VERMEER NEWSLETTER

June 2020

THOUGHTS ON 2020

What's going on

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- **Markets dislocating from economies**
- Short term medical and financial concerns cast aside
- Monetary & Fiscal stimulus keeps on coming
- **Big is beautiful**

Marvin Gaye's classic 1971 album seems an apt title for our current thought piece. As markets have staged a quite remarkable recovery from the lows of mid-March, the thoughts of a veteran returning from war or a Martian landing on earth this week may give us the appropriate tools to take a dispassionate and objective look at where we are now.

Basically, we are in a phase of unprecedented uncertainty, which is usually a backdrop which most asset markets dislike. However at present, investors are choosing to look through the short term and focus on what will appear on the other side of the current crisis. All well and good, but unfortunately, we would defy anyone to confidently predict the shape and scale of any major economy or trend in the future. In our view, asset markets are starting to diverge too much from the underlying position of the real economy. This dislocation is undoubtedly being driven by the unprecedented levels of liquidity being poured into the global economy by all the major central banks. With yields so low on defensive assets, equities have returned to their role of least worst option and all the major indices have reacted accordingly.

Just to give this some perspective, as we write this piece most of the major indices are barely down for the year to date and all the technology ones are actually up. Global markets are down 4-5%, and only Europe down 10% and the UK down 15% show any real scars from the current crisis. A concerning sign is that commentators and analysts are starting to retrofit reasons and numbers to this rise. Bottom up forecasts for corporate earnings now suggest earnings will recover to 2019 peak levels in 2021 ie a one-year blip. Markets are assuming that not only do companies survive but that they actually thrive. This seems somewhat over optimistic to us. We have commented previously on our inherent belief that people, companies and markets will adapt and endure to any change but that takes time.

Why are we cautious? Returning to our recently arrived Martian what would they make of the current situation? The only things they could be certain of are that there is a global pandemic which virtually every major economy has struggled to bring under control and to which at present there is no known cure. They are also certain that fiscal and monetary stimulus by central banks and governments respectively is on a scale never previously seen, and that there is no precedent or guidebook as to how this unwinds. Their list of uncertainties is somewhat longer and diverse: how will the Covid-19 situation develop; who will win the US election; is the current social unrest in the US temporary or permanent; how will the US / China trade wars play out; what will be the outcome of the Brexit negotiations; can the EU hold itself together?

None of the above is unsurmountable but couple this list with the fact that in our view things are going to be very different after Covid-19 and we simply do not believe that markets are factoring in uncertainty. We certainly do not know how consumer behaviours and patterns are going to change post lockdown, or indeed what the implications of the virus will be on a long-term basis. We can guess at less travel, more homeworking, higher health expenditure etc but what will be the impact of higher unemployment, higher debt levels and low to negative interest rates on what consumers and businesses choose to spend their money on?

Taking into account our caution over the strength of the rebound we have seen since March, we are reminded that this does not mean that we should be selling equities on a wholesale basis. However, we do need to take particular care to ensure that portfolios are invested in the right sort of companies that can endure in a lower growth environment, and do not need to employ excessive levels of financial leverage or risk taking in order to do so.

Much of the outcome will be determined by what occurs in the next few months. Aside from the unknowns as to how the pandemic might progress, we are entering a critical phase for how governments construct and implement further fiscal stimulus. Rounds one and two were all about speed and scale and giving markets the confidence to function. This has been achieved and now they must look to much more targeted and specific actions:

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witness the policies announced by Germany recently. The aim has to be prime and lubricate the parts of the economy which will act as a catalyst for the whole to move forward. We expect spend on infrastructure of all varieties to feature across the globe and this is an area we continue to invest in for clients.

In the longer term our views have not changed in that we expect supply in the global economy to recover quickly ie in a V shape but that due to high levels of unemployment for demand to be more of a U shape. This will initially keep a lid on inflation but eventually as the two sides of the economy equalize, and assuming that there has been no meaningful withdrawal of the previously mentioned liquidity, then inflation must inevitably return. One unfortunate side effect of the current situation is that with liquidity basically being handed out to whoever asks for it then many poor companies will survive for longer than they should the zombie effect. This crowds out the better companies and reduces their returns, which is not good for the economy as a whole. Central banks face a fundamental problem in that they do not know what they are trying to deal with ie inflation or deflation.

The outlook for the UK remains very subdued particularly since it still needs to restart and get through the Brexit negotiations. The poor relative performance of the UK market has been partially due to this but also because of the composition of the main UK equity indices. They have virtually no exposure to the Technology giants that have driven the US markets and instead are heavily weighted to Energy, Financials and Utilities which have performed poorly. Price reactions to dividend cuts from the likes of Royal Dutch Shell and British Telecom have had a major impact but do mean that they now discount a great deal of bad news.

We have generally sought to keep a level head during the current crisis and not to radically change clients' portfolios. We have reduced exposures to sectors which we believe have been fundamentally impacted by Covid-19 and replaced them with companies which have the scale, financial firepower and demand characteristics that mean that they can prosper in all economic conditions. We continue to believe that the market leaders in many sectors will continue to exhibit stronger growth profiles than their smaller brethren. We maintain our view that China, India and Emerging Markets will prosper in any sustained upturn and are constantly on the lookout for opportunities in these areas.

Simon King
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