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QUARTERLY INVESTMENT REVIEW

> *"Policymakers have conjured tons and tons of money out of thin air. As a result, we are now in a situation where never before in history has so much money been chasing so few goods and so few financial assets."*
>
> Charles Gave

In the second quarter equity markets rallied strongly on the back of the abundant liquidity provided by the world's Central Banks. The MSCI World rose 18.8% during the quarter which left it down 6.6% year to date. Sovereign bond markets were also firm and credit markets continued to recover. Gold rose by almost 13% in the quarter to finish at its highest level since 2012.

As an event the onset of the Covid-19 pandemic may herald the biggest global change since the collapse of the Berlin Wall in 1989. It presents investors with the challenge of weighing up the most dramatic plunge in global economic activity since 1945, against the largest ever monetary and fiscal stimulus. A fog of uncertainty hangs over the world economy. The unique quality of today's environment is the impossibility of knowing when the pandemic threat will abate (for example will there be a second wave or not), and how businesses and consumers will react until and beyond that point. The likelihood is that the economic recovery will be slow because uncertainty is the enemy of spending and investment. Currently economic activity is only being held together by monumental government support, so on the face of it markets are ahead of themselves, and that is before considering the heightened political tensions and upcoming US elections, with the risks they could bring to globalisation and productivity.

The scale of the shock and response to it has been unprecedented. Once Governments mandated the shutdown of large parts of the economy they had no choice but to provide support. No business is built to survive months of zero revenue, and many businesses such as airlines, hotels, cinemas, cruise ships, retailers and restaurants have had to cope with this. Yet the scale of the support has been breath taking. There have been over 100 interest rates cuts by Central Banks, and Governments have organised in the region of $18 trillion of stimulus. For comparison Gavekal have estimated that the US Government's response to Covid is four times the inflation-adjusted cost of the Vietnam War. These measures landed on a system that was exhibiting vulnerabilities already. There has been a tremendous build up in non-financial debt in the West, which is also grappling with deteriorating demographics, aggravated by the backlash against globalisation that threatens the free movement of both skilled and unskilled labour to countries that are in shortage. While it is early days some predictions can be made of forthcoming changes. It is likely that supply chains for many goods will be brought closer to home. The crisis left many countries reliant on medical supplies from the other side of the world (China manufactures most of the West's anti-biotics for example). Relocating supply chains will reduce efficiency because Chinese production represented the low cost and efficient option, but it will become unacceptable for critical items not to be produced locally. Rearranging the current supply ecosystem may take years, and involve significant capital expenditure on equipment and research and development. Companies are also likely to carry more inventory, so as to be better prepared for a second wave, or other crises. Another feature of this crisis is that the impact has fallen disproportionately hard on lower income groups and minorities, increasing wealth inequality. There will be strong calls for more support for these groups. The thrust of all these changes is inflationary; increased government intervention, higher minimum wages, and de-globalisation all represent a dismantling of the anti-inflation bias in place since the 1980's.

The pandemic has triggered trillions of dollars of emergency spending, and for financial markets the debate is whether this leads to disinflation or inflation. This question has become critical because most markets are priced for continued low inflation, and the current recession and jump in unemployment would be deeply deflationary in normal times. Unemployment in the US, for example, rose from 4% to 12% and would probably be 20% without government intervention. Unemployment on this scale should moderate pay rises, one of the most significant contributors to inflation. But other factors will put upward pressure on prices. There is more political pressure to raise minimum wages; the virus has disrupted supply chains and the likelihood is that the days of optimised supply chains and just in time inventory are behind us; investment has been disrupted which may lead to bottlenecks; the massive monetary stimulus has now been joined by fiscal stimulus which is far more potent than QE alone; austerity has been abandoned by all governments; and commodity prices, particularly food, have been creeping higher. Demand is only part of the inflation equation, inflation is usually caused by a lack of supply. Of equal concern are the huge deficits that are building on top of large existing deficits. The monetary stimulus is estimated to be four times as large as the response to the 2008 crisis, and the fiscal stimulus for the G4 and China to be 17% of their GDP this year alone. Moreover while the 2008 rescue was aimed at filling holes in collapsing banks, this stimulus is flowing straight to companies and households which has a direct economic impact. The US budget deficit has risen steadily under President Trump reaching $984bn last year, despite coinciding with a period of peace and prosperity when the deficit should be shrinking. Even last year the US had run out of buyers to purchase all its newly issued debt, leaving the Fed to buy $80bn. Estimates for the US 2020 budget deficit are around $4 trillion, or 20% of GDP, and presumably the Fed will have to buy the bulk of this. Such money printing brings with it a high risk of inflation, not least as it will be hard to judge when to remove the stimulus. Regardless of whether US current policies trigger inflation, they will have an effect on the dollar. The accumulated deficits of many years have eroded the base for dollar strength which has been built on US exceptionalism. The underwhelming response by the US Administration to the Covid virus and deep divisions evident in US politics and society has undermined this confidence. Together with the leaping deficit and incontinent supply of dollars to finance it, the US dollar is likely to start weakening against other major currencies, and also those EM currencies that have pursued more orthodox policies.

