Psigma
Investment Management

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View from Psigma
VALUATION COMMENTARY

Tom Becket
Chief Investment Officer

Over the years of managing investments for our clients, we have seen a fair number of crises. In the last decade alone, we have experienced financial crises, sovereign debt crises, corporate credit crises, political crises, geopolitical crises, currency crises and commodity crises.

Whilst dealing with the effects of those varied predicaments has left us both battle ready and experienced with market shocks, nothing we have seen before could have prepared us for the extraordinary events of the first few months of this nascent decade.

Indeed, as we mused at the start of the year about the potential for the decade ahead to be "the Turbulent Twenties", and wondered what would eventually bring about the conclusion of the long business and economic cycle that started soon after the Great Financial Crisis of 2008, we obviously had no idea that it would be a global pandemic.

A Combination of Crises

However, as investors we are forced to play the cards that we are dealt and must stick to the long-term plans that we have created to help our clients achieve their investment aims. In truth, such resolve to focus on the "long game" has been uniquely difficult during a period where a medical crisis triggered an economic crisis, which in turn led to financial system liquidity crisis, thereby setting off a market crisis.

The levels of volatility suffered in March were the worst we have endured in the life of our business, surpassing those that we experienced in 2008. When one also mixes in the geopolitical gyrations caused by the deteriorating relationship between the US and China, the unravelling of the last three decades of globalisation, and OPEC-inspired turbulence in global commodity prices, we could understand why any investor would be put off venturing back "into the water" any time soon. That would be a mistake. As we have learned from the eventual recoveries from previous market crises, it is times such as these that the seeds for positive long-term returns are sown.

In this View, we discuss the short-term outlook for the next few months, as well as detailing how we think the post-virus world will look, before assessing the implications for asset markets and our investment strategies.

The Key Message for Investors

Certainly, we think that the prospects for long-term returns from a range of investments are now as attractive as they have been for years and, in some cases, even as good as they were in the depths of the crisis of 2008. However, we realise that we are dealing with an enigmatic situation in the form of the COVID-19 crisis and asset markets could well continue their declines after the welcome period of improvement of the last few weeks. In order to try and evaluate the likely path forward for asset markets, there are several factors for us to consider.

Diagnostic Testing Vital for Resumption of Economy

Whilst the medical situation is troubling for us all and tragic for anyone sadly suffering its worst effects, what matters to investors is the response of various governments, and signs as to when the global economy can once again get up towards "full speed". It is becoming increasingly clear that for economies to reopen and the regional "shutdowns" to be lifted, we must see major developments in diagnostic testing for COVID-19.

Unfortunately, as with the various governments' ham-fisted initial responses to the emergence of the pandemic, decisive progress with widespread testing has mostly been elusive. Moreover, we must recognise that a test might state whether you have or haven't had COVID-19, but it can't predict the future. It would therefore seem likely that we will start to see the current lockdowns relaxed or reversed in the western world over the next four to six weeks, allowing a gradual improvement in economic conditions through the following months, before some form of "economic normality" returns towards the end of the year.

There are both positive and negative risks to this forecast, but this seems sensible as a "base" case and nothing we have learned since our last written update has markedly swayed our thinking around this central scenario.

Equity Markets Price in a Brighter Tomorrow

The economic impacts included within our base case are very severe in the short term. Unemployment rates will rise swiftly, business decisions will be delayed, and the mindset of most economic participants will switch from "growth" to "survival" mode. Trying to frame the likely future economic scenario with numbers is almost pointless at present and we would note that the range of economic projections from various sources has never been so wide.

In very simple terms, what we are about to witness is the sharpest and most severe economic shock since the end of the World War Two. Given that this is the economic reality, one could legitimately ask why asset markets haven't performed worse since the start of the year, particularly after the healthy recovery in risky assets' prices at the start of this new quarter. The view that equity markets appear to be taking is that while 2020 is a "write-off" in terms of corporate profits growth, the rebound in 2021 will be sharp and we will all be spending to make up for lost time. We would view this as Panglossian; it would seem much more likely to us that the eventual economic recovery will be truncated, as various governments pursue different routes to reopening and global supply chains take time to readjust. That is not to say that we don't think that some equity markets can't make further gains, but rather that we would rather wait until we are convinced of a prospective stabilisation in companies' profits and cash flows before deciding to structurally increase our allocations to equity investments.

Governments Step into Economic Void

It could well be that equity markets are not implying a rapid recovery in corporate profitability but are rather recuperating from the ravages of the first quarter due to the potent potions of government stimulus and central banks' monetary measures. Governments have rightly taken the view that they will do "whatever it takes" to assuage the worst impacts of their own economic decisions. It is just a shame that so many of the governments of the world went into this specific crisis with their wallets empty and their debt at already precariously high levels.

