Psigma
Investment Management

View from Psigma
VALUATION COMMENTARY

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It's hard to believe it has only been three months since we wrote our last valuation commentary for the end of the first quarter. Reading back through all the update notes that we have written this year, it is obvious that both the terms "unprecedented" and "uncertainty" have been en vogue. Sadly, they still remain fashionable as we enter the second half of the year, but at least now we are writing these words after an exceptionally strong period for all asset markets, which has allowed investors to claw back the vast majority of the losses experienced in a challenging opening to the year.

In today's latest update, we will endeavour to predict what might happen in the next few months and give some longer-term context to what investors might expect as we progress further into the decade that we entitled "the Turbulent Twenties" before it even began. Worryingly, this description looks prophetic thus far.

Conclusions from our Investment Conference

To try and help us put together the pieces of a particularly testing global economic, political and market jigsaw, we gathered together 16 of the external fund managers that we work closely with from the world of global asset management in late June for a Virtual Investment Conference. The presenters were specifically selected for their different perspectives from a variety of backgrounds and asset class specialisations. They were deliberately chosen from the range of our contacts on the basis that they were not considered to be structurally "optimistic" or "pessimistic" and were renowned for flexibility in their views. The conclusions that we gleaned were fascinating, even if the weeklong event threw up as many fresh questions as it did answers. In fairness, this result reflects the fitting nature of the terms "unprecedented" and "uncertainty". There was an equal balance between those who were positive and those who were more cautious on the economy as it emerged from the first phase of the COVID-19 crisis. There was a roughly identical split between those who felt that the market recovery had gone "too far, too quickly" in the last few months and those who felt that investors would be handsomely rewarded for staying the course through the unpredictable months ahead. Reassuringly, all of the presenters gave us confidence in the specific investments that they manage on our clients' behalf, which in turn gave us confidence both in the funds that they manage and the overall balance of our current investment strategies.

Why the future is so uncertain

It would be easy to take those conclusions from some of the brightest minds in finance and refuse any views of our own under the cover of "uncertainty", but as investors of our clients' valuable assets, we do not have the luxury of throwing our hands up in the air and protesting that it is too hard to have a view, even if the outlook is perilously hard to predict. It is from a medical perspective that the ability to calculate the future is most challenging. The medical situation around COVID-19, including the development of therapeutics and vaccinations, is constantly shifting, and thoughts can become outdated very quickly. Our current view is that we are surprised by how relaxed many appear to be from a global perspective over the currently unconquered virus. Certainly, the situations in North Asia, Europe and the UK appear to be more manageable, even if we are seeing evidence of further outbreaks in all those regions, as they progress with a gradual reopening of their economies. On the other hand, the situation in the US and many of the emerging nations remains troubling and it is becoming quite clear that restarting the global economy is not going to be easy. The good news is that there have been positive developments on dealing with patients who have contracted the virus, and death rates in many places are thankfully declining. However, the situation around vaccines appears to be less certain, with our contacts in the medical sector suggesting that the securing of any preventive measure is far from definite, even if we should take comfort from the financial and mental resources being employed in its search. If there needs to be the successful development and distribution of a vaccine before consumer and corporate behaviour can return to the status quo ante COVID-19, then the outlook for the economy is very questionable.

Unsteady as she goes

Whilst medical forecasts are certainly not our forte, we do have more experience in evaluating economic prospects. The crystal ball is understandably cloudy at this point in time, due to the inconclusive medical situation, but our view remains that an initial sharp "V" shaped recovery, from a point of extraordinary economic weakness, will give way to a shallower rise in economic output, as structural impairments from the COVID-19 crisis weigh on potential growth. The "cloudiness" in our forecasts come from the "unprecedented" government and central bank support that has been provided to the global economy. Indeed, all governments around the world are rushing to spend as much money as they can, to try to ward off the worst impacts of the enforced shutdowns they placed their countries under. Let's try to forget the fact that governments don't have any money for now. At this time, we do not know exactly where the weighing scales will tip as the results of these fiscal stimuli become clearer. We also cannot be precise in adjudging what economic impetus will be secured from the $6trn (and counting) of fresh money that has been printed by central banks and used to buy public and private assets across a growing range of financial markets. This financial alchemy of central bankers is unrivalled through history, both in terms of size and "innovation", and stating with certainty how it will eventually affect economic activity is open to wide interpretation. As we see it, the obvious risks of the uncontrolled and unending central bank activity are a further debasement of "paper money", a rise in secular inflation and a continuing widening of the gap between those who own assets and those who don't. At the current time, there are very few joining us in questioning the negative side-effects, with most just relieved at the opportunity to make short term gains.

