thenavigator

Spring 2020

The two most powerful warriors are patience and time – Leo Tolstoy

THE CLUE IS IN THE TITLE!

COVID-19 is a global pandemic which has led to something we have never seen before: a global health crisis that in turn has led to a global economic crisis.
The virus has no respect for geographical borders, race, religion, politics or economic affiliations, either regional or global. Unfortunately, some people do not understand this yet – but they will before it is all over.
Looking at the great financial crisis of 2008, the world did not cooperate immediately to stem the decline, but it did get there eventually. There can be no solution to the current crisis until we see much greater cooperation on a global scale. Whilst it is tempting now, when we are all in a fragile psychological state, to engage in finger-pointing and a blame game, this will solve absolutely nothing and probably only make things worse. Once the current crisis is over, we can all indulge in this to our heart's content.
As individuals in the rather unusual circumstances we are facing, we must be extremely wary of politicians who will use the current situation to sow discord to divert attention away from their failed policies.
While we have given up some significant democratic liberties in the short term in order to suppress the virus, we must ensure that our politicians give us back these liberties in a swift and timely manner. Make no mistake, we are in a very dangerous period for democracy.
Let's hope there is some improvement in global political leadership and that world leaders put aside their petty squabbles and focus on the issues that affect all of humanity right now. The world needs economic growth to rebound quickly and reassurance from leaders and central banks that they will do what it takes in a coordinated way.

MORE QUESTIONS THAN ANSWERS

As an industry, asset management has an appalling track record on calling things right. Much of the fault lies with the financial media and their global, 24/7, 365 days a year media cycle. Whilst many impressive financial experts (who have called something right once upon a time) are wheeled out to give intelligent-sounding advice, in reality no one has a clue how this will play out – not even the medical community. Your individual opinion has just as much probability of being right or wrong.
So instead of focusing on "what ifs?" and "maybes", let's try and concentrate on what we know.

The economic data is bad – really bad – and it is only going to get worse in the short term. In fact, some of the readings will probably surpass the 1930s in their nastiness. However, we all know this, as do the markets. Of course, this is just a point in time, albeit an uncomfortable and scary one.

BUT

One important point to consider is that even though financial markets are dependent upon economics to some extent, they do not follow every twist and turn in real time and can become somewhat detached over periods.

At some point in time there will be an economic recovery. Nobody knows when, but it will happen and perhaps even sooner than many anticipate. While people are talking about a V shape or a U or even a W, it really is all alphabet soup. We just don`t know until it happens, but if you're not positioned for it you won't participate because the movement is likely to be fast and aggressive in nature.

Human beings are pack and social animals – if we were not then prison and solitary confinement would not be punishments. After this severe crimping of our freedoms there will be some latent and pent-up demand.

Following the herd is not the way to generate long-term outperformance. What may seem sensible now may not be soon. After all, how many pieces of exercise equipment does one household need? How many monthly trial subscriptions to media streaming companies will be cancelled once lockdown ends?

Earnings from companies are and will continue to be awful for a while, but this lowers the bar going forward for future comparisons and early evidence suggests that companies are being prudent in their spending and dividend policies.

Analysts have thrown in the towel on even guessing what company earnings are going to be and companies have ditched any forward guidance, which does leave the hurdle for positive surprises rather low.

Our sleeping rhythms have been disrupted, which makes us sensitive to headline-grabbing news. No, the oil price didn`t really go negative, but rather the future short-term price for US landlocked crude oil (WTI – West Texas Intermediate). Upon reflection, this makes sense given the drop-off in demand and high storage costs.[1]

