Psigma Investment Management

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Your Questions Answered

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Tom Becket
Chief Investment Officer

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 weekly webinars and come directly from our advisers and clients.

Why do we find cause for optimism even as the medical and economic outlook remains grave?

Our view is that over the last few weeks we have finally started to see decisive and definitive actions taken by governments and central banks around the world. Of course, it would have been better if the governments of the West had heeded the obvious threats of the emergence of the virus from China, by shutting down travel routes from affected regions and better preparing the health services, but that is now sadly a long way behind us. The UK has now joined most of the rest of Europe in a "lockdown" situation, which, while painfully restrictive for us all, does perhaps give us some clarity on how long the economic issues will persist. With the Chinese economy now gradually getting up to speed, we are hopeful that both Europe and the UK can follow the same path that China appears to be, with a month of near-total economic shutdown, a month of gradual recovery and a month of further improvement. Assuming no "second-round effects" from either a return of the virus or further uncontrolled outbreaks, we can now see some "certainty" in the economic path ahead.

Why is the US now the greatest source of concern around the world?

The US's approach to the threat of Covid-19 has been chaotic and it has become the new epicentre of this ongoing crisis. Given that the US is still the world's most important economy, this is a major source of discomfort for global investors. In the case of the US government's actions, the early downplaying of the threat, a clear lack of preparation and a failure to understand how contagious the virus is have all now led to serious problems. Trying now to attach blame for this situation on China might in some regards be fair, but it isn't a solution to tackling the problem, and the US government must shoulder a large portion of the blame for their initial inaction. The biggest hindrance to containing the spread of the virus has been the different approaches taken by the federal government and by individual states. In very simple terms, there needs to be a nationwide approach, or the US could become a microcosm of what we have seen around the world, i.e. the almost unchecked spread of the virus from one part of the country to another. The longer this insufficient approach persists, the less clarity there will be about the ability to allow the US economy back up towards full speed.

Could the rolling economic crises in various parts of the world lead to differentiated regional market performances?

We would suggest that any broad market recovery that emerges will almost certainly be worldwide rather than on a region-by-region basis. The complex nature of global trade and the disintermediation of global supply chains ensures that the economic fortunes of all countries around the world are as united as they ever have been in history. It is unthinkable that global markets can recover without there being at least stability in US asset markets. However, there could well be relative winners and losers. Within equity markets, it will be a case of "cash is king", with strong balance sheets likely to be in favour in the post-crisis era; Japan is a perfect example of a country where the conservative nature of managements should be considered an attractive quality at this time. Given the expectation that a very large number of companies will be forced to slash their dividend payments, those that can maintain their own dividends will be considered relatively sound investments.

How do we rate the monetary and fiscal policy responses?

By comparison to the last genuine global crisis in 2008, the actions of the central bankers have been impressively quick and large. As you will all know, we attribute a lot of the blame for the distorted global financial system upon the central bankers, who have repeatedly shied away from making the appropriate and tough decisions in the last decade. This irresponsibility left the global economy in a very weak place to try to combat the economic impact of the medical crisis. However, in this case one can't fault them for trying to help this situation. In effect, the central banks of the major developed countries are underwriting the massive debt creation of governments, who have turned the fiscal taps to "gushing" to support their respective economies. Our previous discussions around Modern Monetary Theory or "MMT" have taken far less time to become reality than we expected. Given the huge unfunded liabilities of governments stretching into the future (recent analysis of the US suggests potential liabilities of up to $132trn), this wholesale resumption of quantitative easing will persist for many years into the future. In very simple terms, the economic reality is that the sheer amounts of government spending cannot come close to being matched by revenues, so central banks will have to make up the difference and there will have to be a large amount of "debt forgiveness". We have long predicted that this would be the most politically acceptable option, but we should be clear on the ramifications; this is effectively applying the financial and monetary alchemy normally associated with "banana republics".

How worried are we about the banks and the wider financial system?

