financial planning corporation

Investment Review – 1st Quarter 2020

Mike Lea, Investment Director

9th April 2020

Introduction

There was no way to predict this crisis, but we believe FPC clients will have been well prepared.

This update to clients is rather lengthier than originally anticipated and akin to a full year review, but I think appropriately so given how momentous the quarter has been with developments that are unlikely to be seen again for many of us.

Whichever way we choose to reflect on the events of recent weeks, we have all been truly living in historic times. The impact of the COVID-19 pandemic has been sudden and severe and though we have been through crises before, the majority of us have not experienced a direct threat to both our personal safety and financial wellbeing like this. We have spent considerable time talking to clients recently and it is clear the priority is not the performance of financial markets but rather the health and wellbeing of family and friends and, for some clients, the intense disruption of business life. These priorities are as they should be.

From an economic perspective, the impact on normal business operations has been unimaginable. There are few companies, especially those small and medium sized, which trade in a manner that would allow them to, in many cases, withstand the total loss of demand resulting from the pandemic. Many firms have little in the way of reserves to rely upon and some were highly leveraged going into the economic shutdown due to years of low interest rates and availability of credit. It is a timely reminder that debt can be dangerous, even when it is cheap and plentiful.

The economic disruption has, or will, impact everyone to varying degrees. This is why the response from global governments and central banks has been to step in with swift and powerful measures to try to absorb the economic shock, supporting both workers and employers alike. The support offered has, up until now, stopped a major market liquidity event from engulfing the system. This is what government is for, to assist when the private sector is embattled, and the policies being adopted are unprecedented during peacetime.

Introduction

The economy has in essence been put into a deep freeze to limit the damage caused and positioned for a slow thawing as the peak of the pandemic passes, but we will all have to be patient in that respect and trust that the policies in place will allow a return to some form of normal life.

There is no way, nor reason, to sugar-coat the health, social and economic challenges we all face. What we must do is stare these challenges in the face – from an appropriate distance of 2m for the time being – and consider the implications on our families and others, moving forward with hope and optimism.

The whole FPC team is here to support you at this challenging time and we welcome your calls and queries.

On behalf of us all, stay safe and well.

