

April 1, 2020

BILBoard March 2020: Patience, discipline and opportunistic portfolio rebalancing



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The global economy is in an induced coma and the coronavirus pandemic will lead to a profound, but not permanent, reduction in economic activity. 2.5 billion people (one-third of the global population) now have some kind of

restriction on their movement as governments attempt to snuff out the virus. The consequent fall in demand, halted production and severe supply chain disruptions undoubtedly mean that the global economy is now in recession.

The length of the recession will depend on the course of the pandemic (epidemiological factors such as when new infections will peak are an unknown) as well as the policy response. There is no playbook for what's going to happen next; nor do we have any comparable historical episodes. However, China now seems to be approaching the light at the end of the tunnel, and with the virus having peaked, the cogs of its economy are gradually starting to turn again.



Our base case scenario sees a government-led 'Great Cessation' spanning Q2, with both supply and demand hitting the rocks. This

could be devastating for the millions of small businesses that form the backbone of the global economy. A wave of layoffs, missed rental payments and bankruptcies are likely to follow, even if governments move quickly to bridge the disruption. But the economic system has a natural adaptive ability: it will survive. Q2's deep recession will not result in some kind of economic ice age: once social distancing is no longer required, the economy will gradually come back to life. Consumer spending will resume, delayed purchases will be made. Robust companies will further extend their leadership, while new needs, ideas and opportunities will erupt.

But in the meantime, markets are struggling to think that far ahead, with media-induced fear and anxiety steering sentiment. The result has been a precipitous stock market drop, faster than any other in history.

To calm capital markets and prevent a prolonged recession and self-fulfilling feedback loop, regulators, governments and central banks are on the frontline, with some resorting to war-time measures. Monetary authorities are promising as much liquidity as financial intermediaries and credit markets want, and the heaviest artillery lines are being reinforced by massive public and fiscal spending. At the same time, financial institutions are in a much more robust position than they were in the past, with smaller balance sheets and high capital buffers, allowing them to offer credit lines to temporarily cash-strapped companies.

Theoretically, the S&P 500's valuation has recalibrated to more attractive levels. The reason we say "theoretically" is because no one has any idea what earnings will actually be. But eventually, anxiety will decline and consumption, spending, investment and production will return. Markets will have already rebounded before the recovery shows up in the macro data. With this in mind, we decided to top up our equity exposure to rectify the 'portfolio drift' effect (the decline in the market value of stocks naturally meant that they accounted for a smaller portion of our portfolio than they did before the sell-off), and bring our overall equity exposure back to neutral. We did so by cherry-picking **high-quality** names, using fundamental screening to identify well-poised, high-cash, low-debt companies generating high levels of free cash flow,

while avoiding sectors/activities at acute risk of disruption in the current context.

We have also rejiggered our sovereign bond exposure. While the overall allocation to this asset class was held steady, we increased our euro-hedged US Treasury holdings towards 20% of the total government bond exposure by selling a proportionate amount of European government bonds. The primary reason for this is to diversify interest curve risk: if the situation deteriorates, Treasuries have more room to move downwards in terms of yield than European equivalents. The best thing to do in the fixed income world at the moment is to stay safe. Credit spreads have blown out across all credit tiers; even those on AAA-rated investment grade paper more than doubled in just ten days, and, if 2008 levels are anything to go by, spreads could still widen significantly. High yield is basically a no go for the time being and the new issue market is closed. The segment, in both the US and Europe, is threatened by a wave of fallen angels (the downgrade of IG bonds to the junk category), while the US high yield space looks even more febrile when you consider its close correlation with the oil price (due to the presence of many shale-producing firms). For now, Saudi Arabia's price war persists, which last week caused crude to dip below \$25 per barrel.

With so many moving parts, it is true that things may get worse before they get better. However, we should stay focused on long-term investment objectives, reassured that with so much fiscal and monetary firepower being brought to the table, this is not the beginning of the end. The majority of blue chip companies and household names will survive this.

For now, the best thing we can do is play our part in "flattening the curve" and getting this disease under wraps by staying at home if possible, while implementing social distancing and near-obsessional hygiene. If in need of something to watch and/or reassurance, the new Netflix series "Night on Earth" is a solid pick. Using the latest camera technology, it lifts night's veil to reveal the hidden lives of the world's creatures after dark. A reassuring anecdote comes from the arctic frog. These tiny amphibians are captured surviving almost completely frozen, to the point where they stop breathing and their hearts stop beating entirely for weeks at a time. But when warmer weather comes, the frogs are shown miraculously defrosting and coming back to life – let's think of the economy like an arctic frog.

Current Asset Allocation 24/03/2020		DEFENSIVE	LOW	MEDIUM	HIGH
		Stance	Stance	Stance	Stance
Global allocation	Equities	●	●	●	●
	Bonds	●	●	●	●
	Cash & Cash Equivalents	●	●	●	●
Currencies	EUR	●	●	●	●
	USD	●	●	●	●
	Other	●	●	●	●
Equities	Europe	●	●	●	●
	USA	●	●	●	●
	Japan	●	●	●	●
	Emerging Markets	●	●	●	●
Bonds	Government Bonds - Developed	●	●	●	●
	Corporate - Investment Grade	●	●	●	●
	Corporate - High Yield	●	●	●	●
	Emerging Market Debt	●	●	●	●
	Total return	●	●	●	●
Commodities	Oil	●	●	●	●
	Gold	●	●	●	●

Stance: Indicates whether we are positive, neutral or reluctant on the asset class

Change: Indicates the change in our exposure since the previous month's asset allocation committee

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