MONTHLY MARKET BLUEPRINT

Coronavirus, an economic health check?

March 2020

MAZARS

CONTENTS

Market Performance 1

Asset Allocation 2

Risks Ahead 3

Global Macroeconomic Backdrop 5

UK Macroeconomic Backdrop 6

US Macroeconomic Backdrop 7

Europe Macroeconomic Backdrop 8

Japan & Emerging Markets, Macroeconomic Backdrop 9

Macro Theme 1: COVID-19... A Cause for Concern? 11

Macro Theme 2: US-EU Trade War? 12

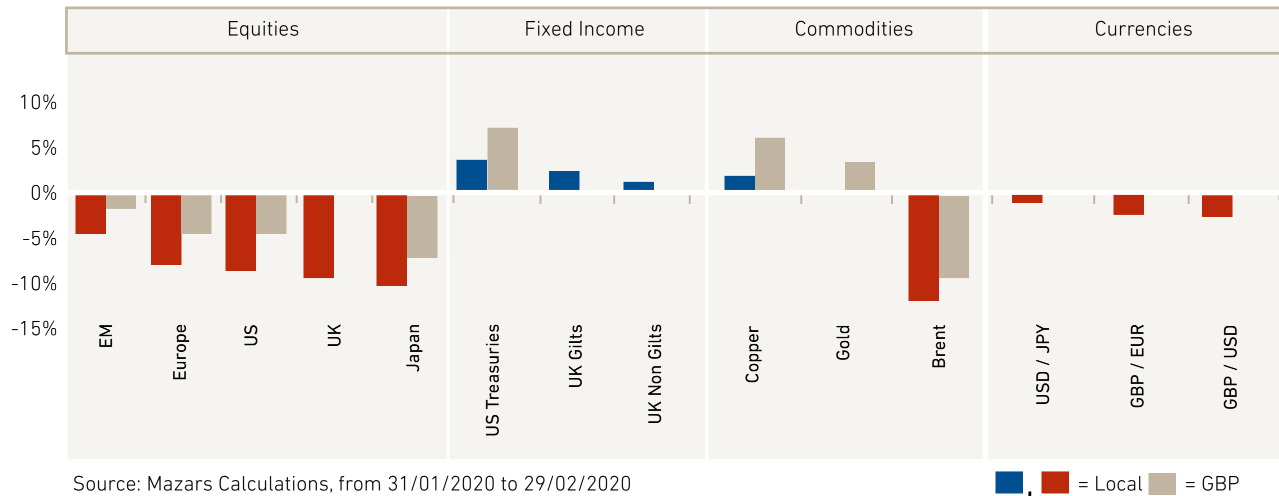
Macro Theme 3: The British Government's US Pivot Post Brexit 13

Fixed Income Spotlight: Index-linked Gilts 14

Equity Spotlight: Index Concentration 15

Equity Spotlight: Companies No Longer Going Public? 16

MARKET PERFORMANCE – IN A NUTSHELL



Source: Mazars Calculations, from 31/01/2020 to 29/02/2020

= Local = GBP

The month in review: COVID-19 disruption supresses risk appetite

February was a tale of two distinct periods. Initially, with the Federal Reserve and the ECB printing money and an economic slowdown more probable than an imminent recession, global stocks continued to climb, with major developed market equity indices setting new highs. However the number of COVID-19 cases in China continued to climb, while countries across the globe such as Italy, Iran and South Korea saw a rapid spike in their case count too. With workers away from their offices and factories, and individuals deferring travel and entertainment expenditures, this virus has the potential to cause a simultaneous supply and demand shock, with China, the world's growth engine, the epicentre. Equity markets gave up their 2020 gains, with US equities observing their quickest 10% correction since the Great Depression. UK stocks also saw a correction in late February which erased year-to-date gains. Globally, more defensive stocks were the best performers, while Energy stocks failed to keep up with the wider market as Oil prices fell. Capital fled into the fixed income markets, with the 10Y Gilt yield closing at 0.44% and the US 10Y Treasury yield falling below 1% for the first time on the back of the emergency 50bps rate cut by the Federal Reserve. Markets are pricing in another 50bps rate cut at the Fed's March meeting.

In the political sphere, the UK continued to signal its desire to "diverge" from EU standards, however, the EU in turn expect a "level playing field" on issues such as labour laws and state subsidies. These differences, paired with more idiosyncratic issues such fishing waters access, will cause friction as negotiations unfold; if the Withdrawal Act developments are a precedent to go by, uncertainty will likely remain until the final hour. In early March markets were briefly cheered by the strong performance of former Vice President Joe Biden in the 'Super Tuesday' primary elections. Biden is considered far more 'market friendly' than the other frontrunner for the Democratic Party presidential nominee, Bernie Sanders.

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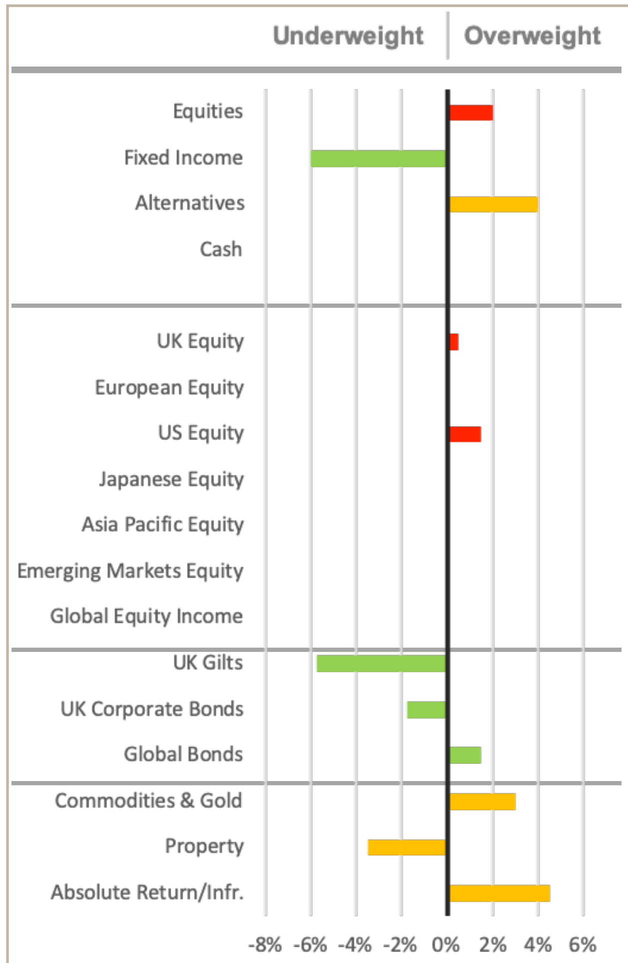
ASSET ALLOCATION



