



Investment Review – 2nd Quarter 2020

Mike Lea, Investment Director

6th July 2020

Summary

In Q1 we said that there was no way of predicting the crisis that engulfed the economy and financial markets and, equally, it would have been as remarkable to call an almost full recovery for most markets, just a few months later. The positive returns seen in Q2 have surprised many, and confounded some investors.

By some measures it has been the fastest market rally in history, set against a background of steeply falling economic activity resulting from the lockdown, which saw the UK experience an historic GDP decline of 10.4% between February-April. If there was ever a period to confirm financial markets as being unpredictable then, surely, we have just experienced it.

Key points:

- Like all investors FPC clients will have experienced higher volatility over recent months, but our highly diversified and global investment approach has proved resilient and portfolios have recovered.
- There has been no need for any knee-jerk change of approach, besides a temporary hold on portfolio activity, which we have now reversed as volatility returns to more acceptable levels.
- Exposure to corporate bonds within portfolios has yet again proved defensive supporting recovery.
- Portfolios have also benefited from the weaker pound as this has had a positive impact on overseas share exposure.



Summary

- It is anticipated that Companies with sufficient liquidity and a reason to exist will return to delivering profit growth sooner than many had expected.
- The key driver of markets going forward will be the ongoing support offered from governments and central banks.

We cannot tell you that it is going to be smooth sailing from here, but as the last few months have shown we can help you to plan for success and invest with confidence, whatever the weather, by adhering to our core investment principles.

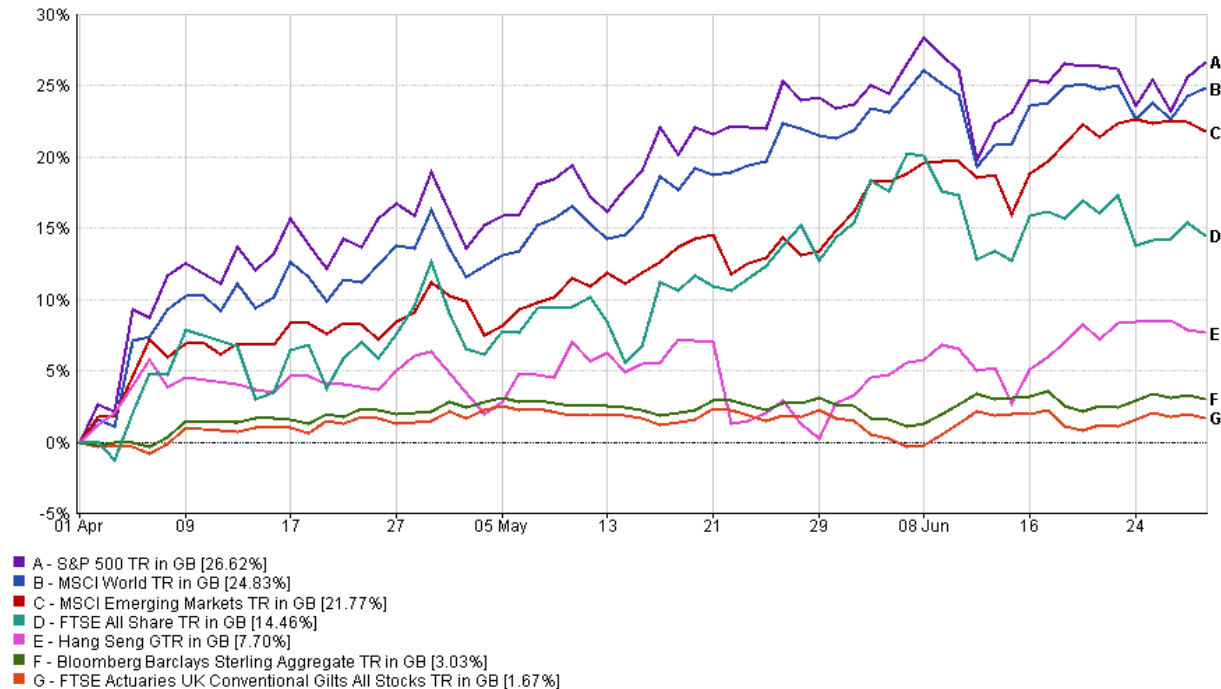
MIKE LEA

Investment Director



Market performance

The Q2 period covering April-June has seen very strong performance from the major asset classes of shares and bonds, as enormous government and central bank support provided confidence that businesses, at least viable ones, would have liquidity available to deal with the downturn:

