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Market Review – Where to Now?

The near 45% increase from the March lows seen in the valuation of the US S&P 500 Index and a lesser but still respectable 23% rise in the case of the FTSE-100 here in the UK, has resulted in headline statements such as "Bull-Market Territory", "Bear-Market Rally", "The Disconnect Between Main Street and Wall Street", and "The Equity Bubble", to name but a few, being made by financial markets commentators.

In reality and as we enter the second quarter's earnings season, whilst there may be some substance to many of these comments which have been made, there are also a multitude of different lenses through which the current situation can be viewed at present.

S&P 500 and FTSE 100 23rd March 2020 to Present

Source: Bloomberg

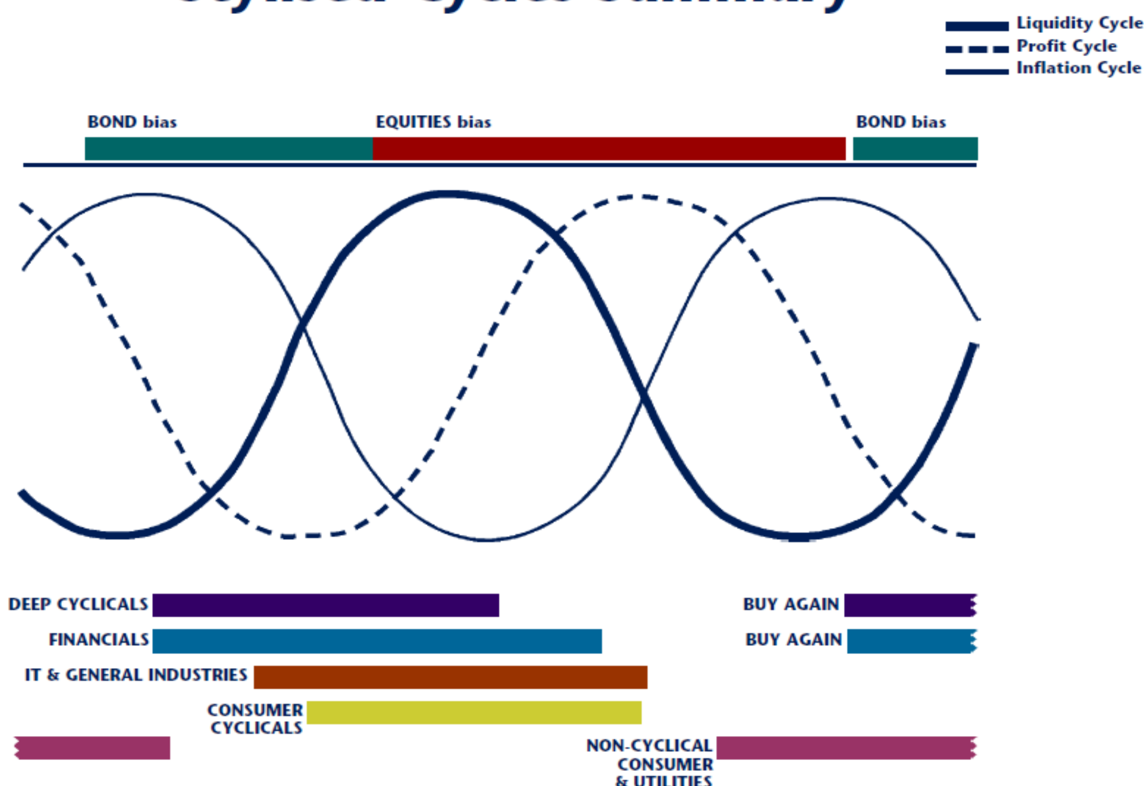
The man-made recession discussed in our last quarterly letter, as well as the Covid-19 pandemic which caused it, are now fixtures for some time to come. The forthcoming earnings season will give us a much better picture of what an entire financial quarter impacted by the global lockdown looks like, and will shine a light on those companies in the diverse range of sectors which comprise the markets and in which we invest.

Although leading economic indicators such as the UK Manufacturing Purchasing Managers Index (PMI), have shown signs of stabilising in June, and those for the USA for June were very strong, a still dire global economic backdrop and concerns (in the continued absence of a vaccine) over a second outbreak of COVID-19 once winter returns in the Northern Hemisphere, continue to persist.

Many investors and market commentators scratch their heads when debating the juxtaposition of the continued rise in financial market indices, amidst the current recession. Their problem with this apparent contradictory situation is that the conversation sometimes begins with a focus upon only the market indices as a whole, in the absence of: (a) the effects caused by the various constituent parts of the index (i.e., the companies and sectors within the index); and (b) how well those individual constituents and sectors reflect and react to the economic environment that they operate in.

Coupled with the huge injection of liquidity (circa US$4 trillion to date) which has been pumped into the financial system since the start of this pandemic-driven crisis by the US Federal Reserve Bank, points (a) and (b) may go some way towards explaining where we are now.

