VERMEER NEWSLETTER

March 2020

THOUGHTS ON 2020

Lockdown

By Simon King
Chief Investment Officer
T +44 (0)20 7123 5204
E simon.king@vermeerllp.com

- **Markets to remain volatile - transmission mechanisms not functioning**
- **Balance sheet strength and focus on income is key**
- **US medical response to the crisis is a major concern**
- **Change brings opportunity**

It seems an eternity since our last piece of only a few weeks ago and a particularly gruelling one given the incessant flow of misery and suffering. We maintain our stance that it is pointless to try and predict or second guess the medical science. And unfortunately, we are still some way from peak bad news flow when watching the 10pm news will be very unpalatable. Trying to call the bottom of the market is a particularly unpleasant task but it is likely to coincide with either a flattening of the Covid-19 incidence curve in the G8 countries, or significant medical progress in identifying a solution.

In the meantime, we expect all markets to remain very volatile as market participants contend with inconsistent news flow, technical situations they can neither see nor understand and the fact the vast majority have never witnessed anything even resembling the current crisis. At present everything is being driven by deleveraging and a dash for liquidity. Even the strongest companies are looking to maximise cash holdings and those with high borrowings are either being forced or electing to reduce them where possible. Traditional financial metrics are not relevant in today's markets, even equity investors must concentrate just on solvency in the short term. We continue to believe that a recovery will be more V-shaped than the sceptics believe, but the depth of the V will be more pronounced than we had originally anticipated.

Our main concern is that despite the best and laudable efforts of the central banks to inject a sea of liquidity, in an attempt to keep all boats afloat, these will be stymied by ineffective transmission mechanisms. Will banks give loans to poor companies and simply the ones they do not like? Will they finance existing customers when they may feel there is significant risk to their franchises? Will they lend to each other? Governments can send all the "hurry up please" letters they like but, in the end, it is about the willingness and ability of many financial institutions to deliver credit to all parts of the economy. We would also add however, the responses by global monetary authorities have been both speedy and overall, well targeted. They have learnt many lessons since 2008/9 and have made the hard choices much earlier in the process.

Obviously, governments have a major role to fulfil here and once again there has been no shortage of effort and grand schemes. Most countries have now thrown everything including the kitchen sink at the problem. At times it has felt like a high stakes poker game as each successive announcement has raised the bar. They are not quite out of bullets, but any future actions will have a more limited impact at the margin. Again, our concern is there are simply not enough systems and people to deploy the money and as such, many individuals and companies will suffer extreme hardship.

The area we are most troubled by is the US which is in danger of fragmenting into 52 different nations. The current crisis has laid bare the limitations of the current President and his administration. It also

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highlights the lack of investment and fractured state of US federal infrastructure. The President's response to Covid-19 is at best inconsistent and at worst frightening. His chances of re-election in the Autumn have been severely reduced, and with the emergence of Joe Biden as the leading democratic candidate then a democratic victory becomes more palatable. Although there are many strong US companies that can weather the storm, there is a real danger that as the rest of the world is slowly turning the corner, the US will still be embroiled in a huge medical disaster. This would create another blow to the global economy and could result in a more protracted recovery in other markets.

One unfortunate by product of market conditions, is the increasing number of companies who are suspending dividends and consequently clients should be prepared for a reduction in dividend income in 2020. Not only are they cancelling future dividends but also ones that have already been declared but not yet paid. Some of these decisions have been forced by governments eg all the UK banks, but the majority are simply attempting to retain as much liquidity as possible with so little visibility in their businesses. It is impossible to predict precisely which companies will abandon their dividends, which will reduce, or which will continue unchanged. Obviously the stronger a balance sheet, the less likely a cut and we believe our clients' portfolios are relatively well placed in this regard. Security of cash-flow and income remains a major part of our fundamental analysis of all investments.

We have also attempted to turn our thoughts to some of the themes that may emerge after the effects of the pandemic have started to subside. We believe healthcare will be front and foremost in most developed markets and many large pharmaceutical and medical technology companies offer very attractive opportunities to capture long-term growth. Individuals will want to be healthier and fitter in order to increase their survival chances in any future global incidents. This will lead to increased demand for fitness services and products, healthier diets and non-prescription medicines. Whether this will allow governments to discuss with their populations the long-term changes that are necessary to meet overall health demands is a moot point. But it seems obvious that cheaper and more effective delivery methods, such as care in the home and remote diagnosis and testing, will be more prevalent.

We are increasingly of the view that despite being the source of Covid-19, China will emerge in a stronger position. It will view its eventual speedy containment of the virus as a testament to its centralised system, and its ability to quietly assist other countries during the crisis will earn it numerous political credits for the future. Contrast this with the US where the woes we highlighted earlier mean there is a real prospect of a prolonged medical situation and a dysfunctional election process. With Europe in its own state of disarray, we expect China to continue to take an increased role on the global stage. This will make its economy a very interesting prospect in the next decade and therefore one we will continue to seek exposure to.

In terms of the economic backdrop, as we enter a recovery phase then there is no real precedent. One can argue the current policy responses are akin to war time economics, but both the entry and exit points are very different to any previous times in the past century. It is clear that economies and populations will be paying for the current malaise for a very long time. What is not clear is whether any of the major developed nations is prepared to use this to alter the wealth distribution trends that persisted ahead of the current crisis. Given the current composition of global

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leaders then there is a distinct possibility that there is no more than token change. If this is the case it is likely in our view, that markets revert to the patterns of the last 10 years, when a sea of liquidity kept all asset prices high, obscured a lack of productivity and skewed wealth distribution, and there was general lack of economic progress.

A decade of low interest rates means that leverage has crept into every corner of the financial system. While it has taken the onset of a "black swan" event such as Covid-19 to reveal some of the frailties hidden within corporate balance sheets, the sell-off in companies' share prices has been largely indiscriminate with balance sheet strength being one of the few hiding places during these volatile times. Large technology, consumer staple and, as mentioned above, healthcare companies exhibit some of these qualities. Even some of the large resource companies, despite the fall in the oil price, still have sufficient levers to pull in terms of reducing expenditure, halting share buybacks and reorganizing credit lines to ensure that dividends can be maintained. As with the 2008/9 crisis, the strong will get stronger.

We like to end our commentaries on a positive note and rather than state the obvious, that there is an abundance of cheap and attractive investment opportunities, we would instead remind everyone that there will be the other side to the current malaise. People, companies and economies are remarkable in their ability to adapt and we are convinced that they will. The shape and patterns of markets will undoubtedly change, but this change will bring opportunity for many, both at an individual and financial level.

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