ALBERT E SHARP

INVESTMENT MANAGEMENT & STOCKBROKING

MARKET COMMENTARY

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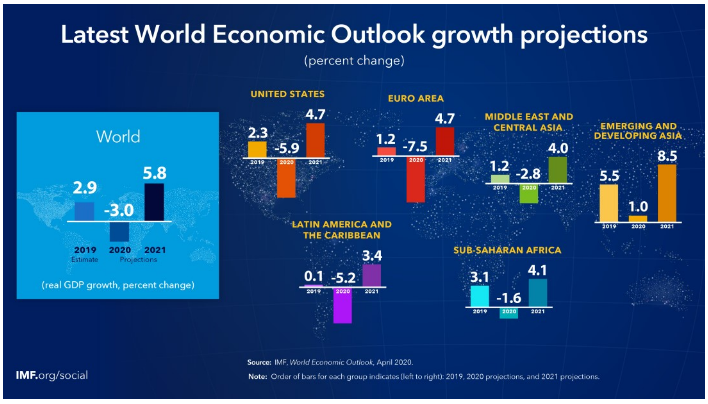
Looking Out From Lockdown

Our last quarterly valuation update in January seems like an incredibly long time ago. Back then we were not alone in looking forward to the early start of the new decade with a degree of optimism. Brexit wrangling had finally come to an end, economic data in the Eurozone was improving, US unemployment hit a 50-year low and trade tensions with China appeared to be easing. The IMF was expecting global GDP growth to accelerate from 2.9% in 2019 to 3.3% in 2020, helped by Asia and other emerging economies.

Fast forward ten weeks and the COVID-19 pandemic's 'Great Lockdown' has changed everything. We are now looking at a global GDP contraction of 3%, the largest drop since the depression of the 1930s.



By March 28th, the number of unemployed in the US leapt from 200,000 at the start of the month to 6.6.million, the highest since records began in 1967 and ten times the previous record in 1982. Financial markets crashed, with the UK stock market faring amongst the worst. In just 17 trading days, mid and small-cap equity indexes fell by an astonishing 40%, as genuine panic set in. The low point proved to be the day before lockdown in the UK and as central banks across the world stepped in with a coordinated rescue plan, fears subsided. The speed of the decline will be a hallmark of this episode in stock market history. The subsequent recovery also broke records, with the Dow Jones enjoying its best single day since 1933, rising 11.4%. At the time of writing in mid-April, the UK is still down over 20%, but with the US down less than 6.5% year to date, the word 'crash' needs to be put into context.

Right now we are seeing a tangible crash in the oil price, to the point that it has turned negative for some futures contracts. With demand having been switched off almost overnight and storage capacity reaching its limit, suppliers are prepared to pay recipients to take their output. They can't just burn it, or pour it down the drain. The knock-on effects are huge. Where does this leave Saudi Arabia and the Middle East in general in terms of global political power and status? What does this mean for Scottish independence? Can central banks or governments somehow intervene? Will this keep the airlines in business?

More to the point – since fuel is one of the greatest consumer costs and national sources of income across emerging economies, will this prove to be a structural benefit or hindrance? For oil-rich nations such as Brazil, Venezuela and Mexico, this is a potential nightmare situation and the implications for the currency is huge. For major importers such as Japan this is the equivalent to a huge lottery win. Suffice to say that the second order effects of the coronavirus are complex and likely to be enduring.

In the recent turmoil, one of the saving graces for UK investors was exposure to overseas assets, particularly those denominated in US dollars. In the middle of March, sterling fell a massive 13% against the dollar, 13% against the dollar, meaning that the value of US-based assets increased by a similar amount, all else being equal. Of course, this only dampened the blow but it was particularly beneficial for investors with exposure to the technology sector which held up better than most. Year to date, the NASDAQ is down just 8% in sterling terms. Painful maybe, but hardly a crash. Indeed, COVID-19 has been a huge boost for companies such as Skype (owned by Microsoft) who saw the number of daily users increase to 40 million in March, up 70%. In an attempt to meet demand, Amazon looks set to grow its workforce by 20% in a matter of weeks, breaking the 1 million employee mark.