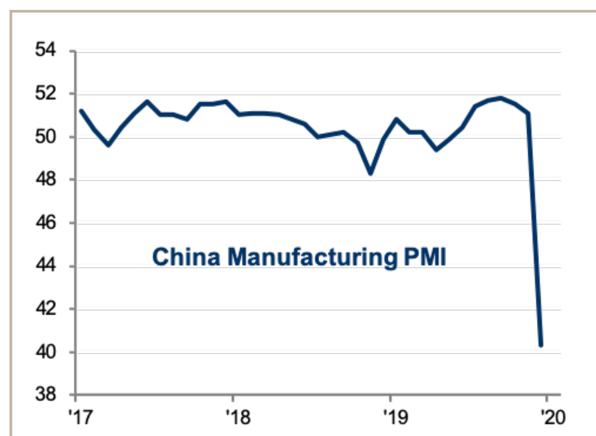
Asset Allocation based on the Mazars Balanced Portfolio, as of 3 March 2020.

Outlook and portfolios

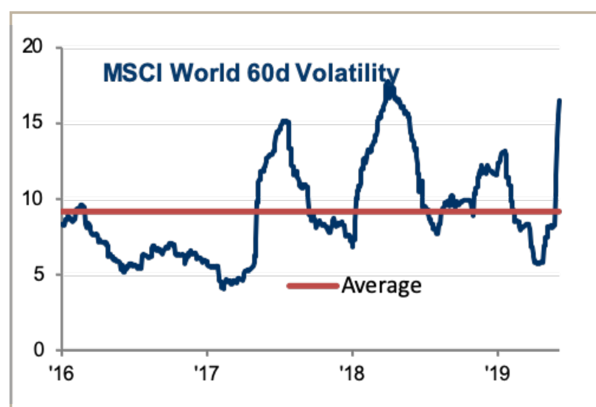
- Global economic data, which had picked up in the first two months of the year, deteriorated sharply in late February due to reduced economic activity resulting from the coronavirus outbreak. Yet a rebound, when the demand and supply shock recedes, is a scenario which garners a high probability. Central banks, already very accommodative, have pledged more support, with the Fed and the CBOC actively reducing rates. On March 3, Jay Powell announced a 50bps rate cut.
- As for longer term numbers, global inflation remains at bay and unemployment in developed markets is near all-time lows, however some employment pressures are manifesting at the tail end of the manufacturing contraction.
- Risks for trend growth are persistent: trade wars, Brexit uncertainty and the Chinese slowdown, the fact that the cycle is well into its tenth year, as well as the more temporary coronavirus; all factors which may unnerve investors. On the back of these risks, central bank accommodation is increasing, along with investor willingness to buy dips, as the world's de facto central bank has increased the pace of QE. Prior to the coronavirus outbreak this helped risk assets break new highs, ignoring tepid fundamentals.
- Our latest investment committee in January 2020 felt that, although little more clarity has been achieved (mostly on the Brexit front), the sheer availability of cheap capital and scarcity of risk assets create favourable demand/supply dynamics for equities. In January we decided to add 2% to our allocation in UK small-caps, from cash. We also switched holdings in index-linked Gilts to traditional Gilts to mitigate risks around future inflation calculations that feed into the pricing of these instruments. We don't have strong geographical preferences at this point.

RISKS AHEAD

- Global economic growth continues to be tepid, albeit bottoming out over the medium-term.
- Over the short-term, the coronavirus has had a significant impact on both economic fundamentals and market sentiment. Chinese manufacturing indicators crashed, despite a recent rebound, and equity markets lost more than 13% of their value in the last week of February, when it became apparent that the virus was reaching the West. We treat the risk as short-term and non-systemic and believe that whatever the economic impact, over one or two quarters, it should be followed by the rebound predicted at the beginning of the year.
- Over the long-term, markets are mostly focused on risks stemming from protectionism (which is why they cheered Joe Biden's success during Democratic Super Tuesday), the European and Chinese economic slowdown, and global debt levels.
- Global bond yields pose less of a risk, but we are still worried about deteriorating credit quality, as the share of BBB bonds has been increasing significantly.
- In the US the main risk is a further economic slowdown. Additionally, investors are now worried about the impact of a change in the presidency next year, the possibility of more divided government, as well as illiquidity in the short-term debt market.
- In the UK, the outcome of the election on December 12 helped investors gain more visibility on the Brexit path ahead. Risks now lie in achieving a trade deal in record time.
- We feel that short-term systemic risks are mostly manageable as liquidity is still ample, although the coronavirus has the potential to usher in a recession and upend the economic and financial cycle.



Chinese manufacturing has crashed as a result of coronavirus fears, significantly disrupting the global supply chain.

