Q2-2020
QUARTERLY PERSPECTIVES

Tavistock Wealth - Investment Outlook
Christopher Peel - John Leiper - Andrew Pottie - Sekar Indran - Alex Livingstone
Jonah Levy - James Peel

REVOLUTIONARY THINKING
Key Themes
This has been the most volatile and could well be the shortest duration bear market in history. This global downturn is very different to what has come before, such as the burst of the dot-com bubble in 2000 or the subprime mortgage crisis in 2008, both of which required economic adjustment. This sell-off is different in that it was born from a political decision to shut-down the economy to save lives. As a result, the economic data has deteriorated very quickly. However, we believe it makes sense to look-through these numbers towards the sharp recovery in GDP forecast for late 2020 / early 2021.

Looking Through the Numbers
We think this for two reasons. The first is the duration of the virus, and whilst we are not virologists, we can be optimistic. Lock-down appears to be working, as evidenced in China and South Korea, and Europe is now showing tentative signs of improvement. Predictive models also suggest the virus will recede into the spring and summer. The shorter the virus, the shorter the decline in economic activity and the greater the likelihood of recovery. Central to this is the way in which countries relax restrictions. This will be a delicate balancing act between economic necessity and the development of the virus. The Chinese roadmap suggests factories will come back first, where distance working is possible, followed by shops and then offices using team structures. International travel will likely remain limited and require quarantine on arrival. Conferences and large social events will remain on hold. People will adapt social behaviour and start wearing masks, if not already.
The second question is how much the public sector can cushion the blow to individuals, families and corporations during the lock-down period. Here we are also optimistic. The bold monetary and fiscal policy we’ve seen across the globe has helped contain the fall-out and will pave the way for economic recovery. It buys much needed time to get to the other side of the crisis. Until then, we exist in a window of time, on a sea of liquidity, where cash is king and all-eyes remain firmly fixed in the development of the virus and whether the market perception, that the duration of the virus will remain short, proves true.

To Infinity & Beyond

We like assets which have proven resilient to the virus and where there is the scope, and willingness, to ease policy further if required. This applies to certain east Asian countries, particularly China given that it has proven to be remarkably resilient to the virus. As such, we remain overweight Chinese equities and bonds. It also applies to US equities. Even though the country is currently going through a rough patch, it remains better positioned to weather the crisis than other developed markets, notably Europe. In fixed income, we like assets that are being targeted by central banks, specifically US investment grade debt given its elevated position in the capital structure and improved liquidity profile.

Finally, we adhere to our investment philosophy that, during this uncertain period, the return-of-capital is as important as the return-on-capital. One way to achieve that is to inject resilience into the portfolios via diversification. As such we continue to hold moderate levels of cash with exposure to inflation-linked bonds, physical gold and sustainable investments which exhibit quality-like factors.

This chart shows the total US Federal Reserve Bank balance sheet and how this has grown through several rounds of quantitative easing following the financial crisis in 2008. We believe additional measures remain likely over the next few months.

We like assets which have proven resilient to the virus and where there is the scope, and willingness, to ease policy further if required. This applies to certain east Asian countries, particularly China given that it has proven to be remarkably resilient to the virus. As such, we remain overweight Chinese equities and bonds. It also applies to US equities. Even though the country is currently going through a rough patch, it remains better positioned to weather the crisis than other developed markets, notably Europe. In fixed income, we like assets that are being targeted by central banks, specifically US investment grade debt given its elevated position in the capital structure and improved liquidity profile.

Finally, we adhere to our investment philosophy that, during this uncertain period, the return-of-capital is as important as the return-on-capital. One way to achieve that is to inject resilience into the portfolios via diversification. As such we continue to hold moderate levels of cash with exposure to inflation-linked bonds, physical gold and sustainable investments which exhibit quality-like factors.
Despite the magnitude and suddenness of the recent sell-off, the S&P 500 remains in a long-term uptrend. This trend has existed, uninterrupted, for over 70 years having endured the 2007-2008 financial crisis and 1973-1974 oil shock.
Fixed Income

Liquidity has been our focus through Q1, and will remain so until the spreading of the virus begins to slow. The elevated demand for US dollars has put emerging market governments and corporations under pressure to pay and refinance their debt. We are positioned underweight emerging market debt relative to our benchmark, except for Chinese local currency government bonds which have fared well amongst the turmoil.

