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April 2020

Global strategy

Quarters when decades happen

To adapt a well-known Lenin quote, there are years where nothing happens; and there are quarters where decades happen. In what now feels like a lot longer than three months ago, we came into the year with an optimistic outlook that the global growth backdrop would be stronger than it was last year, but our enthusiasm for adding risk exposure was tempered by stretched valuations and sentiment in both equities and corporate credit. An eventful start to the year saw escalating tensions between the US and Iran threatening to cause volatility in financial markets, while extensive wild fires in Australia thrust climate change into the spotlight together with the associated trade-off between economic growth and sustainability. These of course pale in comparison to the global COVID-19 health crisis.

The market reaction to the initial reporting of the shutdown of Wuhan in China towards the end of January was muted on the hope that the virus would be a temporary shock and largely contained within China. However, by late February, evidence that the virus was spreading outside of China on confirmation of an infection cluster in the Italian region of Lombardy suggested that the virus had begun to spread across the globe. However, the speed of escalation westwards into other countries was such that the news flow proceeded to progressively deteriorate and investment markets that had initially viewed the outbreak as containable grappled to come to terms with the severity of what was unfolding.

Policy responses have varied significantly by country. The UK initially appeared slow to react, but the response was guided by research suggesting that the cost of social distancing measures and economic shutdowns would outweigh the cost of allowing the virus to naturally spread through the population. The evidence from China and the rapidly deteriorating situation in Italy however

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led the UK to quickly change tack and impose measures to shut down large swathes of the economy, with severe consequences for economic activity. In contrast, the response in the US was slow and chaotic. Overall it is estimated that around one in five people on the planet now operate under some sort of lockdown and that social distancing measures now impact around 92% of global GDP.

As the magnitude of what was happening became apparent, equities had their worst quarter since 2008, corporate credit spreads widened markedly and sovereign bond yields plunged. We do not believe in calendar rebalancing strategies (buying or selling equities at the end of the month/quarter to get to our house view position), but favour discretionary rebalancing based on what we are seeing in markets. During this period we have refrained from adding to equity exposure due to the level of uncertainty. We have though identified a number of guideposts to help us determine when the time might be right to buy back into equities. Broadly speaking these are (1) effective monetary and fiscal policy action, (2) evidence that the virus is being contained and the "curve is flattening", (3) some sense of the extent of economic damage, and (4) a better sense on the impact to company earnings estimates.

On the positive side, the post-2008 experience provides central banks with a playbook for easing financial conditions and we are now seeing this extended aggressively. To aid the functioning of financial markets and small businesses, interest rates have been cut to near zero and major central banks are buying corporate bonds and have introduced a range of programmes, which are too long to list. In addition, government support has been quick to arrive relative to previous crisis periods. The US and UK are now covering some or all of the wages of private sector workers for those affected by the virus shutdown, which should help to limit the economic fallout. The flattening of the virus curve is unfortunately trickier; it is expected that the number of new virus cases will peak mid-to-late April in Europe and the US, but this is something that we are watching closely. Until we get some clarity around the virus containment, it is very difficult to have any degree of confidence in the economic or earnings outlook. China

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was the first major country into the crisis, so should be the first to emerge and we are tracking its progress closely. The economy is re-opening and many factories are operating again. However, the recovery has been slower than hoped as there is a very fine balance between preventing a second wave of cases and getting back to normality.

On a separate note, the Asset Management team is now fully set up to work remotely and the age of technology has made this a relatively seamless transition. We have long had a collaborative approach across our team members based in Bermuda, Cayman Islands and Guernsey and are used to holding regular conference calls. In fact, it is fair to say that levels of communication have actually increased, with more regular conference calls and increasing use of internal messaging systems to share news and ideas.

As investment managers we are never blessed with certainty around the outlook or having complete information when we make decisions. We are aware that, on average, risky assets tend to bottom around one to two quarters before recessions end and that the best times to invest tend to be periods when uncertainty and fear is most elevated. However, we are conscious of the responsibility and trust placed in us, and we continue to balance the potential investment opportunities with the risks around a situation the likes of which we've not seen in the post-war period.