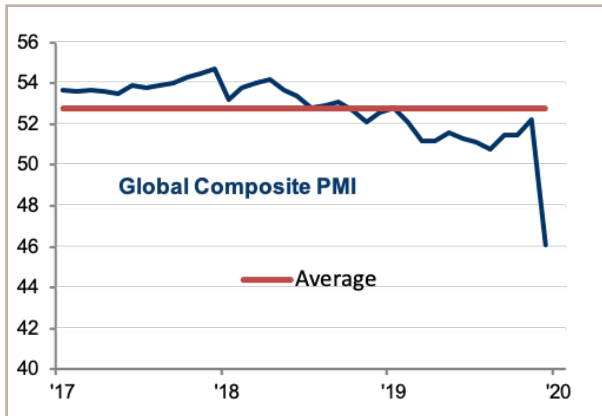


Volatility for global stocks has risen markedly following the coronavirus outbreak.

Charts Source: Mazars Calculations

THE MACROECONOMIC AND MARKET BACKDROP

GLOBAL



Global economic conditions deteriorated sharply.

Economic surprises have been turning downwards.

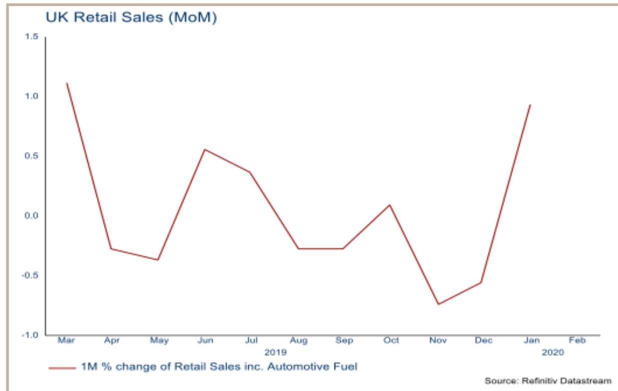
Global equities fell 5.8% in Sterling terms and 8.3% in local terms in February. Defensive sectors such as Healthcare and Telecoms were least affected, whereas Materials and Energy were the worst sectors for the second straight month. Global stocks are trading at 16.2x P/E, 6% above their 10-year average of 15.2x.

The effect of the coronavirus on the global economy has been profound. After signs of stabilisation over December and January, global economic activity saw one of the sharpest contraction episodes since the 2008 Global Financial Crisis and 9/11. Supply chains, especially those linked to China have been severely disrupted and trade flows, which had previously rebounded, fell precipitously. The Manufacturing sector, which was just getting out of its rut, contracted along with Services, which saw an incredible 126-month expansion run end abruptly. New orders contracted as well. The data spurred central banks into action, with the PBOC and the Federal Reserve reducing rates to stimulate the economy and the ECB standing “at the ready” to act as needed. Inflation is still low, despite efforts by central banks to rekindle it in order to deal with mounting debt and restore a sensible structure between short and long term interest rates.

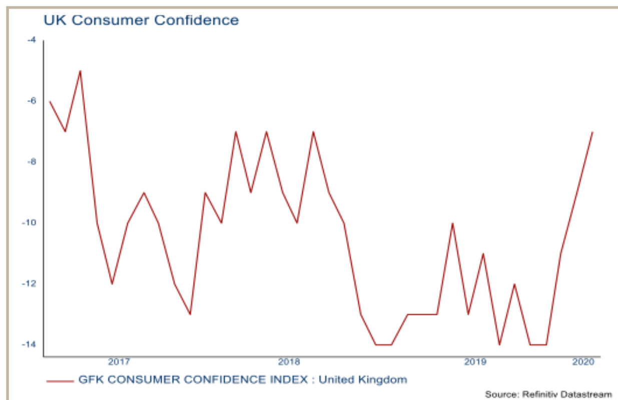
Outlook: A cyclical rebound for the global economy may still be on the cards, but will be delayed by the onset of the virus. Global economic organizations such as the IMF and the OECD continue to downgrade global economic forecasts, especially for Europe. Having said that, risk assets overall are well supported by central banks. While currently nervous, businesses generally view the coronavirus as a short-term disruption rather than a long-term threat.

Charts Source: Mazars Calculations

UK



UK retail sales showed stronger demand in January, which saw the largest monthly rise since March 2019 and beat expectations. This January data, released in February, shows signs of the so-called 'Boris-bounce'. It is worth noting that on a 3-month horizon sales fell across all sectors.



Consumer confidence rose sharply in February, with the third consecutive monthly rise. The data provider GfK commented that rising wages, low unemployment and stable inflation all helped contribute to an uptick in consumer confidence. Despite the movement in the right direction, the overall index score remains negative, as it has done since 2016.

UK equities endured a challenging February, falling -9.0% over the month. All sectors posted negative returns, with IT and Energy the worst affected. Energy's poor month can be partly explained by a -20.7% fall in the Oil price year-to-date. UK equities are now trading at a 7% discount to their long-term average, at a P/E ratio of 12.4x.

Before the coronavirus took hold of markets at the end of the month, data in the UK had been relatively favourable. The Citigroup Economic Surprise Index had turned positive during February, and consumers appeared to be supporting the economy as shown by upticks in the consumer-related data in the graphs to the left. Labour market data remained tight as the ILO unemployment rate fell 0.1% compared to the previous quarter, down to 3.8%, whilst the employment rate rose to 76.5%, an all time high. Wages have continued to rise faster than inflation, as they have done since 2018. Wage growth increased to 3.9%, meaning real wages are now at an 11-year high and have finally surpassed their pre financial crisis peak. Whilst the encouraging data had suggested the UK economy was picking up momentum, news of an outbreak of the novel coronavirus across many cities in Northern Italy fostered panic across European markets. The FTSE 100, up 2.4% month-to-date after the labour data arrived on 18 February, then entered market correction territory, falling over 10% to month end.

