Psigma
Investment Management

View from Psigma

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Tom Becket
Chief Investment Officer

It goes without saying that it has been a wild week in global asset markets, in many ways reminiscent of the violent gyrations that we saw in the final months of 2008.

In very simple terms, the outbreak of volatility in equities and higher risk credits has now spread to other asset markets. The US equity market has had a particularly rocky week last week, even if finishing basically flat on the week, after both major up and down moves each day.

Overall losses were worse in other parts of the world, but the most worrying volatility was seen in the US equity market, which has behaved more in keeping with a frontier equity market and where late last week we saw the VIX or "volatility" index hit levels we hadn't seen since the financial crisis of 2008; before another monster rally in the market in the last 30 minutes of trading helped to curtail losses (another sign that activity within financial markets is unhealthy).

Volatility Across All Asset Markets

The behaviour of fixed income and commodity markets has been even more dramatic than equity markets. The move in the US Treasury market has left me searching for new ways to describe it, but I can't. It is history-making. The US 10-year Treasury is currently trading at around 0.50%; as a guide, a year ago it was 2.64%. The acceleration in the drop has been the clearest sign of "panic" in markets, as investors have sought "safe havens", but we are also sure that there have been some funds holding short positions in US Treasuries that have been forced to "cover" or buy exposure, thereby exacerbating the buying frenzy around US Treasuries.

Markets Increasingly Price in "Deflationary Shock"

The bond market has demonstrated clearly the view taken within the wider markets is that the ongoing situation around Covid-19 will bring another deflationary shock to the global economy, such as we last saw in the China devaluation and commodity crisis episodes of 2015 and early 2016. This could well be true and notably, we saw the crude oil price fall by >30% in the last few days, as fractures in the relationships of global oil producing nations became evermore apparent and concerns over economic growth mounted. This will potentially be troublesome for energy companies' earnings, the prospects for their optically high dividends and the ability of certain energy companies to pay back their loans.

Expect Zero Earnings Growth in 2020

It is certainly interesting to note that this week several large investment banks lowered the prospect for US corporate earnings this year, with the consensus view now for a decline in earnings growth in 2020.

Whilst this is a problem for equity markets, everybody knows that equity markets are risky, and the volatility and declines should come as little surprise.

All Eyes on Credit Markets

A far bigger problem than the oscillations in equity markets would be a decisive deterioration in the now gargantuan corporate credit markets, which have ballooned in size over the last decade and where we have seen increasingly questionable credits issued in the last few years. We've said this a few times already, but it should be very eye-opening that in the last few days we have experienced the largest spike in credit indices' risk measures since 2008-9, in no small part triggered by worries over the energy sector. This is where we should be most worried about "contagion" and were problems to start appearing in the credit markets then that would be a cause for genuine concern, given that is exactly where we have said the biggest risk to the global economy exists. This deserves further comment later in today's note.

The Central Bankers Come Marching In

The Federal Reserve (Fed) shares our view and that (fears over a freezing of credit markets) is why they cut rates in a "surprise" move on Tuesday. They need to both shore up confidence in investors and ease pressures in credit markets. So far, the efforts of the Fed have failed. There has also been no positive impetus from the hundreds of billions of dollars pumped into the financial system this week by the Fed, the European Central Bank (ECB) and the Bank of Japan (BoJ), amongst others. Markets now expect the Fed to cut rates by 75 basis points (0.75%) at their meeting in 10 days' time; history suggests this will be their playbook. Some commentators expect US interest rates to be at 0% before very long; we would have no strong reason to expect anything different. The Fed's natural post-crisis response has been to shoot first, think later; rather than try to alleviate the panic, they themselves are panic epitomised. One of the Fed's members this week questioned out loud whether the credibility of central bankers was being called in to question; I'm amazed that he had the temerity to still ask that question.

Where Next for Fiscal and Monetary Policy?

