KINGSWOOD

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Q2 | 2020

INVESTMENT OUTLOOK

SUMMARY

- The global economic downturn is of unprecedented severity but the policy stimulus unleashed is equally unparalleled
- Economic activity should recover now lockdowns are being relaxed but a return to normality is unlikely for some time
- Equity markets have rebounded from their sharp sell-off earlier in the year on the hope of a swift economic recovery
- This looks overly optimistic and equities are likely to fall back near term as valuations are looking expensive again
- Longer term, we are rather more positive as equities usually see substantial gains in the early stages of a bull market
- Within equities, we have turned more cautious on the UK, are less negative on the US and remain positive on Asia
- We retain a sizeable exposure to thematic equities including technology and environmental change
- Corporate bonds look reasonably attractive unlike government bonds where prospective returns are minimal

ECONOMIC AND MARKET OUTLOOK

The first few months of the year were exceptionally volatile for both equity and bond markets.

Global equities saw one of the sharpest ever declines, losing more than 30% in little over 30 days. This was then followed by one of the sharpest ever recoveries, with markets rebounding 25% in the space of just over a month.

The sharp downturn in equities was caused by the prospect of a collapse in economic activity as much of the world went into lockdown in March. Global business confidence fell to record lows in April and in the US, jobless claims have risen 36mn in recent weeks, unwinding all of the employment gains and more since the Global Financial Crisis (GFC).

In the UK, GDP could fall a massive 25-30% in the second quarter. Indeed, the Bank of England is forecasting **UK GDP to shrink 14% over 2020 as a whole,** the largest decline since the Great Frost of 1709. As for global GDP, this could fall by 3% this year, which would compare with a decline of only 0.3% in 2009.

Global business confidence collapsed in April

Source: JPMorgan

Why then have equities bounced back so strongly? The answer is the unprecedented policy stimulus which has been put in place across the world. The fiscal stimulus now amounts to around 6% of global GDP and exceeds that enacted during the GFC. The exact form has varied depending on the country but has generally involved programs to limit the rise in unemployment, income support measures and government-backed loan schemes for companies.

Meanwhile, interest rates have been slashed to almost zero in the US and the UK. Quantitative easing (QE) has also been either restarted or increased in the US, UK, Eurozone and Japan, with the US Federal Reserve initiating a massive new program of bond purchases. **This QE amounts to a direct injection of liquidity into the markets** and has been a major factor behind the recovery in both equities and corporate bonds.

Equally important, however, has been the hope that the stimulus will ensure a rapid recovery in the global economy, particularly now that lockdowns are starting to be eased in Europe and the US. Developments in China have also helped fuel this optimism, as the lockdown has been relaxed for a while now and activity is normalising without yet triggering a major secondary spike in infections.

The policy stimulus will be crucial in preventing major lasting damage to the economies. Even so, it is far from clear how strong the rebound will be. Most obviously, it will depend critically on how quickly and sustainably the lockdowns can be eased.

A vaccine looks unlikely to be developed, tested and made available for mass distribution before mid-2021 at the earliest. Consequently, social distancing looks set to remain a fact of life for at least another year yet. It is also not impossible that a renewed phase of lockdowns could have to be imposed.

If so, quite a few sectors, most obviously travel and hospitality, will be unable to return to anything like normal operating conditions for quite some time. Indeed, this prospect is already causing airlines to lay off, rather than just furlough, a sizeable part of their workforces. It is also questionable how quickly individuals will return to their old free-spending habits given inevitable continuing worries over contracting the virus.

The US-China trade war, the bane of 2019, could also re-emerge as a drag on growth. Tensions have escalated again recently, with the US blaming China for the coronavirus, casting into doubt the viability of the deal agreed early this year.

All this leaves us **sceptical that there will be a sharp V-shaped recovery in the global economy.** Absolute levels of growth will undoubtedly be high, at least initially, but only because the downturn has been so deep. We think it unlikely that economic activity will return to pre-Covid levels until the end of next year, with a risk that it could take longer still.