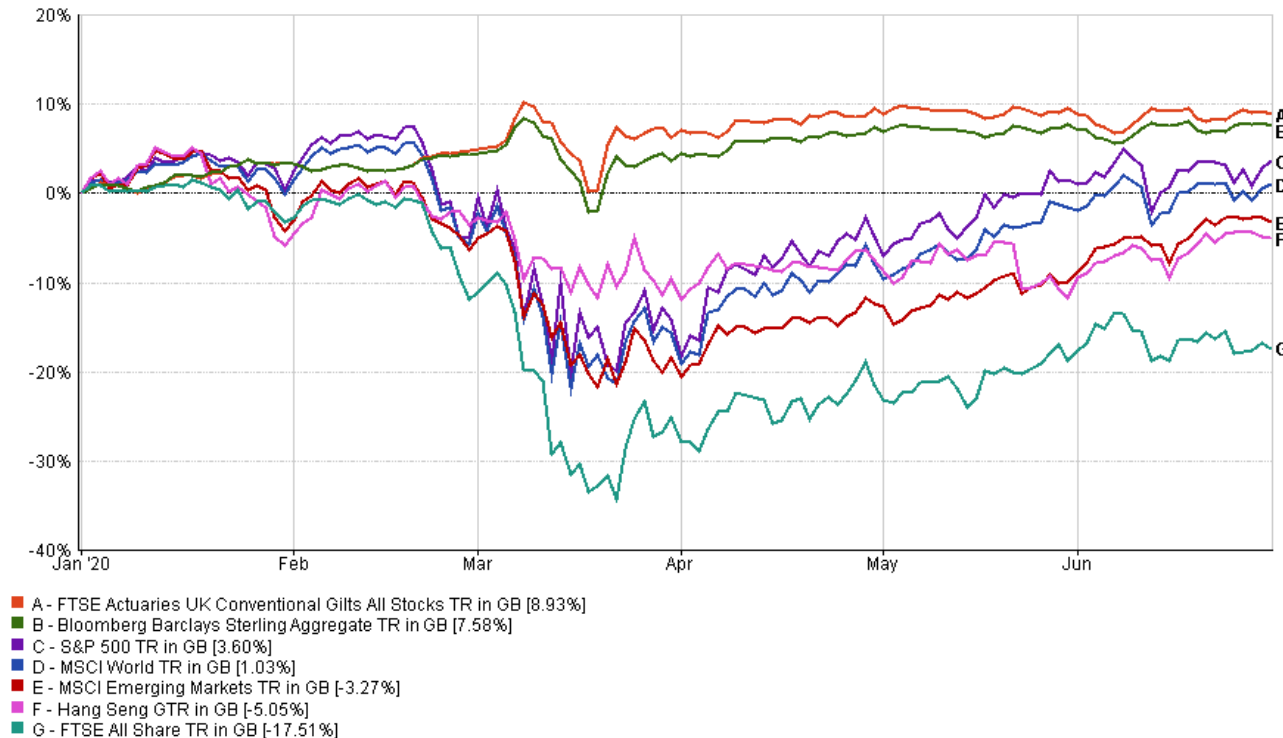


01/04/2020 - 30/06/2020 Data from FE fundinfo 2020



Market performance

As ever, too close a focus does not tell the whole story, so looking at the year to date chart we see markets have, or are close to, reversing the earlier losses from Q1 with the exception of the UK:



01/01/2020 - 30/06/2020 Data from FE fundinfo2020



Market performance

Bonds

Bonds have continued to perform well with the **FTSE Actuaries UK Gilt Index** rising slightly by +1% (+8% year to date), as investors continue to value security of capital and are willing to accept lower returns, with 10-year gross redemption yields below 0.2% pa.

The **Bloomberg Barclays Sterling Aggregate Corporate Index** has similarly gained in value by +3% (+7% year to date) despite a more volatile journey, as business solvency became questioned mid-March prior to the launch of funding support measures.

Bonds are really bought primarily for income and their defensive merits, with capital growth a secondary effect that has resulted from falling interest rates.

Shares

In Sterling terms, global stock markets have performed strongly with the **MSCI World Index**, representing companies across 23 developed markets, delivering a total quarterly return of +24% (+1% year to date).

Within this index **North America** is the dominant component with a weighting of 65% and the S&P500 outperformed other countries returning +26% (+3% year to date). Continued strength has been helped by the 25% weighting to the technology sector.

The **UK** represents just 4.5% of this world index and the FTSE All Share has returned +14%, but still remains -17% year to date. The reliance on the energy and financial sectors have been detractors from performance within the current climate.

The **MSCI Emerging Markets Index**, which represents 26 emerging markets has provided a total return of +21% (+3% year to date).