There are other guideposts from the last few weeks that are worth noting in the monetary and fiscal authorities' likely response to this evolving situation. On Friday, the Federal Reserve wheeled out seven members to speak in public to soothe the growing tensions in markets. Tt didn't work, but there were comments from one Fed member over whether the Fed would have to broaden the scope of the assets they can buy, thereby following the lead of the ECB, who have acquired large swathes of the corporate bond markets, and the BoJ, who have become the largest owner of Japanese equities. Our understanding is that the Fed would need a legal change in their official mandate to buy private assets, but I would rule nothing out at this juncture. It has also become increasingly obvious that the fiscal efforts, led by the Trump administration in an election year, are going to be Herculean. Given that borrowing money is basically free, governments will think "why the hell not" and create a massive fiscal response. The Trump administration is also mulling further tax cuts. This should help to shore up economic activity, even if they might struggle to get people out of their homes and into cinemas, shops, restaurants and public swimming pools, whilst fears over Covid-19 persist. Notably, we have now seen some countries, with Hong Kong being the first, giving out free "helicopter money" to try and boost consumption, which we have long expected to be one of the next moves and another signpost towards our "you ain't seen nothing yet" world.

Are We There Yet?

Putting long term philosophical and financial objections to one side, the pressing question that we need to ask ourselves is whether we have seen enough "panic" to take the view that we are now "through the worst" in financial markets. It is hard to take that view when one would expect the news flow around Covid-19 to get worse in the coming weeks; the pathetically slow and imprecise actions of governments in Europe, the UK and the US have ensured that as testing for Covid-19 finally picks up, the news will become more worrisome. As you know, our view has been that this is far less about the tragic human impact of this virus, but rather about how the fragile balance between fear and confidence is tipping towards the former and that affects decisions that drive economic output. We can have no certainty as to when that will improve.

But Things Have Got Cheaper, Right?

Our assessments must then switch to whether "value" has been created in financial markets because of the recent moves. We are far from sure that it has for three reasons. Firstly, the ongoing reduction to corporate earnings growth means that valuations might not be as cheap as one might expect as the "E" has fallen; indeed, you could easily make the case that equities have become more expensive on a "P/E" basis as you must adjust the earnings denominator. In addition, it is hard to argue that many assets were that cheap in the first place; in part this has been simply a fall to levels that are more realistic from a long-term valuation perspective. Finally, while the falls so far have been heavy in some cases, most notably in sectors like European banks, global commodity companies and Japanese exporters, they have not been as extreme as they might have been given the potential economic impact and the possible damage to corporate profits. Certainly, we haven't seen the purging of the excesses of en vogue investments like the technology sector yet, although it started to underperform last week, but were that to happen we would start to consider a buying opportunity as being presented.

Taking a Proactive View in Credit Markets

Our attention has been mostly focused on our credit allocations and the approach we have of using a small number of select managers helps enormously in such situations. We know exactly what we own within funds, why we own such instruments and how they are performing. Having had calls with each manager last weekend and late the week before last, we have had follow-up conversations in the last few days. So far, the performance of the credit investments has been as we would have expected.

Given some of the funds were defensively positioned heading into this year, we have been in discussions with the managers to selectively add risk to portfolios, as yields have become more attractive.

This is not a case of being "gung-ho" but taking a measured approach to increasing risk on very down days. To be clear, we have been hoping for volatility to afford ourselves the opportunity to gain further exposure to credit instruments at more attractive yields. This might be premature now, but by being selective and buying assets where we have a high degree of certainty now feels appropriate.

Conclusion

Broadly, we feel that a significant step up in risk of our portfolios at this time would be irresponsible. It is impossible to predict the economic path at this juncture and trying to balance the authorities' response against the likely economic damage is precariously difficult. However, targeted and tactical increases to oversold investments are probably sensible and we are pursuing such a strategy in both equity and credit markets. Further out, there are some obvious pockets of potentially extremely oversold assets, so creating a "shopping list" of investments to buy makes sense. One of the key factors to take into consideration is that with yield now becoming virtually extinct in core "fixed interest" markets, investors will be forced more deeply into risky asset markets, where income is still available. Whilst there remains a high degree of uncertainty, we will persist with our balanced and diversified approach, keep an open mind and promise to update you as best we can.

Tom Becket
Chief Investment Officer

For further insights from our CIO Tom Becket check out the Psigma Voice, our communication platform providng you with a variety of investment and market commentary.

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Psigma
Investment Management

client.services@psigma.com
businessdevelopment@psigma.com
www.psigma.com

@PsigmaIM

company/psigma-investment-management

London

11 Strand,
London,
WC2N 5HR

+44 (0)20 3327 5450

Birmingham

4 Temple Row,
Birmingham,
B2 5HG

+44 (0)121 230 1937

Edinburgh

The Capital Building,
12/13 St Andrew Square,
Edinburgh, EH2 2AF

+44 (0)330 094 0090

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defaqto 2013 – 2020 DFM MPS Direct

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