eQInsight

Market View Q2 2020

This document presents a summary of our investment views. It explains our latest thinking on world markets and the most recent decisions we have made about what to buy and sell within your portfolio.

In April we conducted an ad hoc rebalance to increase the defensive positioning of portfolios in response to the global coronavirus pandemic. Please note that our views may change at any time.

Overview

We have reduced growth asset exposure and increased focus on defensive sectors within portfolios.

While there are a multitude of risk factors out there, the single biggest driver is government and central bank responses to the coronavirus.

The virus is still spreading around the globe, but the intensity of new cases is shifting away from the developed world and into parts of the developing world. Countries that first went into lockdown are the first ones emerging. But the pace at which each country restarts its economy is a function of how severely it suffered from the virus and the success of its lockdown strategy.

Overall, we think the economic rescue packages in many countries are gargantuan and so the risk of economic depression has largely been avoided. The strength and durability of the economic recovery will be governed by how quickly each country eases restrictions, how effective its economic rescue package has been at maintaining productive capacity and how severe its ongoing social distancing practice will be.

Given the virus is at different stages in different countries, it is clear there will be some form of restrictions on the movement of people for quite some time to come. We think markets have rightly reacted to the speed and scale of the rescue packages, but we think the assumption of a return to normal is increasingly unlikely and represents downside risk to markets. We think we will be returning to a different kind of normal whence we came.

In addition, as the world tries to slowly ease lockdown measures, other risk factors are also coming back into focus. The top two are renewed US-China aggression and Brexit.

1) A ‘phase one’ trade truce was agreed between the US and China but in our view, this was an agreement not to escalate tensions rather than an agreement to improve relations. Most of the tariffs announced so far remain in place. But we are now seeing a renewed focus on China from both President Trump and from the presidential hopeful Joe Biden. Bipartisan aggression towards China will create additional challenges for international companies.

2) With the coronavirus having consumed about 3 months of negotiating time, the UK has just under 7 months left until leaving the EU, but less than one month until the 30 June deadline to extend the negotiating period. We see no indication that the government has any intention of seeking an extension. The upside for UK assets is attractive, but increasingly risky.

Growth assets

Equities make up the majority of growth assets in our portfolios. This section summarises our views on the most important regions. The dials indicate whether we are currently overweight or underweight our long term, strategic allocation to each region.

Recent portfolio changes have seen us reduce our overall exposure to growth assets. We have focused remaining exposure on high quality companies and within defensive sectors. We know companies in this part of the market are expensive, so within our active portfolios we have also increased our focus on managers with strong valuation discipline.

Future proofing portfolios

After careful analysis we've decided to reduce our allocation to UK equities across portfolios because we believe that will deliver better risk-adjusted returns.

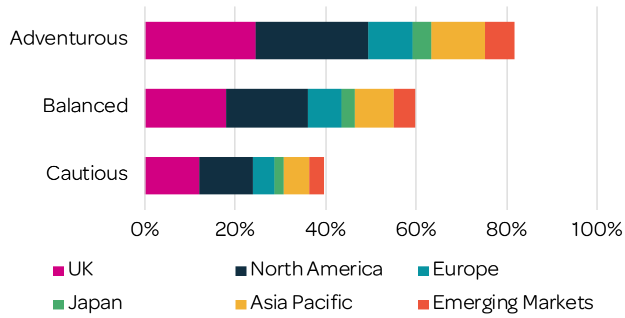
This is a strategic decision that is being implemented in phases over 2020, depending on market conditions. For a brief summary of our reasoning behind this change, please see the article on future-proofing in our Spring 2020 newsletter. This and other relevant articles can be found on the EQ Blog:

eqinvestors.co.uk/blog

In practice this means that – while the total proportion of growth-focused assets in your portfolio will not change – the proportion invested in the UK will decrease and this will be reinvested across other regions.

