Psigma
Investment Management

Quarter 1 2020

View from Psigma

17TH MARCH 2020

Tom Becket
Chief Investment Officer

After one of the most extraordinary periods in recent economic and market history, we thought it would be useful to update you briefly on our core views. We would also like to take this opportunity to contact you personally in order to keep you updated on the actions that we are taking in these troubled times.

The health and safety of both our clients and staff is of paramount importance, but we will do everything we can to ensure that there is as little disruption as possible to our services during the coming weeks and months.

We are encouraging staff to work from home as much as possible and have introduced where appropriate a rota system to ensure there is team coverage in the office. We have suggested that, whenever possible, meetings are conducted by telephone rather than in person, and if you have a meeting planned, we will be in contact to discuss the options available.

Global Economic Outlook

As we see it, there are three different possible outcomes from the ongoing Covid-19 crisis enveloping the world: namely, a base, a bear and a bull case. We need to ensure that our investment strategies respect each outcome. It is likely that markets oscillate between each of these views over the next few months.

1: "Base Case" Outcome

Our "base case" is that we have a savage and sharp economic deterioration in the first half of 2020. If the global authorities further strengthen their actions to curtail the worst elements of the virus in the developed world, economic improvement in the latter half of the year should be strong, but this will come at the price of a more severe economic downturn now. This is effectively a U-shaped recovery. The subsequent recovery should be fuelled by inventory restocking and the fulfilment of pent-up demand, and will be aided by the policies of the fiscal and monetary authorities. We would assign a 60% chance to this outcome; how much damage is done in the short term is hard to predict at this juncture, but we are of the view that harsh medicine now will be better for the long-term health of the economy.

2: "Bear Case" Outcome

Our "bear case" would assume an L-shaped recovery. This would mean that we see no economic improvement for the remainder of this year. We should not ignore this outcome, as we simply don't know how bad this situation will become. Moreover, if we start to see "second round effects" as China goes back to work, or we see a return of the virus in the winter, as was the case with the "Spanish Flu" pandemic of 1918, then a protracted economic downturn is certainly possible. We would assign a 20% chance of such an outcome becoming reality.

3: "Bull Case" Outcome

There is also a "bull" or optimistic scenario, which again is impossible to ignore. Should the worst effects of the virus dissipate sooner than currently expected, potentially as the Northern Hemisphere starts to warm up, then this could pass quite quickly. When the natural economic recovery meets the potent fiscal and monetary assistance measures, we could see a hugely powerful burst of economic growth, which would likely be very positive for risk assets. We have assigned a 20% probability to this outcome.

Where Are We Now?

Our interpretation remains that news flow is going to continue to deteriorate as the authorities ramp up testing for Covid-19 in Europe and North America. It is obvious that the problems are far worse than governments initially assumed and that they have been completely caught off-guard. We should expect an intensification of the shutdown of the Western economies, which we have now started to see in recent days, as this seems to be what has helped in China and South Korea. Of course, this brings greater peril to the short-term economic trajectory and is akin to the "economic heart attack" that we experienced in 2008; but this "tough medicine" might be what is needed here. It is impossible to say whether this is real or too conservative, but it would be wise to prepare for any economic outcome, given the pervasive uncertainty that currently lingers.

Monetary Policy

Each day we are seeing fresh monetary measures announced. So far, we have seen large cuts to interest rates in those countries where that was possible, including the US (where astoundingly interest rates have been cut to 0%), Canada and the UK. We would expect interest rates to be held near 0% for a long while ahead. We see interest rate cuts as near pointless. There is already plenty of liquidity for those who banks want to lend to; the problem has been getting credit to those companies that banks don't want to extend credit to. Therefore, the measures announced by the Bank of England and the European Central Bank last week to help in this regard were positive and it is reassuring to now see that the Federal Reserve is following suit. Such packages should help the flow of money in the financial system at a time when it is at significant risk of seizing up.

We always urge people to view the global economy as an economic engine, with bank lending as the oil that keeps the engine working; what central bankers must do is avoid the experience of the autumn of 2008 when banks and companies stopped lending to each other through lack of trust.

Fiscal Policy

The simple message is that governments are going to throw all that they can at this situation and hopefully that will limit some of the economic downside in the short term. It is impossible to know where the balance lies between fiscal packages and the swingeing effects of the impending shutdown of economies in the West, but governments are now waking up to the seriousness of this issue and starting to increase financial support. This will obviously have negative impacts upon the debt levels and debt sustainability of governments in the long term, but this is a "shoot first, deal with the consequences later" situation. Whether US politicians can come together and announce anything sizeable and sensible in an election year is a question for the coming months. We view the actions announced by the UK Treasury at the recent budget as sensible, and they should lead to a strong rebound in the UK economy later this year, once the worst effects of this virus start to dissipate.