China has the largest global weighting at 39% with the Hang Seng (the Hong Kong based exchange for Chinese mainland countries) returning +7% (-5% year to date).



Market performance

As UK investors, FPC clients need to be mindful of the influence of currency movements on returns. Since the start of the year the pound is 7% weaker against the US and Hong Kong dollars, Euro and Yen, which results in increased values when translated back from local markets.

It is worth providing context of just how far the pound has fallen since the EU referendum. Over 5 years it has weakened -25% v US and Hong Kong dollars, -27% v Euro and -43% v Yen:

It seems the negative economic and political news relating to the UK is constant, with overseas investor enthusiasm at a low. The currency strategy team at Bank of America referred to Sterling as an *'emerging-market currency, in all but name'* (1), which is a troubled argument for what remains one of the world's largest and most influential developed economies with a major reserve currency.

It is always darkest before the dawn, and it is our view that the negativity will cease once the UK-EU relationship is determined, albeit volatility will remain for now. Having past the 30th June deadline for extending the transition period we would hope that common sense prevails from both sides.



01/07/2015 - 01/07/2020 Data from FE fundinfo 2020



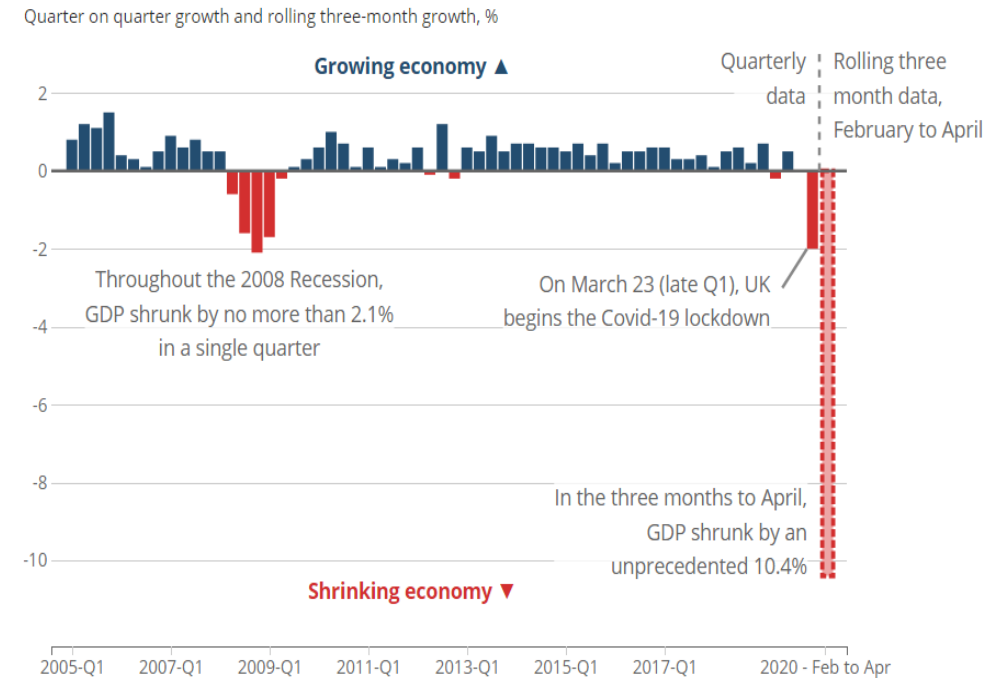
Looking back

It has been said that the stock market is not the economy and that appears increasingly the case. It certainly does not reflect the economic health of society perhaps as much as it once did.

The chart below from the ONS ⁽²⁾ shows the historic fall in UK economic output over the past few months, with the rolling 3-month data to April showing a steep fall. It would have been quite reasonable to assume lower stock markets as a result and in talking to FPC clients these past few months that was clearly the expectation.

We have certainly entered a deep recession but this is very different to others, especially the financial crisis of 2008, which was more drawn out. The intensity of the fall this time spared few sectors and will ultimately bring the finish line closer for some companies and jobs that were already in a perilous state. There is however considerable optimism and emerging evidence that a faster bounce back than expected is possible, providing companies and individuals have sufficient money on hand to pay bills as they fall due and virus flareups can remain locally isolated.

UK GDP growth, Quarter 1 (Jan to Mar) 2005 until February to April 2020



Source: Office for National Statistics



Looking back

FPC's independent economist Peter Stanyer comments:

'Economists expect the negative economic impact to be more transitory than the 2008-9 global financial crisis, for one reason: the declines in output are due to a forced shutdown rather than, as was the case in 2008, a systemic threat to the financial system, which is the life blood of the global economy.'