The Charge of the Central Bankers

The day of reckoning over the financial consequences of the debt accumulation necessitated for fighting this crisis has been put off by the aggressive and swift actions of the major central banks, who have dusted off their printing presses, hit the start button and cranked them up to full power.

In the last few weeks alone, we have seen central banks from across the developed world commit to printing money to buy large swathes of their domestic asset markets, including government bonds, investment grade corporate bonds, high yield corporate bonds, municipal bonds, asset backed securities, mortgage backed securities and, in the case of the Bank of Japan, domestic equities. Their efforts have already gone above and beyond what we saw in the last major crisis of 2008.

In our view, this imprecise and blunt application of liquidity into markets is what limited the falls of the first quarter and has expedited the short-term recovery in asset prices. In very simple terms, the governments and central banks are trying to fill the black hole created by the COVID-19 response, and asset markets are currently implying that they will be successful.

Key Long-Term Conclusions

Having already discussed the immediate outlook, it is now important to look through the deafening short-term noise of markets and analyse what we think will be the long-term consequences of the ongoing situation that we are facing. Concerning the medical state, it is only when a vaccine is widely in use that the global economic engine will be able to purr rather than the stuttering that we expect in the coming quarters; this is likely to be in early 2021. We also consider elements of the economy will change forever, including working habits and some of our daily practices. A large part of the economic output "lost" in 2020 will not be recovered.

We are increasingly convinced that interest rates in the developed world will have to stay at close to zero for as long as we can realistically forecast, to help manage the teetering debt piles accumulated in the ongoing crisis. It is also impossible to imagine a future without persistently aggressive monetary easing to both calm markets and aid governments to foot future bills and obligations.

Inflation will now ultimately accelerate following a sustained period of moderate inflation rates, as government spending and loose monetary policies combine with truncated global supply chains, in an era where "reshoring" production of strategically important products is fashionable. A rise in inflation could also contribute towards more political uncertainty.

Creating the Right Balance

The key points outlined already in this piece lead to both positive and negative conclusions for asset markets. The result is that we will persist with a balance across our investment strategies, with the major decision that we must make remaining 'how much of a portfolio do we own in defensive and offensive investments'?

There were points in March when every asset was falling in unison in a genuinely worrying phase for global asset markets, until the aggressive actions of central banks provided support, but, taking a longer-term view, we recognise there will be assets that offer protection and others that will suffer, should economic weakness persist. Currently our broad assessment leaves us with asset allocations that are underweight equities and overweight cash and short-term corporate bonds.

We view conventional government bonds as "return-free risk" and highly vulnerable to any return of inflation or a surfacing of fears over the sustainability of government debt levels.

Inflation Protection

To protect against rising inflationary pressures, we also have diversification in the form of inflation-linked bonds, commodities and gold mining shares. Gold mining shares are perhaps one of the best examples of the volatility that we have seen so far this year; in the first quarter of 2020, the gold mining index was down 14.6% in GBP, despite the attractiveness of gold investments in such troubling economic times, before it rebounded 21.5% in GBP from the start of the second quarter to the start of the long Easter weekend. Ultimately, we believe such investments have the potential to add significantly to recent gains.

Focusing on Opportunities in Credit Markets

The best prospects that we can currently identify are in selective credit markets, where there are presently exceptional opportunities on a level with those that we saw in 2008. It is on such investments that we are primarily focusing our attention and where we are convinced that we can create the best long-term returns from any recovery from today's medical, economic and market troubles.

Corporate and consumer debt prices have been understandably weak in recent months, but there are reasons to believe that future returns will be very attractive. A key factor is the view that investment income is now an increasingly scarce commodity; interest rates are going to be at zero for a long time and it has become clear that equity dividend income will be greatly reduced due to economic uncertainty. The fact that companies are shelving growth plans to focus on survival also helps the prospects for bondholders to get paid their interest during the term of a loan and to receive their principal back at redemption.

Another major pillar of our positive thesis is that the actions of governments and central banks have been specifically designed to prevent a structural rise in loan defaults. Certainly, it would be naïve to assume that defaults will not rise from today's low levels, but as long as an investor focuses on specific credits and understands the idiosyncratic risks to those investments, then future returns from today's cheap valuations could be very powerful.

Conclusion

The events of the last few months have left us all in a state of disbelief and having to deal with an array of new challenges. As investors, we need to analyse and deal with the immediate risks that the medical, economic and market predicaments create, but we also need to be level-headed and open-minded enough to take advantage of the opportunities that are thrown up by the volatility that has been unleashed over the last few months.

We do not expect the volatility to subside in the coming months, but we must focus on the long term and recognise that we will get through this situation. As in previous crises, it is the decisions that we make today that will ultimately lead to long-term investment returns; we feel confident in being able to achieve our clients' long-term aims and excited by the potential returns of certain investments in the years ahead.

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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