Investor Insight

SPRING 2020

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What has happened?
The spread of the coronavirus around the world has precipitated an unprecedented health emergency.

The global economy
We consider the impact of the outbreak on consumers, businesses and governments.

Positioning portfolios
What is the likely impact of the coronavirus on asset prices?

Close Brothers
Asset Management

A rocky start to 2020

Summary

- Covid-19 will weigh heavily on global growth in 2020, especially on consumption spending, the services side of the economy, and employment.
- Governments, central bankers and regulators have implemented unprecedented policies in order to support the economy at this time and to limit the impact on employment and income.
- Significant increases in government spending will result in much higher government debt in years to come, though central bank asset purchases will help to keep the cost of government borrowing low.
- The economic impact will depend on how the health crisis evolves, and how long social distancing measures are in place.

What has happened in the markets?

The spread of the coronavirus around the world has precipitated an unprecedented health emergency. Countries worldwide are racing to introduce measures to limit the contagion of the virus, in order to avoid health services being overwhelmed.

The virus was first recorded in China, with the Hubei province worst affected. The virus has since spread across Asia and into Europe and the US, as well as India and parts of Africa. Cases elsewhere are arguably unreported and the impact in developing countries could be considerable. While reports of new instances of the virus in China are falling rapidly as a result of a rigorous containment programme, they appear to be peaking in Europe and accelerating in the US.

To limit contagion, many countries have introduced widespread social distancing measures, including closing schools, restaurants, shops and other non-essential workplaces. While these measures are key to public health, they have a high cost to economic growth. Firstly, if schools are closed, many parents are unable to work.

Closure of social places, such as restaurants, bars and gyms, shuts off a large segment of the economy, as well as a significant chunk of employment. Limits to travel have weighed especially heavily on leisure and tourism sectors, most notably airlines.

While the situation only materially deteriorated in February, we are already beginning to see the effects of the coronavirus in economic data. Unemployment claims have surged in the US, Europe and the UK, and surveys point to a further deterioration in business conditions. All of this points to weak near-term global growth, with 2020 GDP forecasted to be close to 0%, with recessions in some economies.

For investors, global growth matters because it is the primary driver of corporate earnings and earnings growth, over the long term, has been the primary component of equity returns. A global recession will likely result in negative earnings growth for many businesses. Global growth also predicates monetary policy.

Markets have been quick to attempt to estimate and price the negative outlook for earnings.

What remains unclear at this early stage is the magnitude of the hit to economic growth, and how the side effects of extraordinary measures being taken will impact markets and growth. In this Investor Insight, we consider the impact on consumers, businesses and governments.

The consumer

Consumption will likely be hit hard in 2020, with a knock-on impact to employment.

Characteristically, developed market economies are consumption-led. In 2017, household consumption constituted an average of c. 60% of per capita GDP for The Organisation for Economic Co-operation and Development (OECD) nations, and was above 50% for all nations except Norway – where oil is a high proportion of output – and Luxembourg and Ireland, where financial services exports are unusually high.

Economies generating enough income growth to sustain healthy consumption growth need to worry less about what is happening overseas because exports will be a smaller share of output. This makes these countries less sensitive to demand shocks in other areas of the global economy. However, the coronavirus pandemic is likely to impact consumption-led economies in a profound way.

Firstly, in countries where shut-downs have been mandated, consumers have fewer opportunities to consume. If we look at the US, in current prices, restaurants, hotels, personal care and recreation together constitute around 13% of personal consumption expenditure. This is spending that now cannot happen, as these businesses have been closed in many areas. Retail spending, beyond food and petrol, will likely also have been dented and in total constitutes around a quarter of consumption expenditure, though some of this may be able to continue online. Transport, a further 4%, is also likely to be down sharply, with travel discouraged. In summary, the coronavirus has caused a direct negative demand shock to consumption.