The key is a vaccine. The longer it takes to develop, the greater the adaptation required from companies to survive the loss of income i.e. cost cutting. Market strength is suggesting that companies with **sufficient liquidity and a reason to exist** will return to delivering profit growth sooner than many had expected. There are probable explanations for why markets have confidently moved higher despite the economic background:

- **Institutional pledge of 'whatever it takes'**. Interest rate declines, central bank bond buying, furlough payments, business grants and a continuing rhetoric that more stimulus will come, if it is needed.
- **Productivity improvements**. The adaptations being made to business may increase productivity and bottom line profits, albeit potentially at the cost to society.
- **Opportunity cost**. Investors still seek positive real returns on their investments, and this is becoming more difficult from traditional defensive assets.



Looking back

- **Markets get bored.** Financial markets are forward looking and quickly adjust to news before focusing on the next event. Brexit and the US election are returning to focus but are relatively less impactful.
- **Higher present values.** The value of any company today is the present value of all future cash flows. Those future cash flows have become more valuable as interest rates have fallen and look likely to remain lower for longer.

The latter point has a large impact on the present value of companies whose future earnings are expected to grow significantly. For example, Amazon.com Inc, which has high expected earnings growth (\$18 in 2020 growing to \$37 per share in 2021) has seen its shares rise in value by 45% since January to a market value of \$1.4trn (equivalent to the entire Australian economy!).

Online retail sales have obviously grown sharply during the crisis, but so have costs. Amazon's global retail sales are actually in a slowing growth trend, despite the recent lockdown stimulus. The jewel in the crown is actually the cloud-based web service platform 'AWS' but even here market share has been falling recently as competition heats up (3).

Investors are however willing to pay more today to get a slice of the expected growth of tomorrow. For Amazon, that equates to a share price 78x next year's earnings, compared to the S&P500 market average of 21x and the UK FTSE All Share multiple of 14x.

The valuation of certain sectors and companies, particularly US 'big tech', needs to be considered. Would you want to be invested in such companies? Undoubtedly. Is any price worth paying? No. Quality assets can be risky if you pay too much for them.

It is all a balancing act. To re-iterate a well-trodden FPC principle, **diversification** is the best method of long-term, risk managed, wealth creation and we continue to monitor market valuations and ensure that portfolios are not over exposed to any one area.



Looking forward

The latest World Economic Outlook from the International Monetary Fund (IMF) suggests that global growth is expected to be -4.9% in 2020, before recovering 5.4% in 2021. This would ultimately leave global GDP -6.5% lower than projections made in January 2020 (4). These projections have, and will, continue to change frequently subject to the stable re-opening up of economies.

The key driver of markets we suspect going forward will be the ongoing support offered from governments and central banks. Interest rates are going nowhere for the next few years, if not longer, and supportive measures need to stay in place to provide forward confidence.

There are obvious concerns about changes to the furlough payment scheme due to end in October. The problem with households of course, unlike the government, is that there is no 'magic money tree'. The government will therefore remain under pressure to support incomes to some degree for longer than is planned and this is being pressed for by think tank The Resolution Foundation (5), who are urging support throughout 2021. How spending will be paid for is really just a problem for tomorrow.

The plan put forward so far from the government is to '*build, build, build*' the UK out of recession by bringing forward, but sticking to, already planned capital spend of 3% of GDP, which appears a very underwhelming response to the questions that lie ahead (6).

Infrastructure spending also appears the way forward in the US, but here a more ambitious \$1trn spending plan, equivalent to an additional 5% of GDP, is being muted. This is obviously an important year in the US with elections due in November. Democratic opposition leader Joe Biden leads the way in the polls presently and, if elected, could cause increased market volatility simply by way of a proposed corporate tax rate increase from 19% to 28%.



Final thought

Clearly, we are going through an incredibly uncertain period. There are many imaginable scenarios about how the next few years are going to work out in both the real economy and financial markets, which are not the same thing. It is always easier to look to the future when markets are performing well and delivering strong returns, but less so during periods of volatility and falling values, which will naturally raise anxiety levels and force you to reflect on your own risk tolerance.

This is where detailed financial planning really shows its value in restoring confidence in the future, come what may. Building and maintaining a plan from solid foundations, with sufficient margin of safety so your immediate needs can be met and longer-term aspirations remain in sight, means the ups and downs of markets should be less troubling.

"The function of the margin of safety is, in essence, that of rendering unnecessary an accurate estimate of the future"

Benjamin Graham

We believe that government and central bank measures in place will continue to support markets. We cannot tell you that it is going to be smooth sailing from here, but we can help you to plan for success and invest with confidence, whatever the weather.