Investors face an extraordinarily difficult outlook. Cash yields nothing and the US 10-year bond is on an equivalent PE ratio of 150x. Both are vulnerable to inflation should it revive. Quality equities have soared to high ratings that give little room for error. All equities face an uncertain environment where the shape of a post-Covid world is unclear, but where more tax and regulation and wage growth are likely to increase pressure on profits. The violence of the collapse in March has been matched by the violence of the rally since then, but that recovery feels precarious given that so many companies have stopped giving guidance because of the lack of clarity. Yet despite all this, equities are priced as though an economic recovery is assured. Equally concerning is that the blanket rescues by Governments mean that the market was not allowed to clear. New economic cycles require a clearing process to reallocate capital and labour more productively to generate growth, and an essential part of that process is allowing poorly managed companies to fail. Central Banks' and Governments' actions have blocked such a cleansing process, protecting many companies that should have failed, essentially financing dud capacity. With the cost of debt so low and government support so abundant, healthy companies are forced to compete against zombie companies that should have been killed off, stunting their and the economy's growth because the excess supply is never cleared. The corrosive effect of overly easy fiscal and monetary policies sap productivity and drain enterprise, and threaten to lead to a secular stagnation because of policy rather than in spite of it. This combination of un-restructured economies and chronic money printing is a recipe for stagflation. It is also occurring during a time of disruptive

technological change. Just how disruptive this can be was shown by Tesla's threat at the end of June that it will cut the price of its cars from $40k to $17k. This saving will be financed by turning their fleet of electric vehicles into a power storage market that consumes electricity at cheap rates and supplies it at expensive rates. If Tesla can make this work then they will brutally disrupt not just the auto industry, but the electricity and perhaps the oil industries as well.

There is a chance that markets are on the cusp of change. Investors are increasingly unwilling to buy Developed Market bonds at these stretched levels, leaving Central Banks to fill the gap. The strength of the bond market has supported equities, particularly those of consumer staples. These stocks will now depend more on their intrinsic earning power which is inevitably constrained by lower economic growth, and if inflation revives they may be de-rated. On the basis of a slow economic recovery, credit risk will become more relevant, and investors will need to separate the winners from the losers. Investment strategies will need to be less hidebound by geography and sectors and to focus more on those companies that can adapt successfully to the new environment. It is a fragile balance and markets are edging along a narrow ledge, but it does offer opportunities for idiosyncratic stock picking. Many companies will struggle, especially those with substantial debt, and their slow decline will hold back the indices. This gives opportunities to active stock pickers for both long and short strategies. If Central Bank policy continues to print money anywhere near current rates then commodities and gold will need to form a greater part of portfolios. This is potentially a particularly lucrative area because investors are so underweight. A drip from the swimming pool of the bond market could have an enormous effect on the gold share market. What is almost inevitable is that the unpleasant volatility of the past few months will continue. On top of the already mentioned uncertainties investors also face an ugly US election campaign, and a deteriorating geopolitical environment which has broadened out from the US/China trade dispute to a much deeper stand-off over technology, and issues like Hong Kong's civil rights. In the middle of June China and India clashed on their border following the first Chinese aggression on its borders in fifty years. At just the moment when international co-operation is most needed it is threatening to disintegrate.

The near term effects of the virus are deflationary as the world struggles through lockdown towards more normal conditions. As economies stabilise inflation is not a certainty but it is clearly a plausible danger given the scale of the money creation and its forceful injection into company and households accounts. If it occurs then it will be a major shock for markets as they are not priced for it. This environment makes bonds unattractive, but for the time being, with so much liquidity sloshing around, it is hard for equity markets to fall. For this reason no stock in the S&P 500 fell following the ten weeks after the bottom was reached on March 23rd. However should inflation emerge it will effect different sectors in different ways, so technology and consumer staples would be hurt, while asset heavy companies would do well so long as their debts are long term. As a roadmap investors could assume that up to 2% inflation would be fine for equities, but if it goes over 4% things would get difficult. Any inflation at all would be unpleasant for bonds. Commodities should do well as governments are likely to deploy large spending plans on infrastructure, for example green energy projects in Europe and basic infrastructure in the US. All these projects are commodity intensive. In the currency world little stands out, though the Singapore dollar could be one refuge if the dollar declines. However the best currency appears to be gold. Even if inflation does not appear gold should do well as fiat currencies are debased through continuous printing. You cannot print gold.

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