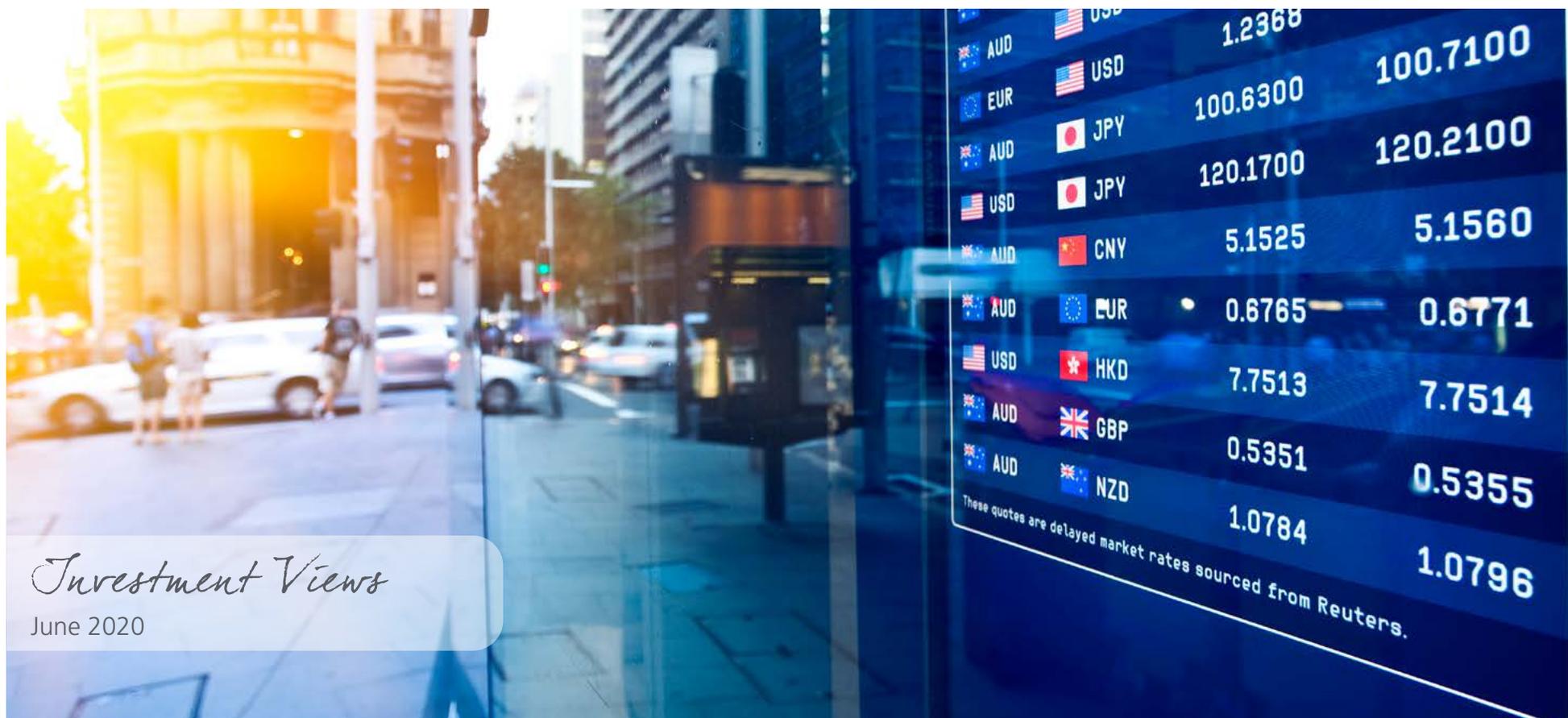




Butterfield





# Global Strategy

## Have policymakers done enough?

A good way to frame the past few months is that policy makers (central banks and governments) have been going to extraordinary lengths to bridge the gap in economic activity caused by the coronavirus-induced shutdown and associated measures. Investors have had to contend with three extraordinary 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. Over the past decade, many governments have been hesitant to increase spending given worries about high debt levels and budget deficits, but the immediacy and extent of the economic shock necessitated governments putting these concerns aside. Direct fiscal spending across the G20 countries has amounted to 4.6% of GDP, and we have also seen loans and guarantees on top of this. To put this into context, the stimulus over three months has been around double the levels we saw as we came

out of the financial crisis in 2009, and estimates suggest that the average unemployed worker in the US has been eligible to receive benefits amounting to 134% of his/her previous income, versus 40% on average historically.