Outlook: The economic outlook globally is highly impacted by the latest developments in the novel coronavirus, with the UK no exception. Mark Carney, governor of the Bank of England, has told MPs that the Bank is considering the impact of various scenarios and are prepared to make policy changes to help the economy. Over the past few weeks markets have significantly increased their expectations of a UK rate cut. Meanwhile Boris Johnson has announced that the UK is prepared to walk away from Brexit talks if there is a lack of progress by June. A government assessment in 2018 forecasted an 8% hit to GDP over the next 15 years if the UK leaves on a WTO basis. This comes in the same week the UK announces ambitions for a free trade agreement with the US which Boris Johnson's government believes can add 0.16% to GDP, equating to a 50 times differential between the two deals. As such we expect the relationship with the EU to be a stronger determinant of UK growth.

Charts Source: Refinitiv

US

The US 10 Year yield has fallen to record lows due to the 'flight to safety' combined with an emergency Fed rate cut.

S&P 500 valuations are now closer to their long-term average.

US equities fell 5.1% in Sterling terms and 8.2% in Dollars. Telecoms and Healthcare were the best performing sectors, with Financials and Energy the worst. US equities are currently trading at 17.7x P/E, 10% above their 10-year moving average of 16.0x.

The US economy is slowing, along with the rest of the world, as the effects of the coronavirus continue to disrupt global markets and economies. US earnings were almost flat in Q4 and could take a further hit in Q1, as both supply and demand are likely to be disrupted by the outbreak. Exports turning negative again is an added headwind, added to that of supply chain disruptions. So far the impact has seen a fall in inflation as consumption has been subdued.

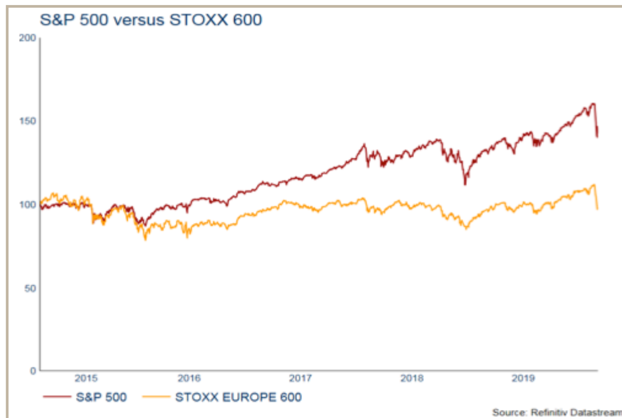
The data justified the Fed reneging on previous pledges to keep interest rates stable this year as it proceed with an emergency 50bps rate cut at the beginning of March.

Outlook: The US economy is slowing at a rate commensurate to that of the rest of the world, and is hamstrung by supply chain disruptions. However as the Fed remains dovish the outlook for US assets, which feature very high ROE (return on equity) companies, continues to remain upbeat relative to the rest of the world.

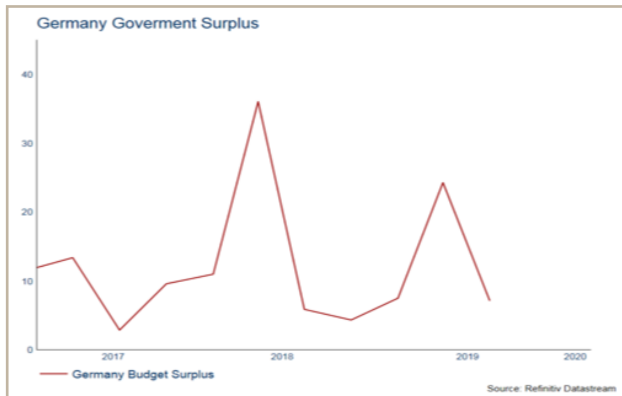
Markets, however, did not cheer the emergency rate cut and it is becoming obvious that more accommodation may be needed. The Fed is already back in QE mode and lowering interest rates, so the question for investors is whether the central bank is running low on ammunition.

Charts Source: Mazars calculations

EUROPE



European stocks have lagged the US, driven by weaker economic growth, lower ROE and fewer technology giants that have experienced P/E multiple expansion.



Germany has ran a consistent budget surplus for some time now, and in a world where monetary policy is losing its potency, it is likely policymakers will call for a loosening of the purse strings.

European equities were down -11.7% in local currency terms in February, which translated to a -9.1% loss in Sterling terms after the Pound fell -2.3% versus the Euro. Utilities and IT stocks were the best performing sectors, while Energy and Materials stocks lagged.

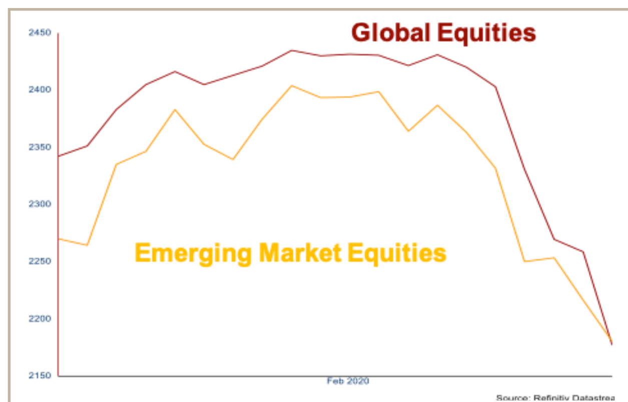
Growth conditions in the Eurozone still lag the rest of the developed world, with GDP figures and PMIs consistent with an economic slowdown. Even before the onset of the coronavirus, the Eurozone grew at a rate of just 0.1% last quarter, as both the French and Italian economies contracted. The IHS Markit Eurozone PMI remains below the 50 level, indicating ongoing weakness in the region. Output and new orders declined at an accelerating rate, presenting a lower probability for a cyclical rebound. Furthermore, spare capacity has resulted in further job losses, implying the weaker economic backdrop is starting to weigh on employment.