Social distancing does not only affect direct consumption, but also employment. For example, a quarter of Americans in private employment work in retail, leisure and hospitality, sectors where work is also often less secure meaning that these jobs are likely to be vulnerable. Early unemployment data reinforces this view. US initial jobless claims increased sharply, reaching 6.6 million in the final week of March, as figure 1 shows.

Corporates

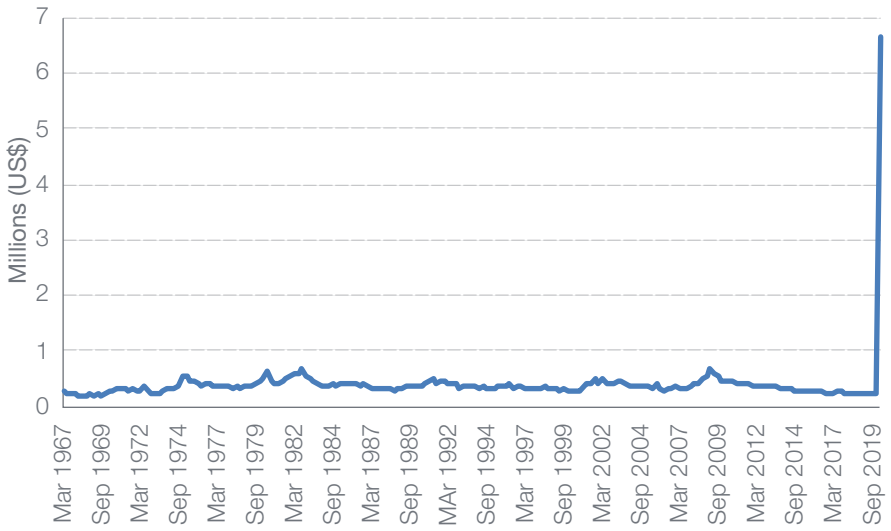
Corporates are experiencing a supply and demand squeeze.

For corporates, the impact of the coronavirus has taken the form of both a supply and a demand shock. As we discussed above, demand has weakened immediately in response to shut-downs. This has, so far, weighed most heavily on services sectors, as figure 2 shows.

This collapse in demand has caused a cash flow crisis for some companies – expected sales will now not be made and this is having a knock-on impact along supply-chains, meaning the consequence is not limited to those sectors directly impacted by social distancing measures.

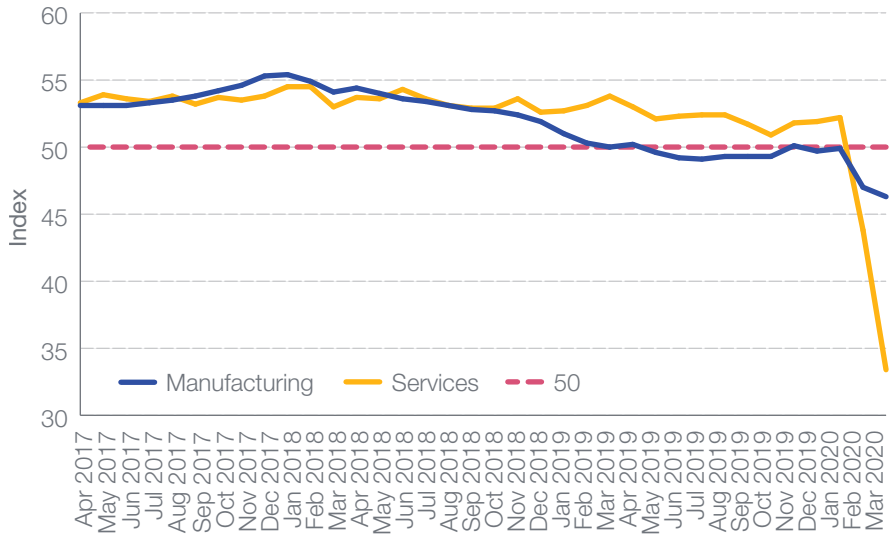
On the supply side, the pandemic has caused supply chain disruptions and is likely impacting worker productivity. School closures mean that a share of the population has to forgo work in order to carry out childcare. Beyond this, productivity in a number of industries may be being negatively impacted, as firms adapt working practices to facilitate social distancing. This is even before we consider those households where an individual is suffering from severe, and sometimes even fatal, symptoms of the coronavirus itself.

