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"All changed, changed utterly. A terrible beauty is born" Easter 1916, W B Yeats

Highlights:

- **As we near the year's midpoint all is "changed, changed utterly" in markets, on the high street and in our lives. A key theme that courses through the recent period is *speed*. The speed of spread of the virus, the speed of the market reaction, the speed of the surge in unemployment claims, the speed of central banks and governments to respond to "dull the pain" and the speed of rating agencies to downgrade companies. Then there has been the speed of the partial market recovery in response and the speed of society's adaptation to new norms. It is indeed dizzying.**
- **Markets around the world fell precipitously in late March, in response to the globally enforced pause on economic activity. They reached a low on March 23, and since then have retraced a significant part of their lows, at least in the US, again with extraordinary velocity. While performance has been mostly dominated by tech and so-called stay at home stocks the latter half of May saw signs of life in value as well as small-cap stocks, which had been laggards as the markets seemed compelled to respond to any good news.**
- **Other developments included the collapse of the oil price into negative territory for the first time ever as inventories surged in late April. The collapse of short-term demand for oil as airlines and transport remain at a fraction of capacity was the key driver and it is this that is expected to delay an inflationary impulse that would normally flow from a large stimulus.**
- **Unemployment claims topped 40 m in the US, a record high, while in the UK, it hovered close to 2 million, and was expected to top 3 million or 10% post furlough, a level not seen since the 1990s. The UK economy has been particularly battered by the current crisis and fallout. Sterling remained under pressure throughout the period and the FTSE remained weak despite some recovery.**

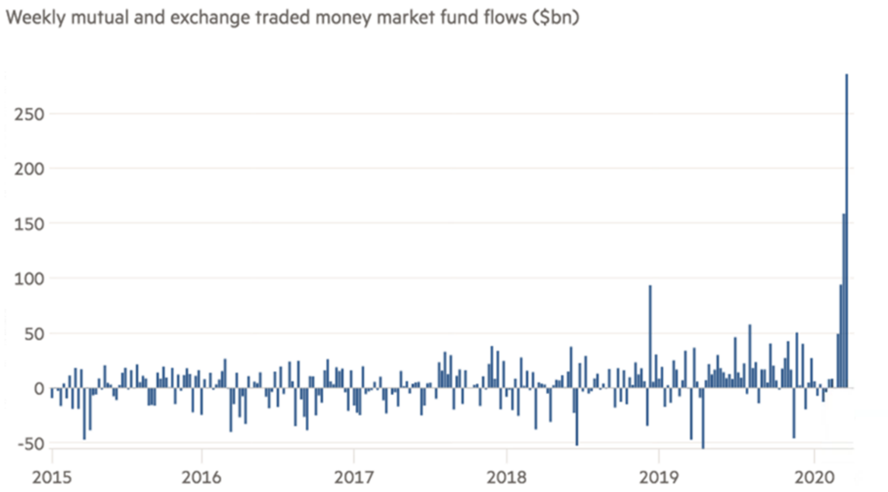
- **In geopolitical developments US/China trade tensions mounted while China extended its reach into Hong Kong through changes in the national security law.**
- **Looking to the future, most real estate valuations remain frozen, as rents have been suspended/deferred in certain retail and commercial properties and cash flows temporarily erased. This pain seems to be a foreshadowing of corporate distress that is still to come. As noted by the CEO of the rental car company Hertz in their recent Chapter 11 filing, "no business is built for zero revenue".**

Current Macro Snapshot

Coronavirus, what we STILL don't know
At the date of our last quarterly update only China was in quarantine and there were just over 3,000 deaths out of a reported 81.000+ cases. There was a rudimentary testing and tracing regime and a protocol of 2 weeks quarantine for exposure. Now, three months on, the global deaths and case numbers have risen to 362,000 and 5.9 million, respectively, and while testing has ramped up massively, it remains patchy in its efficacy, while anti-body testing is still at unsatisfactory levels. The entire world is cycling through lockdowns of various severity, but all have resulted in some stoppage of economic activity, massive upticks in unemployment, school and university closures and the cancellation of mass gatherings. The impact on the economy has been profound, in particular within the hospitality and service industries which have essentially seen revenues grind to a halt.