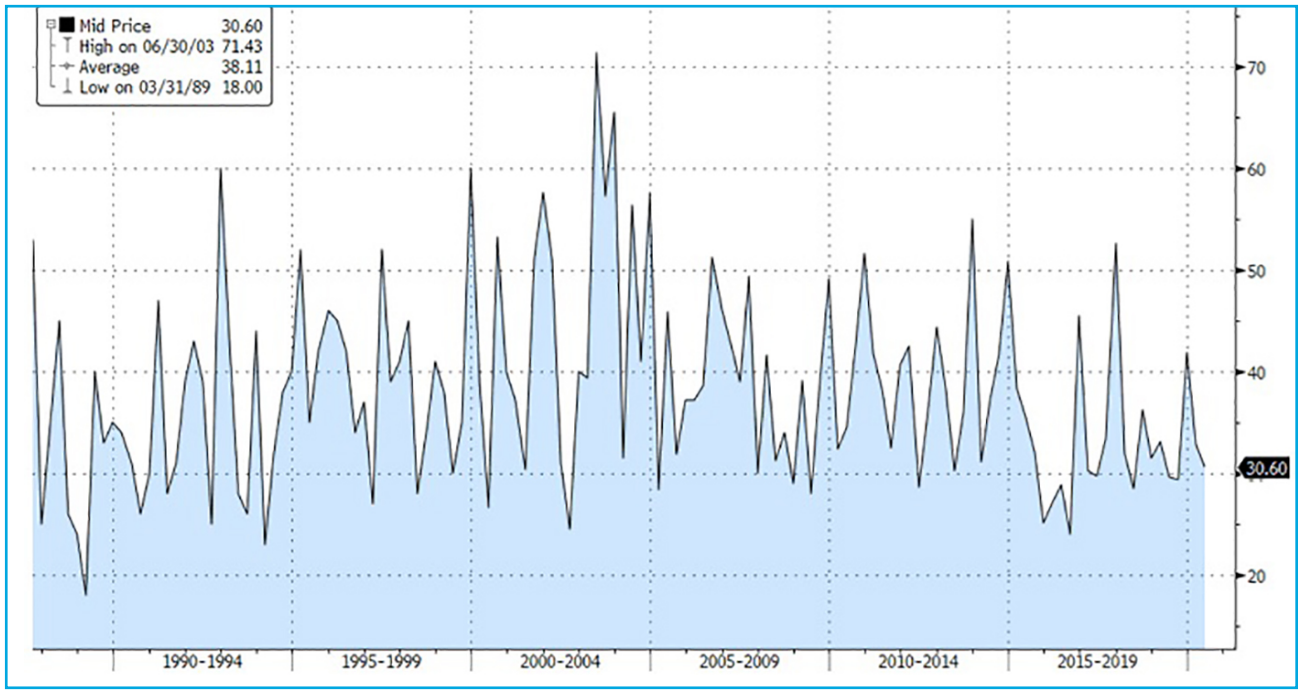
Be careful of prominent, definitive announcements as there are many agendas out there. The airline industry has announced it will take years to recover even though it knows no more than you do. Could this sector just be looking for an excuse to streamline its businesses without taking political flak?
A large amount of very talented professional work on treatments and vaccines for the virus is being undertaken in a global and coordinated manner. At any point in time there could be a breakthrough and it will be a binary event. The sooner it occurs the shorter the duration of the economic damage and the quicker and more pronounced the recovery.

Unemployment has risen and will continue to increase substantially. However, on a percentage basis the vast majority will remain employed. Those who have been laid off are mainly in the service sector and could be re-employed rather quickly as and when things get back to normal.

Those who are lucky enough to have steady, well-paid jobs will have rather a lot of accumulated savings given that there has not been much to spend money on. Once confidence returns that spending firepower will be deployed.

Central banks have pumped unprecedented amounts of stimulus into the system but can and will do more. Governments have also joined in, though they need to do more.[2] It is way cheaper in the longer term to fuel the recovery now via stimulus than to have a weak and prolonged recovery in the future.

Markets take great delight in wrong-footing the maximum number of participants. Looking at the AAII Sentiment Survey[3] below, in which bullish sentiment on the part of individual investors is near 2008 lows, the maximum pain trade would be for markets to continue their upward trajectory.



Source: Bloomberg, American Association of Individual Investors, Sentiment Survey bullish readings; data represents what directions members feel the stock market will take in the next six months, 1 January 1986-30 April 2020.