Fixed income

Central banks rise to the occasion

This quarter is truly a tale of two halves with the year starting on a very firm footing led by a buoyant US economy and a recovering global manufacturing sector. Global bond yields were rising as risk assets made new highs with the 10-year US Treasury yield starting the year at a now distant 1.92%. Market volatility was also subdued and market rumors were starting to whisper a rise in the US base rate by year end. While news of the virus was making some headlines in the West, most market participants expected it to be contained as per SARS in 2003.The market reaction was initially restricted to equity markets, but soon there was no escape in any asset class as correlations converged and most risk assets had their worst performance since 2008. Leveraged investors faced margin calls and outright panic ensued with the US 10-year Treasury yield falling to 0.34%, before rapidly rising again. Inflation expectations collapsed to depression levels and high-yield credit spreads breached 1000bps–implying massive default rates across broad sectors.

As COVID-19 spread, global central banks acted promptly, implementing multiple base rate reductions, led by the Federal Reserve's emergency 50bps cut on 3 March. However, it was soon apparent that this action alone would not be sufficient and was therefore followed by yet another emergency 100bps cut, this time enacted on a sleepy Sunday afternoon. Central banks were not finished there though, with printing presses fired up yet again with even Australia dabbling in quantitative easing for the first time. The Federal Reserve didn't hold back, promising open ended balance sheet expansion and immediately purchasing US$75bn and US$50bn per day in US Treasuries and agency mortgage backed securities. There were also pressures in USD funding markets, much like 2008, and these were addressed via a massive currency swap programme, which can lend to 170 foreign central banks and allows them to avoid the need to sell US Treasuries. This alleviates pressure on the Federal Reserve to purchase US Treasuries directly.

Fixed income

Central banks rise to the occasion

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Market liquidity has been a major concern of ours for some time and during March all asset classes, including US Treasuries, experienced a complete collapse in liquidity. This led to large dislocations in credit spreads, a major widening in bid/ask levels and in some cases no bids at all from any dealers. The Federal Reserve's actions have largely resolved the liquidity situation and markets have resumed activity, but credit spreads remain wide with the CDX IG index (a proxy for credit spreads) finishing the quarter at 113bps vs 45bps at the end of 2019. Therefore, another programme has been created which will enable the Federal Reserve to purchase primary and secondary BBB rated or above US corporate bonds with maturities of less than five years. The central bankers have effectively backstopped the US investment grade credit market and as a result the Federal Reserve's balance sheet looks likely to reach at least US$6trn very soon.

Due to the speed and severity of the virus induced shutdown, economic data releases are largely irrelevant at this point. We do know that the US economy entered this period in very good shape, but it will be many months before we know the level of damage inflicted and whether the multi-trillion dollar global fiscal and monetary stimulus has cushioned the real economy. For now, we look to rather niche data releases that provide us with a real-time measure of economic activity such as traffic and pollution levels, electricity usage and even Google trend analysis on consumer spending behavior. This is truly a once in a generation event, but policy makers have provided a very firm and prompt response. The baton now passes to the medical experts who are working on anti-viral medication and ultimately a vaccine which means the world can return to some level of normalcy.

In terms of portfolio positioning we were largely defensive before the virus really started to impact risk assets, which has helped portfolio performance somewhat. However, the magnitude of the disruption to markets surprised us, especially the complete illiquidity we witnessed during the middle of March. However, we did move swiftly for appropriate mandates with a higher tolerance to risk and added credit risk selecting high quality companies with stable revenues and low leverage. We also took advantage of the collapse in inflation expectations as explained above, switching out of nominal US Treasuries and into TIPS, for appropriate

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portfolios. US mortgage backed securities outperformed credit markets significantly over the quarter, as we expected they would in such an environment.