Price-earnings ratios are looking expensive again

Source: Refinitiv

Taking all this into account, the rebound in equity markets looks overdone. The fall in corporate earnings this year is likely to be larger, and the recovery next year smaller, than the consensus now expects. Global earnings could fall as much as 25% in 2020 and look unlikely to regain all these losses in 2021.

Valuations are also looking on the high side, particularly as major uncertainties remain over the economic outlook. Even using the optimistic consensus earnings forecasts for next year, the global price-earnings ratio is back up to to 15.3, above the long-term average of 14.9.

Equities also no longer have as much support from dividends as they did. A number of high profile UK companies have suspended their pay-outs and dividend payments could fall 30-40% in the UK this year. That said, UK equities still offer a significant pick-up in yield over gilts with the 10-year yield now down to all of 0.25%.

While we believe **global equities are likely to fall back again near term,** we would expect them to move up again in due course. After all, they are still some 15% below their February highs and the economic backdop should improve in time, if not as quickly as the market currently expects.

Past experience is also that global equities usually see substantial increases in the early stages of a bull market. The average gain over the last fifty years has been been 29% over the first six months and 37% over the first year. Consequently we expect **equities in a year's time to be back above current levels – possibly significantly so.**

Global bear markets and recoveries compared

Bear Market	Peak	Trough	% Peak-Trough	% Gain after Trough 6 mths	1 year
Coronavirus	**Feb-20**	**Mar-20**	**-34**	**-**	**-**
Oil Price Collapse	May-15	Feb-16	-20	19	24
Eurozone Crisis	Apr-11	Oct-11	-24	23	22
Global Financial Crisis	Oct-07	Mar-09	-59	63	74
Tech Bubble	Sep-00	Oct-02	-49	10	36
Black Monday	Aug-87	Dec-87	-23	19	28
Recession	Nov-80	Aug-82	-27	36	47
OPEC oil embargo	Jan-73	Oct-74	-46	31	28
Average			**-37**	**29**	**37**

Source: Refinitiv, Kingswood

Moving on to fixed income, the outlook is very different for government bonds than for corporate bonds. Government bond yields have fallen to exceptionally low levels and look certain to rise over time, raising the **prospect of negative returns for UK gilts**. Indeed, the massive monetary and fiscal stimulus poses the risk of a marked pick-up in inflation down the road.

Even so, over the coming year, the rise in government bond yields should be limited. Inflation, near term at least, is falling because of both Covid and the related collapse in oil prices. Central banks also look set to keep rates super low for some time to come. Not only that, QE will absorb most of the bond issuance needed to finance much increased budget deficits.

Corporate bonds, by contrast, look considerably more attractive. Spreads over government bonds widened sharply in the market sell-off and, even though they have narrowed again, they remain some 1% above their pre-Covid levels.

Importantly, credit markets have the support of central banks who are now purchasing corporate bonds as part of their QE programs. As economic conditions slowly return towards normal, spreads should contract further, boosting returns in the process. Even so, spreads are unlikely to return to pre-crisis levels, which were close to historical lows.

This all leaves **corporate bonds set to see mid single digit returns over the coming year.** This is significantly less than we are expecting from equities but corporate bonds do come with considerably smaller downside risk.

POSITIONING

We went into the crisis broadly neutral on equities. By this, we mean equity allocations in portfolios were in line with the weightings we deem appropriate for each risk profile. When market declines left our portfolios underweight in mid-March, we took advantage of the lower prices to top up our positions and return to neutral.

Subsequently in mid-April, on the back of our view that the rebound in markets was overdone, we reduced some of our exposure to UK small and mid cap stocks, leaving us with **a small equity underweight**. Our intention at the moment is to reinvest the cash raised in equities after a correction.

We have turned more cautious on UK equities. Despite valuations remaining attractive, the prospect is now for a deep recession, rather than the pick-up in growth we had been expecting pre-Covid. The gloomier outlook also means small and mid-cap stocks, which are the most sensitive to economic growth, no longer look so attractive.

We have become less negative on US equities even though high valuations remain a background concern. The elections in November pose less of a risk now that the centrist Joe Biden has become the Democratic candidate. Our positive view on the technology and healthcare sectors also adds to the attractions of the US market, which has relatively large weightings in both.