The following illustration represents a simplistic model of what happens during a normal economic cycle:



Source: JM Finn

Focusing on the left-hand side of the illustration first, when liquidity is pumped into the economic system by central banks, typically investors would purchase investments in the following industries:

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Financials: *An early cyclical sector, which outperforms in the early phase of the liquidity cycle. Central banks cut short term rates thereby creating easier lending conditions, which leads to banks making greater margins on their lending, in tandem with a greater expectation in respect of bad loans.* In the current situation, the worst of the pain has yet to be experienced by the corporate sector, hence banks still have uncertainty over the overall quality of their loans and indeed their future cash flows;

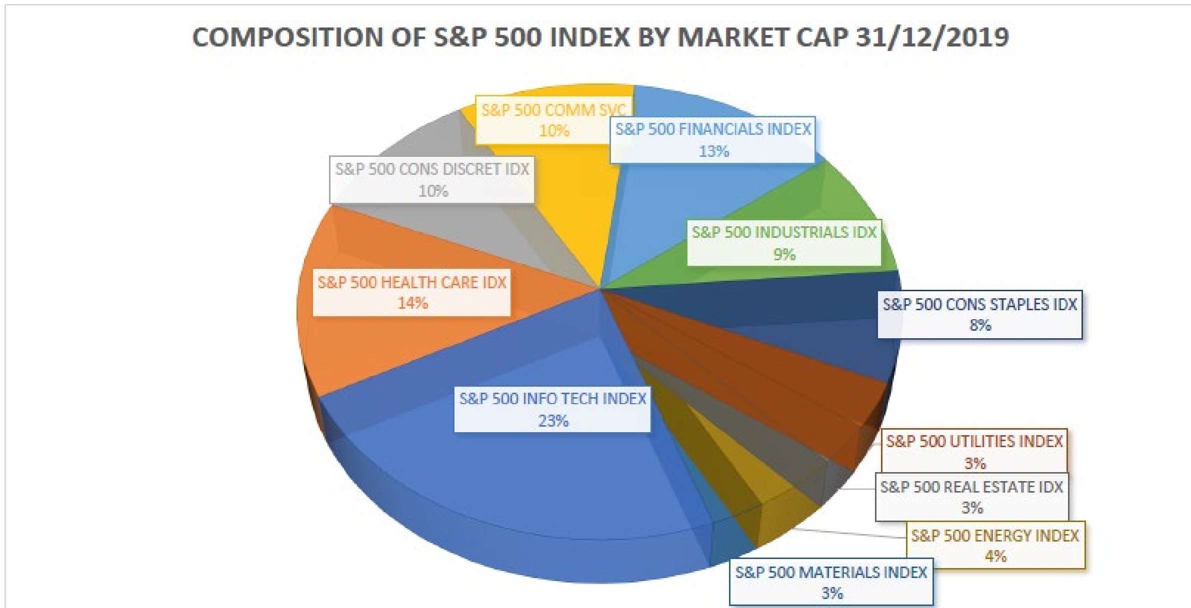
Deep Cyclicals: *Companies such as basic industries and resources thrive, as increased manufacturing production creates demand for these industries as the economy starts to expand once more, driven by low interest rates and increased liquidity in the system.* Global demand in these industries has in many instances been crushed by the global lockdown, so far through the current pandemic;

IT & General Industrials: *During a recessionary period, corporations would typically cut back on all unnecessary costs, only boosting outlay on Investment Technology and machinery when the profit cycle has bottomed.* Corporates have accelerated outlay on IT in response to globally imposed lockdown measures. A Microsoft executive commented recently that, "the company had completed two-years of software development with companies globally, within the first two months" …of the lockdown measures being imposed;

Consumer Cyclicals: *Consumers typically scale back their purchases of consumer discretionary items during downturns in the economy. This creates pent-up consumer demand which is then released as the economy turns the corner and starts to accelerate once again, causing the price of these stocks to surge.* With countless millions of people furloughed and stuck at home, demand for online shopping has surged with the resultant impact in the Consumer Cyclical Sector;