One consequence of the COVID story that seems to have been seriously under-reported has been the impact on the global bond markets. There has been a genuine crash here too, although it may not have lasted for long in some cases. Generalising about fixed-income markets is difficult because bonds vary hugely in nature.

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Gilts (UK government bonds), German Bunds and US Treasurys are generally regarded as amongst the safest, in the sense that the chances of a default are slim, but these all fell sharply in a few crazy days in mid-March.

The UK Index–linked Gilts Index fell by an astonishing 17.5% at one stage. With many other bonds priced around government benchmarks, the knock-on effects can be significant. For highly rated, investment grade debt, issued by 'safe' entities such as Unilever or Tesco, analysts will compare their yield to an equivalent gilt. Since these companies carry business risk, unlike the rock-solid UK government, this needs to be compensated through a higher yield; this difference is known as the spread. Just before the crisis, investment grade bonds were trading with a spread slightly below 1%, leaping to almost 4% at the height of the panic.

High yield debt (issued by companies with a riskier business model) saw a much more pronounced move, with spreads 'blowing out' over 10%, or 1,000 basis points in bond-speak. Though somewhat unusual, Andrey Kuznetsov, a senior portfolio manager at Federated Hermes, notes that on the 57 occasions that this happened since the late 1990s, in only three instances did high-yield investors lose money in the following 12 months - and even then, it was less than 5%. The average return was almost 40%. Past returns are no guide to the future as we know, but this demonstrates the extent to which financial markets frequently sell off disproportionately.

Going back to equities briefly, the team at Montanaro Asset Management has produced some similar research on UK smaller companies. They note that when the price/earnings ratio falls into the 12-14x range, the average annual return over the next 8 years has been around 15% per annum.

In conclusion, it would be folly to announce that the worst is behind us, but it would also be wrong to predict that another leg down is coming. It seems most likely that VC Day (victory over coronavirus) will coincide with the announcement of a successful vaccine, but that does not imply either that the stock market will immediately take off, as tempting as it might be to assume. To some extent the financial markets are already pricing this in. However, what we can say with some confidence is that by sticking to a method, maintaining discipline, buying quality and not getting drawn into too-good-to-be-true stories, the long-term rewards will accrue – and from this point on they could be very significant.

Over the last few weeks at Albert E Sharp, it appears that contingency plans that have been in place for many years have worked perfectly. Our team are all working from home and service levels seem to have remain unchanged. If you have any questions, as always, contact us through your financial advisor in the first instance (if applicable) and we are available over the phone or online video-conference should you wish to arrange a call.

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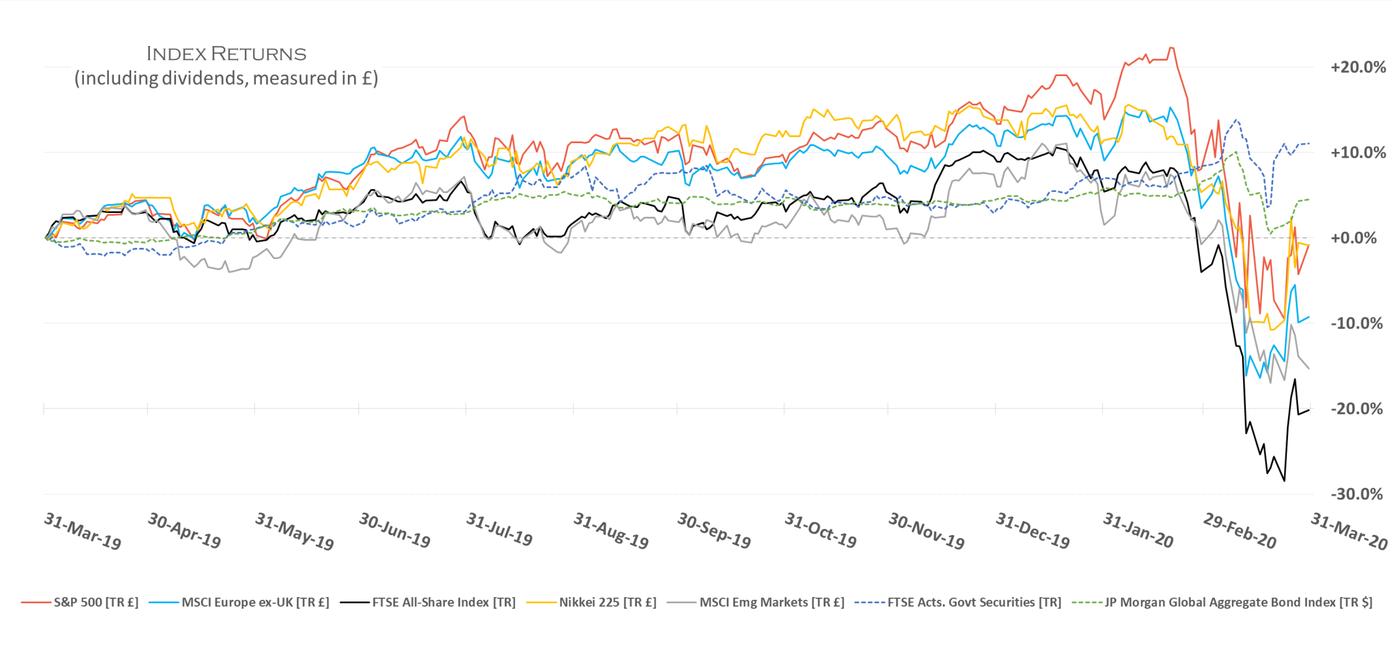
Index Returns

