease could be contained within China were soon dashed and the virus has spread very rapidly around the globe. Governments around the world have been forced to shut down large parts of their economies and societies in an attempt to slow and contain the pandemic. Events have moved at a dizzying speed and financial markets crashed as stock and bond prices reflected the sudden collapse in demand across large swathes of the economy.

Global stock markets have suffered one of their worst quarters in over 30 years and on some measures, the worst on record. The FTSE All Share fell 25% and many global indices are more than 20% lower than they were at the beginning of the year. Fixed income markets, outside of the safest government bond markets, also fell as investors began to reassess the abilities of companies to maintain and repay borrowings; in addition to there being a general move out of financial assets and into cash. The pound suffered in the currency markets, falling by 7% and 4% versus the dollar and euro respectively.

By mid-March the sell off in financial markets became violent, as the FTSE 100 fell more rapidly and by a greater magnitude than in the stock market crash of 1987. At one stage this index had fallen by 35% from the near all-time peak that it had been trading at a few weeks earlier. Bond and currency markets were similarly affected as investors rushed to raise cash, particularly US dollars, from whatever source was available. This scramble for cash created disorderly trading conditions and took on a similar tone to that of 2008 as the international banking system came under pressure. Thankfully on this occasion banks have been operating with a more comfortable cushion of liquidity and capital, and swift action by central banks to inject cash helped to return some semblance of stability to the financial system. There have been huge swings in all markets, including traditionally quite staid assets such as government bonds. During a one-week period UK government bond prices slumped by 10%, before rallying to finish the quarter up 6%. At times, market volatility exceeded the darkest days of 2008.

Thankfully, governments and central banks have rushed to help support businesses and employees affected by the shutdown. Interest rates have been slashed, central banks have been swift to provide the banking system and large companies the funding they urgently require as business supply chains were abruptly interrupted. Governments around the world have acted to produce support packages for their economies in staggering size, far in excess of what occurred in 2008. Governments have not so much loosened their purse strings but ripped them apart. Their mantra has been that they will do whatever it takes to ensure that the economy will get through this period.

This action has helped to bring some stability to financial markets, which benefited from a sharp rally towards the end of the quarter. In fact, the US S&P 500 had its largest three-day gain since 1931. As with so much of what has happened, the speed and magnitude of events has been pretty much without precedent.

As if the pandemic wasn't enough for investors to deal with, the oil market also collapsed as a production war started between OPEC and Russia. For many years, Russia had acted as a fair-weather friend to OPEC and taken opportune moments to seize market share from OPEC and in particular Saudi Arabia, despite the enormous growth in US production from shale oil fields. It seems that the Saudi's are taking the current crisis to ramp up production

GLOBAL RECESSION BECKONS

and regain this market share. Oil is largely used for transportational purposes and the market is braced for the largest contraction in demand in history. Perhaps unsurprisingly oil prices slumped from around $60 to $20 per barrel over the quarter. While on paper this provides a useful boost to oil consuming nations, it makes little practical difference if demand for travel has vanished.

The Impact on Portfolios

Thankfully, the portfolios were cautiously positioned going into this downturn. However, their widely diversified nature has provided little protection, with virtually all assets falling in value very quickly. Nevertheless, to help provide some illustration, over the quarter the lower risk portfolios have suffered losses in high single digits, while those taking a more balanced approach have seen values fall by low to mid-teen amounts, whereas those few who have elected to take a more adventurous posture have been hit by losses approaching 20%.

Many of the portfolios' equity positions have fallen in line with the sharp falls in equity indices and some equity funds which we had hoped to be more resilient in difficult markets have failed to be. The Polar Capital Global Insurance fund has joined the general rout in finance related stocks and it fell by 19%. This was a disappointment to us since many of polices underwritten by the insurance companies held within the fund specifically exclude pandemics; few policyholders had elected to pay the additional premiums to incorporate pandemic coverage. The bulk of the underlying insurance exposure covers businesses in the United States with a relatively modest exposure to personal insurance, principally motor insurance. Several States are now considering retrospective legislation to extend the policies coverage to include the impact of the epidemic on business disruption clauses. We can only hope that justice and common sense will prevail. Otherwise these firms may face a protracted legal battle and, if insurance companies no longer feel that they can rely on the law of contract to specify the risks that they undertake, then anyone buying insurance in future will find it becoming very, very expensive. As such, we expect investors to begin to recognise this and hopefully the fund is set to produce a much stronger relative performance in the coming months.

Likewise, we were slightly disappointed by the performance of the Legg Mason IF RARE Global Infrastructure Income fund, which pleasingly fell less than global stock markets but perhaps more than we would have expected. The majority of the fund's holdings are in utilities such as water and power, which should face little drop in demand in the crisis and indeed the value of their cash flows should become more valuable as interest rates hit rock bottom. We suspect that some investors within the market have resorted to selling off their best assets as they rushed to raise cash. Here again, we believe that the fund's qualities should be recognised soon, meanwhile the fund is now yielding over 6% so we are more than content to maintain our position.

We suspect that many high quality corporate bonds have sold off for similar liquidity reasons and this has impacted the prices of funds that represent the core defensive part of many of our portfolios. However, the very fact that they are high quality has meant that these funds have fallen less than the broader market, as investors have rightly decided that the majority of underlying companies will be able to continue to honour their debt obligations. Square Mile's large team of analysts are in contact with the underlying managers to check that any impairments are likely be low and we remain hopeful that a significant degree of these price moves will be temporary, reflecting a rush to raise liquidity rather than concerns about the collateral supporting the value of the bond. On a more positive note, six months ago we took a significant position in the Vanguard US Government Bond fund which has climbed by 8% over the quarter, one of the few assets to appreciate in value during this crisis.