Liquidity is the most important factor

Investors' responses to the actions of the governments and the central banks have been unwaveringly bullish. The economic outlook and corporate fundamentals have been largely ignored, as investors have chosen instead to ride the central bank liquidity wave. For those who can't quite grasp the arcane terminology of "asset purchase programmes" and "quantitative easing", the basic premise is actually very simple: central banks have so far printed $6trn in new dollars, euros, pounds, yen and other currencies and bought low-risk assets at high prices from the banks and investors to encourage them to buy riskier assets, with the implicit guarantee that central banks "have their backs" and there are basically no risks associated with buying "risky" assets. We can all see from the "unprecedented" recovery in asset values in the last three months that the central banks have been successful in their aims. However, we think that the magic wand of central banks and the spell they have cast over financial markets is not an absolute guarantee of a relentless march higher in asset prices. Firstly, can central banks and governments continue their "hand in hand" support of asset markets forever? In addition, what happens if the economic outlook does not become positive enough to support expensive asset valuations? Furthermore, what happens if investors start to baulk at the enormous amount of debt issuance from governments like the US, where a fiscal deficit of close to 20% of GDP this year will take debt levels from $24trn to c$30trn, or the UK, where our debt levels relative to total GDP of the UK economy has surpassed 100% in recent weeks for the first time since 1963? All of these questions remain fully unanswered and factors we need to assess in the coming years.

Can asset markets continue to rise?

At least for the time being, central banks have made clear that they are fully on the side of investors. The assumption we could all make, therefore, is that asset prices could divorce from economic fundamentals indefinitely. However, that is not our view. We feel that for asset prices to maintain their recent gains or to push on to higher levels, we will need to see confirmation that economic activity is starting to improve. From the perspective of investing in corporate credit, we will need to see evidence that the worst fears of corporate defaults that were made a few months ago will not be realised. We are comforted that with markets now steadier, with companies being able to refinance their debts easily and with the view that the economy will gradually recover, investors in corporate bonds should continue to make healthy returns, albeit at a slower and more volatile pace than has been enjoyed in the last three months. The outlook for equity markets is less certain, not least as valuations of many global markets have moved into "expensive" territory, and it is hard to forecast with any certainty how strong the recovery in corporate profitability will be. Generally, we see the recent move higher in equity markets and valuations as having overshot short term economic fundamentals and we have taken a tactically cautious view, having been more positive on equity markets at the end of the first quarter of 2020.

Opportunities abound for investors

While our allocations to equities have been reduced and we are storing up higher levels of cash within our portfolios than normal, this should not be viewed as a negative long-term view on the potential to achieve our clients' long-term investment aims. Indeed, we continue to be very positive about the prospects of many geographic regions and equity sectors. While certain indices are very expensive, not least the behemoth US equity market, others are cheap by comparison to history, and we remain optimistic about the potential for returns from Asia, Japan and the UK. In addition, our recent Investment Conference reminded us of the opportunity to make money from developments in sectors such as technology, healthcare, infrastructure and "green" energy. Away from equity markets, we remain excited about the income opportunities on offer from a range of corporate and consumer credit markets, which is where we continue to focus much of our attention. We are also enthusiastic about the yields on offer from certain emerging market countries' debt, where we feel that adequate compensation is being paid for the risks that one takes investing in such markets. In other less well-travelled markets, we can still find opportunities to exploit amongst investments in precious metals and commodity markets, which can provide protection against any rise in inflation: a risk which is too easily discounted by markets at this time.

Conclusion

It would be easy for all of us to retreat into the bunker at the end of a truly "unprecedented" period for the world, the global economy and financial markets. We are satisfied with the improvement we have seen in asset values and respectful of the risks that the lingering "uncertainty" brings to financial markets. We have tried today to outline the economic recovery and the path for markets ahead; we feel that both will be "bumpy" and "brittle" and that risks remain for investors, despite the obvious helping hand of governments and central banks. We continue to "do as we always do" with portfolios: invest in a balanced fashion, create diversified investment strategies and focus on long-term investment opportunities. We feel strongly that this approach is the best way to manage portfolios through further "unprecedented uncertainty" in the years ahead.

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