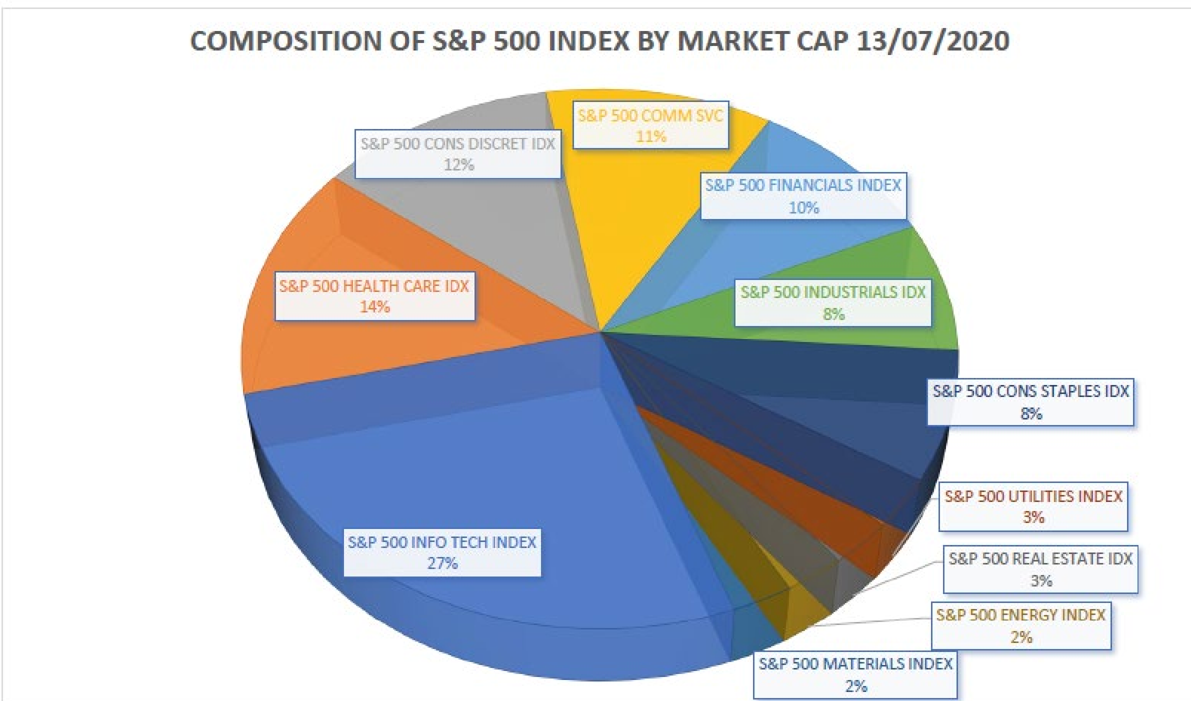
Non-Cyclical Consumer Goods/Services: *An early defensive sector when profits peak, investors move into companies which sell products or services which are unimpacted by the economic cycle, that is, necessities.* This sector would have to be assessed on a case-by-case basis - companies such as e-Grocery chain Ocado have shone in this environment as increased numbers of households have tried online grocery shopping for the first time. In speaking recently to a marketing executive from retail giant Boots however, this painted a dire picture of vastly reduced sales across many of their product ranges apart from Personal Protective Equipment (PPE), which saw increased demand.

Whilst this is only a simplistic model of how investors react in the various stages of the normal economic cycle and of how consumers have behaved throughout this pandemic, current man-made events in the form of the pandemic and resultant lockdowns have resulted in the year-to-date performance of the world's largest market by value (the US's S&P 500 Index) as follows.



Source: Bloomberg

At the turn of the year 57% of the S&P 500 Index comprised of IT, Consumer Cyclical and Non-Consumer Cyclical sectors, all of which would go on to outperform the overall Index, which has fallen some 2.16% year to date. Compare the above sector percentages to those at the end of July:



Source: Bloomberg

As a result of the pandemic, these three sectors as mentioned above now comprise 64% of the S&P500 versus the previous 57%, which in an Index worth not far off US$30 trillion is significant. The increases in the IT, Consumer Cyclical, and Non-Consumer Cyclical sectors came at the expense of the Financials, Industrials, and Materials sectors.

In many cases, those companies with a product or service best suited to this 'new normal' environment have seen a marked increase in their overall addressable market, that is the market size they can hope to sell into. We expect that the forthcoming earnings season will give us some insight as to whether the increased market size and potentially the market share for many of these businesses, will translate into a sustainable increase in their future revenues and earnings.

We believe that as many or most market participants have already speculated this to be the case, and with forward earnings visibility at this juncture still uncertain, we will be dealing with very thin margins for error over the next several weeks.

Portfolio Allocation

Having increased exposure in mid-March of this year to sectors such as IT, Consumer Cyclicals, and Non-Cyclical goods, all sectors which have enjoyed increased exposure and accelerated global activity during this pandemic, the MPL investment team reduced these positions in June, taking profits in the process. In the large-cap equity and technology sectors in the US, holdings of the AXA Framlington Global Technology Fund were reduced, along with a reduction in holdings of the JPMorgan US Equity Income, Blackrock US Dynamic, and Rathbone Global Opportunities Funds, along with the iShares S&P-500 ETF and the Fidelity European Values Investment Trust.

In terms of positioning for the restart of the global economy - which restart is admittedly still in its infancy - exposure has been increased to the mid-capitalisation equity sectors in the UK, Europe and the USA, via increased holdings respectively in the Schroder UK Mid-250 Fund, to the Carmignac Euro-Entrepreneurs Fund, and to the Schroder US Mid-Cap Fund. This aim was additionally achieved by increasing exposures to the iShares Russell 2000 and the iShares FTSE-250 Exchange Traded Funds. By doing so, we hope and expect for the portfolios to participate in the next area of market recovery.

Yours Sincerely.

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