The liquidity of firms is also the primary driver of our overweight position in investment grade credit and underweight allocation to high yield debt. The Fed’s vast stimulus package has given respite to US credit by acting as a buyer of last resort. This will disproportionately benefit investment grade versus companies lower down the credit curve, which have inferior balance sheets and are at risk of deterioration over the longer term from weaker demand. Furthermore, the dramatic decline in the price of oil will negatively impact oil-producers, a disproportionately large component of sub-investment grade debt. Therefore, we see the default rate in high yield credit rising in the short-term.

A rally in safe-haven assets has provided opportunity to take profit and underweight European government bonds as the German commitment to a balanced budget comes to an end and the fractured national response to the coronavirus puts strain on an already precarious European Union. In the US, we maintain our slight overweight to the front end of the Treasury curve where the majority of recent issuance has been focused.

Chinese Government Bonds Outperform

Chinese government bonds have outperformed both developed and emerging market government bond indices since the start of the crisis.
Don’t Fight the Fed

Equities

COVID-19 was at the epicentre of global equity markets as they suffered their worst quarter since the Great Recession beginning in 2008. The sharp nature of the sell-off has left dislocations in the market, which gives rise to opportunities.

Our decision to remain invested in mainland Chinese equities proved effective. It was one of the only major equity markets not to enter bear territory. As China leads the way in restarting its economy post-shutdown, it is set for further outperformance. Additionally, its government and central bank are in a strong position to enact further stimulus if required. We are overweight east Asian equities and recently initiated a new position in South Korea, which looks to be closely following its Chinese neighbour in containing the virus. Their equity market was recently among the first few to retrace back into bull territory.

Investment grade bonds enjoy improved credit and liquidity risk profiles, relative to high yield, and will benefit directly from the Fed’s novel decision to buy corporate bond ETFs as part of QE5. This chart shows daily fund flows into the iShares Investment Grade Bond ETF.
Within our global single factor strategy our overweight exposure to the momentum, minimum volatility and quality factors benefited the portfolios this quarter as they outperformed the value and size factors as well as the MSCI World equity benchmark.

Technology remains one of our preferred sectors in the US due to corporate balance sheet strength and record low interest rates. Given the heightened market volatility, we maintain a tilt towards the momentum, minimum volatility and quality factors within our smart beta allocation.

We added to our ‘pivot-east’ theme via new positions in South Korean and Indonesian equity markets. The collapse in the price of oil should benefit both countries given that they are net importers and they were among the leaders back into bull market territory.

Technology remains one of our preferred sectors in the US due to corporate balance sheet strength and record low interest rates. Given the heightened market volatility, we maintain a tilt towards the momentum, minimum volatility and quality factors within our smart beta allocation.

Smart Beta Shows Resilience

Within our global single factor strategy our overweight exposure to the momentum, minimum volatility and quality factors benefited the portfolios this quarter as they outperformed the value and size factors as well as the MSCI World equity benchmark.
Commodities

With notable exceptions, commodity returns have come under pressure throughout Q1. Volatility in the price of oil and gold resilience have dominated headlines, as markets have been faced with two idiosyncratic shocks: the COVID-19 outbreak and an ongoing production war between Saudi Arabia and Russia. The consequences of this have been widespread, with oil prices falling over -60%. Our decision to remove exposure to oil and gas producers last year largely insulated us from this fall, and we have since increased our equity allocation to oil importing countries. Other commodities have suffered a less severe but nonetheless broad-based fall and ongoing uncertainty may yet prolong the recovery in the industrial complex.

Gold and gold-backed assets have continued to shine amid the chaos. Despite acting more akin to a risk asset for a brief period, the need for gold in a portfolio has been emphasised during this sell-off, outperforming the Bloomberg Commodity Index by approximately 30%. During the month, our shift from producers of gold to the physical asset will improve liquidity, benefit from the global gold shortage and avoid the idiosyncratic factors that come with the mining sector.