Here are our current strategic allocations for regional growth assets in Cautious, Balanced and Adventurous portfolios:

Growth assets for different risk profiles



UK

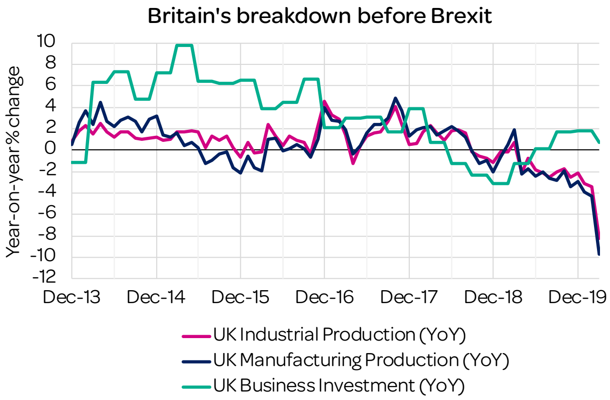
Britain has made no progress with trade negotiations since passing the Withdrawal Agreement Bill. There seems to be little appetite in Westminster to request an extension to negotiations, increasing the likelihood of a hard Brexit.

The whole world has been dealing with coronavirus with most other issues relegated to the side lines. When it comes to Brexit, there is a ticking clock running towards a 30 June deadline to request any extension to the negotiating period. So far, we do not see any indication that the UK government plans to make such a request which means the total time to negotiate a new trade relationship with the EU is reduced to less than 7 months. This poses significant downside risk to UK domestic assets.

With larger companies, UK valuations look attractive versus other markets, but the sector composition looks unattractive with a longer-term view. It's hard to believe the returns from financial services companies and fossil fuels will be higher than those from technology and healthcare.

However, the UK has implemented significant fiscal and monetary expansion in the wake of coronavirus and could redeploy or further expand these policies later this year or during 2021 to limit the negative impacts from Brexit.

Overall, we feel there are better opportunities in other markets and so have downgraded our view. We continue to maintain portfolio balance across industrial sectors and company sizes.



Europe

As we wrote in our previous update, the recovery in Europe was quashed by the impact of coronavirus. Recovery now relies on easing of lockdowns being successful and on trade relations between the US & China not deteriorating further.

European equities are more heavily geared towards industrial and manufacturing activity than they are to discretionary consumer spending. The recovery in European equities relies as much on the successful easing of lockdown measures as it does on the health of trade between the US & China, given supply chain links.

Additionally, the high weight to financials within European markets means any weakness in the corporate sector or with consumers could impair bank lending. The timeliness of fiscal rescue packages and the balance between grants and loans will govern the strength of any recovery.

While we are confident the fiscal rescue package will come, given European bureaucracy is far from smooth sailing, we are concerned that it could be too little too late.

United States

We prefer to maintain a defensive stance. The US-China trade war is a distant memory but the US government and the Federal Reserve are filling people's pockets with cash – both in the real economy and in the capital markets. This can't go on forever, so the only thing that matters is getting Americans back to work.

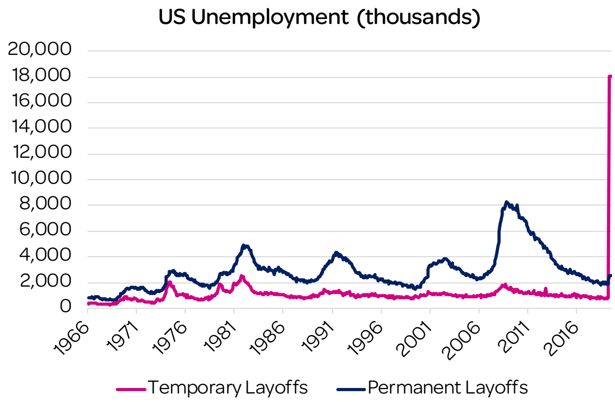
The market has been relatively efficient at differentiating between parts of the market based on sensitivity to the movement of people. Consequently, the outlook and portfolio positioning must be based on answers to two questions.

1) Will the gradual increase in activity and public consciousness about the risks of COVID-19 allow Americans to prevent a reacceleration in the number of virus cases?

2) Will the fiscal rescue package succeed in placing the economy into stasis, such that with the increase in activity, individuals made temporarily unemployed will successfully find re-employment?

If the answer to both questions is 'Yes' then we think US equities will be very strong. However, if the answer to either is 'No' then we think there is renewed downside risk. We are monitoring the levels of activity versus the number of cases to answer the first question and we are monitoring jobs data to answer the second.