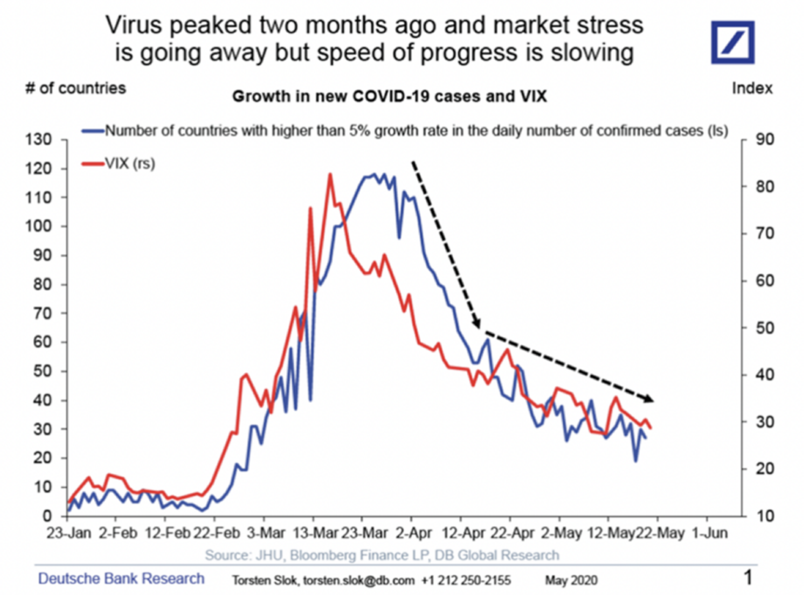
While the curves of infection levels and deaths from the disease would appear to be in decline, there is considerable **uncertainty** around the social distancing measures that are necessary to prevent spread, what level of COVID immunity in the population is already present and what is necessary and whether restrictions should be relaxed at the same or a different pace. This level of complex uncertainty is fuelling a paralysis in certain areas of the market such as real estate although in other areas such as tradeable equities and bonds, markets have seen a surge in activity, despite the same uncertainty. This suggests that the **abundance of dry powder** or cash that investors have on the sidelines and the very low rates available on that cash is driving a **hunt for return**. Investors who have already endured sharp losses may now have a **fear of missing out** on the equity market recovery. The effective **backstop** that central banks have provided has also shored up demand for bonds that have seen **record issuance** in recent weeks. Some banks have seen record months for trading as a result.

Markets have been volatile yet strangely forgiving
The chart below shows the surge in trading activity in recent weeks:



Source: Morningstar

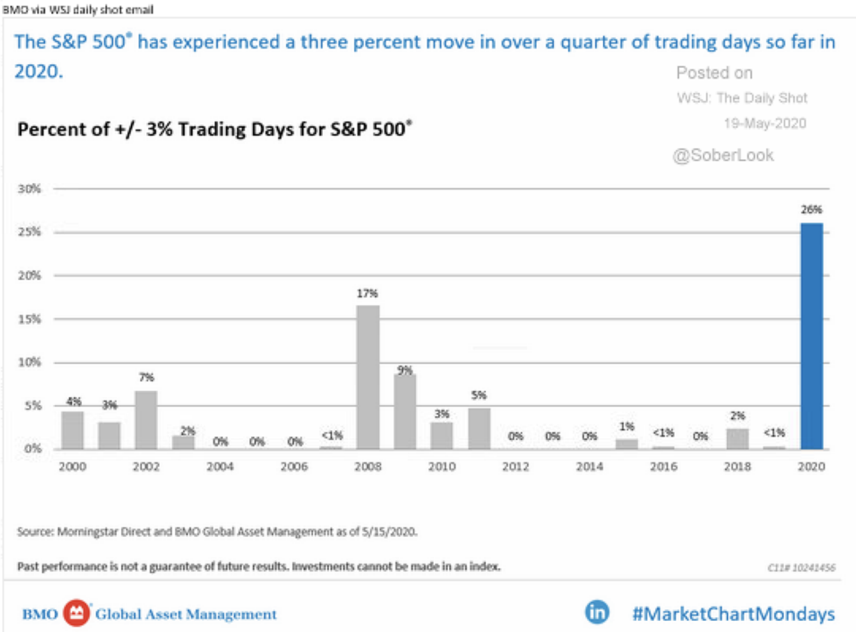
There has also been a very high level of volatility as markets have gyrated violently on pandemic-related newsflow. This is ebbing now as shown by the red line below, but it still remains elevated compared to earlier in the year.



