Butterfield

Global Strategy
The Great Disconnect

Fixed Income
A Strong Month for Credit

Equities
Investors Pay up for Growth

Global Asset Allocation

Investment Views
May 2020

Global Strategy

The Great Disconnect

As people around the world were practicing social distancing to curb the growth of COVID-19, financial markets distanced themselves from economic reality in April. Both corporate credit and equities staged strong recoveries from the lows in March against a backdrop of rapidly deteriorating economic data. Commentators have gone to great lengths to explain the disconnect and many of the explanations hold varying degrees of truth. Company earnings tend to follow the economic cycle and estimates have indeed been revised down sharply over recent weeks. Generally speaking the more exposed a company or sector is to the economic cycle the more earnings expectations have fallen. However, the multiple that investors are prepared to pay for those earnings is driven by a multitude of different factors.

A key driver of financial markets is investor sentiment around what the future may hold—more specifically factors such as the outlook for economic growth, earnings growth and interest rates. Sentiment reached a point of extreme pessimism in March, which reflected the level of uncertainty around the extent of the damage caused by the economic shutdown in response to the virus. Furthermore there was a significant amount of uncertainty around the speed, scale and effectiveness of potential policy responses to help support the economy and financial markets through such a challenging period. Thankfully the policy responses from both central banks and governments have been unprecedented in terms of scale and the speed at which the measures have been implemented.

Rather than spending time peering into a decidedly cloudy crystal ball to try to forecast how the virus will evolve, when economies will reopen or when a vaccine or antiviral treatment may become available, we have been spending time trying to understand

Global Strategy

The Great Disconnect

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where policy support can be most effective and which companies or industries are best positioned to come out of this stronger on the other side. We were therefore quick to recognise that lower interest rates and central bank asset purchases (quantitative easing) were likely to provide support to corporate bond markets and help to fix some of the market dislocations that we saw in March. Some have been critical of central banks for providing a "backstop" to so many businesses and suggesting that it is not possible to "fix a debt problem with more debt"; however, the issue with that argument is that this is not primarily a debt problem, it is a "the economy is temporarily shut down due to a global pandemic" problem. Essentially policymakers have been attempting to bridge the gap until the economy can reopen again and when it comes to financial markets we can say that this has so far been incredibly successful.

Where the efficacy of the policy response gets harder to measure is in the real economy. We have seen some truly horrendous economic data releases over recent weeks, but this is unsurprising given how much of the economy has been shut. We know that this downturn will be very deep, but what matters for markets is the path of the recovery. China was the first country into the crisis so has been the first to reopen and Europe is now in the process of slowly opening up. We have already seen that reopening is a process rather than an event and the road is likely to be bumpy, so given how strongly markets have rebounded, overall our tone remains one of caution and one of selectively taking advantage of opportunities in both credit and equities.

Fixed Income

A Strong Month for Credit

With the global economy still shell-shocked by the impact of COVID-19 and most market participants trading blind—with outdated economic data releases to work with—the rally in risk assets, especially US equity markets, does seem a little bewildering! Fear of missing out, or FOMO, appears to be driving flows with the shock and awe from fiscal and monetary policy currently providing enough of an incentive to add exposure. However, bond yields remain low with 10-year and 30-year US Treasuries ending the month at 0.64% and 1.29%, the US dollar remains strong, US inflation expectations have barely moved and commodity prices are actually lower than last month; so why the disconnect and will equities prove the bond market wrong for once?

It's true we have also seen a rally in credit markets, in which we have fully participated, with the CDX IG index falling in April from 113bps to 87bps. However, this can be fully explained by the Federal Reserve's purchasing program, which at this stage although having not purchased a single corporate bond has successfully returned some normalcy to the asset class and now provides the opportunity for elevated risk adjusted returns. With this level of central bank support we have seen massive levels of activity as US corporations issued $534 billion in debt during March and April alone, twice as much than the same period last year as companies shore up liquidity and extend debt maturities. For companies such as Boeing, this has enabled them to avoid a US government bailout, but also carries the price of higher leverage at least in the short term.

We also witnessed some extraordinary behavior in energy markets with the near dated WTI futures contract trading at a -$37, yes negative, for the first time in history. This was largely a technical move with owners of the contract leaving it to the last day of trading to reduce their exposure and given the psychical settlement nature, where you are obligated to take actual delivery of barrels of oil at expiry, coinciding with zero storage space at at key facilities due to the abrupt economic shutdown, sellers had to pay to offload the liability. OPEC and various other governments have already agreed to cut production substantially, but this does

Fixed Income

A Strong Month for Credit

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not offset the collapse in global demand and production cuts also take time to rebalance the market.

