APRIL 2020

UK EQUITIES - MARKET UPDATE

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The Coronavirus has triggered two issues in the market. First: liquidity. Companies started making less money and hoarding cash; this had the effect of pulling money from low risk corners of the financial markets (money market funds, the repo market) and making banks less willing to extend credit to financial borrowers as they were busy seeing deposit outflows and revolving credit facility loans being drawn down by their “real world” customers. This drove the panicked sell-off in March as leveraged investment strategies lost access to funding, forcing liquidation in a market that was already pricing in a considerably more negative outcome than previously expected.

The Federal Reserve has stepped in with a panoply of tools to address this problem, both in the US and internationally through extensive swap lines with other central banks. The chart below shows the excess yield earned on investment grade credit over government bonds: this has corrected from an extraordinary 400bps to below a “conventional” recession level of 250bps. Given the intervention by the Federal Reserve, I would be surprised if we saw new lows in investment grade credit. The current elevated level of spread is effectively entirely due to the government bond market suggesting that the Federal Reserve is going to miss its mandated inflation targets for 30 years. That seems an unlikely outcome to me. Investors holding long dated government debt are unlikely to make much money over the longer term in my view.

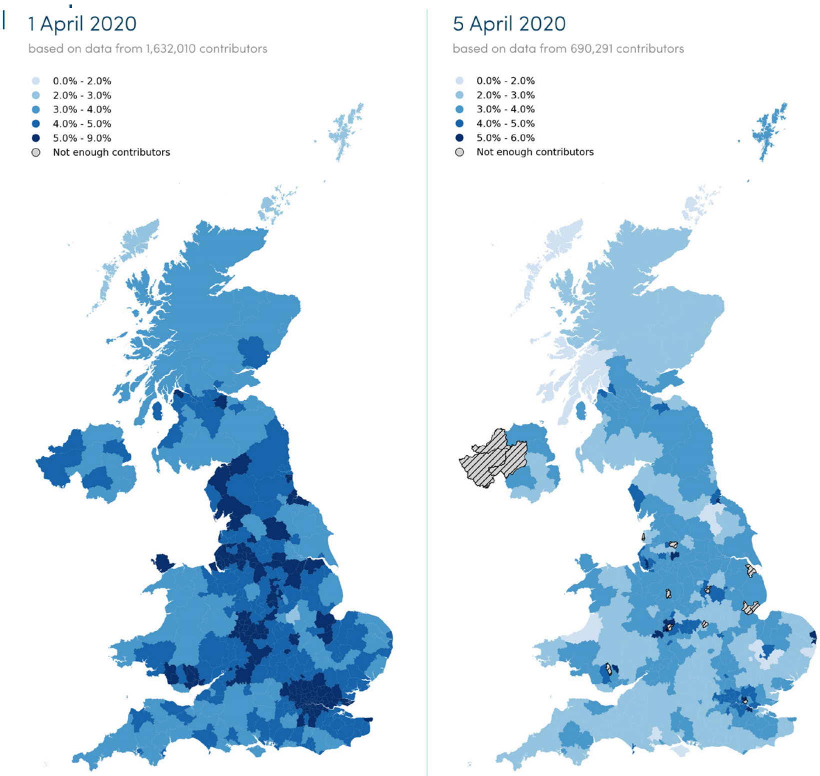
Source: Mirabaud. Bloomberg Barclays Liquid USD Investment Grade Credit Index Yield to Worst less yield on 10yr US Government Debt.

The second issue is a more serious one: solvency. Not many businesses can survive for a prolonged period with zero revenues. As you move from investment grade credit into high yield and equity, corporate solvency becomes a bigger concern. Lower interest rates, plentiful liquidity and extensive government support are all helping. The UK package looks superbly well designed, but currently is not working well enough in practice. The US package is tackling the liquidity challenge well, but how effective it will be in supporting employment, or livelihoods through unemployment, and business survival is unknown.

There are two principal risks which could potentially tip us back into a sell-off (and possibly to new lows for ‘risk’ assets): the first is a solvency crisis caused by widespread unemployment or business failures impacting an asset class. High on my list of things to worry about are asset backed securities such as US mortgages, auto loans and (possibly) student loans where non-performing loans look almost unavoidable.