Figure 1: US initial jobless claims



Source: Bloomberg Finance L.P..

Figure 2: Average manufacturing and services PMIs



Source: Bloomberg Finance L.P. (PMIs, or Purchasing Managers' Indices, track prevailing economic trends in different sectors. A number above 50 suggests a sector is expanding; below 50 that it is contracting).

Corporates have been impacted by changing financial conditions also. Due to corporates drawing early on credit-lines and increased investor nervousness, we have witnessed a tightening of financial conditions, which has further exacerbated the squeeze on companies.

As with households, we have already seen swift and decisive action from governments, central banks and banking regulators in an effort to get businesses through the pandemic. These efforts have been focussed on providing bridging support to businesses, reducing the cost of finance, and encouraging banks to continue to make credit available. In the UK, in order to maximise the ability of large banks to make loans to the broader economy, the UK banking regulator the Prudential Regulatory Authority has asked these banks not to pay out dividends and similar measures are being introduced in Europe.

Governments

Governments have stepped in, and borrowing will be much higher as a result.

Governments are in the invidious position of balancing the cost to the economy of implementing social distancing measures with the cost to public health of foregoing them. Given the seriousness of the pandemic, most developed market governments have responded with strong social distancing measures which we all hope will be effective at limiting the loss of life, as well as reducing the necessary duration of such measures.

In acting in the interests of public health in this way, governments have necessitated a significant increase in their spending in a way that was hard to imagine before the pandemic. While central banks have long talked about the need for greater fiscal stimulus in order to boost growth, the amounts now required must be beyond what even they reasonably envisaged possible.

However, higher spending to support the economy is likely to result in government debt levels being significantly higher across developed markets in the future. Fortunately, central banks propose to carry out significant purchases of debt instruments, which should help to keep the cost of government borrowing low. Nonetheless, there is no escaping the fact that we will see a sea-change in global debt levels.

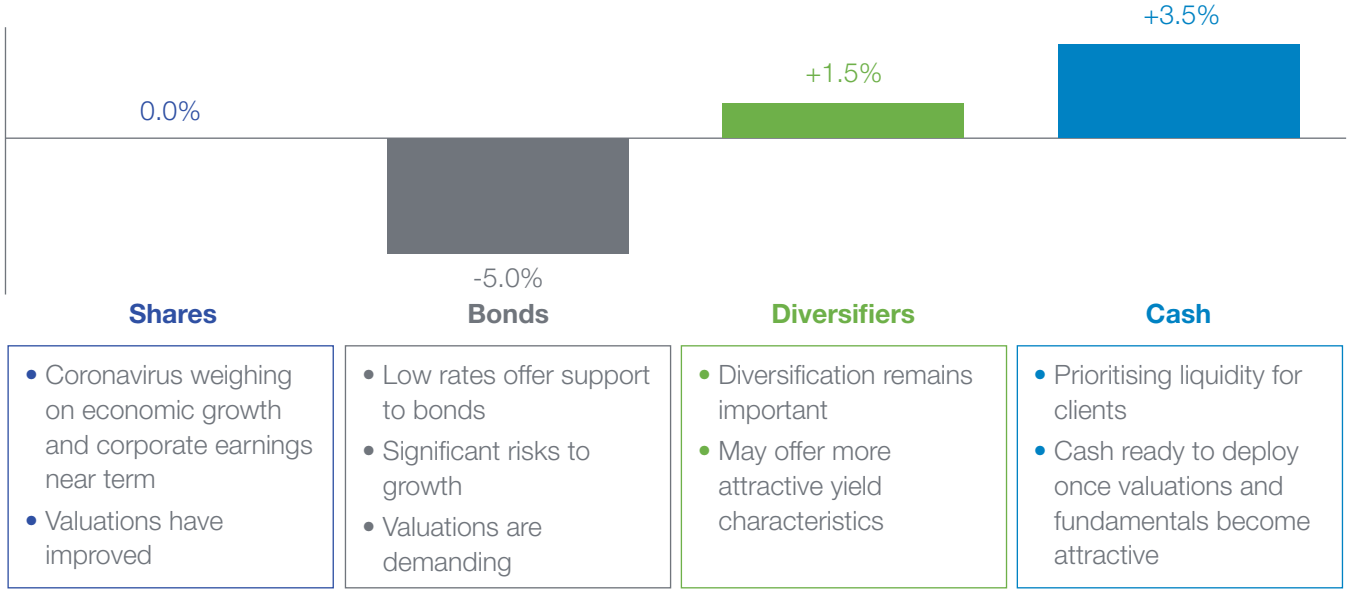
Given that this is a novel strain of virus, the degree of uncertainty as to how long social distancing measures will be necessary presents a significant challenge to governments. Such robust fiscal measures from governments are not sustainable over a longer period, and policy makers will be looking to those countries beginning to roll back measures for clues on which path to take. The quicker this is able to happen without compromising on containing the virus, the better for the global economy.