If this tragic virus had emerged in 2008, we would undoubtedly have been calling into question the entire viability of the banking and financial systems. The good news is that banks are now much steadier and their business models more stable than they were in 2008. The post-crisis years have seen a genuine strengthening of banks' balance sheets, and the recent issues the banks have caused have been more about their willingness (or rather lack thereof) to lend rather than any dangerous excesses they have created. That is not to say that all banks are extremely strong, and we still harbour concerns over some of the banks in Europe, but in the US and the UK we are a very long way from the perilous situations of a decade ago. Of course, it would be naïve to assume that banks have no risk if we end up in a global economic depression, but for now we are comfortable and we agree with the comments from the Bank of England that, in 2008, the banks were the problem, and now they are in a position to be part of the solution. We also view the recent decisions from the regulatory authorities to stop banks paying dividends as sensible: conserving cash now is key. This cessation of dividend payments is also very positive for banks and financial companies' bonds, as it will ensure that more cash is on hand to meet income payments. Finally, the regulatory authorities have also relaxed some of the capital adequacy rules for banks, which should lead to longer term decision making rather than a sole focus on acting on a day-to-day basis.

Do we still believe that financial markets could be closed to help with the Covid-19 situation?

We would rule nothing out. Were the virus to get much worse, especially in the US, and if we see a further spike in market volatility, then we might see authorities decide to close financial markets. This should be something that should only be considered as necessary in extreme situations. Markets are currently still highly volatile, but liquidity has improved (bid-offer spreads are still wide, but have narrowed), and trading functions appear to be operating better than they did two weeks ago. In addition, governments need to follow financial markets as a guide to where the issues are. Given that the stock market appears to be one of the few things that the US administration follows closely, closing it down would not be a good thing! Moreover, it could be a decision that breeds panic rather than confidence, so this should be a "last resort" decision and only taken to ensure that retail investors are protected.

Where can we find protection in global asset markets for our portfolios?

It has become increasingly clear that "safety" is now a term that is extinct in financial markets. Certainly, government bonds have gained this year as economic fears have grown, as interest rates have plummeted and investors have sought the perceived safety of such assets, but this perceived view of the asset class as a "safe haven" is increasingly challenged as we move forward. With the vast amount of supply of such assets set to balloon in both the near and distant future (to pay for the effects of this crisis and to cover future liabilities) and with yields already basically at zero, the prospects for further capital appreciation from government bonds is very limited. It is likely that risks have risen due to the twin threats of oversupply and a return of inflation, expediated by the hyperactive tendencies of governments. Gold should be a key beneficiary of these fears, but notably it has been very volatile in the last few months, although we now expect its protective qualities to shine through. Gold should perform well as markets come to the same realisation that we have, namely that the temporary money-printing activities of central banks will not be "temporary". But where else can we find "surety"? Our approach is to hold high-quality, short duration corporate fixed interest investments. Such investments have not provided the same protection as government bonds in the last few months, but they offer a yield and the potential for positive returns. We view the likelihood of default of such assets as remote, not least as central banks have stepped in to support corporate bond markets. In addition, we continue to hold a decent cash buffer, both to afford some short-term protection and to allow us to invest opportunistically.

Has the balance of our portfolios shifted materially in recent weeks?

We entered 2020 underweight equities across our portfolios. In recent weeks we have topped up our allocations back towards model weights on Cautious and Balanced portfolios. In higher risk portfolios, we have taken a more proactive view on equities. To be clear, strategies such as our Growth strategy were materially underweight equities and we have simply rebalanced to models, equating to a 4% increase. We are unconvinced about the short-term prospects for equity markets, as it is impossible to say with any certainty where earnings will be in the coming quarters or whether companies will be able to maintain their dividends. We are far more convinced about the prospects for corporate and consumer credit, as these markets have now priced in a scenario as negative as we saw in 2008, something that equity markets clearly haven't done. Recent updates from our selective managers have been reassuring and we have seen signs of stabilisation in credit markets in recent days. Going forward, we would strongly favour the relative prospects of credit instruments over equities. Elsewhere, we remain positive on the outlook for gold equities, inflation "break-evens" and higher quality emerging market bonds.

How has the change in working practices affected our investment process?

Nothing has changed, except the reduced human contact. In fact, I would suggest that everything has become more efficient. Every morning (or PM if with a contact in the US) we have a call with an external fund manager, as well as our regular internal calls. The investment team "meet" every day at 11am to discuss all facets of the process, and unlike when we are in the office "as normal" we can guarantee that everyone can attend. Our systems work, our research tools function and, personally, aside from dealing with three increasingly bored children, I couldn't be in a better place. Well, I could be on my holiday in Miami, but there we go... I certainly know that things could be worse and am thankful that they are not.

As always, we are ready to help in any way we can and are delighted to support you through this challenging period.

Please let us know if there is anything we can do to help.

Tom Becket
Chief Investment Officer

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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