The Herculean scale of fiscal and monetary stimulus means we have probably avoided the worst possible outcome, but one glance at the below chart of unemployment is enough to illustrate the scale of the challenge and the degree of uncertainty:



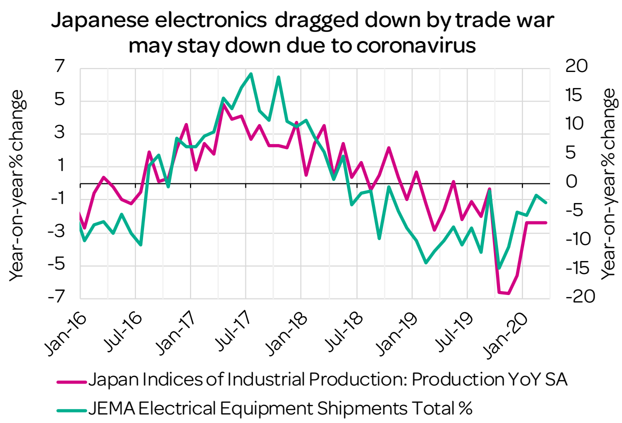
Japan

When coupled with low valuations and high cash balances, there is a lot to like about Japanese equities. But for us to have a positive outlook, we need to see things start to return to normal.

The Japanese market is like Europe, in that it is highly geared to the level of manufacturing activity around the world. Its market is dominated by industrial companies making machinery and cars, and many technology companies involved in robotics and automation.

Before the world shutdown in response to the coronavirus, Japan had already been suffering due to the US-China trade war and its supply chain links. The tentative recovery observed in the data may well be delayed.

The Japan Olympics due to be held this year have now been postponed until 2021. Even so, Tokyo's governor has said the event's organisers are considering what changes to the delayed event may be needed if there are no signs of COVID-19 being eradicated. This shows again how the world may return to a different kind of normal. We have slightly reduced our exposure as a result.



Asia Pacific

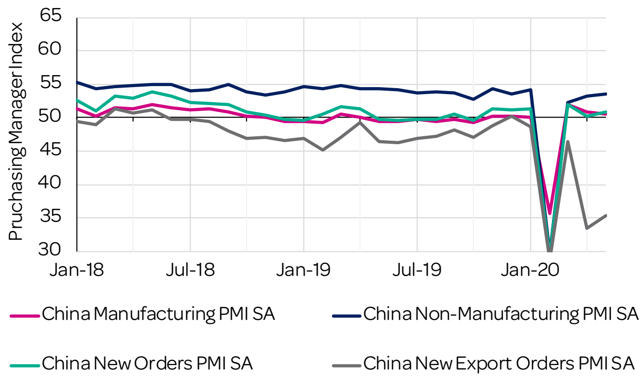
As the first country in the world to institute a nationwide lockdown to contain the coronavirus, China has emerged from lockdown to materially lower global demand as the rest of the world tries to contain the virus. This creates a bleak short term outlook for the region's export-oriented companies. For companies serving Asian consumers, especially Chinese ones, the outlook is better.

China's dominance means the strength of its economy and markets have significant influence on outcomes across other countries in the Asian region. Over the last decade, China developed as the manufacturing hub for the world but over the last several years, a lot of low skilled work has been outsourced to other Asian countries. The technology supply chain for consumer electronics, for example, is highly complex.

Although the US-China trade war had reached a truce at the end of 2019, it was an agreement to not further escalate tensions and not an agreement to undo damage. There is bipartisan support in the US for a tough stance on China, there are questions over China's handling of the virus and candour with the rest of the world and companies learned a tough lesson about the concentration of risk of their supply chains as China initially went into lockdown. We think the overall impact of these things could spell danger for the scale of manufacturing in the region.

On the flip side, although the overall market size for serving Chinese consumers is far lower than the market size for American consumers, given the risks to manufacturing, we think there will be significant support provided for the accelerated development of the service sector in the region. We maintain a cautious stance while assessing these opportunities.