New ECB chief Christine Lagarde will be conducting a strategic review of monetary policy this year; the second review in the central bank's history. One key area investors will be watching is the price stability objective. Philip Lane, ECB Chief Economist, recently said the objective should be "symmetric", which could mean the bank allows inflation to remain above the 2% target for some time before hiking rates. Inflation in Europe remains below target, despite extremely loose monetary conditions, with the ECB deposit rate at -0.5% and QE at a pace of €20bn per month; the 50bps cut by the Fed has put pressure on the ECB to ease further. Despite the weak economic backdrop the unemployment rate for the Euro Area remains near cycle lows at 7.5%.

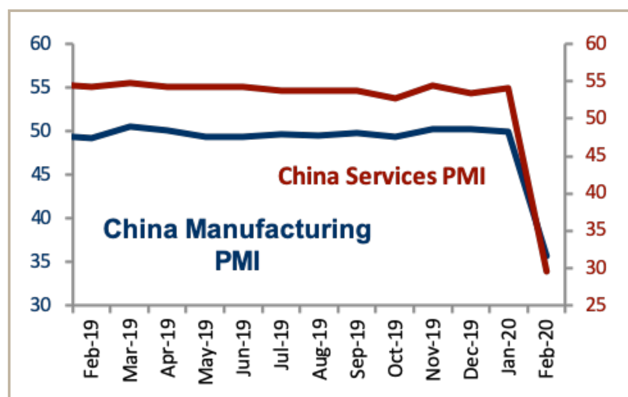
Outlook: External uncertainties persist for the Eurozone. These include geopolitical risks such as EU-UK trade deal uncertainty and potential trade conflict with the US, as well as the COVID-19 outbreak which has the capacity to disturb supply chains for large European businesses. Overall we remain neutral on EU risk assets.

Charts Source: Refinitiv

JAPAN AND EMERGING MARKETS



From a regional perspective, Emerging Market equities outperformed developed markets, despite the fact that most COVID-19 infections are currently in Asia, as investors factored in declining rates of new infection in China compared with increasing infections outside China.



Both China's Manufacturing PMI and Services PMI fell sharply on account of the coronavirus.

In February Japanese and Emerging Markets equities were down -7.0% and -2.0% in Sterling terms respectively as the coronavirus (COVID-19) outbreak replaced trade as the main focus for markets and represented a large shock to the Chinese economy. To reduce the spread of infection, the authorities in China implemented significant restrictions on travel and production. Manufacturing activity in China came to a halt in an effort to contain the virus outbreak as production, new work and staffing levels all fell at the quickest rates since the survey began nearly 16 years ago. The Official NBS Manufacturing PMI in China plunged to a record low of 35.7 in February from 50.0 previously and well below market expectations of 46.0, disrupting supply chains globally. The Services sector saw a sharper decline from 54.1 in January to 29.6 as the spike in COVID-19 cases earlier in the month led to quarantine measures and travel restrictions. However, firms in both sectors anticipate a recovery over the next year due to expectations that orders will begin to flow in once any restrictions are lifted.

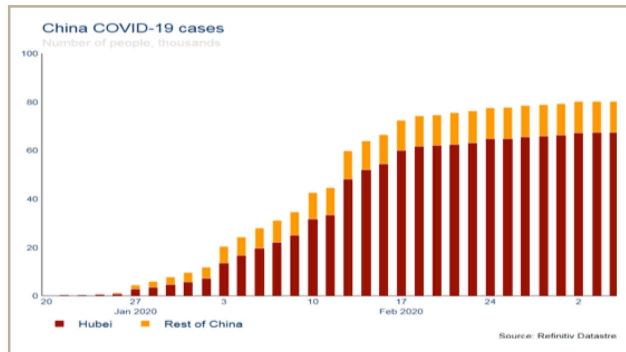
Japan's economy suffered as the region saw a series of negative economic data releases. Markets were expecting Q4 2019 GDP to contract due to the sales tax hike in October last year, however GDP fell and an annualised rate of -6.3%, the worst pace since the previous hike in VAT in 2014. Manufacturing output was hit by the biggest drop in new orders since December 2012 due to lower sales in China. The Jibun Bank Japan Manufacturing PMI fell to 47.8 in February, down from 48.8 previously. A sharp fall in demand was also observed in the services sector as the COVID-19 outbreak squeezed tourism, a key source of demand for Japanese services. Services PMI fell from 51.6 in January to 46.8. Exports from Japan continued to decline, the rate of change falling for the fourteenth consecutive month to +2.6% YoY.

With COVID-19 expected to hit Asia's inbound tourism and trade in Q1, the risks for Emerging Market economies have risen.

Charts Source: Refinitiv, Mazars Calculations

OUR THEMES

MACRO THEME 1: COVID-19... A CAUSE FOR CONCERN?



Most of the cases in China originated in the Hubei area, however throughout February we saw an uptick in the number of cases outside this region, and now there is an accelerating number of cases across the globe. Investors will be watching the rate of change in the number of cases carefully

As the number of COVID-19 (“the coronavirus”) cases continues to climb both inside and outside of China, CEOs, politicians and investors alike find themselves trying to gauge the impact of this Black Swan event on the global economy. With workers away from their offices and factories, and individuals deferring travel and entertainment expenditures, this virus has potential to cause a simultaneous supply and demand shock, with China, the world’s growth engine, the epicentre.