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Investment Director

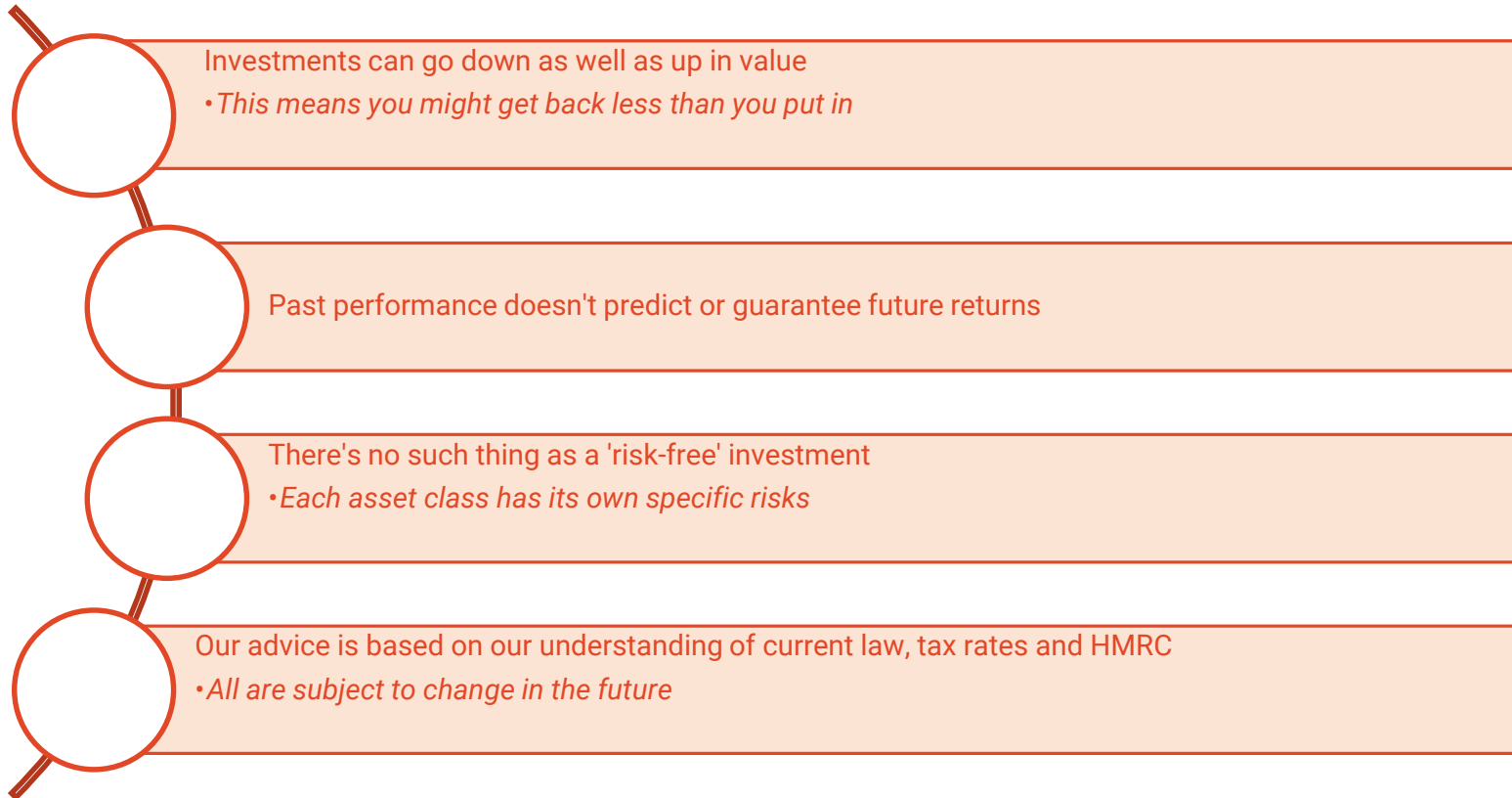


Sources

1. *Financial Times 'Pound becoming an emerging market economy' 24th June 2020*
2. *Office of National Statistics 'GDP Monthly Estimate' April 2020*
3. *The Economist 'Briefing Amazon' 20th June 2020*
4. *International Monetary Fund 'World Economic Outlook' June 2020*
5. *Resolution Foundation – 'The Full Monty' June 2020*
6. *The Economist – 'Boris's Infrastructure Plans' 2 July 2020*



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Do call us for a chat with any queries

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