As stock markets fell during the quarter, we 'rebalanced' the portfolios on two occasions, when the UK stock market was down 11% and 20% respectively. This had the effect of gradually adding to equity positions as they fell in value and at prices that at the time we considered attractive. Whilst this may have been a little forward as markets continued to fall, it did mean that we managed to buy further, but not excessive, equity exposure at what we believe to be attractive long-term valuations.

Global interest rates have fallen to rock bottom rates and henceforth defensive assets are likely to produce negligible returns over the long term, which lifts the relative attractiveness of growth assets. However, as the crisis intensified volatility climbed to unprecedented levels and prices on a daily basis began to swing by extraordinary amounts, both downwards and upwards. As a result, we have held back from making further changes to the portfolios until markets become more settled.

THE SELL OFF AT TIMES HAS BEEN INDISCRIMINATE

Dealing with the Virus

We are pleased that central banks and governments have reacted as they have done and we believe that they are doing the right thing in offering financial support to businesses, including enabling them to furlough employees, albeit at reduced wages, rather than force them onto the dole. As a result, we will have a workforce still largely in place when we emerge from this, which should support a more rapid economic recovery once the worst of the pandemic is over. If large swathes of the corporate fabric are allowed to disappear, a deflationary slump is almost certain to develop. Central banks are helping to support economies with vast injections of liquidity and cash. We are mindful that this may have an inflationary impact over the long term but in the short term the action may only go some way to offset the profoundly deflationary impact of the crisis.

History informs us that economies and stock markets can bounce back quickly from external events such as pandemics and foreign wars. In contrast, structural bear markets, such as the 2008 credit crisis, can take many years to recover from. News from Europe is encouraging and the rise in the number of infections are beginning to level off, though the UK and US remain a few weeks behind. This lifts hopes that the worst of the market falls may now be behind us, though this of course it not yet known. Whilst it is not possible to close down our economies indefinitely, it does provide us with a window to develop treatments against the infection and increase health care capacity to help those who become severely ill. We are all very thankful for the forward planning by the NHS in this regard and by the ongoing heroic efforts of our healthcare professionals.

Highly infectious diseases such as Covid-19 can largely burn themselves out rapidly, though a speedy development of a vaccine would provide great relief. In the meantime, we can observe and copy the approach that Asian nations have taken to contain the spread of the virus. It remains to be seen whether western economies can accommodate these measures while still retaining the civil liberties that represent the foundation of our culture. Some difficult political compromises may have to be made between these, the economy and our health over the coming weeks. The outcome of which may determine whether financial markets have reached their lows.

The Aftermath and Outlook

We are long term investors and for the majority of clients we are seeking to produce returns over the course of a decade or two. While we are in the midst of this crisis it is difficult to extend our horizons, but to achieve the best results this is something that we must strive to do.

Politicians are inclined to term this as a 'war' against the virus. In some sense, our public finances will suffer a similar impact that a war might create and is a useful model for us to work from to judge what might happen. Governments will face huge costs to support businesses and workers over the coming months. This will be financed by borrowing, as is the usual case during wars. Hopefully, the battle against the coronavirus will not be as lengthy or as expensive as were the two World Wars or the Napoleonic wars, when British government debt soared to unprecedentedly high levels. However, many governments are already starting with a hefty debt pile. Over the long term, these debt piles can be addressed by real growth in the economy or, less benignly, through inflation. Regardless, taxes are almost certain to rise.

While some businesses will be more or less unaffected by events others face a significantly different future to what was before. Over recent years we have seen a political trend away from globalisation towards a more nationalistic focus, particularly in the US. Certainly, in the short term, nations will be looking to shorten their supply chains and become less reliant on global trade. This seems almost certain as countries seek to constrain the spread of the virus. We believe that this is misplaced: economies greatly benefit from free trade and viruses show no respect to borders. However, we cannot influence what will happen. We need to think carefully how economies will work in this new environment, we suspect that the arrival of the virus will accelerate several trends led by new technologies that were already happening within society.

We shall also need to consider what the governments' tariff will be for bailing out industry. Businesses such as EasyJet have already faced scorn for suggesting that the airline industry will require support from governments, yet they have recently distributed a £180m dividend to shareholders. Higher corporation taxes seem an almost certainty, as do greater controls on how some businesses structure themselves to minimise tax bills. It strikes us that, as fixed income markets represent to investors a contractual payment for the hire of their capital, this may be a better option than buying their shares and becoming owners. As a result, some of the higher yielding bonds may present a more secure return than equities of a comparable risk. Again, this is an avenue of approach that we are considering carefully.

Perhaps it is wishful thinking that we might have already seen the lows of this sell off, however, this is highly dependent upon the progress and severity of the virus which at the moment is unknowable. Many financial markets are now offering valuations that have not been seen for many years, even if we factor in some savage cuts to dividends and profits in the short term and some impairments in the risker end of fixed income markets. We expect prices of more secure investments in corporate fixed income markets to improve as the liquidity driven distress

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eases. This should be a benefit for your portfolios in the short term.

In our experience as professional investors, market conditions such as we have encountered over the last few weeks typically present the best opportunities for long term investors. We are working hard to identify where these may be and ensure that the portfolio is appropriately positioned so that it can benefit from the recovery once it finally gets underway.

Important Information

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