There have also been more days with wide swings this year, as seen below:

S&P 3% days – 25% of days this year have seem moves of more than 3%. That's a lot of volatility.

BMO via WSJ daily shot email



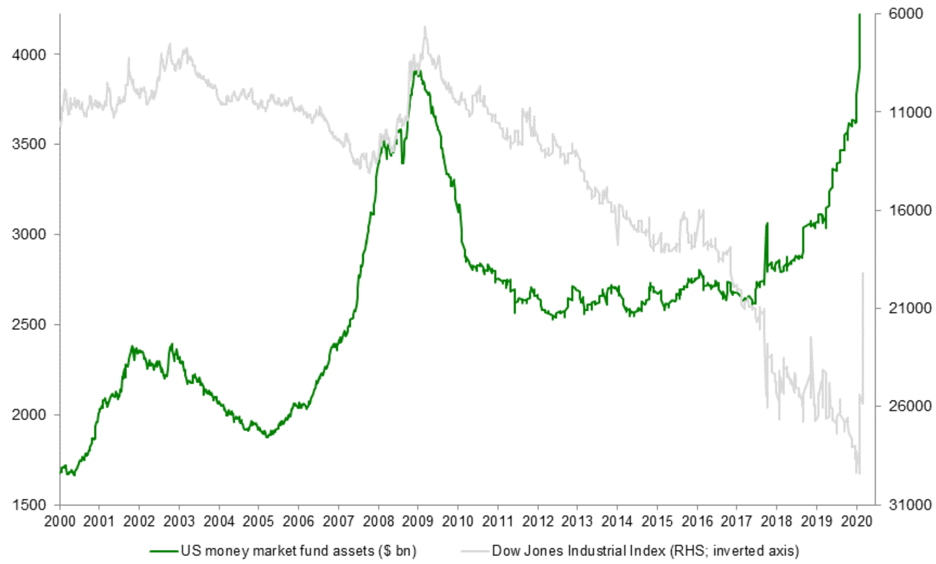
Yet markets have been strangely forgiving, notwithstanding the current levels of uncertainty and record-breaking economic data, as the graph below shows. For example, April saw the S&P 500 deliver 12.7%, its best month since 1987, and its best April in over 80 years. Meanwhile the economic news globally plumbed new depths as new unemployment claims reached over 30 million during that time period (now over 40 million) while the oil price remained at multi-year lows. The result of this has been a market that is more akin to a "square root" than a V-shaped recovery, but it certainly, for now, does not appear to be either U shaped or L shaped, although we cannot say whether a "double dip" looms. The chart below also notes the dominance of US markets compared to the other regions, the continuation of a long-term trend, partially driven by the dominance of tech stocks.

The other notable trend in equities is the likelihood that dividends will be cut and share buy-backs will decrease as companies seek to preserve cash on hand. There is a school of thought that suggests that they simply won't be acceptable going forward as cash preservation and a conservative positioning is key.   Dividend investors expect dividends from European companies will be cut by 30% in the aftermath of the current crisis while those in the US will be cut by 15%. The last time this type of widespread change happened was in 2008 and (even more so) in 2009.