China's New Export Orders struggle to recover
(below 50 indicates contraction)



Other Emerging Markets

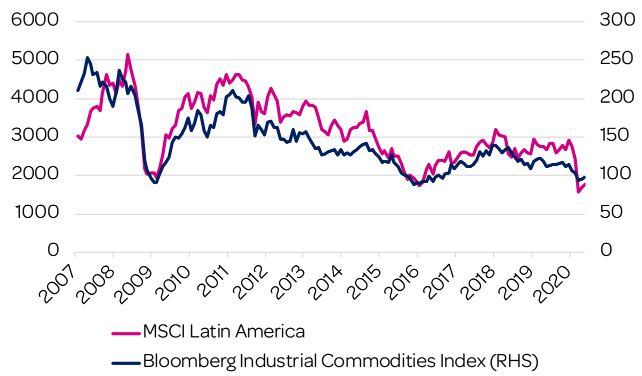
As well as being tied to pro-cyclical sectors like commodities, Latin America is the latest region to face its test against coronavirus. The initial indications are grim. If the virus spreads into frontier markets the prospects are equally dire, so we have reduced our exposure.

In the longer term, as we have discussed many times in the past, Latin American equity market prospects are highly correlated to industrial metals. Industrial metals are in turn highly dependent on moves in the US dollar and infrastructure spending.

Until recently, the single biggest source of demand for commodities for infrastructure spending has been China. Also until recently, we have thought that China would limit the credit financed infrastructure spending that boosted the economy out of its weak patch in 2016.

Our expectations here are changing. Given the weaker global demand outlook, China could restart infrastructure spending as a means to shore up growth. Additionally, we think now that the fiscal purse strings have been loosened across most major developed markets, the prospects for infrastructure spending are improving. In the short term however, we think the rise in coronavirus cases in Latin America serves as reason to be cautious on the region.

Latin America tied to industrial commodities



Defensive assets

Given our broadly cautious view across growth assets (equities) we have increased our exposure to the defensive qualities of bonds.

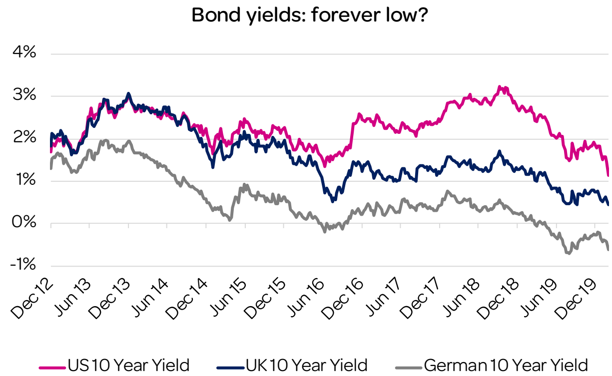
Government bonds

Despite low levels of yield, we think the downside risk to owning government bonds in the short term is limited and hence they can still provide invaluable portfolio ballast.

Government bond yields fell as investors rushed for safety and the prospects for future growth fell dramatically in the wake of the coronavirus induced shutdown. The cost of rescuing developed markets from the economic shutdown is massive for each country. In order to fund these fiscal rescue packages, governments have and will borrow colossal sums of money. If they were to try and get this from the capital markets, there is every chance government borrowing costs would rise and significant risk the market would simply not agree to lend the money.

In recognition of this risk, the mountain of government debt issuance will instead be hoovered up by national central banks through fresh money printing. This is like what happened in the Great Financial Crisis. However, the difference this time is rather than central banks pumping money into the banking system with hope of generating a recovery, this time the money is going directly to central governments. From there, it is getting straight out into the wider economy either through direct transfers to individuals or through grants and loans to companies and charities.

The net impact of government bond issuance and central bank purchases is zero, and so we shouldn't see any significant impact due to either of these forces in isolation. The marginal influence on government bonds will therefore come from the financial markets as they put a price on future growth expectations, relative credit worthiness and the potential for inflation in each country. But in some markets, central banks have even basically said they will make sure that government bond yields don't rise to much.



Corporate bonds

We are comfortable holding high grade corporate bonds from quality issuers, with a preference for US issuers.

The yields available on investment grade corporate bonds increased significantly as investors got worried about the potential inability of companies to repay their debt.

However, this quickly reversed as the US Federal Reserve announced that it was going to purchase vast quantities of corporate bonds alongside government bonds. The European Central Bank and the Bank of England have instituted similar purchase programmes, albeit with slightly different foci.

These central bank measures create a significant backstop for high grade corporate debt.

Alternative assets

We maintain some exposure to three main classes of alternative assets to add further diversification to portfolios. We do not change our overall weighting to this asset class on a tactical basis.