Index	Region/Asset Class	31 March 2020	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	5,672.0	-13.8%	-22.1%	-19.6%
UK Mid Cap	UK	410.9	-20.8%	-22.2%	-22.4%
UK Small Cap	UK	4,262.5	-20.8%	-22.0%	-23.8%
Dow Jones Ind Avg	USA	21,917.2	-13.7%	-15.5%	-9.1%
S&P 500 Index	USA	2,584.6	-12.5%	-8.8%	-2.1%
NASDAQ Comp.	USA	7,700.1	-10.1%	-0.4%	+9.0%
Nikkei 225	Japan	18,917.0	-10.5%	-10.8%	-11.8%
Euro Stoxx 50	Europe	2,786.9	-16.3%	-16.9%	-17.1%
CAC 40 Index	France	4,396.1	-17.2%	-17.8%	-14.9%
DAX Index	Germany	9,935.8	-16.4%	-13.8%	-17.9%
Milan Index	Italy	17,050.9	-22.4%	-19.9%	-23.9%
MSCI Emg Mkts (£)	Emg Mkts	485.6	-12.9%	-13.5%	-13.8%
IBOVESPA Index	Brazil	73,019.8	-29.9%	-23.5%	-14.5%
IMOEX Index	Russia	2,508.8	-9.9%	+0.5%	+10.5%
S&P BSE SENSEX	India	29,468.5	-23.1%	-23.8%	-10.6%
Shanghai SE Comp.	China	2,750.3	-4.5%	-11.0%	-13.2%
Hang Seng	Hong Kong	23,603.5	-9.7%	-18.8%	-21.6%
UK All Property	UK Property	124.5	-2.3%	-7.0%	-6.1%
UK Conv Gilts	UK Gilts	4,102.7	+1.4%	+9.9%	+14.0%
UK Index linked Gilts	UK IL Gilts	5,295.1	-4.1%	+2.2%	+7.8%
JPM Glob Agg. Bond ($)	Global Bonds	510.0	-2.2%	+4.2%	+3.8%
iBoxx Non-Gilt	UK Corp Bonds	354.0	-5.7%	+1.5%	+5.2%
WTI Crude ($/barrel)	Oil	20.5	-54.2%	-65.9%	-68.5%
LMEX	Base Metals	2,335.3	-10.4%	-23.6%	-27.1%
Gold Spot ($/oz)	Commodities	1,577.18	-0.5%	+22.0%	+19.0%
S&P Agri & Livestock	Agriculture	589.19	-6.7%	-15.0%	-21.2%
£1 = US$	Currencies	1.24	-3.1%	-4.7%	-11.4%
£1 = €	Currencies	1.13	-3.2%	-3.1%	-1.1%
£1 = Yen	Currencies	133.59	-3.5%	-7.5%	-10.3%



Source: Bloomberg® Albert E Sharp

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