As a portion of the total returns of equities flows from the dividend yield, this could lead to a contraction in total equity returns going forward.

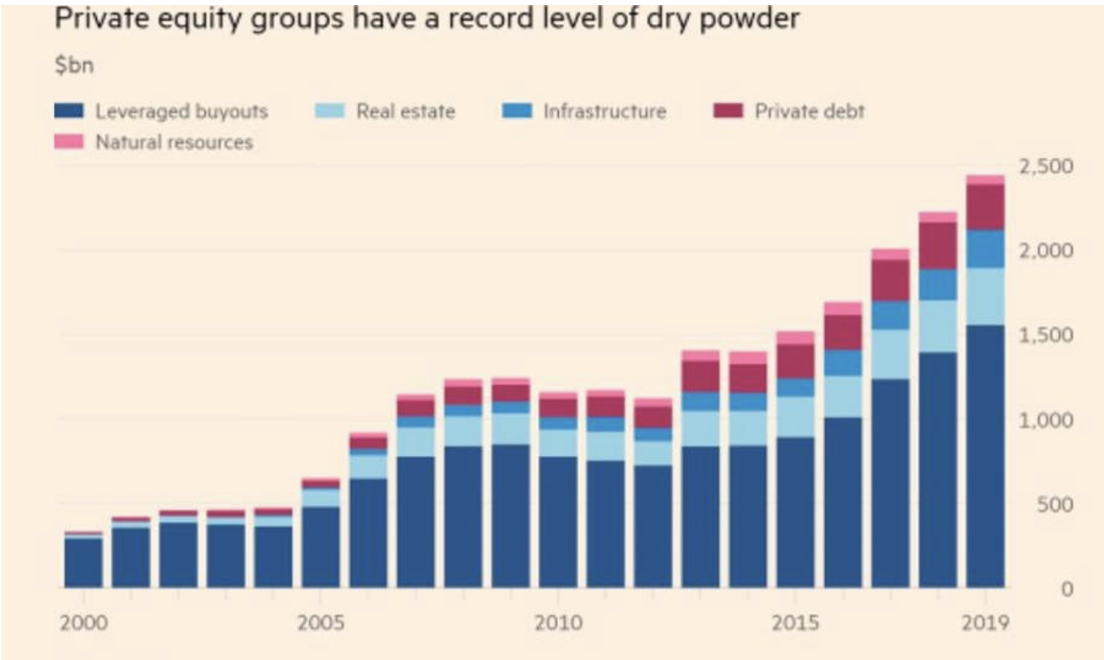
Dry powder conundrum:

The other driver of market strength has been dry powder, as noted before. This can be measured by assets that have recently flowed into money market funds and the chart below shows just how much this has soared compared to how markets have moved (the grey line is an inverted chart of the Dow Jones Industrial Index, which illustrates how flows into money markets tend to coincide with market drops, which also occurred this time, except that money market fund assets have also been steadily increasing over recent years and are now near $4 trillion).



Source: Federated Hermes and Bloomberg Data

There is also a record level of dry powder in other private asset areas, which is likely to support markets going forward.