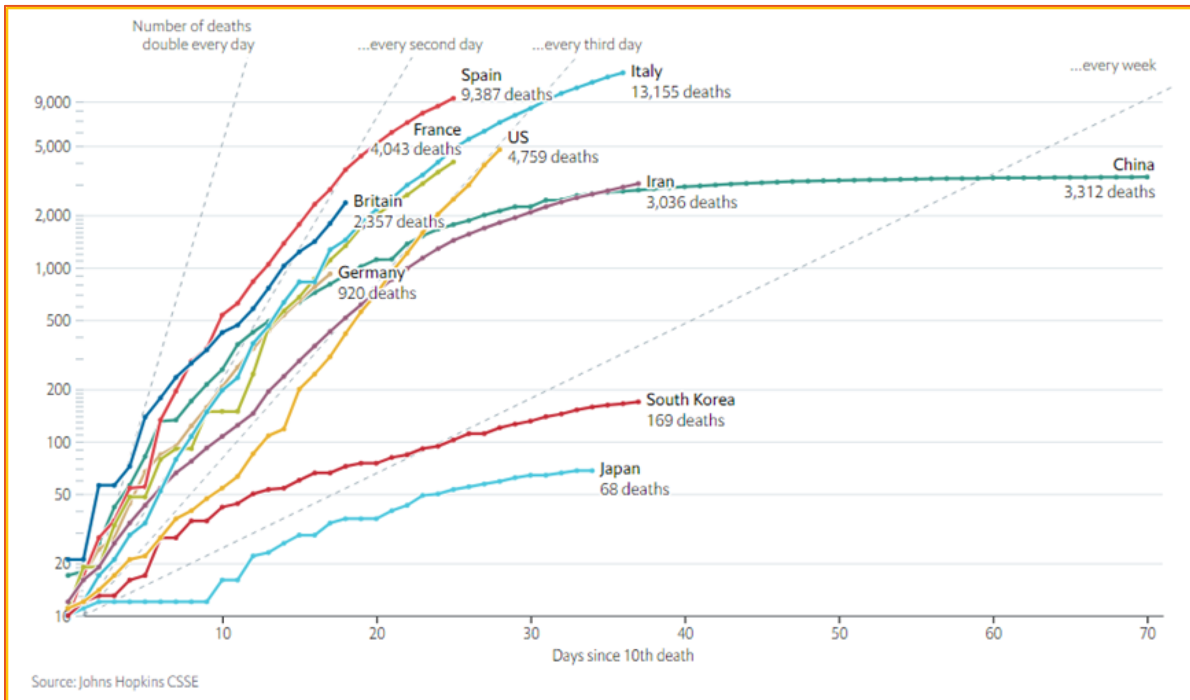
MIKE LEA

Investment Director

Virus spread and economic impact

This information will not be new to you but for context, according to Johns Hopkins University Coronavirus Resource Centre, there have been over 1m people across 180 countries infected with the COVID-19 virus, with over 53,000 deaths at the time of this research. There will unfortunately be many more deaths throughout the first wave of the virus, with possible secondary waves that will hopefully be less impactful as we learn and improve our ability to manage by way of testing, isolation and, in time, widespread vaccination.

The chart below shows the pathway of the virus by various countries, each of whom have adopted various suppression strategies:



The main observation is that China is obviously someway ahead of the world, as you would expect, and according to official information released has had a relatively modest mortality rate. Japan and South Korea have also had relative success.

Different approaches have been used in containing the virus, as China locked down 11 million people in the city of Wuhan, whereas South Korea who have also successfully supressed the virus, relied upon significant testing and isolation practices.

Virus spread and economic impact

The shift in global power from Europe in the 19th century to the US in the 20th century is now turning towards the East.

Given the re-emergence of China as an economic and political power, Europe particularly may welcome their data, and expertise and could look to adopt the containment practices of Asian countries facing this crisis.

This is at a time when the US is now the focal point of the virus, with the world watching the political grandstanding and overconfidence in containing the spread within their own borders. The US is significant, as it is the engine of global demand making up 23% of the global economy according to IMF data, compared to the UK at just 3%. When the US manages to get on top of the virus spread remains important to the rest of the world in terms of restarting the global economic engine.

The world has certainly entered a global recession in 2020. The shock to the system in terms of loss of economic activity through gross domestic production (GDP) readings will start to emerge in Asia in Q1 data, but will be starker in Q2 for the rest of the world. US investment bank Goldman Sachs suggests that US GDP alone could fall by over 30% in Q2 on an annualised basis, in a downward revision to earlier estimates, before having a strong rebound in Q3 and Q4. I think the rebound will be more modest than suggested.

How quickly we return to global economic output levels preceding the virus outbreak is largely guesswork, but rating agency Fitch believes that GDP will not revert to pre-virus levels until late 2021 and this matches estimates seen elsewhere. It is clear that this disruption has been very serious, but it is not destruction, as former Bank of England governor Mark Carney stated.

Government intervention

The scale of the disruption did however require decisive government intervention and a global commitment, though un-coordinated, to doing 'whatever it takes' to support jobs and the economy. There was simply no other choice but to fill the gap left by the private sector in order to avert a far more prolonged economic retraction.

In regards the UK government and treasury, I commend the speed of the actions taken, which was certainly no easy task, but has staved off an even graver situation for many. UK chancellor Rishu Sunak had a baptism of fire having only been appointed in mid-February yet shortly after he has had to roll out wartime policies. That is not to say the response was perfect, and certain parts of society took longer than others, or not at all, to receive the assurances they required. Implementation of such a large-scale project will obviously have administrative problems and delays, but having no support on the horizon would be far worse.

Global packages have involved fiscal stimulus through support of individual incomes, tax deferrals, debt repayment holidays, business grants and loans. This has been combined with monetary policy adjustments with reductions in bank base rates and commitments to buy endless government and investment grade corporate bonds to keep sufficient liquidity in the system, and to ensure long term borrowing rates also remain low. The support has been enormous, with the measures amounting to 5% of UK GDP and 10% of US GDP according to analysis by Fitch.

Whether or not the actions taken by governments are enough to stave off a prolonged recession will only be determined as economies begin to thaw later this year and consumer and business activity resumes. There could also be unintended consequences down the line in terms of inflationary pressure, so that is something that we need to be mindful of.

