Psigma Investment Management

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Your Questions Answered

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Tom Becket, Chief Investment Officer, answers some commonly asked questions about the impact of the coronavirus on financial markets and the wider economy. The questions below were raised during our new recent webinars and come directly from our advisers and clients.

How can we explain recent market strength versus economic weakness?

The most repeatedly received question in the last few months has been, "how can we explain the growing disconnect between asset market performance and the global economy?". In very simple terms, asset markets have made a near-full recovery since the miserable month of March, while the global economy is suffering its worst period of economic growth since the end of the World War Two. In our view, there are two main explanations for the surge in asset prices: unprecedented levels of liquidity, and optimism about the future. In terms of liquidity, there have been trillions of dollars, euros, pounds, yen and other currencies printed and handed to the banks and investors to splurge on financial assets in recent months. Global asset markets are floating atop the crest of a wave of freshly printed money. This "wall of money" first supported then drove asset prices higher. This aggressive money printing has contributed towards rich asset valuations, which some commentators are justifying on the basis that the combination of the trillions of dollars of monetary easing and the trillions of dollars of fiscal stimulus will lead to a full economic recovery next year. We would rule nothing out at this time, and we continue to stress that we are experiencing a period for the global economy without historical parallels to help us model future economic output.

However, our "base case" remains that governments and central banks have probably so far only done enough to help fill the economic output hole, rather than spur new growth, and this leads us to believe that the global economy will see a "U" rather than a "V" shaped recovery. Certainly, there will be a powerful recovery from the desperate economic centration we have suffered, but we are unconvinced that a full recovery will take place as speedily as markets imply. This ensures that our key conclusion is that markets better reflect liquidity rather than actual economic conditions. We should all note that this disconnect could persist for a long time into the future, not least as we see a new policy launched nearly every day from increasingly active central banks. However, we have used the recent investor exuberance as an opportunity to take profits across our investment strategies, reverse the increase to risk that we took in March, and prepare our clients' portfolios for potentially volatile times ahead.

What could bring about increased market volatility again?

Given that "second waves" are currently very fashionable discussion points, we should start there. The perceived wisdom is that we are likely to see a "second wave" of COVID-19 infections later in the year, as the northern hemisphere starts to cool once again. We are not medical experts, so we are being guided by medical experts' views, but this could well be something to trigger a "second wave" of selling in asset markets. However, we would also note that in the UK, the US and many developing nations, it is far from apparent that the first wave of this virus has been conquered conclusively. The situation in some of the US states and many emerging nations remains desperate and further signs of victory on a global scale need to be seen before we can breathe the same sigh of relief that many asset markets have seen in recent months.

Aside from medical concerns, we have been asked whether it might be the reality of persistently lower economic growth or corporate earnings that leads to a return of "reality" over "hope" in global equity markets. It is certainly possible, but the obvious attitude on display from investors is that "2020 is a write off; let's look to a brighter future". We are not sure that this laissez-faire stance is currently appropriate and if, as we suspect, corporate profits don't rebound as impressively as is being factored into asset prices, then this could well be the pre-eminent factor behind a renewed troubling period for equity markets. This is a key reason behind our recent efforts to de-risk our investment strategies after the healthy recovery in asset values since the March lows.

Is "Brexit" potentially happening at the worst time possible for the UK economy?

Unsurprisingly, the most frequently raised question on the webinar and in other client conversations concerns the seemingly never-ending tale of "Brexit". We must be honest and say that any further economic uncertainty for the UK economy and indeed for Europe is unhelpful at this time. To some extent, markets have become focused on other matters in the last few months and there are obvious signs of "Brexit fatigue" from investors. It could also be that markets assume that the normal pattern of dealings with Europe occurs and that discussions drag on to the very last minute before a deal is struck. We are not sure that this is the case this time around and our view of the last four years has not changed; any deal will be near-impossible to achieve and will please almost nobody.

There is clearly a not insignificant chance that the UK leaves Europe at the end of the year with no agreement. This would likely lead to a short-term underperformance of sterling and repeated weakness in parts of the UK equity market. This would not necessarily be a disastrous situation for our portfolios; as we saw in 2016, we have the tools to protect portfolios and sterling weakness can provide a boost to portfolio returns. From a medium-term view, we are relatively optimistic on the UK economy and on the pound, not least as many other parts of the world have serious issues themselves, and we expect UK investments to outperform in the future, albeit after a period of sustained relative disappointment. Frankly, I'm sure like many of you, we now just want the whole situation to be concluded and to hopefully refocus upon making positive investment returns from UK investments.