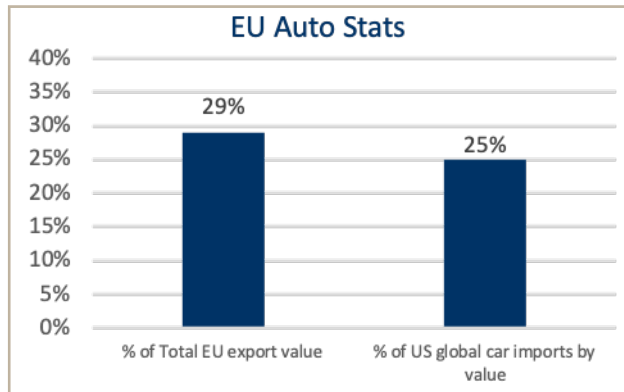
In times like this, risk management professionals seek to identify an event in history that could have an analogous effect on the operating conditions of the system in question. Naturally, one would first look to the SARS outbreak in 2002/2003. However this model runs into problems quite quickly. First, China’s economy now makes up a much greater proportion of global GDP than it did back then (more than twice the proportion). This implies the impact could be more pronounced, especially given the extent to which multi-nationals such as Apple have integrated Chinese companies into their supply chains; while reliance on China may have increased efficiency, the price to pay has been reduced resilience. Also, SARS had an estimated 10% mortality rate, significantly higher than the 2% figure data suggests so far for COVID-19.

One aspect to consider is the current day accessibility of news via social media, which no doubt adds to the anxiety of both the general public and traders buying and selling assets. A more modern case to look at for insight is the Ebola outbreak. However this was more localised than the COVID-19 outbreak and a simple scaling up of the effects by figures such as GDP or population will not capture the systemic risk China plays in the global economy today. More novel approaches have looked at disaster scenarios such as Chernobyl or the Taiwan earthquake in 1999 to understand the effects of a supply shock on local businesses and general market sentiment. However, these models can at best give guidance as how to consumers and business owners will respond.

Heraclitus said, "You cannot step into the same river twice, for other waters are continually flowing on”. The same is true for financial markets. All macroeconomic or political developments are unique because markets, technology and the political environment are also in constant flux. However, our research suggests that in the near term consumer confidence will be hit, and as a result consumers will hold back on purchasing high ticket items such as electronics or cars. Retail sales will fall, and the travel and tourism industry will be hit hard. Airlines and luxury clothes brands such as Burberry or LVMH may also see a temporary fall in sales growth. However, on a multi-year horizon, one more consistent with an individual saving for retirement, equity markets are still likely to provide a healthy return above inflation and today’s discounted prices could act as a good entry point for a long term buy-and-hold investor.

Charts Source: Refinitiv

MACRO THEME 2: US-EU TRADE WAR?



Tariffs on EU-built cars could significantly reduce trade between the two regions.

The recent announcement that Huawei will take a "limited" role in the UK's 5G network has highlighted the growing tensions between different trading blocs, while the temporary truce between Macron and Trump on a digital tax, which Trump argues disproportionally affects US firms such as Google and Facebook, gives rise to the chance of renewed conflict in the near future. Tensions between Europe and the US have been increasing since Trump took office, and they don't appear to be moderating any time soon.

If America can continue to grow, and the population find work, Trump stands a good chance of securing re-election. Many US citizens approve of Trump's policies and buy into his dream to "Make America Great Again". If we ultimately see another Trump term, he may be minded to double-down on the China trade war and widen his sights geographically, with the EU an attractive target for tariffs; especially EU autos.

There is already an ongoing dispute between the two regions regarding Boeing and Airbus. The WTO ruled that the US government had failed to end illegal support of Boeing, and that the EU continued to subsidise Airbus, with both Brussels and Washington threatening tariffs on each other's goods as a result. The EU have said they do not want a "tit-for-tat" trade row, but they do demand that European companies be able to compete on fair and equal terms. Trump has in the past called the EU worse than China on matters including trade, suggesting he feels justified in escalating this spat further.

President Trump has also been vocal about the ECB's use of negative interest rates and extensive QE, arguing that this offers Europe an unfair advantage through depreciation of the Euro, which benefits European exporters.

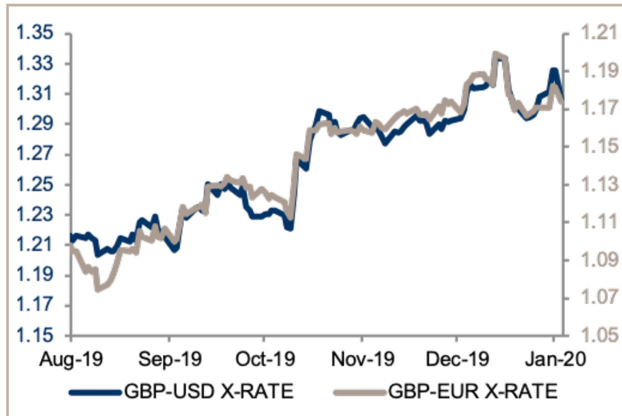
In the near term it is unlikely the conflict will escalate, especially given continued US-Iran tensions, presidential election uncertainty and now the spread of the coronavirus. However if Trump secures a second term anything could happen, and asset allocators will have to assess the likely outcomes with regards to overall trade volumes and the prospects for earnings growth.

"The recent announcement that Huawei will take a "limited" role in the UK's 5G network has highlighted the growing tensions between different trading blocs."

George Lagarias
Chief Economist

Charts Source: Mazars Calculations

MACRO THEME 3: THE BRITISH GOVERNMENT'S US PIVOT POST BREXIT



Sterling rallied versus the Euro and US Dollar on the general election result, although has fallen back since.

Fears that Brexit will see the UK squeezed between the US and the EU are real, but maybe ignore significant nuances. This is a multi-level chess game, touching politics, intelligence and trade, and a move in each field directly affects the other two.

Politics: First and foremost, what needs attention is the personality of the new PM himself, who appears adaptable. We have often made the case in the past three years that the post WWII multi-lateral global order was changing, as the US President opted for simpler bilateral and interpersonal relationships. Solutions for global problems were not to be found in global forums, but rather in intense New York-style negotiations. At the onset of his political rise, even before assuming the premiership, Mr. Johnson saw fit to build a personal relationship with the US leader. Hence, despite disagreements over Huawei, the White House has been mostly silent and has not attacked the British Government.