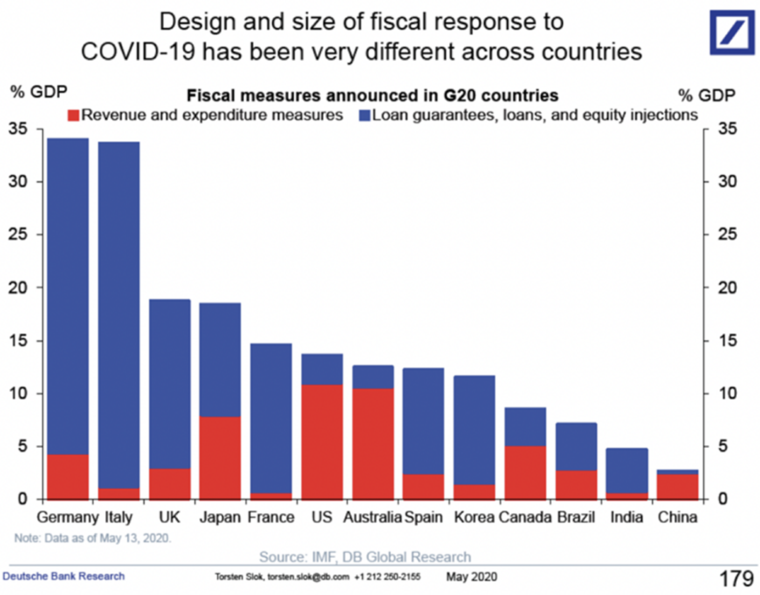


Energy swoons
The chart below illustrates sharp movements in the oil price (WTI Crude) since the beginning of the year, and the staggering drop into negative territory that was seen in late April. This was for delivery of the May contract, as it was clear that short term demand for oil had collapsed and storage was at a premium. The recovery since then is indicative of a depressed demand level, but not one that is dramatically different from previously

Inflation v. Deflation
The current crisis has been characterized by both a collapse in demand and supply, as evidenced by the stark volatility in the oil price. In normal circumstances the extremely low interest rates (akin to "printing money") would lead to an inflationary scenario, and, indeed, food shortages due to a disruption in the supply chain have led to some increases in prices, especially of meat. However, the expectation of lower demand is likely to, in the near-term, result in more deflation than inflation. Typically housing represents a significant share of the inflation basket and this is widely anticipated to fall over the next 12-18 months. This is relevant for portfolios as while typical portfolio components such as equity, real estate and infrastructure tend be positively correlated with inflation, only fixed income and private credit– which makes fixed payments, is a good deflation hedge. The chart below shows another point of view that as capacity utilization is at very low levels currently there is less impetus for inflation than before.

How to assess the impact of government intervention:
In the past crisis (2008-2009) there was a perception that central banks and governments were too slow in responding to the crisis, and ever since central banks have been highly responsive to avert market turmoil. The two swift rate cuts of the US Fed in March took rates to close to zero and this was replicated in the UK, which cut rates an all-time low of 0.1% in March. The ECB had little ammunition to cut further, but did promise a "whatever it takes" package of funding, the European Recovery Fund, totalling over €750 bn. Meanwhile the US Fed redoubled its commitment to purchase bonds in the open market, which it extended to cover high yield ETFs, and the US congress passed a landmark **Coronavirus Aid, Relief, and Economic Security Act** which provided essentially a bridge loan of enhanced unemployment insurance and stimulus checks to lower income families. In the UK, the Chancellor essentially provided a "blank cheque" to replace lost income and provide a tax holiday to companies.

As the chart below shows, most countries affected have taken meaningful action to shore up the economic pain being inflicted. The red bars are more likely to have a direct flow-through to GDP, so it can be expected that these countries (such as the US and Australia) will have a swifter recovery in terms of growth later.



Currency movements:
Just as the US has dominated in market developments, the USD has remained strong relative to the beleaguered Euro and Sterling. Sterling was particularly severely impacted in mid-late March just as the UK's lockdown commenced, reaching a low of 1.14 to the USD. There has been some recovery since, but it remains in a relatively low range for the year, which will enhance the impact of the non-Sterling components of a portfolio.

Source: Marketwatch

Other geopolitical developments
While the Coronavirus acceleration has arrested most economies globally it has not halted festering tensions and processes. The Brexit process has shifted off the front pages, but is continuing, albeit with less public scrutiny than would be typical. US/China trade tensions have been heightened by President Trump's need to cast blame for the "Chinese virus" and there is a strong possibility that Chinese relations will be weaponised as the November 2020 election nears. The Covid-19 experience has ranged drastically between different regions, with Russia and Brazil particularly severely affected, while whole areas of Eastern Europe and countries such as Greece and Turkey had a relatively low number of cases. This is likely to further slow development, investment and recovery in areas such as Brazil while there remains the taint of geopolitical risk around China (especially after it signalled its encroachment on Hong Kong through changes in the national security law). Meanwhile in Europe, divergent Coronavirus experiences, as well as the massive government spending needed to prevent

economic ruin looked likely to deepen tensions and divisions within the European Union, but for now it is too early to predict any end game.