When individuals receive money they can choose to spend it, save it or pay down debt. One of the potential consequences of the economic shut down was a significant rise in bad debt, but the disbursement of funds to individuals has helped to offset this at the consumer level, and we have indeed seen delinquency rates fall in April across every major consumer loan category. As so many people have been confined to their homes it is unsurprising that we have seen savings rates increase, with the beneficiaries (grocery, e-commerce, logistics and technology) being offset by weakness in other areas such as travel, leisure, clothing and many others. So we are left with the critical questions of how many of the layoffs that we have seen are temporary versus permanent, and the good news is that the signs are positive.





# Global Strategy

## Have policymakers done enough?

*(continued)*

Such a unique situation has posed challenges for economists and data collectors, but the latest indications are that the labour market in the US is in better shape than many thought. While May's 2.5 million bounce back in employment is relatively small versus the 22 million job losses over the preceding two months, it was much better than the additional 7.5 million job losses which were expected. As Capital Economics put it, "even if the rebound didn't do much to dig the labour market out of the hole, it helps that the hole wasn't as deep as we previously feared." A better (relative to expectations) employment picture bodes well for consumer spending as the economy continues to re-emerge from the shutdown, and we have already seen signs of this in some of the real-time spending numbers from the credit card companies.

Looking outside the US, we have also seen positive news from the eurozone where Germany and France have proposed a €500 billion COVID-19 recovery fund. The plan involves the EU borrowing in the market at long maturities with an implicit guarantee from the common budget, then channelling the borrowed funds to regions and sectors hardest-hit by the

COVID-19 crisis. While there is still much to be negotiated, and €500 billion won't solve all the issues, the proposal reaffirms a commitment to solidarity by the EU's two largest economies and has therefore had an outsized impact on supporting financial conditions.

In addition to the government support, we have also had a tremendous amount of monetary policy activity, which we have written about previously. The reason that we have focused here on the government support programmes for the real economy is that the situation with the monetary support is comparatively simpler. Central banks successfully fixed the liquidity issues in markets, which peaked in March, and have substantially eased credit conditions, both of which have helped the market through this period of depressed activity and uncertainty. It is likely that the US government will need to provide additional support to small businesses and extend the jobless benefits due to expire at the end of July, but overall the picture looks brighter than it did last month, and activity should continue to improve unless we see a substantial second wave of the virus.





# Fixed Income

Cautiously optimistic

Risk assets continued to rally in May with High Yield credit spreads finally catching up with US equities and Investment Grade bonds, in what could have been one of very few times the equity market has outsmarted bonds and called sentiment correctly. Time will tell, but it is worth mentioning that commodities, inflation breakevens and the US dollar, whilst moving in the right direction, are not fully embracing this rally still. For now, economic data is improving globally, with housing and confidence in the US proving particularly resilient. This is consistent with declining growth in new virus cases and consumer fatigue over being locked down for months, but there is still a long road ahead in order for growth to return to trend.

While it is tempting to sound the all clear, join the retail traders and fully allocate to risk assets, we still prefer caution at this stage. Monetary policy has been extremely powerful during this downturn and undoubtedly one of the most successful in history, in terms of solving a confidence and liquidity crisis, and central

bankers are unlikely to take their foot off the accelerator any time soon. However, most developed countries are in the very early stages of lifting their lockdowns and we simply have no idea if the virus can be kept at bay. Fighting the Federal Reserve has never been a smart investment strategy (and they have plenty of ammunition left if needed), we therefore remain optimistic, although more so in financial markets rather than the real economy.

Mobility data in the major economies all show that a return to normality is taking place, with Germany and the US leading the way. Although, public transport usage is far below average (NYC is down 70% compared to normal) as commuters either cycle, drive or walk to work. If we drill down into the mobility data, we can see some interesting developments, for example, restaurant diners in Germany are returning in droves, which bodes well for consumer spending as bored people look to spend money saved during the lockdown with pent up demand looking strong. However, the risk of an uptick in virus cases will remain for most of the summer. Vacationers are also attempting to fly again with increased demand, although much of the travel remains domestic,



# Fixed Income

## Cautiously optimistic *(continued)*

with travel in Europe restricted to countries that have set up “air corridors”. This uptick in air travel and driving should lead to firmer oil prices and this has important, positive second-order spending effects for the broad economy.