Economic data releases remain dire, but as expected, on the positive front China's economy is almost back to full activity and the massive 1930s-level unemployment numbers coming out of the US appear to be mostly temporary; however, global activity cannot and will not return to normal in the near term. Although there will likely be an element of pent up demand, we are seeing some signs in the US of this, the ongoing nature of this virus with no vaccine in sight leaves some sectors such as airlines with no choice but to scale back, cut jobs and investment. We are entering a period of deleveraging, lower revenues and increased costs due to supply chain adjustments. This bodes well for debt holders but not equity where buy backs and dividends have either been cut completely or reduced and thus this disconnect between asset class performance becomes wider.

Given our purchases of risk assets such as investment grade credit and US Treasury Inflation Protected securities during the volatility in March, our portfolio activity this month was relatively subdued. Although, in some portfolios we did opportunistically add to credit via Financials and REITs and we continue to favour UK and US banks due to their solid capital, conservative lending practices and ample central bank support. We believe that the unprecedented level of support for US credit markets will likely lead to further tightening of credit spreads (the premium companies pay to borrow), with valuations still much cheaper than normal, over the coming months and provide a cap to higher spreads in the event of another downturn in equity markets.

In addition, within our US Mortgage Backed Securities holdings we have started to reduce exposure as spreads have returned to levels last seen at the start of 2020 and refinancing risk is likely to increase as the economy reopens. The asset class performed exceptionally well relative to higher rated US credit and was one of the first to receive massive support from the Federal Reserve and thus the investment thesis that drove the establishment of the position has largely played out. The proceeds will be used to either replenish dry powder, add to cheap credit or US TIPS where price appreciation has lagged.

Equities

Investors Pay up for Growth

Just as various economic metrics (unemployment, Purchasing Manager Indices, GDP growth for example) displayed the destruction COVID-19 left in its wake, equity markets jumped 10.9% for the month. Equity markets recovered approximately 40% of the first quarter losses. The relief rally was welcomed by investors big and small who saw losses build up similar in magnitude and pace to historical sell offs like the Global Financial Crisis or the Great Depression of the 1920s. Sentiment has clearly improved as a roadmap to reopening economies has emerged entailing a staged approach. However, significant uncertainty remains in terms of the path forward for equity markets.

The speed in which the sell-off and recovery occurred is historic, and displays the extreme levels of market volatility. The S&P 500 fell 34% in 23 trading days, more than triple the next largest drawdown over a comparable number of days. The S&P 500 then recovered 50% of the total drawdown in just 13 days, compared to an 18% recovery over a comparable number of days coming out of the Global Financial Crisis. The incredible moves in both directions have given multi-asset portfolio managers and asset allocators little time to rebalance portfolios, even if there is a desire to do so in the face of low levels of liquidity in many capital markets. Over the course of many ad-hoc investment committee meetings over the past several months, we have decided to maintain our underweight stance towards equities as the move in April may have come too far, too fast.

Due to the rally we have experienced over the past 45 days, equity markets are now as expensive as the Dot Com Bubble. At the time of writing the technology heavy NASDAQ index is positive for the year and within 10% of its all-time high back in February. Conventional wisdom is that the market on the whole may appear inexpensive as prices have fallen, however, earnings expectations have fallen further. Clearly, any measure of earnings-based valuation is up for debate, although the entire market looks more richly valued after the recent fall in prices than prior to the downturn, a function of plunging earnings. Equity markets are not only expensive, but there is a concentrated group of companies propping up their peers. Unsurprisingly, this group of

Equities

Investors Pay up for Growth

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companies is centered in the technology and consumer sectors, and includes Microsoft, Amazon, Apple, Alphabet, and Facebook. A concentrated market in and of itself is not a poor characteristic, however, should any of the above begin to show cracks, their large cap peers could suffer as a result. Before increasing our exposure to the equity market in multi-asset portfolios, we prefer to see more broad based strength, perhaps in sectors of the economy that have been hit the hardest, in addition to improvements in other fundamental and technical factors that we examine on an ongoing basis.

Global Asset Allocation

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

	Asset allocation	Fixed interest	Equities – Regional	Equities – Sector
Overweight +	Cash Non-traditional asset classes	Inflation protection Investment grade corporate debt Emerging market debt	Emerging markets UK	
Underweight –	Equities	US$ interest rate risk Sterling £ interest rate risk Government debt	Europe ex UK	Communication services Energy Utilities

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