We are starting to see some kind of return to normality on a sequential basis. The countries that the virus hit first are the first ones out. Manufacturing in China is starting to rebound, though for this to continue there will need to be demand in other parts of the world.[4]

Markets are discounting mechanisms that look three to six months ahead, while at the moment most investors are just focusing on the here and now or the very immediate future.

Businesses and human beings adapt in order to survive. We have already seen restaurants moving towards a take-out and delivery model. How long will it be before they move to a contained booth model?

Hairdressers and beauty salons have been rather quicker on the uptake. Two days ago I went for my first haircut in more than a month. Everyone wore masks and gloves, and everything was disinfected. At no point in time did I feel at risk and my only downside was not having an espresso, which was no big deal. I gave the hairdresser a tip of 50% because I know that the service industry has been hard-hit and now is the time to be generous if we want our local businesses to survive.

While there have been some very bold pronouncements on how things will change permanently, I am not so sure. But I do believe that many companies across the world will question how much office space they really need, which will impact commercial property and rent prices.

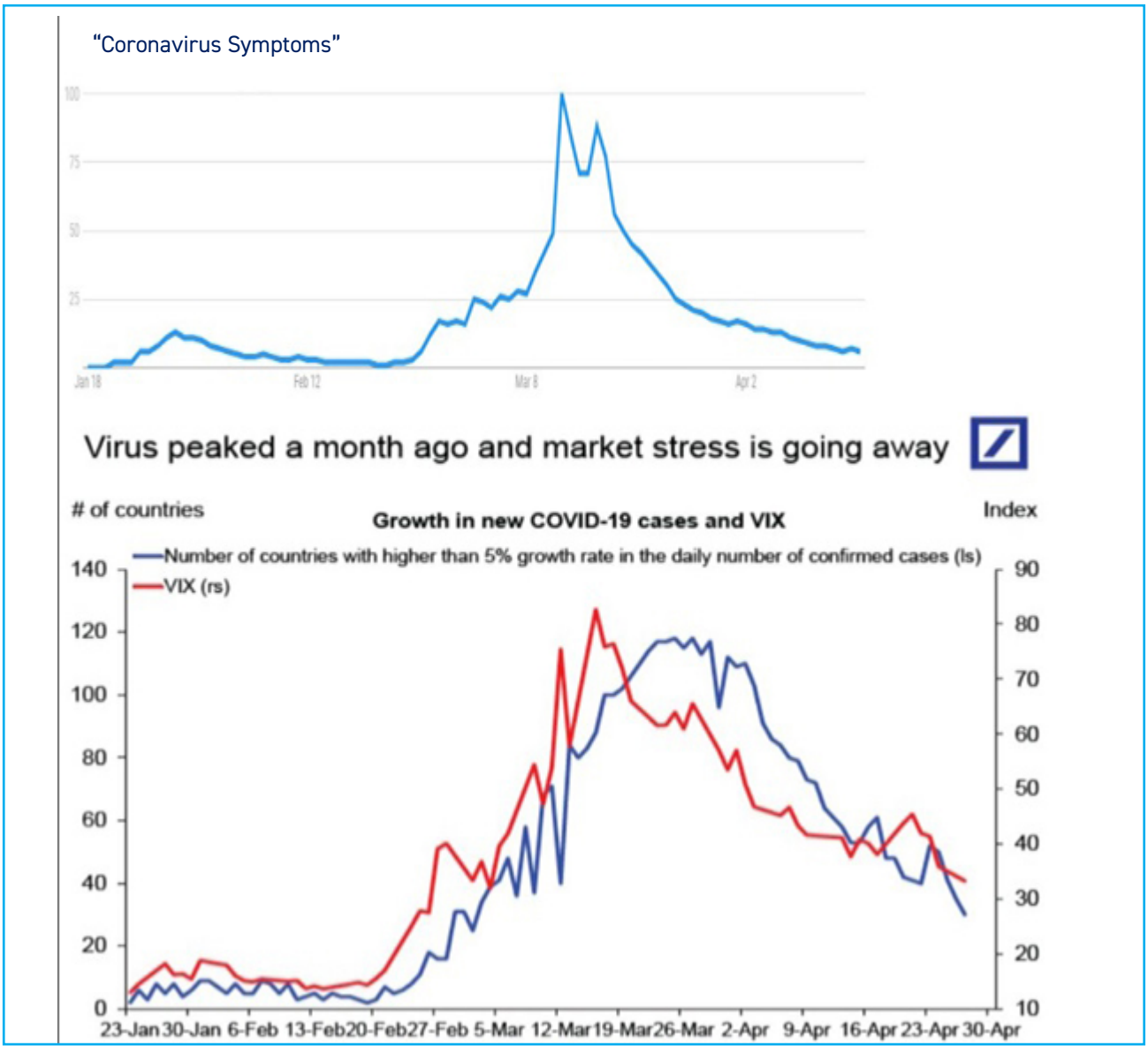
We are all learning new skills – I have become a dab hand at Japanese knife sharpening, and my daughter has taught our dog to jump over ever-higher hurdles of toilet rolls.