Positioning portfolios

What is the likely impact of the coronavirus on asset prices?

As we have discussed, we expect global growth to be much lower than usual this year, and this in turn will weigh on corporate earnings growth, and has already caused some dividends to be cut. Share prices have already re-priced sharply, reflecting some of the likely decline in earnings. Given the uncertainty as to

Figure 3: Illustrative positioning relative to long-term neutral allocation



Source: Close Brothers Asset Management.
Illustrative portfolio shows (RP4) Balanced. As at 31 March 2020.

how long shut-downs will last, it is possible that even these pronounced declines may not have fully priced in the likely impact to earnings. On the other hand, we remain open to the notion that progress toward a vaccine or effective treatment may be swifter than experience would give us any right to hope. With this in mind, for now we maintain our neutral allocation to shares.

Within bond markets, the new outlook for global growth makes it likely that interest rates will remain at new lows for longer, which is generally supportive for bonds. However, the marked increase in government bond issuance is a potential source of concern. While central banks have committed to bond-buying programmes, their appetite may not be unlimited.

Across shares and corporate bonds, we have renewed our focus on businesses with ample working capital, as it is these businesses that we believe will be able to weather the current storm. At some point, social distancing measures will be lifted and growth will recover. Our priority now is establishing the right price for assets that will survive the here and now and will be attractive to hold in the longer-term.

Income will remain a challenge for investors. While bonds continue to play an important role in portfolios at times of market stress, bond yields in high-quality securities remain low and dividends are at risk from both weak corporate performance and regulatory intervention. With this in mind, diversifiers with income characteristics may gain renewed importance (see figure 3).

Conclusion

The unprecedented health emergency we are currently experiencing brings with it much uncertainty, but it will pass in time. For the time being, we continue to closely monitor the evolution of the health data in order to better gauge the likely duration of this period of weak growth, and to analyse in detail individual investments, to find those with the greatest near-term resilience and best long-term prospects.

Close Brothers
Asset Management

As active managers, we aim to add value to client portfolios through the tactical asset allocation process (the tilting of asset classes) within agreed ranges and bottom-up security selection. Our **Strategic Policy Committee**, chaired by our Head of Investment Services, determines our tactical asset allocation. The committee uses an analytical framework that focuses on the key issues of economic growth, valuation of asset classes (relative and absolute), liquidity conditions, currency risk and policy management. Members discuss the implications of overweighting and underweighting individual asset classes, using data and judgment before arriving at a shared house view. Within our decision-making process, we incorporate proprietary analytics and research from specialist independent research firms.

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