The Global Financial Crisis saw a financial crisis become a real-world crisis; this would be the inverse. The second is more simply the cumulative effects of a locked down economy on enough companies to cause entire indices to fall to new lows. If we are in lockdown for 12 months, there is big trouble. If we are in lockdown for another few weeks, I would be optimistic about a fairly rapid snap-back in economic activity.

Unhelpfully, the data on the number of cases of Coronavirus in the UK is rather patchy (worsened by erratic reporting over Easter and constantly changing protocols for who is being tested). Reverse engineering death statistics suggests around 2m infected at peak[1]; this tallies with large scale survey data from Prof Tim Spector's team at King's College which suggested that the lockdown measures were causing a rapid reduction in the number of cases from 1.9m to 1.4m in just a few days. The latest data[2] shows no areas with more than 4% of people symptomatic and rapidly spreading areas of 0-2%. Hopefully deaths data should follow with a 2-3 week lag and we should see significant improvement towards the end of this month. The number of people in hospital beds with coronavirus has also stabilised[3], which is hopefully another indicator of declining disease



UK – People with symptomatic COVID (estimate %) Source: King's College London and ZOE.

I am reasonably optimistic that in the coming weeks we may see restrictions in the UK eased. This would allow builders back onto site, shops to re-open, possibly children back into school and maybe even people back into the pub's beer garden (but not standing at the bar). This would likely to see a sharp rally in the shares of companies that have been hit hardest by these restrictions. However, we are not out of the woods. There is the very unpleasant risk of a "second wave" triggering a further bout of lockdown in the Autumn and there is the risk of business failures / unemployment causing rising default rates. I am optimistic about the latter in the UK and reasonably concerned about the former.

Overall, I can see little investment upside in government bonds and not much in investment grade bonds. The high yield market has just shot upwards (due to Federal Reserve intervention) and is probably fairly priced at an index level, but there should be scope to outperform at a "stock picking" level. Equity on the other hand is far too cheap on an index

[1] https://www.edgehealth.co.uk/post/covid23march2020 methodology updated for deaths as lockdown began
[2] https://covid.joinzoe.com/post/covid-isolation [3] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/879384/COVID-19_Press_Conference_Slides_-_14_04_2020__3_.pdf

level. The FTSE 250 (which avoids being dragged down by oil majors whose problems stretch beyond just coronavirus) is down by 25%. We expect that a lost year of earnings should represent a reduction in Net Present Value (NPV) of 5-10%. A 25% loss would suggest widespread risk of business failure or several years of very poor performance. Within that 25% decline, there are plenty of businesses down by at least 40-50%.

I would be surprised to see new lows in some of the hardest hit shares, but I would not be surprised to see some downside from here (as many have already recovered sharply from the nadir of panic selling) and would not be that surprised if we saw new lows at an index level if one of my stress scenarios emerges. In other words: we have very probably seen the lows for many individual shares and very possibly for wider indices as any future drawdowns should not be fuelled by the fire-selling I mentioned.

The equity investment strategy that makes most sense to me is to identify businesses that you know will be resilient to the current challenges, including the prospect of a "second wave" or more widespread financial distress emerging. If we can see 50% upside or more, our worst case is that recovery takes 3 years and we make a handsome return; our best case is that recovery is complete by Christmas and returns are far higher. The question then becomes one of concern over experiencing volatility and / or frustration at being presented with a better buying opportunity later: investors with long term objectives should not be overly concerned by either.

Which sectors do well is an interesting question: there are some structural trends which look likely to accelerate (e.g. flexible working, online shopping) and shareholders may take a different view in future of the value of a resilient balance sheet (which will likely lower return on equity if less leverage is used). Companies who benefit explicitly from the conditions of lockdown are unlikely to enjoy those conditions for long (supermarkets are already suggesting the early pantry-filling panic is being replaced by a more subdued environment). You could see areas such as video games or online content providers attracting a new audience which they manage to keep (I think Joe Wicks may have become a permanent feature in my mum's life!). We would expect the bigger effect to be seen within sectors as the financially strong take market share from the financially weak.