Butterfield

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July 2020

Global Strategy

The Twilight Zone

For many people, this quarter was much like an episode of the television show "The Twilight Zone", where each episode explores a wildly different reality to our normal world with a plot twist at the very end. The past three months have been truly unprecedented; we have seen many countries lockdown their societies in response to a global health crisis, volatile financial markets, negative oil prices and government spending rising to wartime levels. While progress has been made on "flattening the curve" of the virus, particularly in Europe, China and parts of the US, the potential for second waves of COVID-19 as economies reopen is likely to remain until a vaccine is developed. With additional uncertainty ahead still in 2020 (the US election, Brexit and Hong Kong tensions), there is a high probability that financial market volatility will be with us for some time to come.

Throughout the quarter, investors have had to contend with three concurrent forces: a pandemic which is still not well understood; a sudden stop of the global economy; and the fastest and most substantial policy support ever seen. A good way to frame these three factors is that policymakers (central banks and governments) have been going to extraordinary lengths to bridge the gap in economic activity caused by the coronavirus-induced shutdown. Markets recovered their poise in the last week of March and as we entered April there was a tug of war between the unfolding damage from the virus and associated economic shutdown, versus the policy support to help individuals and businesses weather the storm. The aim was for as many businesses as possible to reopen when the conditions allowed, while also preventing a damaging spiral of unemployment by keeping employees attached to their employers.

We have seen individual countries adopt differing strategies to achieve this, with US authorities focusing on protecting the income of the unemployed, whereas Europe has focused more on companies retaining their workforce. In the short term

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both approaches have had a degree of success, as government benefits have plugged the hole in personal income in the US and in Europe we have seen unemployment rates remain very low given the extent of economic weakness. As government support programmes are pared back and economies reopen, markets need to assess the likely path of the recovery; the relative success of these policies to bridge this economic gap is of paramount importance for asset allocation.

Under the surface of financial markets there are profound changes happening to industries and business models; these are particularly relevant within equities. As the Financial Times columnist Martin Wolf succinctly wrote, "The new economy into which we emerge will — and should — be different from the old one. It will need to take advantage of today's technological revolution towards virtual and away from constant physical interaction. It will also need to provide the people who have been most hard hit with a better future". The virus has acted as an accelerant for many trends which already existed, such as a shift towards e-commerce, cloud based technology and electronic payment. In such an uncertain time at a broad economic level, we have been spending increasing amounts of time trying to understand what this "new economy" will look like, while hoping that the bold new monetary and fiscal policies that we have seen enacted could lead to the "plot twist" being a more resilient global economy than many expected.

Fixed Income

The Flight from Quality

As we look ahead, investors are faced with markets which have been shielded from events by extraordinary policy support. We started the quarter in a shell-shocked state with credit spreads (premium corporates pay to borrow) at their highest level since 2016, and 10-year US Treasury yields having fallen to 0.67% as base rates were cut effectively to zero. Risk-off sentiment led to a flight to quality, but three months later the Federal Reserve has largely backstopped the US investment grade bond market and implicitly much of the US high-yield market. Furthermore, it has provided US dollar swap lines to multiple foreign central banks, aided corporates with various loan programs (directly financing them in the primary bond markets if needed) and has monetised the US government's fiscal spending since the crisis—in total expanding its balance sheet by an additional 70% or US$2.9 trillion.

This unprecedented stimulus has led to a flight from quality with central banks absorbing sales of US government debt, keeping yields low, while providing a tailwind to risk assets such as corporate credit. Investment grade spreads have tightened from 113bps to 76bps, inflation breakevens have risen by over 100bps across the curve, and of course, equity markets rallied strongly as investors reached for exposure to assets which provide prospective returns above inflation. As a result, the "Great Disconnect", which we have referred to in previous commentary between equity markets and almost every other proxy for risk, has largely closed for now.