Individual Asset Class Performance

- Equities
- Fixed income

Equities: A volatile journey

Equity markets provide the first and clearest barometer of market sentiment during volatile times and this time was no different. March was a month of grim reckoning which saw the sharpest peak to trough drop in markets in history (over the 22 trading days from the record high reached on February 19, the index lost 30%). The second, third and fourth quickest 30% pullbacks had occurred in 1934, 1931 and 1929, respectively, during the Great Depression. The FTSE lost just under 20% for the month, while the CAC 40 lost close to 23% for the month and in the US the Dow Jones Industrial Average lost 15% while the S&P was down 20%. Overall, although all sectors were negative on the quarter, there were some standouts such as pharmaceutical companies and other healthcare providers as well as technology providers such as Citrix and Netflix. Asia was relatively strong in March due to its supposed early mover advantage in gaining control over the spread of the virus, and meanwhile the oil price collapsed to its lowest level in 18 years.

In April, despite the growing grip of Covid-19, surging unemployment and a collapse of visibility on corporate earnings, the Dow and the S&P 500 delivered their best April in 82 years, and it was the biggest monthly return for the S&P since 1987. The Dow gained 11.1% in April, while the S&P returned 12.7%, and the tech heavy Nasdaq delivered over 15%, the first monthly advance this year. For all of the US indices this marked a retracement of over 30% from the bear market lows set on March 23 and it was dominated by large tech stocks (as noted in the chart below).

Europe lagged in the recovery, with the FTSE returning 4%, the CAC 40 was up 8.3% while the DAX gained 13.5%. Emerging markets had a solid month, returning 9% for the MSCI Emerging Markets index. Crude oil lost over 34% over the month of April and is -69% for the year to date.

May was another exceptionally strong month in US markets as the S&P delivered 7.55% (now only -5.77% ytd), the Nasdaq added 10.28% (now up 5.76% ytd) and the DJIA added 7% (now -11% year to date). This is starkly different to the more lackluster experiences of both Asian and European markets, which are still notably underwater for the year so far. The FTSE added 5.44% in May (ytd -19.43%), while the mainstream European Stoxx 600 added 3% (-15.75% ytd). In Asia Hong Kong's Hang Seng index lost -6.8% (-18.55% ytd), which is clearly a reaction to political developments there, as the virus is essentially contained in the region. The only exception in the Asian region was Japan, which has ended its state of emergency. The Nikkei 225 added 11.5% for May leading to -7.5% year to date.

Fixed Income/Credit: liquidity freeze, and then abundance.

Fixed income initially saw liquidity challenges and a widespread sell off in credit, despite the ongoing demands for government bonds. The US ten-year yield fell to as low as 0.6%, while high yield fell by close to 13% in the month, with a negative return over -13.5% year to date. The sell-off in credit was more acutely felt in the higher quality credit names, which are naturally more liquid and easier to sell, while lower quality, less liquid names have not seen the same mark to market impact as they did not trade. While there are widespread expectations of higher defaults the timing is still uncertain given the intervention likely to provide support in the short term (although already, in the US retail segment, the default rate looks has risen to 9% after some flagship retail bankruptcy filings and overall the rate in high yield is at a 10 year high of 5.5%) . There was also significant intervention by authorities to ensure banks continued to provide the financial "plumbing" to allow companies to operate, encouraging forbearance from enforcing covenants and banks to continue to lend.

In April fixed income markets were strong on the back of an ongoing liquidity underpinning by central banks, and the global high yield index returned 4.4%. Government bonds remained in demand as the US ten year hovered around 0.64%, where it has remained for much of April and the yield curve has returned to a gentle upward slope, reflecting the relatively sanguine state of equity markets in April.