Going forward, we are moderately pro-risk and are maintaining a decent allocation to credit. We still have ample reserves to increase the sizes of the positions we established during March if market disruption returns in the coming weeks. Thanks to the actions of the Federal Reserve, liquidity has returned to markets. However, the market "plumbing" has not been completely repaired and we still prefer to maintain some additional liquidity at this time, so will likely be running higher cash balances than normal; once we have more clarity on the path of the virus we will deploy further tranches into credit markets opportunistically.

Equities

Equities hit hard by virus induced shutdown

Global equity markets were hit hard by the fallout of the COVID-19 virus during the first quarter of the year. The headline MSCI World index fell by over -21% as investors have been impacted by the sizable sell off in asset prices. The collapse in equity markets was swift, and volatility reached levels never seen before, with an average daily move in March of over 5% in some regions.

All eleven industrial sectors fell over -10% during the quarter and there was nowhere to hide. The distribution of returns resembles other risk off events, with defensive sectors, such as healthcare, consumer staples, utilities, and communication services all outperforming the broader index. Technology, which has been the standout performer over recent periods, continued to exhibit relative strength through a defensive growth theme, with many software companies benefitting from the work from home trend.

The worst performing sector globally was energy, which fell over -44% during the quarter. Energy was hit particularly hard on both supply and demand sides. Transportation, which accounts for approximately 60% of OECD oil demand, has been curtailed to limit the spread of COVID-19 globally. In an already oversupplied oil market, further downward pressure on prices resulted from the price war that followed Russia's refusal in early March to continue to work with OPEC to limit production and help support prices. Russia's stance prompted OPEC, led by Saudi Arabia, to cease previous production quotas, therefore boosting supply further in an effort to maintain market share, at the expense of prices. The current situation is unsustainable for any oil exporting country. However, the market should eventually normalise as unprofitable production is closed and demand increases over time as the economy recovers. Within equity portfolios, we maintain an underweight position in the energy sector, while the exposure we have is generally geared towards a core group of leading integrated oil companies that have already restructured operations to reflect a lower oil price environment.

Much of our recent work revolves around attempting to analyse the impact that the virus induced global shutdown will have on certain industries and companies in our coverage universe. It is clear that there will be companies positioned well to weather the storm and come out stronger during the rebound. There are also companies, and perhaps entire segments of the market, whose