On the economic data front, very few releases are accurate enough to derive significant value, but it is clear from recent reports that the US economy performed better than expected in the second quarter. This is best shown by the rebound in Citigroup's US economic surprise index which, after falling to its lowest level in history of -145 at the end April, rebounded to its highest level ever of +181 at the end of June. Fiscal and monetary policy has clearly provided support globally and averted a possible depression from developing. However, the

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global economy is not likely to return to pre-COVID-19 levels until 2022 and thus the recent good economic news is likely to wane over the coming months as stimulus is rolled back.

As we alluded to above, government debt levels have exploded recently with US (and many other countries) debt to GDP now above 100%. Unlike after the Second World War, with the current low growth and inflation, this level of debt is likely to prove harder to escape. However, governments have some advantages; for example, borrowing costs are the lowest in history with the UK government now able to borrow for 50 years at 50bps. In addition, central banks have effectively monetised recent debt issuance, with the Federal Reserve owning 18% of all US government debt, and likely to rise further in coming months. Taken together, the fiscal deficits are manageable for the time being as long as the central banks maintain their holdings. Although, with the Federal Reserve's balance sheet declining by US$86bn over the past two weeks and the US Treasury still issuing bonds at an elevated pace, long dated US Treasury yields are vulnerable in the short term.

At the time of writing, COVID-19 cases have been rising in various US states which largely avoided the outbreak in March and April. Of the most economically important states, Florida remains most at risk due to its older population. California and Texas are seeing rising case numbers, but there is reason to hope that they will be able to better contain the spread due to their much younger demographics. Smaller states such as Arizona look vulnerable, with available hospital capacity falling rapidly, and we will need to continue monitoring fatalities closely.

Portfolio positioning in risk assets reflects our continued cautious optimism and we remain fully invested in US investment grade credit with small additional exposure, where appropriate, to Emerging Market debt and US High Yield, which are all directly or indirectly beneficiaries of central bank support. We also have an allocation to US Mortgage Backed Securities, where appropriate, for income and US Treasuries to help manage volatility. Although, given the current low level of yields, outright cash does look a suitable alternative for some accounts.

Equities

Technology Leads Equities Higher

After global equity markets posted the biggest drawdown since the Global Financial Crisis, the second quarter proved to be a reprieve for investors as prices recovered 19.4%, in US Dollar terms. Over the first six months of the year, the MSCI World index has fallen -5.8%. Without debating whether the virus itself or broad based lockdowns have been more impactful to capital markets, the swift actions from global central banks, as well as countless legislative acts, have helped equity markets recover much of the ground lost during the first quarter. A number of economic data points from the past month have certainly surprised to the upside (unemployment data for example), but we cannot ignore other more bearish figures such as lower levels of consumption, higher bankruptcies, and PMI data hovering at or below 50 which signals a slower recovery. Overall, economic data should continue to improve over the coming months, with the risk being a reversal and inflection in case numbers.

Returns were robust during the second quarter throughout the world, with all major regions posting double digit gains with the exception of the UK. The headline FTSE 100 index struggled relative to European or North American indices, driven by higher allocations to certain sectors (Energy and Financials) which have struggled during the pandemic. Many of our client portfolios have an overweight to mid-cap UK equities which fared better in the second quarter and are more indicative of the overall UK economy relative to those companies included in the FTSE 100.

At a sector level, technology related businesses continue their strong run of performance. Many of the themes related to technology that we have discussed over recent years have seen an acceleration and pushed share prices higher due to the circumstances surrounding the pandemic. Notable examples include: new forms of advertising (social media), changing consumer behavior (e-commerce versus bricks and mortar) and the necessity of much of the workforce to work from home (cloud computing). Our portfolios have exposure to all of the above themes, which have aided absolute and relative returns over the course of 2020.