Intelligence: The intelligence community believes that the threat to Western intelligence by the British choice to grant Huawei access to parts of its 5G network is real, as it may leave sensitive information open to hacking. It would be good to remember that the US-UK intelligence sharing survived Kim Philby, the British Head of Soviet-Counterintelligence, who was exposed to be working for the KGB in the 1950s, as well as Donald McLean and Melitta Norwood who passed on the secrets of the Atomic and Hydrogen bombs to Moscow. It would be, therefore, simplistic to assume that critical information which has been seamlessly flowing between the US and the UK since WWII would suddenly stop, especially if the US President and UK Prime Minister want that to continue.

Trade: The UK is currently running an almost balanced trade relationship with the US, having a small $4bn trade deficit. The two economies are closely aligned, with similar growth trends and interest rate levels. Will the President's and the PM's personal relationship once again be enough to save the "special relationship"? The recent patterns of behavior on both sides suggest so.

> **A lot will depend on the PM's personal approach and adaptable nature.**
>
> George Lagarias
> Chief Economist

Charts Source: Mazars calculations

MAZARS

FIXED INCOME SPOTLIGHT: INDEXED-LINKED GILTS

Index-linked Gilts differ from conventional Gilts in that both the coupon payment and the principal payment are adjusted in line with a measure of inflation, RPI. Over time, inflation may erode the purchasing power of wealth. The 'linking' of this asset class to the rate of inflation provides protection, a hedge, against rising inflation and so can have a useful role in protecting the real value of your assets.

The Office for National Statistics released a report on the shortfalls of RPI as a measure of inflation. Of these, the most clear is the 'formula effect'. Use of a specific formula, the Carli formula, introduces an upward bias to the measure.

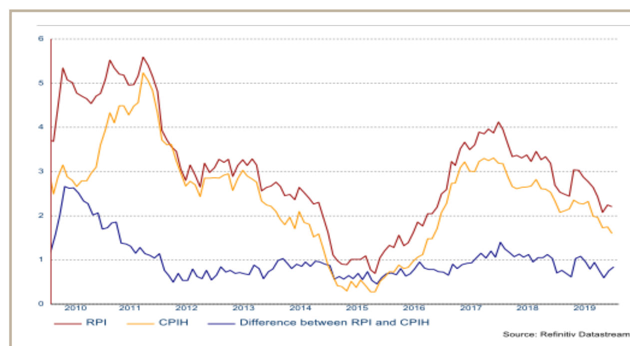
As a result of inadequacies the Chair of the UK Statistics Authority (yes this exists!) wrote a letter to the former Chancellor of the Exchequer outlining intentions to align RPI with a more statistically accurate measure of inflation from 2030, CPIH. In the letter it is asserted the UKSA has the power to do so independently of the Government.

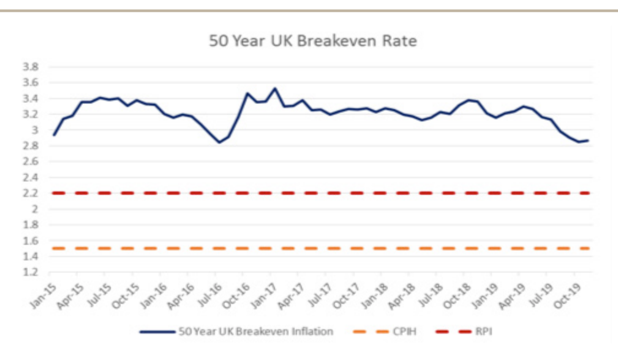
Full alignment of RPI with CPIH will have serious repercussions in the index-linked market. In September 2019 the then Chancellor of the Exchequer, Sajid Javid, replied to the aforementioned letter and publicly released all relevant letters. In the 48 hours following the release the 2068 index-linked Gilt lost 14%. For an asset class used primarily as a means of downside and inflation protection, this is a significant concern. The fall was in fact only equivalent to about 18% of the full wedge between the measures, and much of that original loss has been recouped in the months since.

Total losses to holders could be between £90-120bn depending on the implementation. This loss comes down to the relationship shown in the chart below. CPIH is currently 0.8% below RPI and has averaged 1% less since 2010. Coupon payments are based on the level of inflation, so the lower the inflation calculation, the lower the coupon payments, and the lower the value of the assets.

It is likely the price of these longer-dated index-linked Gilts is not yet fully pricing in this downward shift in yield. A few factors are likely at play. Firstly the government delayed its review, electing to begin a consultation with stakeholders from 11 March 2020. Secondly, these stakeholders (chiefly pension funds) are lobbying for compensation to index-linked Gilt holders.

The combination of a negative real yield to maturity and the potential for significant loss of capital means that, until the Government and UKSA respond to the consultation, we believe the risks on this asset class outweigh the benefits, and so have removed exposure in our portfolios to index-linked Gilts.





Charts Source: Refinitiv

MAZARS

EQUITY SPOTLIGHT: INDEX CONCENTRATION

The Index Industry Association has calculated there are in the region of 3 million indices worldwide. This compares to OECD estimates that there are in the region of 40,000 listed companies in the world. This implies a ratio in the region of 75 indices per 1 listed company. How has this happened, and how does it impact global markets?

Indices are used to measure performance, they are a simple measure that can help show the relative performance of a fund relative to a market or indeed be used to directly gain access to a market. In 2019 the number of indices decreased by 20% due to the decommissioning of redundant indices. In previous years this had been more than offset by the rise in new indices. However for the first time there was a fall in the recorded number of indices.

