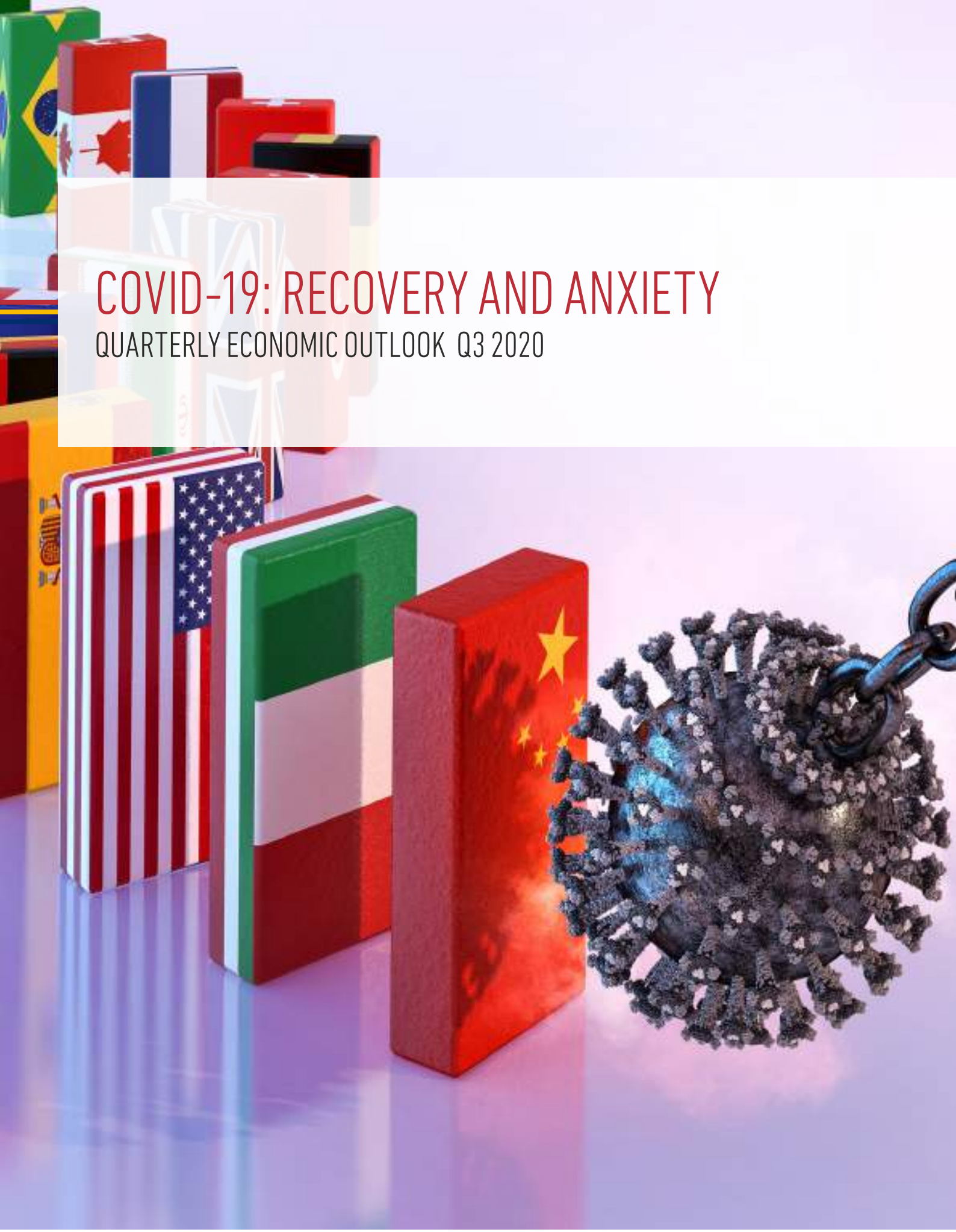
COVID-19: RECOVERY AND ANXIETY

QUARTERLY ECONOMIC OUTLOOK Q3 2020



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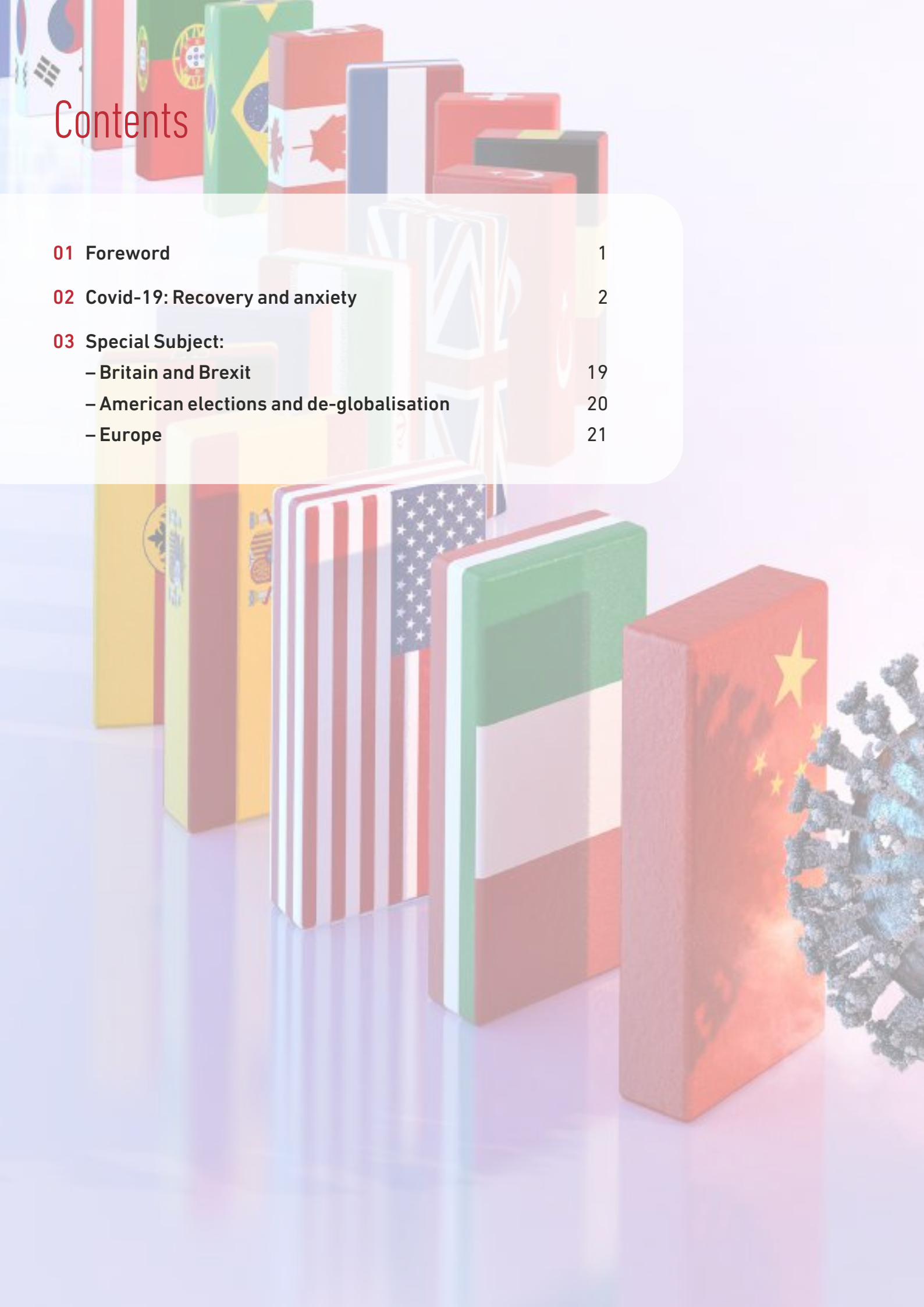

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Foreword

Global stock markets staged a remarkable comeback in the second quarter with the MSCI World Index up nearly 20% in Sterling terms. Whilst not recovering all of the losses from the high point in March prior to widespread lockdowns, global equities are nonetheless at higher levels than at the start of the year. Given the absence of any meaningful advances in the treatment of or vaccination for COVID-19 and that the corporate world is temporarily being held together by a variety of hastily created measures of government support, this optimism could be regarded as being somewhat misplaced. Certainly the significant reinvigoration of Quantitative Easing has played a part in elevating equity prices as yields on safe haven assets plummet creating the so-called "TINA" - There Is No Alternative – trade. The speed of the rebound suggests a level of comfort which is missing from conversations with institutional investors.

Visibility on the short term direction of either the economy or markets is very limited given the dependency on the course of the coronavirus. The fact that one can find scientific support for almost any point of view simply demonstrates the limitations of science when working with poor quality data and a huge number of variables. In such circumstances, as investors, we must reassure ourselves of the appropriateness of long term strategies which in most cases involves a diversification of holdings within a portfolio. Never has this mix of assets been more important than in recent times as our holdings of Gold and short term debt have provided support during turbulent times. Moreover, the diversity within asset classes should not be ignored.. When we write about 'global stock markets' we mask a huge divergence in performance between different sectors and geographies. In the first half of the year, a UK based investor holding the technology rich US market would have returned over 3% compared to minus 17% provided by the FTSE All-Share with its exposure to the Energy and Financial sectors and the uncertainty over Brexit arising once more.