In last quarter's letter we had highlighted the weakening of consumer credit in the form of increased delinquencies. This exposes what was perhaps an already fraught and precarious state of the US consumer before the current upheaval, and points to a tricky time ahead as the shockwaves of the shutdown are felt and an already battered retail sector continues to struggle. While default rates have not yet risen en masse, there have been a spate of retail bankruptcies, namely Debenhams, JC Penney, Neiman Marcus and the car rental firm Hertz.

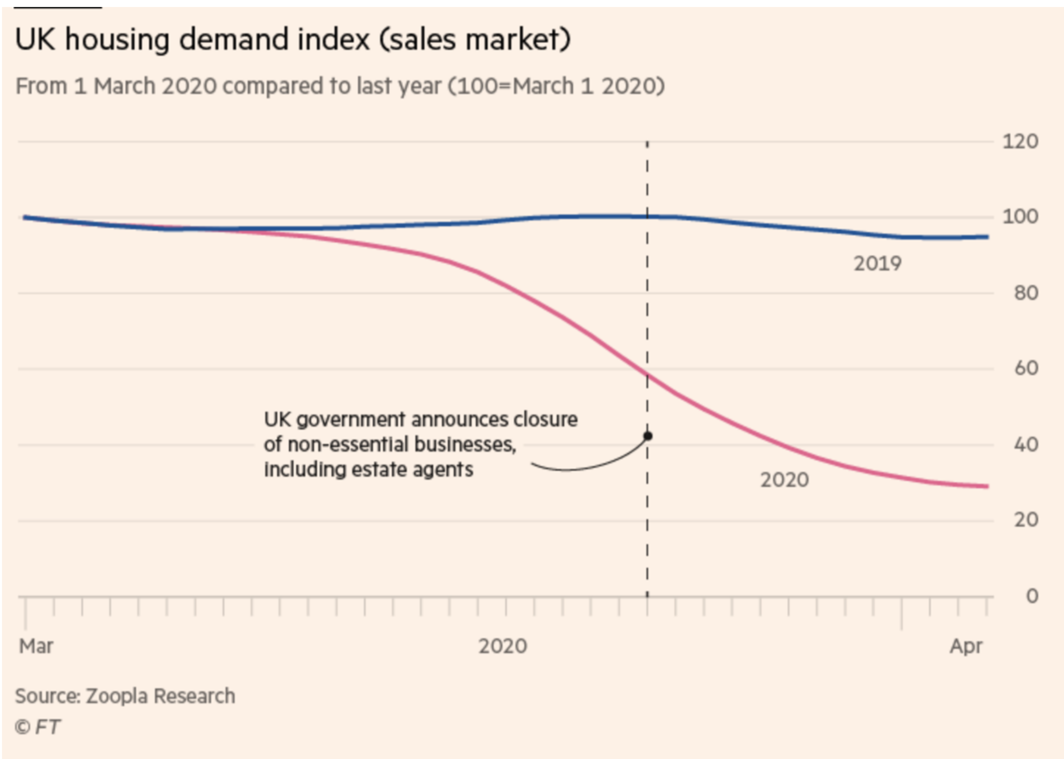
Throughout May there was also a pick-up in large companies drawing upon their revolving credit facilities to shore up cash flow and as rates seemed set to stay low for some time, there was a spate of debt issuance by higher quality companies such as Pfizer, Coca Cola and Philips. These investment grade issues met with robust demand, which continued to defy expectations. As of the end of May there had been $1 trillion of corporate bonds issued year to date including a significant portion in high yield, and in May retail inflows into US high yield were the highest ever. Higher quality performing credits could take advantage of this climate to issue new debt, terming out its holdings and creating a runway for the future. Some companies did as many as 4 bond deals within the short window of the crisis so far.

Private Assets: Spotlight on Real Estate
While the machinery behind the scenes of the traditionally opaque private assets arena continue to whir, there is little we can say at this stage about valuations and the impact of the Covid-19 disruption. The one, glaring, exception is real estate. The impact on real estate has been swift and savage, and certain long-term trends also now look in question.