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Equities

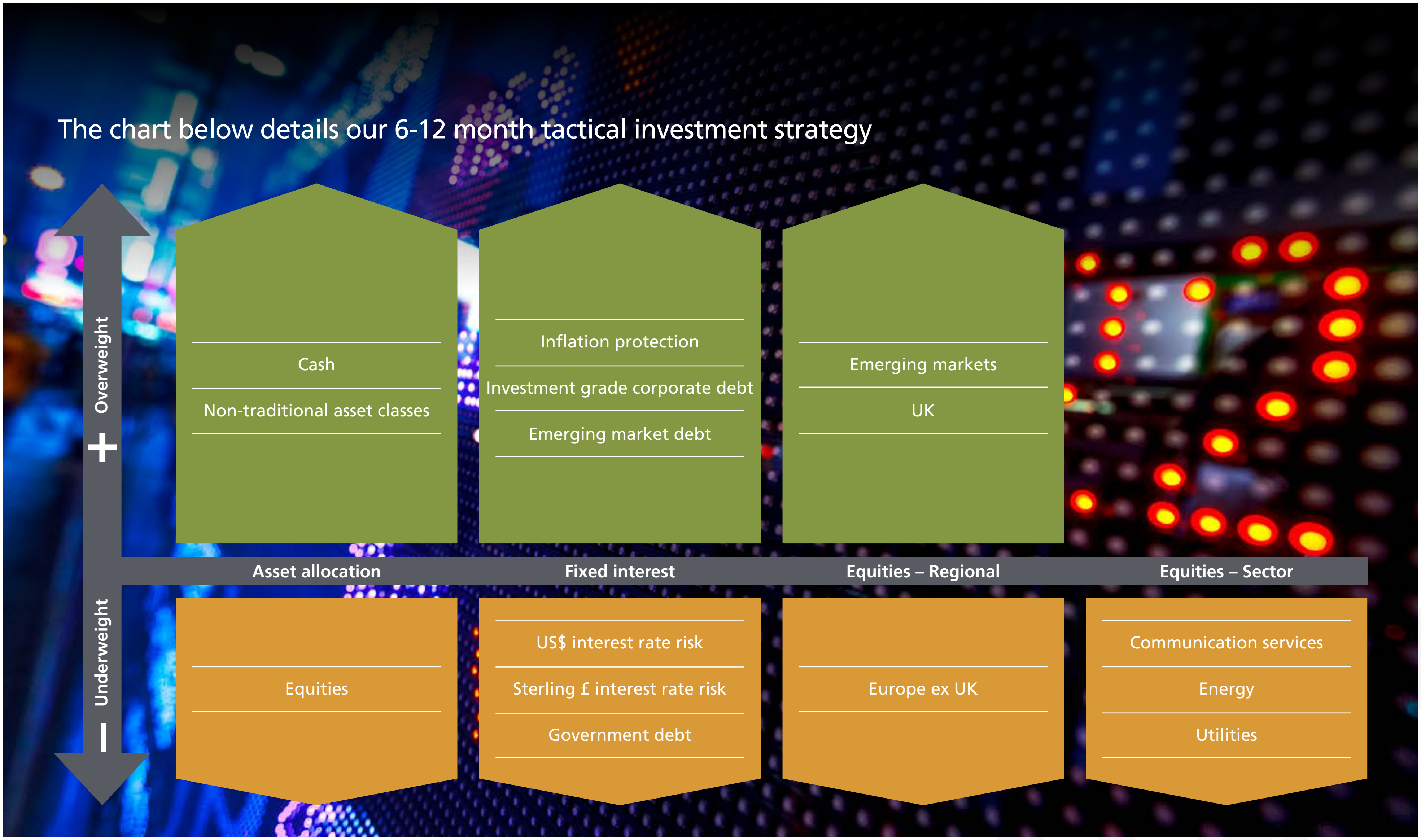
Equities hit hard by virus induced shutdown *(continued)*

business models and capital allocation strategies will be in need of repair. Attempting to put a number on earnings expectations or valuation levels is nearly impossible at the moment, but what we do know is that earnings will fall, and valuations have moved lower to reflect the level of uncertainty. There will also be knock on effects, both good and bad, from recent events. Fiscal and monetary stimulus packages have been released in most major jurisdictions, which spurred markets to recover a third of the losses over the final week of March and if successful, should ultimately help speed up a recovery. These stimulus measures are aimed at assisting those people who will lose their jobs as well as assisting small, medium, and large businesses who may have liquidity or solvency issues.

The outbreak of COVID-19 is an exogenous shock that has spilled into global markets and is unlike most other recessionary type environments, and as such, it is difficult to build a framework for market expectations and portfolio management decisions on a forward looking basis. There are always uncertainties in markets, but when we lack clarity on when economies around the world will reopen, and what reopening will actually look like, our fiduciary instincts push us toward a more conservative stance in client portfolios. Our conservative stance manifests itself in an underweight position to the asset class. Our base case moving forward is a "U" shape recovery as we continue to believe that this economic and market disruption is ultimately transitory for investors who maintain a long-term investment horizon.

The timing of a market recovery is still very much unknown and much will depend on the pace of virus transmission. However, there are positive signs coming from parts of Asia and Europe on this front. There will surely be pent up demand as people around the globe are freed from the confines of their homes, but higher levels of unemployment and lower wages for many will offset some of that demand. Ultimately, the significant amounts of fiscal and monetary stimulus globally should benefit equities longer term, despite near term uncertainty. We believe volatility will persist in the near term, but markets have a demonstrated ability to recover over time and we will look to take advantage of opportunities as they arise.

Global asset allocation



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