Property

Our view on other asset classes is more constructive than property and so we maintain a low exposure.

Unsurprisingly, with so many people at home, the forecast for returns from commercial property are highly uncertain. Even over a 5 year forecast horizon, property investment professionals see an incredibly wide range of possible returns, even within sectors. Unsurprisingly, the outlook for shopping centres and standard retail are the bleakest as the impact of e-commerce accelerates.

Although yields are higher than in most bond markets, property is an illiquid asset class. For this reason, we continue to have a nuanced view on the sector.

With the UK's exit from the EU on the horizon, we are concerned about the risk of shareholder outflows from open ended property funds. This poses the risk of these funds needing to suspend redemptions as some of them did in the immediate aftermath of the EU referendum and others have done again more recently. As such we have sold funds of this type.

Meanwhile, it is buyers and sellers of shares in property funds' listed on stock exchanges that provide liquidity to one another and hence there is no risk of suspensions, though there is a risk of share price falls. Here, we are targeting exposure to those funds with the lowest exposure to the retail and office sectors, but we are comfortable continuing to own industrial and retail warehouse focused exposures, where available.

Commodities

We have limited exposure to commodities, favouring precious metals over industrial commodities.

As discussed earlier, with the fiscal purse strings having been loosened and with greater potential for infrastructure spending, there is potential for higher industrial commodity prices. This improvement in our view would best be expressed through commodity sensitive companies rather than direct commodity holdings.

With precious metals, we know that gold has a negative relationship with real yields, i.e. gold rises when real yields fall. For real yields to fall, interest rates need to fall faster than inflation or rise slower than inflation.

Interest rates have already fallen materially but inflation expectations also fell hard given material concerns about the outlook for growth. Looking forwards, we see limited potential for interest rates rising but if inflation expectations start to rise (if the economic recovery gathers pace), there is potential for gold prices to rise.

Absolute Return

We maintain a neutral weight, with a focus on low risk strategies.

Higher levels of uncertainty continue to cloud over financial markets, and this is upsetting otherwise stable market relationships. This means some funds that manage risk solely by portfolio diversification may be less reliable than historically.

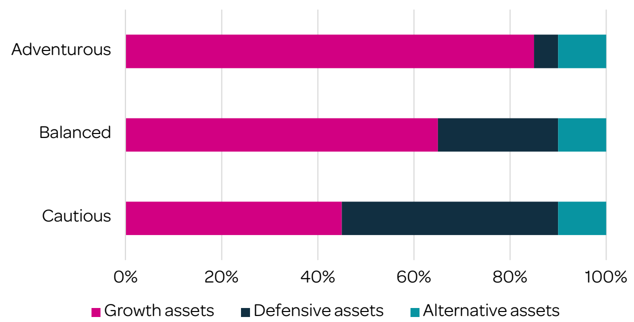
Our preference is for discretionary strategies over systematic and for lower risk where we can find it.

How does this relate to my portfolio?

Portfolios are sometimes compared to recipes – you need the right balance of high quality ingredients to make a great meal. In the investment world these ingredients fall into three broad categories: **growth assets** (used to build capital), **defensive assets** (used to preserve capital) and **alternative assets** (that sit somewhere in between).

The overall 'flavour' of a portfolio is determined by its **risk profile**. Broadly speaking, more cautious investors will have more defensive assets in their portfolios, while more adventurous investors will have more growth assets.

Here is what three typical portfolios might look like:



Growth assets consist mainly of **equities** (shares in public companies). We invest in equities regionally, based on the size and relevance of different markets to UK investors. Growth assets also include other riskier investments such as **high yield bonds**. Defensive assets consist of other types of **bonds**. Alternative assets include **property**, **commodities** (raw materials) as well as more complex financial instruments such as **hedge funds**.

The views outlined in this document will influence how we manage your portfolio. For example, we may decide to increase your exposure to one region at the expense of another. The dials give an indication of whether we are positive or negative on each asset class:

However, our job as your investment manager is to make sure that the risk profile (or overall 'flavour') of your portfolio stays consistent.

EQ Investors, Centennium House, 100 Lower Thames Street, London EC3R 6DL

eqinvestors.co.uk | 020 7488 7110 | enquiries@eqinvestors.co.uk | @eqinvestors | EQ Investors