VERMEER NEWSLETTER

October 2020

THOUGHTS ON 2020

THE LONG AND WINDING ROAD

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- Low growth, interest rates and inflation to persist
- Careful stock selection required
- Challenging UK outlook
- Our thoughts on ESG

We doubt Paul McCartney was thinking too much of the economic outlook when he penned the above classic in 1969, but it seems to us that it encapsulates our thoughts on the long-term global outlook rather well. With all the gloom and despondency that currently prevails, it is easy to forget that we are heading somewhere, and although that journey will certainly include many bumps along the road, history tells us that the outcome will be a positive one. There will be a result in the US election, Brexit will occur, the UK will adapt, and there will be a solution to the Covid-19 crisis. Timing is impossible to predict but we firmly believe that the general economic backdrop will be one of low interest rates, low inflation, and low growth for at least the next five years and probably longer.

Once the current phase of massive monetary and fiscal expansion comes to an end, which it has to, the lack of a strong and rising tide which has carried all ships for the past decade, will mean real growth will become rare and precious and will be highly coveted. It will be the responsibility of any investment manager to hunt out companies whose franchises enable either high growth or lower but more consistent progression. In these type of markets mistakes will be severely punished, so a sound understanding of each investment in any portfolio is crucial.

We stopped trying to second guess the science regarding Covid-19 some time ago, but our fears on the inability of the majority of governments to devise and implement cohesive policies to combat the virus have unfortunately proven correct. We maintain our view that regardless of whether a "cure" is discovered or not, the world's health systems will find a way to better manage infected individuals and to minimise mortality levels. The most immediate problem for all countries is to decide how much economic pain and collateral medical damage (other disease going untreated) the electorate can tolerate. Unfortunately, these decisions appear to be more politically than altruistically driven in most major economies, although we are unclear whether this actually makes any difference to the short-term outcome. Time will once again be the solution.

The outlook for the UK economy still appears bleak. Regardless of one's views on the capabilities of the current Government, the UK is faced with a more fragile Covid-19 situation than most, and the prospect of Brexit for which we appear woefully unprepared. Our real concern is the outlook for Sterling which we expect to come under severe pressure as the world starts to come out of Covid-19, and the markets start to reflect on the relative outlook for individual economies. At present all countries' balance sheets look unappealing but the pace of recovery and repair will be much faster in other countries. This is not all bad in that overseas earners will benefit, and the UK market has already discounted some of the weakness we anticipate, so there are many cheap companies in the UK. We will continue to identify attractive UK listed opportunities, but many will not be operating in the UK.

As a result of our nervousness on the UK outlook we continue to build on our overweight positions in non-UK markets, driven by their better outlooks and our views on currency. Obviously, many of these opportunities lie in the US but we also see attractive opportunities in Asia, particularly Japan, and also in some Emerging Markets. Although we are not attracted to the European economies, there are still many European listed companies that offer exposure to higher growth parts of the world.

An area which has received a great deal of attention in recent times is Environmental, Social and Governance ("ESG") which has basically replaced the term ethical as the main title of socially responsible investing. It has in fact greatly widened the areas investors now seek to address: Environmental is the more traditional focus on polluters, climate etc; Social now encompasses gender and racial equality, low pay and a host of other factors; Governance looks at how a company deals with all of these and a number of more subjective strategic issues. In our view any professional investor should be looking at all of these areas already, as part of their assessment of any individual company or sector. Evidence of failing in any of these areas should be a warning sign of deeper-seated problems and should be an integral part of franchise assessment.

Whilst we fully endorse the general principles of ESG, we believe it should form a part of the investment process, not completely dictate it. In our view the latter tends to lead to proxy investing, ie buying a stock because it ticks boxes rather than because of its overall merits. We have witnessed many stocks with poor business models attain ESG star status resulting in stratospherically high share prices, but which usually end in disappointment. We are very happy to construct portfolios with ESG guidelines for clients, but we look first for good companies and then assess their ESG suitability.

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Putting our thoughts on ESG investing to one side, we do see major attractions in identifying companies with strong franchises and technologies which will benefit from a huge increase in spending on cleaner energy and general industrial processes. Climate change is finally being addressed on a global scale with the combined forces of popular pressure, capital markets and economic reality meaning it is irreversible. Its major consequence will be the long-term demise of oil as the world's main energy source, to be replaced by a general electrification powered by natural gas, hydrogen, wind and solar. This will have profound political and economic implications as petrostates decline and democratize, and the developed nations turn their attention to other ways of securing energy sources which will be more technology driven. There are many potential pitfalls along this road. It will be important to maintain pace, but individual countries will need to watch for social unrest as economies adapt. China already controls vast amounts of technology, manufacturing capacity and raw materials which provide the infrastructure for new energy sources, and every other major economy will have to ensure that it has a viable domestic environmental industry. Therein lies the opportunity for investors.

Simon King
Chief Investment Officer October 2020