During May, we continued to reduce exposure to short-dated corporate bonds within our bond funds, as valuations became expensive yet again. Many of the holdings that we have been selling were accumulated during the March risk-off period and therefore we are now booking substantial capital gains with very little further upside given the macro uncertainty. This rapid tightening in credit spreads is partially due to slower growth in new virus cases and economic re-openings. However, the massive expansion of the Federal Reserve’s balance sheet, which ended the month at US\$7.1 trillion or 33% of US GDP, gains the most credit for the rally with the Federal Reserve now holding US\$35bn in US Investment Grade and High Yield credit. We have been net sellers into this strength not because we fear a wave of defaults (although there almost certainly will be some) but the risk versus reward is now very unattractive and we prefer to allocate

capital to assets that will still benefit from the ongoing economic recovery, such as inflation protection, or build liquidity to await attractive opportunities.

In terms of duration, we remain neutral for short duration accounts, as developed market base rates are unlikely to rise for some time, and underweight at the longer end of the US Treasury curve, where the Federal Reserve has less control. The 10-year US Treasury yield ended the month at 0.65% after having hovered around this level for the past two months, with this part of the curve continuing to benefit from hedgers nervous of another bout of risk aversion. Given the size of the US fiscal deficit and the link between government bond yields and consumer sectors, such as Housing, the Federal Reserve is likely to try and keep short-term bond yields low, possibly via an outright cap or target on nominal yields as per Australia and Japan, until the recovery becomes more entrenched and US Treasury issuance normalises. However, bond yields at the very long end of the curve are vulnerable if sentiment continues to improve and a second COVID-19 wave proves to be manageable.



# Equities

## A rally in cyclicals

The risk on trade that began at the end of March continued throughout May as equity markets price in a higher probability of economic recovery. Global equities climbed 4.8% for the month of May, following a 10.9% return in April. Global equities have now recovered the majority of the COVID-19 market drawdown, and have fallen approximately 8% on a year-to-date basis. There was a clear cyclical tilt to the distribution of returns for the month, where a handful of the best performing sectors, Industrials and Materials, were among the worst performers in the midst of the market volatility. The bounce seen in cyclically sensitive sectors displays the belief that investors have in the strength and pace of the economic recovery globally.

Global capital markets have clearly moved from indiscriminate selling (March) to indiscriminate buying (April and May). There is clear evidence that various stimulus measures, coupled with the reopening of economies after lockdowns are lifted, have improved investor sentiment. A portion of the gains in risk assets can be attributed to retail investors. Quarantined, and devoid of typical forms of entertainment such as concerts, sports, or the ability to enjoy time at bars and restaurants, swaths of prospective investors opened brokerage accounts and began to invest their hard saved (or government stimulus) dollars as a new form of “fun”. Over 2.1 million bored Americans have opened new brokerage accounts across Fidelity, TD Ameritrade, and E-Trade platforms so far in 2020; massive increases relative to any prior period. Data from Robinhood, the favourite millennial brokerage app, points to higher levels of activity among younger professionals, whose affinity is to own a combination of companies that have been hit the hardest with those that have performed the best.





# Equities

## A rally in cyclicals *(continued)*

The defensive growth nature leading to retail demand has pushed prices of tech giants up higher than their smaller peers, but this also leaves these companies vulnerable to a sell-off in price. Deutsche Bank's research team refers to these tech giants as "Mega-Cap Growth" companies, and along with those companies that have been beaten up, retail investors have been adding to these companies with increased pace over the past several months. The recent run up in share prices of the collective "Mega-Cap Growth" cohort leaves investor positioning crowded and stretched and the diverging valuation gap can lead to these companies falling back to Earth. While we maintain exposure to most of these "Mega-Cap Growth" companies, we have made adjustments to our allocations within portfolios to better reflect our medium and longer-term outlook, instead of chasing returns.

We have made a handful of tweaks to our equity portfolios over the past several months to take advantage of market dislocations. Within our ETF portfolios, we added in a position to US Homebuilders which had been hit hard, but should perform

well as falling mortgage rates spur people to buy new homes. We also augmented our allocation to the Communications sector, while reducing our exposure to more defensive sectors. In our segregated portfolios, we have rebalanced our technology exposure and have begun adding a position in Apple, at an attractive entry point. We also rebalanced the Industrials sector after M&A activity altered our target exposure. Our portfolio managers continue to avoid many companies and sectors that will have difficulty thriving in the new normal we all now know. Hundreds of thousands of investors on brokerage platforms like Robinhood have been buyers of companies like Hertz even after the company filed for bankruptcy protection, with no promise that they will receive even a penny per share after those higher in the capital structure fight for repayment. Our investment process includes a stringent review of many factors affecting the value of an asset, and as such, adding companies such as Hertz or American Airlines, another Robinhood favourite, would be imprudent regardless of any recent gains.



# Global Asset Allocation

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





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