Financial Markets

The intense volatility and pace of the declines aside, what we have seen in terms of the direction of broad asset markets mostly makes sense. Equity markets have retraced from record levels, as the expectation for corporate profits has been reduced aggressively. Statements around how equities are cheap are not useful at this time, because we have no idea where earnings will come in for the year ahead and how quickly the economy will recover. We are keeping very "open-minded" and will assess the ongoing situation as it develops.

Corporate credit markets have also started to weaken. The credit markets have been hit by the twin threats of a deterioration in broad economic conditions and the oil price war between the Saudis and the Russians. Given the high weighting of the energy sector in markets like US high yield, these falls were unsurprising, and we should be clear that we have very limited exposure to energy company debt.

The readjustment in credit prices makes sense, with the future direction set to be determined by the length of the economic downturn. There is likely to be a material spike in the default rate, albeit from historically low levels.

Our Investment Strategy

We continue to work very closely with our selected external managers, and we are reassured by the discussions we have had. There have been no funds that behaved "unpredictably" during this recent sell-off. Our investment process has been specifically designed to ensure that at times such as these we are able to stay on top of every position in our portfolios, due to the concentrated nature of our fund buy list. With a longer buy list it would be impossible to conduct the level of research and the updates we have had over the last month. We have had weekly updates with every manager that we needed to, as well as more frequent discussions with managers in the credit and alternatives arenas.

We have started to become more tactical with our equity allocations. As you may be aware, we reduced exposure to those equity investments that we felt were most expensive in February. More recently, we have moved to top up positions in global equities, which have become very oversold in the short term. This is also to ensure that if a recovery does ensue, we are positioned to benefit from it. We have enough "dry powder" in the form of cash and short-dated liquid credit to accelerate this strategy if we feel it is suitable to do so.

Two weeks ago, we started to aggressively reduce and take profits from our short-term inflation-linked bonds allocation. This made sense as we expected a collapse in inflation expectations. This decision has also been helped by the further falls in inflation expectations brought about by the declines in the oil price.

Most recently we have used the serious weakness in gold equities to increase our allocations. We feel a sensational opportunity has been presented by the indiscriminate liquidations taking place in markets and we moved quickly to try and buy further exposure at what we believe are bargain prices.

We have not made major adjustments to our credit funds and mandates. One of the managers we use in the US has been gradually increasing risk from a defensive starting point, but others are holding on to existing positions and focusing on trying to find a better time to increase risk. We have identified a list of assets that we would like to buy in some of our credit funds, but the managers believe that a better entry point will present itself and we do not disagree.

Conclusion

Hopefully this latest update provides you with "up to the minute" views on the economic outlook, what to expect from asset markets going forward and an explanation of the various moving parts that are currently contributing towards a complicated picture. We must admit that there are plenty of unknowable factors making investments precarious at this time. However, we can assure you that we are keeping open-minded and endeavouring to use the volatility to the benefit of our investment strategies. While the short-term outlook looks extremely concerning, we must ensure we are in a sensible position to benefit from the recovery when it presents itself. The most optimistic thing we can state at this time is that if the governments and authorities can act decisively, there are finally some attractive valuations and a growing list of investable opportunities for us to exploit later this year. For now, we can only promise to keep you updated as best as possible and encourage you to please let us know if we can do anything else to help you at this time.

John Howard-Smith
Chief Executive Officer

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.

www.psigma.com/psigma-voice/

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

defaqto 2013 – 2020 DFM Bespoke

defaqto 2013 – 2020 DFM MPS Direct

defaqto 2016 – 2020 DFM MPS on Platform

3D 2019 PSIGMA INVESTMENT MANAGEMENT LIMITED AWARDED BY ARC

Important information

This document is prepared for general circulation and is intended to provide information only. The information contained within this document has been obtained from industry sources that we believe to be reliable and accurate at the time of writing. It is not intended to be construed as a solicitation for the sale of any particular investment nor as investment advice and does not have regard to the specific investment objectives, financial situation, capacity for loss, and particular needs of any person to whom it is presented. The investments contained in this document may not be suitable for all investors. Prospective investors should consider carefully whether any of the investments contained in this document are suitable for them in light of their circumstances and financial resources.

If you are in any doubt whether any of the investments contained in this document are suitable, you should speak to your Investment Director, or take appropriate advice from a professional adviser, such as an accountant, lawyer or Financial Adviser authorised and regulated by the Financial Conduct Authority.

Investment Risks:

- The value of investments and the income from them can fall as well as rise. An investor may not get back the amount of money that he/she invests. Past performance is not a guide to future performance.
- Foreign currency denominated investments are subject to fluctuations in exchange rates that could have a positive or adverse effect on the value of, and income from, the investment.
- Investors should consult their professional advisers on the possible tax and other consequences of their holding any of the investments contained in this publication.

(L6_BVFP_2020-033_FINAL)