Within public (listed real estate) markets we have seen seen NAV discounts narrow to 15% from 20% a few weeks ago. There remains meaningful dispersion across sectors, with retail most severely affected and discounts of up to 70% to current NAV in evidence. Meanwhile, in line with the explosion of online commerce and delivery, logistics and distribution sectors are trading at a premium, as is anything tied to the digital economy. So far, the market is pricing a 5-10% fall in aggregate capital values, but this will also differ across sectors with one in ten retailers in the UK facing imminent collapse. Given that many funds have frozen redemptions due to valuation challenges, it is also likely that the market hasn't fully priced things in and that this fall is an understatement.

While the decline in high street retail has been telegraphed for some time, a new shift may be away from office use. As recently suggested by one tech company – does this mean that "officentricity" is over? Large tech companies have been the main drivers of office demand in recent years, and it is now suggested that even a small change in the level of demand from tech will lead to a significant change in aggregate demand. This also throws into question the urbanisation debate as if more people work from home and public transport remains out of favour will there still be this trend?

Even though residential real estate should, technically, retain its demand level, there has been a steep drop off in transactions as the graph below shows, and a widespread expectation that prices will fall (especially in the London area) after transactions resume.



Overall it is likely that income from real estate will run below trend levels in the short- to medium-term as landlords and tenants share the partnership in pain that the recent economic shutdown has brought. Sector exposure will be critical with some clear winners and losers. While real estate has traditionally provided inflation protection, it may well see falls in capital values and yields in coming years which would be more of a deflationary trend overall. This part of a portfolio deserves particular scrutiny going forward.

Outlook
So where do we go from here?

2020 has unfurled at dizzying speed, but we have at least added knowledge and data to our first statement made last quarter: *"With the development of a vaccine as much as one year away, we are very far from a sense of control over the spread of the Coronavirus and a first concern may be knowing the scale of the problem."* While much uncertainty is still in place, we have learned the hard way about the importance of prioritising nursing homes and the protection of vulnerable populations, about the need for testing, PPE and awareness. The coming few months will see more adaptation to a new normal, but the shock factor will have dissipated somewhat. The notable exception of what can shock, however, will be the fallout once furlough payments are eased and the true impact on employment is revealed (likely to be late in the year). In the months ahead it will also be interesting to watch for the following:

- **Rigorously watching the success of economic reopening** As European economies lead the way on reopening to preserve some of their essential tourist season, watching their ability to contain new virus cases and inject life into areas such as hospitality will be critical to build confidence among other populations that economic activity and jobs can be restored. While Coronavirus prevention measures can boost certain industries such as re-fitters and enterprise software, many more will be forced to adapt and accelerate other changes, as we saw in the Marks and Spencer's "never the same again" shake-up.

- **Not taking an eye off China** Amid chaotic economic developments in European economies and record-breaking economic data, it is important to not lose sight of developments in Asia. The stealth by which the extension of the national security law to Hong Kong took place underscored the laser-focused ambition of China to consolidate power, just as was demonstrated in its draconian containment of its own citizens in recent months. There has been a view, however, that the Coronavirus will be China's "Chernobyl" due to allegations of cover up as well as the negative reaction that its origination in China will have. President Trump has accused China of "malfeasance" and tensions have intensified. It will be interesting to observe how China's role in a new world order post-Covid-19 is in fact forged.

- **Watching and waiting in US politics** Again, this is all we can do between now and year end, as the November presidential election nears under a cloud of uncertainty as to how rallies will be held and voting will take place (in-person v. mail-in). The rhetoric from President Trump has reached a new intensity, with two of his tweets recently attracting Twitter warnings (one for fact-checking and the other for glorifying violence) and the current state of US cities is one of patches of unrest due to a recent police killing of an African-American under arrest, with curfews imposed (c.f. Chicago) just as lockdowns start to be eased.

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June 1, 2020