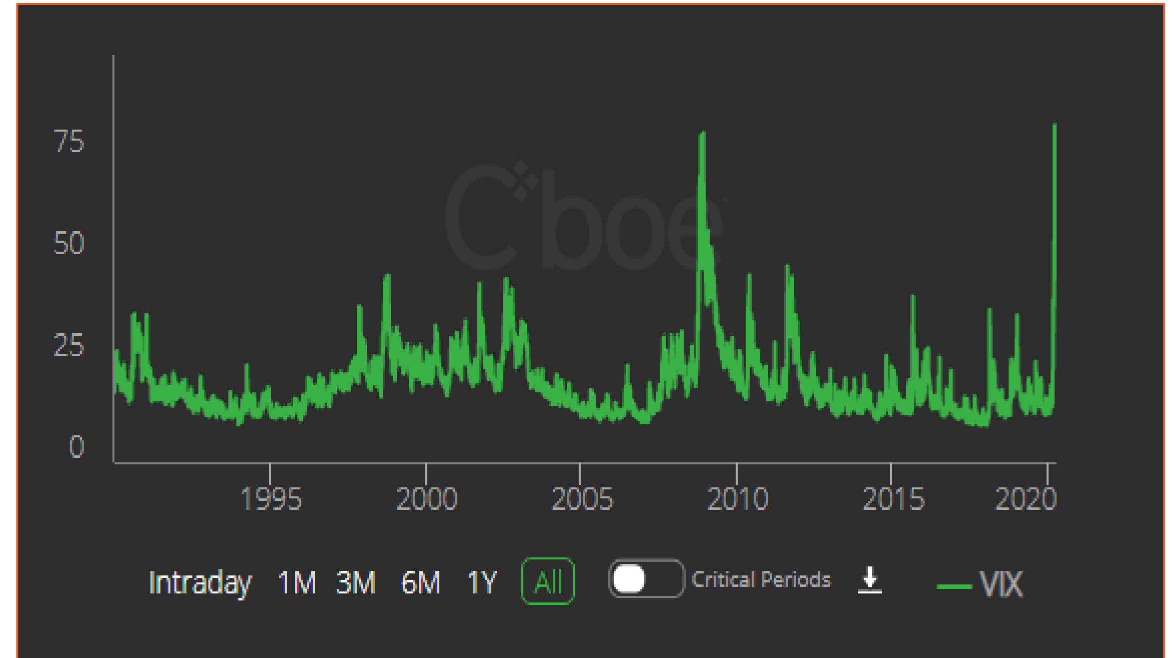
Market volatility

It is not surprising, given the environment, that we have seen an extreme increase in market volatility through March, with consistent daily index moves of over 3% and, on March 12th, the FTSE 100 suffered its worst trading session since the Black Monday crash in October 1987 falling over 11%.

Electronic trading volumes on the London Stock Exchange rose 144% in March from February as panic emerged and a 'dash for cash' ensued.

However, we do now believe that we have past 'peak panic' as evidenced by the Chicago Board Options Exchange (CBOE) VIX index, which provides an indication of sentiment and expected forward volatility in financial markets.

The longer-term chart opposite shows the sharp increase in the index, which hit a peak of 82, but has since fallen sharply to 53 at the quarter end and continues to fall. The measure even surpassed the Great Financial Crisis reading of 79 in October 2008, which then took 6 months to return to pre-crisis levels.



Investment performance

Performance has been clearly negative for risk assets over the quarter, or more precisely the latter part of February and throughout March. The increased volatility has led to fear inducing news, which combined with daily virus updates has amplified nervousness throughout financial markets.

FPC client portfolios are invested in a mixture of growth and defensive assets and so performance data from popular indices as shown on the headlines is not indicative of the underlying portfolio journey.

In terms of performance, the UK FTSE All Share fell -25% over the quarter, leading the declines in major global markets when considering currency movements. The US S&P 500 returned -14% (GBP) and -19% (USD) whilst the Euro STOXX returned -21% (GBP) and -24% (EUR). One of the least badly affected markets was ironically China, where of course the first case of COVID-19 was detected back in December 2019, with the CSI 300 returning -5% (GBP) and -10% (CNY).

The economic uncertainty impacted the corporate bond market too as concerns about defaults and short term selling to raise cash caused prices to fall, but to a lesser extent, with the Bloomberg Barclays Sterling Aggregate Corporate index returning -5%. What distinguishes the move from previous crises however was the speed of the sell off, as represented in the chart on the right, the 2020 spike in yields happening in weeks not months as in 2007-2008.