**Outliers Across the Commodity Complex**

![Graph showing performance of different commodities](image-url)

*Gold was the notable outlier this quarter against an otherwise broad-based decline across the commodity complex.*

Source: Bloomberg / Tavistock Wealth

Date of Data: 31/12/2019 - 08/04/2020
Foreign Exchange

In currency markets, the COVID-19 induced liquidity crunch drove a dash-for-cash into the global reserve currency, the US dollar. This is because individuals, families and corporations need cash to see them through the lock-down period. The key driving force is global debt, which needs to be paid even as underlying revenue dries-up. The significant rally in the US dollar is a serious issue for the global economy as it tightens financial conditions and disproportionately hits emerging markets. As such, the US Federal Reserve eased monetary policy and the US Treasury opened FX swap lines, improving access to the currency. This policy response proved effective, causing a sharp reversal in the US dollar. Out of the developed market currencies, the UK pound suffered disproportionally given its superior liquidity characteristics in the inter-bank market. This is a technical adjustment and has not been driven by any change in the underlying fundamentals. The US dollar remains overvalued and we expect it to depreciate over the remainder of the year, especially given the twinned responses of the US Federal Reserve and government backed initiatives.

Dash for Cash

GBP/USD fell dramatically this quarter from 1.32 to 1.14 before rebounding to end the quarter at 1.24. This move is consistent with the dramatic jump in the Deutsche Bank currency volatility index (in white) which rose to its highest level in a decade.
ESG Investing

ESG Investing is often labelled by critics as a ‘fair-weather’ strategy, fine when times are good but one that will crumble when the going gets tough and investors take shelter behind what they know. The experience thus far of ESG-linked assets during the ongoing COVID-19 outbreak, a rare black swan event (low frequency, high impact), is pouring cold water on that argument. Not only did ESG-linked assets outperform their conventional counterparts in Q1, but it was the ‘best-in-class’ SRI strategies (socially responsible investing) that performed most handsomely i.e. the greener the better. An analysis by Morningstar corroborates that outperformance wasn’t simply due to the exclusion of hard-hit energy companies, but in fact largely because of superior stock selection i.e. companies with superior ESG Scores. ESG-linked assets are, at present, earning their ‘all-weather’ badge and with portfolio cash levels elevated, perhaps yesterday’s critics will look to ESG when reshuffling for brighter (but uncertain) times ahead.

All Weather Investing

In the Q1 2020 Quarterly Perspectives, we wrote that the integration of ESG analyses into fixed income was less mature than in equity markets, due to the complexities associated with separating the various drivers of bond market returns. It is also the case that, due to patchy data, ESG analysis is more difficult in emerging markets. Looking to the accompanying chart, we can see these dynamics writ large i.e. ESG-labelled investments have outperformed their non-ESG equivalents in developed market equities but less so in fixed income or emerging markets. As the disclosure of ESG data improves, it follows logically that these spreads should tighten.
Final Thoughts

It has been a difficult beginning to the year but there are many reasons to be optimistic for the future. The quarantine measures appear to be effective in slowing the spread of the virus and the scientific community is working 24/7 to find a cure. As with other pandemics, COVID-19 will pass in time and the global economy will recover. Several countries in Asia have already reached the peak of new infections and economic activity is slowly rising in China and South Korea. This cycle of recovery will be repeated across the globe within months, supported by record low levels of interest rates and trillions of US dollars of fiscal stimulus packages.

The consequences of the ensuing, self-inflicted global recession will be felt for many years to come, especially in the bond market. Money does not grow on trees and the cost of financing these emergency fiscal measures will last a very long time. The next generation will pay a heavy burden in the form of higher debt repayments. Long-term investors such as sovereign wealth funds, pension funds and individual retirees will need to seek investment returns from other markets, namely global equities and commodities. Given the recent sell-off, both markets offer substantial upside in a new reflationary world and are likely to drive portfolio returns in the years to come.

Post-Recession Global Equity and Commodity Returns

The average return of the MSCI World equity index and the S&P Goldman Sachs Commodity index for the 2-year period following the end of the last 4 recessions in the US have been 19.49% and 22.33% respectively.