Equities

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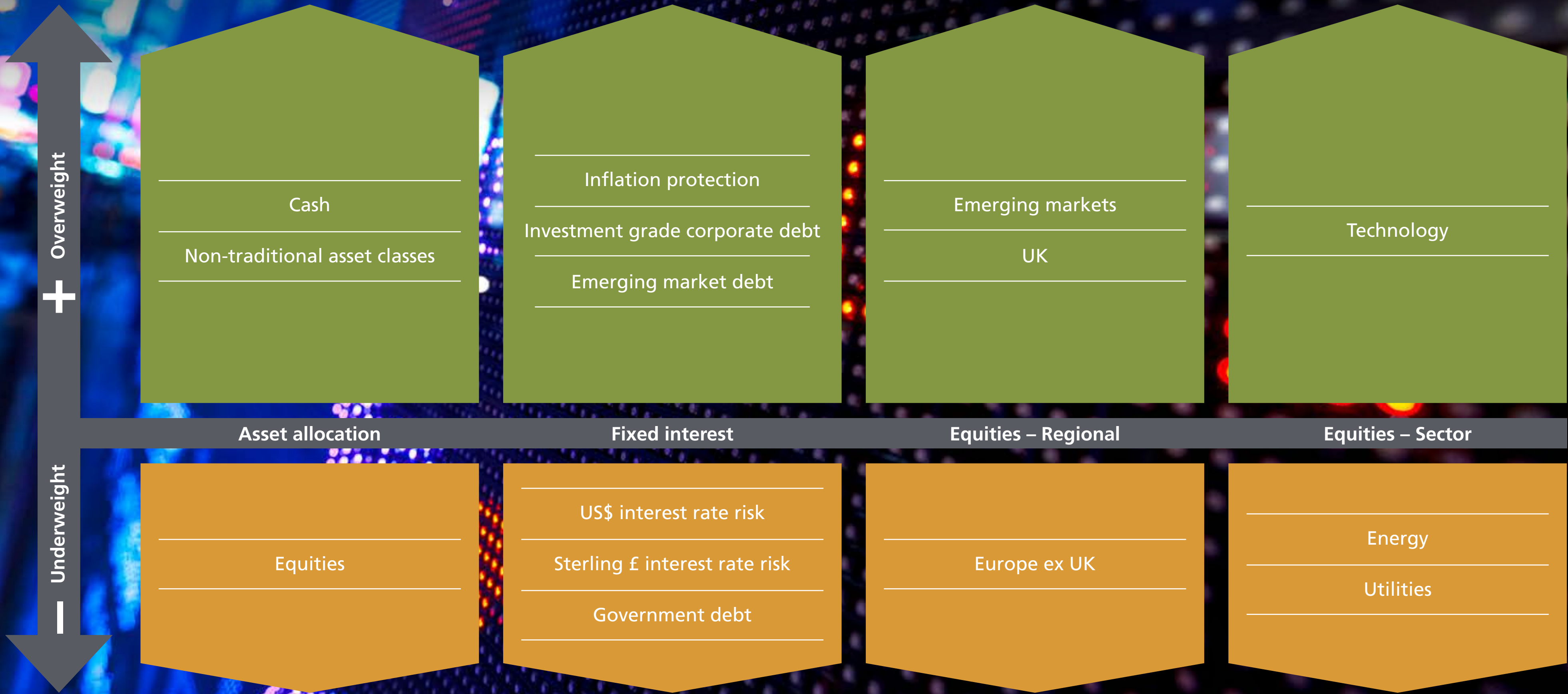
Moving forward, we believe that the risk-reward equation has become more balanced than it was in March or April. The economic destruction caused by the virus has largely been offset by fiscal and monetary policy, at least in capital markets. The risks that we see on the horizon are both virus related and policy related. Very recently, there has been a reacceleration of new COVID-19 cases as various cities around the world have reopened, which can lead to further lockdowns and lower levels of economic activity. Policy risks are focused on the extension of unemployment benefits in the US, as well as the impact of the US presidential election in November.

Offsetting some of that risk is the positive effect on equities from the unprecedented support benefiting other asset classes. As monetary policy has pushed bond yields close to their lower bounds, asset allocators have been forced along the risk spectrum into equities in the search to meet target returns. Although equities are by no means cheap, they remain attractive relative to government bonds and, given that we believe there are pockets of value in bond markets, fixed income remains an important diversifier in our portfolio construction. However, moving forward, we believe that global equities can outperform fixed income on an absolute and risk adjusted basis.

Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy



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