I KNOW YOU'RE STILL SCRATCHING YOUR HEAD

After one of the worst months and quarters in the history of global markets we are now experiencing one of the strongest months in April.[5] What changed and when is the second leg down coming?

THE HONEST ANSWER IS THAT NOBODY KNOWS!

Perhaps it was the removal of uncertainty that this crisis would be never-ending. The first part of the chart below shows that Google searches for coronavirus symptoms peaked a month ago. The second part of the chart shows that as the growth in new virus cases declined, so did volatility in the US equity index.[6]

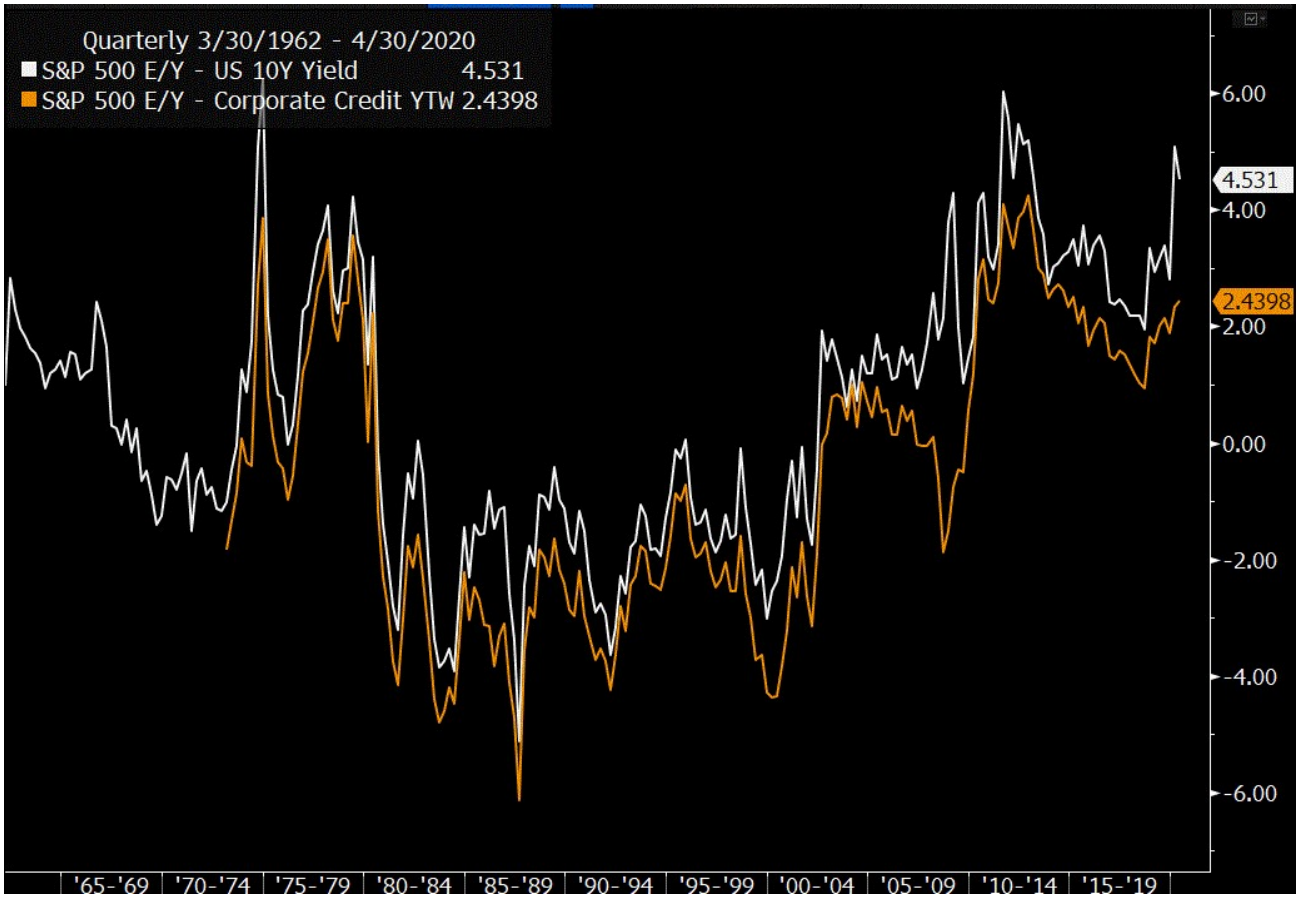


Source: JHU, Bloomberg Finance LP, DB Global Research; growth in new COVID-19 cases and Chicago Board Options Exchange Volatility Index (VIX) compared with Google Trends searches for "coronavirus symptoms", 23 January 2020–30 April 2020.

It is also possible that markets have written off earnings for the time being and are now just looking forward to the recovery.

It could be that as individuals we have just become less scared of the virus as time has elapsed.

Sometimes simple daily observations can be useful in identifying human behaviour. Looking at Switzerland, I can see that the car park at our local DIY shop has been permanently full since it reopened. The queue at the McDonalds drive-in has a waiting time of at least 25 minutes. The car park at the local shopping centre is five times busier than it was before.



Source: Bloomberg Finance LP, S&P 500 Index; equity risk premium versus bonds, 30 March 1962-30 April 2020.

Looking at the chart above, which shows the equity risk premium versus bonds (how much extra you are rewarded for taking equity risk), we can clearly see that we are currently at elevated levels – ahead of the great financial recession and closing in on 2011 and 1974 levels. In simple terms, equities look cheap compared to bonds.