Shared by the Investment Strategy Group, documented by Janus Henderson Investors.

Investment performance

That said, the US Investment Grade debt market saw the 3rd largest weekly issuance on record in April, so demand for financing quality companies remains available, supported by liquidity measures from government. Once it became apparent the market was open, prices started to recover. UK Gilts benefited from a flight to safety returning +6% but this hides the volatility seen even in this market as investors sold any asset to raise cash.

Property, as an illiquid asset class, has effectively been a closed market given the 'material uncertainty' surrounding valuations, and most unlisted property funds have temporarily suspended withdrawals. We have already addressed this in a separate update to impacted clients.

A further factor, if the pandemic was not enough disruption to markets, was that the oil market suffered a shock in early March when it was reported that Saudi Arabia and Russia butted heads about production quotas, leading to large oversupply and a collapse in prices. The benchmark WTI crude oil price fell by as much as 30% after the news, the biggest fall since the 1990s Gulf war. This oversupply into the market matched reduced demand for transportation as private and industrial travel was curtailed with the price falling from $60 to a low of $20 in Q1.

This is important on a number of fronts, not least because the industry is a large employer. OGUK, a trade body for North Sea operators, suggests that cash flows could turn negative for the only the third time in 40 years. This may mean that companies in the energy sector become one of the biggest casualties, and only partly because of the virus outbreak.

One factor that will require consideration going forward is the impact of the shutdown, and the oil shock, on investment income and particularly dividends. We have already seen a number of companies cancel their scheduled payments to investors because of trading uncertainty due to either cash flow constraints, moral concerns from the need for government support or, as we have seen in the case of the banking sector, restriction imposed by the regulator. The impact on clients here is uncertain as yet, but could be severe in the short term.

Investors should therefore plan prudently and expect a reduction in their 2020 investment income, though the consensus is that earnings, and thus dividend distributions, will be reinstated in 2021, albeit from lower levels as some version of normality resumes.

Sector impact

As shown earlier, the UK FTSE All Share index has performed the weakest of all developed markets. Leading into the crisis the UK was already in an unstable position due to leaving the EU, though Brexit has not been mentioned for a good while now as it takes a backseat of investor concerns. The UK economy is a net importer and is also heavily service based, rather than manufacturing, which has been hit particularly hard as we are told to ‘stay at home’. These particular weaknesses resulted in the currency falling sharply before staging a recovery in Q1.

The FTSE All Share index is also weighted 18% to financial services and 11% to energy, two sectors that have been hit particularly hard. Compare this to the US S&P 500, which is a broader index and has a 25% weighting to Technology, which has outperformed, and you can understand why the UK has struggled relatively. From an historic earnings perspective the UK does remain relatively better value than other developed markets, but now the jury is out on future earnings for the time being.

Diversification, as ever, across countries, sectors and investment styles remains the way forward. Any investor who is too concentrated to any particular sector takes on the corresponding risk of amplified gains or losses.

The chart overleaf shows the performance of a selection of sectors from the FTSE All Share index over the quarter. There is a great deal of variance, with the defensive Utilities sector returning -7% as against the Travel & Leisure sector -43% due to the obvious impact from the virus suppression strategy.

FPC client portfolios are extremely well diversified and whilst, as we have said previously, there will be corporate casualties from this downturn, they will represent only a very minor part of portfolio exposure. The global economy will recover, and the strongest, most well capitalised companies will survive and continue to provide the products and services the market demands. This will, in turn, lead to positive returns for client investments over time, not just in capital terms but also growth of income.

Sector impact

20%
10%
0%
-10%
-20%
-30%
-40%
-50%
-60%

01 Jan 09 17 27 04 Feb 12 20 28 09 Mar 17 25

A
B
C
D
E
F
G

- A - FTSE All Share Utilities TR in GB [-7.48%]
- B - FTSE All Share Pharmaceuticals & Biotechnology TR in GB [-7.97%]
- C - FTSE All Share Food & Drug Retailers TR in GB [-10.53%]
- D - FTSE All Share Banks TR in GB [-32.88%]
- E - FTSE All Share Oil & Gas Producers TR in GB [-33.48%]
- F - FTSE All Share General Retailers TR in GB [-36.96%]
- G - FTSE All Share Travel & Leisure TR in GB [-43.51%]

31/12/2019 - 31/03/2020 Data from FE fundinfo2020

Economic recovery

In terms of the speed of recovery there are various scenarios in regards to the re-opening of the economy, all subject to the path of virus spread. The benchmark has become China, with economic data suggesting a fairly rapid return to economic activity throughout March and few secondary cases of the virus.

