INTERNATIONAL FUND SOLUTIONS

STRATEGY UPDATE

June 2020

VALUATIONS, FLOWS, PANICS AND PANDEMICS – THIS TIME IT ISN'T DIFFERENT

May has been another positive month for risk assets with most equity markets making further solid gains. The tech heavy NASDAQ is up nearly 30% from where it was a year ago and is now in positive territory on a year to date basis. Elsewhere, corporate bond markets appear to have returned to more normal conditions, with improved liquidity and new issues being oversubscribed but with the caveat that there does appear to be a higher level of dispersion between the pricing of high-quality credits and those in more challenged industries and from weaker issuers.

Despite many ongoing uncertainties the second half of 2020 is still expected to show a strong recovery in economic activity, partly due to base effects, but there are also other factors at play. By way of example the US government social benefits in the form of care packages such as income transfer and economic recovery payments have been successful in cushioning household finances. These fiscal initiatives have resulted in a 10% or $1.9trn jump in personal income during April with more to come during the next few months. With consumer spending still constrained by COVID-19 restrictions the personal savings ratio in the US has jumped to 33% of disposable income, which looks set to form a base to fuel an acceleration in consumer spending as the economy reopens. In addition, it is also encouraging to see that business and consumer surveys appear to have bottomed.

So, is that it? Have we seen the full market reaction to the COVID-19 pandemic and are now out the other side?

To us, unfortunately it appears highly unlikely that markets are only set for further recovery in the short term and the full effects of this pandemic are fully discounted in the current prices of securities. The improved outlook should be evaluated against the fact that many of the fiscal support initiatives are temporary and will be coming to an end as the year progresses. Employment is also highly unlikely to revert to pre-virus levels in the near term as many companies have reverted to debt burdens to safeguard the cash resources available on their balance sheets. Companies with weak balance sheets will be constrained from hiring during the initial phase of recovery. And then of course there is always the possibility of increased tensions between the US and China and the risk of reinfections as people go back to work.

If that was not enough for investors to ponder, although the extent of the sell-off in equity markets in March was both massive and sudden the technical indicators we monitor monthly, which measure participation in market movements, did not indicate that a market panic took place, equally there has been no euphoria in the market as it subsequently rallied. This tallies with the feedback we are getting from fund providers (the companies that own the fund structures we buy on your behalf) where individual strategies may be getting inflows or outflows, but overall there does not appear to have been either a wholesale risk-on move or significant disinvestments. In short, most investors rode the markets down and back up again and have not made sweeping fear induced liquidations.

What are our managers doing? We have written several times before about the extended valuations in some areas of the equity market and what we have seen in the recent volatility is that valuations in these areas fell and then rebounded very strongly, to the point that they now appear to be pricing in the most optimistic of scenarios – a near term V-shaped recovery with strong growth next year. Although one of our managers invested heavily following the market falls, having run a relatively high cash balance for the last couple of years on valuation grounds, they are certainly in the minority. The result of this is that if managers were worried about some valuations before the sell-off they are almost certainly more concerned now as valuations have recovered but future earnings look set to be lower.

However, at recent meetings with some of our managers it is clear that they have been tilting the weighting of their portfolios more heavily towards resilient companies. That is those companies that not only have a competitive advantage but are also financially structured in such a way that they will be able to withstand even a prolonged COVID-19 related downturn. We view this as further development of the survivors and winners theme that we have touched upon previously as a strategy that our managers have been adopting over the last couple of months. This would appear to be a prudent and sensible approach given the current climate. However, investing in resilient companies does come at a price with the managers cautioning that they now need to be willing to hold companies beyond the valuation levels they would normally find acceptable in exchange for the resilience offered.

With a cautious medium-term outlook, we have made alterations to our fixed income exposure in portfolios during the month, reducing credit exposure in favour of government bonds and slightly extending overall duration towards benchmark. This should provide us with some protection should we see a negative reassessment of risk appetite. It is also likely that we will see some changes within our equity exposure over the coming months, with a reduction in exposure to mid and small cap companies in favour of large cap companies.

In the near term, the outcome of our monthly tactical asset allocation meeting was to maintain the underweight equity positioning, with the remaining allocation to cash. Forward looking indicators continue to point to negative market returns over the coming month and valuations for both equities and fixed income appear stretched.

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TACTICAL ASSET ALLOCATION UPDATE

Asset Allocation Committee Commentary: **US Dollar - Leading Indicators**

- The exposure to global equities has been maintained at Underweight
- Leading indicators for all equity regions are still negative
- Fixed Income leading indicators are positive, however valuations remain at extremes

Underweight Equity

Categories	Equity			Fixed Income
	Domestic	Developed ex US	Emerging	
Monetary and Rates	▲	▲	▲	▲
Economic	▼	▼	▼	▶
Trends	▲	▶	▲	▲
Total	▼	▼	▼	▲

Asset Allocation Committee Commentary: **Sterling - Leading Indicators**

- The exposure to global equities has been maintained at Underweight
- Leading indicators for all equity regions are still negative
- Fixed Income leading indicators are positive, however valuations remain at extremes

Underweight Equity

Categories	Equity			Fixed Income
	Domestic	Developed ex UK	Emerging	
Monetary and Rates	▲	▲	▲	▲
Economic	▼	▼	▼	▲
Trends	▼	▲	▲	▲
Total	▼	▼	▼	▲

Asset Allocation Committee Commentary: **Euro - Leading Indicators**

- The exposure to global equities has been maintained at Underweight
- Leading indicators for all equity regions are still negative
- Fixed Income leading indicators are positive, however valuations remain elevated

Underweight Equity

Categories	Equity			Fixed Income
	Domestic	Developed ex Europe	Emerging	
Monetary and Rates	▲	▲	▲	▲
Economic	▼	▼	▼	▲
Trends	▶	▶	▲	▲
Total	▼	▼	▼	▲

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