Could the equity "growth" theme continue to outperform "value"?

In a similar vein to our "expect the unexpected" economic prognosis, we should not rule out that the recent trends of a marked outperformance from the very fashionable "growth" areas of equity markets continue long into the future. At this time our client portfolios are balanced between "growth" and "value" equity investments and we will continue with this blend in the short term. When we have taken profits recently, it was from both sides of the "growth" and "value" split of our equity allocations.

However, there are a few observations we would make as we assess the balance of our portfolios beyond tactical trading decisions. Firstly, everyone is now fully embracing the "growth" theme: every piece of analysis we conduct upon request normally concerns investors wanting to sell "value" and buy more "growth". We need to ask the question of whether there is yet more untapped appetite for "growth" themes, particularly as the valuation gap between "growth" and "value" is now as wide as it was at the time of the "tech bubble" bust in 2000. We certainly do not think that "growth" will be immune to a further period of stress in equity markets, as one question from a recent webinar asked. In fact, there is a fair chance that the sectors where investors are currently crowding could perform worst, should risk aversion occur once again.

On the other side of the argument, the growing chorus of "growth" fans would point out that the trends of the last few years, namely low rates of economic output, constantly gushing central bank stimulus and the increasing uptake of technology, are supportive of "growth" themes; "who cares about valuations" is a fair motto for this side of the argument. "We still do" is our response. Our long-held philosophy is that ultimate investment success is founded upon the price you pay for an asset and your holding period; pardon the pun but it is obvious where the "value" in markets currently is, and our investment style typically leads us to embrace contrarian equity investments. We are seeking clarity on the economic outlook to evaluate a decent opportunity to increase our allocation to cheap cyclical or "value" equity investments.

How high could inflation go and how can we buy inflation insurance?

Our view is that the current deflationary impact of COVID-19 and the disinflationary trends of the last decade could give way to a period of rising inflation in the next three to five years. A combination of the aggressive monetary stimuli, the need to secure domestic production of vital products in a deglobalizing world and a focus on infrastructure spending to boost lacklustre rates of economic growth could trigger higher levels of inflation than we have seen in the post-Great Financial Crisis world. Our view does not mean that we expect to see inflation rates back to where they were in the 1970s, but we can realistically imagine inflation rates in excess of 3% and possibly up to 5%. We know from speaking with our advisers and clients that this is a growing concern for those who are sitting on high levels of cash, particularly given that we do not expect interest rates to rise in the next five years. We have deliberately positioned our fixed interest allocations to protect against a return of inflation at a time when many core bond markets are at significant risk of any surge in inflation.

The important factor for investors to recognise is that markets are basically pricing in 0% inflation for years to come. This means that it is a great time to own inflation insurance, both through short duration inflation-linked bonds and gold investments, the latter of which we still believe is in the "foothills" of a long-term bull market. Any sign of a return of inflation could also easily unsettle the long run market trends of "growth" equities outperforming economically cycle sectors, leading to a return to favour of inflation-proofing sectors such as commodities and the banks. We feel that most investment portfolios are woefully under-prepared for any return of inflation in the future.

What corporate sectors do we like or are we switching out of?

The first point to note is that the extreme shifts in sentiment towards markets generally and specific sectors this year has afforded active investors plenty of opportunities to adjust their portfolios. We have been able to repeatedly upscale and downshift allocations to specific sectors that had become excessively disliked or worryingly "en vogue". As an example, we used the weakness in March to increase our exposure to economically sensitive areas of the equity market, a trade that we reversed in recent days as sentiment improved and which generated a strongly positive return on our tactical investment. In addition, while we like healthcare from a long-term perspective, the strong outperformance and broadly positive view towards the sector from all investors led us to take profits in our dedicated healthcare strategy. We were able to use the proceeds released from a reduction in healthcare to buy into "environmental" sectors that will likely benefit from increasing governmental focus on "green technology". We expect this sector to enjoy huge amounts of money in the future, due to the governments of the world's unquenchable desire to spend money they haven't got in the aim of tackling environmental issues.

We have fielded questions on the beneficiaries of "life after COVID-19", and within our portfolios we also have funds that have selected the likely technology and retail winners of a future that could be very different to that which we imagined only a few months ago. Finally, whilst we like "contrarian" equity opportunities, there are some sectors such as airlines, travel, property, hospitality and traditional retail where we are taking a sceptical view, both on the equity and debt of such companies. We continue to be very selective with our clients' investment portfolios.

Please let us know if you have any further questions that we can answer. Thank you for your ongoing support.

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