As to the second down leg, some profit-taking would be understandable. However, if it never happened we could also understand why.

Whilst we are painfully aware that there could be some short-term weakness, we do not believe that the March low in markets will be revisited, mainly because we think the unprecedented monetary and fiscal stimulus (which we believe will be greater going forward) will ultimately be successful. We are also investors and not day traders and fully expect the stocks we hold to significantly appreciate from their current levels over time.
Of course, this does raise other issues such as the longer-term worries over such a high level of government debt, which could eventually lead to inflation if and when we get through to the other side of this crisis. To counter this we have sold some longer-dated bonds and increased our allocation to gold.

But at the end of the day only time will tell.

The Navigator
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[1] https://www.forbes.com/sites/jimcollins/2020/04/20/the-us-oil-etf-uso-is-the-culprit-behind-oils-massive-plunge/#6fae2ae724e8
[2] https://www.reuters.com/article/us-health-coronavirus-economy-factbox/factbox-global-economic-policy-response-to-coronavirus-crisis-idUSKCN21W2AJ
[3] https://www.aaii.com/sentimentsurvey?
[4] https://www.bloomberg.com/news/articles/2020-03-31/china-factory-rebound-hints-worst-is-over-as-stimulus-lies-ahead
[5] https://markets.businessinsider.com/news/stocks/stock-market-news-today-dow-sp500-best-month-since-1987-2020-4-1029152392
[6] https://www.bloomberg.com/opinion/articles/2020-04-29/stocks-rally-has-roots-in-waning-fear-of-coronavirus

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