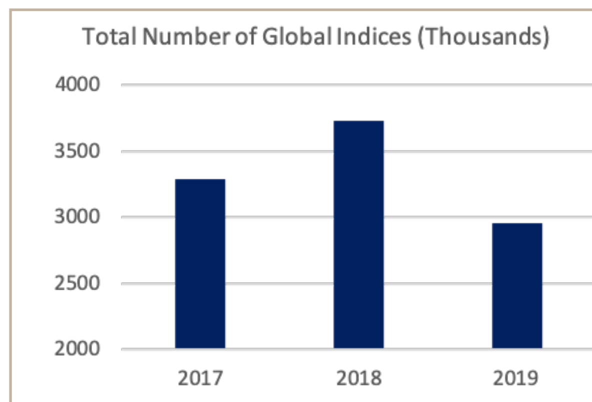
New indices are created for several different reasons. First among them is active managers seeking to set their own benchmarks. The rise in the number of indices has been criticised as facilitating a culture of ‘index-shopping’ whereby managers seek to find benchmarks they are most likely to exceed. Since compensation is often linked to outperformance this can cause a principal-agent problem between the investor and the manager.

On the other hand managers will argue that these new ‘blended’ benchmarks in fact provide greater information about relative performance against a comparable benchmark.

Another explanation for this phenomenon has been the rise in passive investing, and thematic ETFs. These investment strategies which often seek to take advantage of factor investing styles generally involve the creation of a new index that can be passively invested in.

It is for this reason many hedge fund managers seek to keep their investing strategies secret. Yesterday’s active has become today’s passive. The increased ease with which one can create a passive strategy based upon previously active strategies (such as seeking high ‘quality’ companies) creates a challenge for the active industry.

Active managers control the vast majority of global equities, but by 2028 the largest three asset managers (chiefly through passive vehicles) will own a quarter of the S&P 500 according to the NBER. Research from the FCA suggests that as the proportion of a firm’s shares owned by passive funds increase, the quality of corporate governance decreases. This creates a dilemma for passive ESG funds in that their increased ownership could be facilitating worse, not better, management.



There was a clear difference in flows for managers with greater or lesser passive exposure

Charts Source: Mazars Calculations, Index Industry Association, Financial Times

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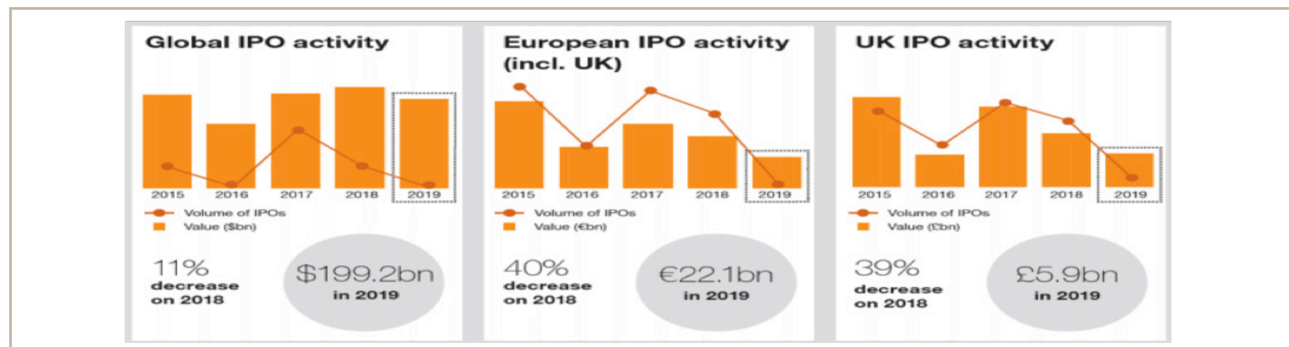
EQUITY SPOTLIGHT: COMPANIES NO LONGER GOING PUBLIC?

According to PwC, the value of UK listed IPO proceeds in 2019 were £5.9bn, down 39% compared with 2018. Furthermore the number of IPOs was 27, down 60%. Overall the European IPO market (which includes the UK) was €22.1bn in 2019, down by 40% compared to 2018. What is striking is that the levels in 2018 had fallen significantly from the 2017 number, raising the question of whether we are seeing a protracted downturn in firms choosing to become publically listed companies.

Looking at Europe over a three year period is perhaps over-simplistic, after all we can expect the value and amount of IPOs to be cyclical due to levels of investor confidence (there is little point in bringing a company to market if no one wants to buy anything) and valuation levels (why bring a company to market when valuations are low – those selling shares would likely be doing so at a discount to intrinsic value). However global equity returns were over 20% in 2019, which to a certain extent counters these two narratives. That said IPOs take time to come to market, and the significant sell-off in late 2018 may have delayed listings – in which case we should expect a rebound in 2020.

Yet as the economy grows we should expect to see the value of IPOs rise, which has not been the case since they hit a high in 2015. One reason seems to be that firms' ownership are finding the arguments in favour of listing (access to cheaper capital and the opportunity to realise investment gains) less compelling than the reasons not to list (greater reporting costs and regulatory requirements). There is a trend away from listing at valuations below £100mln. Instead firms are allowed to grow to greater market capitalisations before the need to list and deal with the extra scrutiny that brings. The vast amount of money going into private equity funds has made this possible where previously the only practical way to realise profits was to list a company.

These trends are a double edged sword for regular investors who generally do not have access to private equity funds. The downside appears to be that there will be fewer companies coming to market with excellent growth prospects, as a lot of the value gained from company growth can be enjoyed prior to listing. On the other hand it should be supportive of equity prices due to simple supply and demand – the reduced supply of equities means there is less to go around, so that they are bid up on a scarcity basis. However a similar 'Wall of Money' argument, that the sheer amount of savings in Japan would support the ludicrously high equity valuations of the late 1980s, was proven incorrect.



Charts Source: PwC

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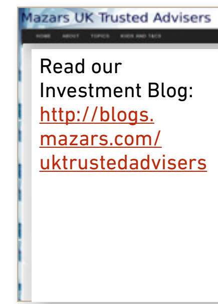

Investment blog

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