We remain positive on Asia ex Japan and also Emerging Markets which are dominated by Asia these days. Longer term, cheap valuations and relatively strong growth prospects are appealing. Near term, Asia has the attraction that it is dealing with the coronavirus more effectively than elsewere and its economies are recovering quicker as a result.

We remain neutral on Japan. Its cheapness is a positive, as is improving corporate governance, but the weakness of the economy is a concern.

We are not that keen on continental Europe. The structural fragilities and tensions underlying the eurozone have been brought to the fore again by the crisis.

Long term thematic investments remain a major focus for us. We have exposures to technology, artificial intelligence, environmental change and frontier markets, all of which continue to have good long term growth potential. Indeed, the secular forces favouring technology have only been reinforced by the changes which the coronavirus has forced upon all of us.

We also have allocations to infrastructure and global brands, whose defensive characteristics are appealing. Our allocation to alternative assets gives us additional exposure to equities in a risk controlled manner.

In fixed income, our exposure is mainly to corporate bonds given their return prospects are much superior to government bonds. That said, we have only a limited exposure to the riskiest corporate bonds because of the rise in defaults the recession will inevitably trigger. One also needs to protect against unexpected deflationary shocks and government bonds should still provide some protection here, so we have a moderate allocation.

Finally, **we have an allocation to gold** which has performed strongly this year and provided some offset to the declines in risk assets. Gold should continue to garner support from both the very low level of interest rates, quantitative easing and the longer term danger of a major upturn in inflation.

MARKET VIEWS

	Previous view	Change	Current view	
Lower Volatility Assets				
Cash	Negative	-	Negative	Remains unattractive longer term with interest rates so low
Government Bonds	Negative	-	Negative	Yields to trend higher from their very low levels, severely limiting returns
Corporate Bonds	Neutral	⇧	Positive	Spreads have widened out and prospective returns are looking more attractive
Index-linked Bonds	Negative	-	Negative	Inflation should remain low near term at least, limiting their appeal
Lower Volatility Alternatives	Neutral	⇧	Positive	A more attractive source of protection than government bonds
Higher Volatility Assets				
Equities	Neutral	⇩	Negative	Markets have rebounded too far too fast and likely to fall back near term
Higher Volatility Alternatives	Positive	-	Positive	Equity exposure with downside protection is appealing given big uncertainties
Property	Negative	-	Negative	Illiquidity remains a problem and Covid has exacerbated UK high street woes
Gold	Neutral	⇧	Positive	Supported by low rates and a hedge against risk of further major equity sell-off
Equities				
Regions				
UK	Positive	⇩	Neutral	Valuations are still attractive but a deep recession is now in prospect
US	Negative	⇧	Neutral	Election risk is reduced & sector composition a positive but valuations are high
Europe ex UK	Negative	-	Negative	Covid is highlighting once again long-term structural problems of the eurozone
Japan	Neutral	-	Neutral	Valuations are cheap but economy was weak even before Covid
Asia ex Japan	Positive	-	Positive	Economic damage from Covid should be considerably smaller than in rest of world
Emerging Markets	Positive	-	Positive	Cheap valuations and relatively good long term growth prospects remain attractions
Themes				
Global Infrastructure	Positive	-	Positive	Defensive sector offering moderate growth and inflation protection
Global Technology & AI	Positive	-	Positive	Covid has only reinforced the existing strong secular growth story
Global Brands	Positive	-	Positive	Quality nature of these companies is attractive in challenging environment
Frontier Markets	Positive	-	Positive	Attraction of very cheap valuations, structural reform and good demographics
Environmental Change	Positive	-	Positive	Climate change is now major growth area and focus for corporations and investors
Small & Mid Cap Stocks	Positive	⇩	Neutral	Typically lead early stages of bull market but outperformance may be delayed this time

Our view reflects our assessment of the relative attractiveness of each asset class after taking into acccount its riskiness/volatility

Change = change in view over the last quarter

● = Positive ● = Negative ● = Neutral

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