However, the aggressiveness of containment has varied significantly across countries, ergo the path of recovery will potentially vary also. The cultural approach to containment by China and the US has clearly varied and it would not be surprising to see a prolonged episode of economic closure in the US, or policy error leading to further containment measures being required down the line.

There will be structural changes, as with any crisis, both at a business and national level. We have already seen the impact on employment data, especially in the US where 10 million Americans made new claims for unemployment benefits in the two weeks to the end of March. The April unemployment rate is estimated to reach 10% according to Capital Economics, as published in the Financial Times.

Unfortunately, employers will likely fail to justify the retention of all employees furloughed during the lockdown as trends in technological developments gather pace and make for new ways of working. Further, the impact on companies in certain sectors may just be too severe, with re-financing for leveraged outfits simply not viable, with only the strong surviving.

Independent economic consultant to FPC Peter Stanyer comments on such changes:

‘In the private sector the widespread take up of the tax-pay funded furloughing and extensive home-working will show many firms a route to leaner patterns of production. As restrictions are lifted, many firms will not survive and existing trends (most obviously in retail and property market) will have been accelerated. Many furloughed staff may not be retained, even in companies that recover and prosper. One consequence of the crisis could be that it encourages productivity growth, and faster productivity growth would make the higher national debt less of a burden for tax-payers’.

Economic recovery

Eventually all the additional government funding will need to be paid for, but this is clearly a problem for tomorrow. The question as to how much debt governments can carry relative to GDP is difficult to answer, but as Peter suggests, higher productivity growth could make it less of an issue. The other answer is of course tax increases, but this would put a brake on an economic recovery that is likely to be initially fragile.

The position of FPC is that we believe, as in all other downturns, that the world will get through this current crisis. We do not know how long the recovery will take, but there are optimistic signs from Asia the virus can be contained and economies can slowly re-open for business.

Financial markets are seeing increased levels of stability but we know from experience this can be fleeting, and we sense that negative news flow from the US has not yet peaked. We therefore proceed with caution and deem it too early to determine that we have entered a recovery phase. It would not be surprising if the market 'bottom' has not yet been reached, which will only be known in hindsight of course.

As a result of the increased volatility in March we made the decision to place all major portfolio rebalancing on hold, as we did not wish to be 'out of the market' whilst transactions were implemented, given the evidence that missing the best market rises can impact on long term performance. As illustration, returns from investing within the UK stock market, over the last 30 years, are impacted as follows (Source Schroders):

- 11.6% pa if you invested the whole time
- 9.6% pa if you missed the 10 best days
- 8.2% pa if you missed the 20 best days
- 7% pa if you missed the 30 best days

It is our view therefore that the chances of timing the market in the short-term, both going in and getting out of the market, is not possible on a consistent basis. Remaining invested is our best advice.

In closing …

We talk about sequencing risk with those who are drawing upon their investments. As markets trend steadily higher, this is not too great a concern, but caution is advised when drawing from investment markets as they fall suddenly, as is the case now. Markets have certainly travelled ‘up the stairs and gone down the escalator’ and distributions should be re-visited at this juncture.

We are therefore reviewing client cash positions, especially in light of the expected reduction in investment income this year, to ensure that suitable, and even additional, cash reserves are in place to provide comfort that cash flow will be there as planned.

At an investment fund level, we have been consistently monitoring the position of our client investments with our research partner Square Mile, who use their significant analytical resources on our behalf to ensure the funds we choose to invest client capital in are performing as would be expected. Our relationship with Square Mile is proving beneficial to obtaining the information we need to enhance our internal due diligence process.

We have full confidence in our financial planning and investment process, particularly during times of financial stress. We believe our conservative planning principles allow our clients to focus on the most important matter at hand, being the health and well-being of their nearest and dearest.

We continue to work on monitoring market developments and considering the impact on individual financial plans closely to ensure clients stay on the best path to achieve their longer-term objectives.

I look forward to keeping you up to date as we move throughout the year and would wish to re-affirm that the whole FPC team are at your disposal during these volatile times.

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