As lockdown measures continue to be relaxed we will look carefully at the rate of resumption of consumer expenditure. Inevitably there will be some pent up demand, but it is difficult to imagine a return to pre-pandemic levels whilst caution around the virus and fears in the labour market remain.

As economies reopen, the support measures from governments will contract with no chance of a frictionless resumption for businesses or the people they employ. The question will be how much of a gap remains and how quickly might it close. The answer lies of course in the path of the virus, and we should have learnt by now, about this we know very little.

What is known is the amount of stimulus both fiscal and monetary which has been thrown at the problem. 'Go big and go early' has been the approach, without worrying for the time being about the longer term consequences. Will one of those be inflation? Certainly our experiences of central bank largesse following the Global Financial Crisis would suggest not, and if one assumes a fall in demand then even less so, however, a disruption in global supply chains could cause a short term temporary spike.

At our June meeting the Investment Committee voted to reduce our exposure in longer term Gilts and add to our positions in higher yielding corporate bonds. Although an increase in risk during uncertain times, we feel that we are adequately compensated for this risk particularly given the very low returns currently available on Gilts

DAVID BAKER

Chief Investment Officer
Mazars Wealth Management

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Covid-19: Recovery and anxiety

Global overview

A quarterly report is not normally a difficult document to put together. Usually it consists of an account of the trending state of affairs, the more possible outcomes and risks to those outcomes. In the past few years, these reports were actually made easier. The US Federal Reserve was underwriting risk at such an unprecedented scale, nearly unwavering for more than a decade, in a manner which suppressed all major hazards to the economy and financial markets. Ever since 2010 the question, repeatedly, had been: "With opportunity costs driven down so much for so long, whatever can bring markets down?"

This report sees all previous economic trends broken but, persistently, financial risk assets back up to trend.

The first exogenous shock to the economic and financial system, a global pandemic which led to extensive lockdowns, especially in key economies, has produced a range of negative outcomes to the economy. While similar pandemics occurred in 1958 and 1968, the "Great Lockdown", i.e. successive and strict lockdowns of all major economies, was indeed a first in recent recorded history. All of the world's 11 major economies, representing more than two thirds of aggregate output, have virtually stopped most non-essential economic activity at varying degrees from March until early June in an effort to stop transmission of the virus.

As a result, a record 11-year anaemic economic expansion came to an abrupt end. Global demand for goods and services has retreated to its lowest levels since the Great Financial Crisis, supply chains have been broken, capital investment virtually stopped, while unemployment - and even worse the threat of it - is soaring. It is worth mentioning that we are entering this environment from a position of weakness. A 10 year period of "secular stagnation", deteriorating global trade conditions and de-globalisation. Massive monetary and fiscal stimulus have been pledged to fight the effects of COVID-19, yet, according to the IMF, global aggregate output is set to contract 4.9% for the year, the worst since WWII. British output is set to contract close to 10%, the worst year since 1921 and before that 1709-1710, years where Britain suffered from the worst winter in half a millennia.

Total Covid-19 Deaths

An 11-year expansion ended

Chart Source: Johns Hopkins, IMF

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Covid-19: Recovery and anxiety (continued)

Meanwhile, emerging markets are haemorrhaging investment money at yet another record pace. The situation is momentously accentuated by the lack of central coordination between the G7, but also within the EU and, incredibly, the United States of America.

It is frustrating certainly that the final depth of the recession, and the subsequent shape of the recovery, are at the mercy of an invisible enemy who does not comprehend economic and financial cycles, doesn't sleep, may shift its composition, moves in stealthy and unpredictable ways and may re-appear anywhere in the world. No defence can be mounted against it, except for isolation and good hygiene. At the time of writing, the virus was in full upswing in populous countries like Brazil and India, while the US was either seeing a second wave or a significant extension of its first wave. In search of a modicum of certainty, the global economy remains in suspended animation, like particles in the air waiting for the next gust of wind to blow them in any direction.

So it probably confounds logic for many an investor that the opposite holds true for financial markets. At the time of writing many US stocks were up for the year, while Europe and the UK were suffering a only a mildly bad year, not nearly reflecting economic realities and dangers to potential earnings. Additionally, despite a record projected amount of borrowing and global debt to GDP levels rising to levels previously ascribed to Greece and Italy, bond yields remain at their lowest levels in history, and thus prices at their highest.

The answer to this conundrum is, surprisingly, easy. The purchase of something, anything, be it a debenture, a fork or a forklift, depends on the need for the asset weighed against the opportunity cost for it. If the opportunity cost is - virtually - zero then the decision to purchase said asset becomes that much easier, especially if they come with the promise of further returns. Quantitative Easing, from which the global economy has seen nearly $5tn of new money since last September, is a process specifically designed to boost prices for intangible financial assets, stocks and bonds.

EM capital outflows

Markets decoupled from economy

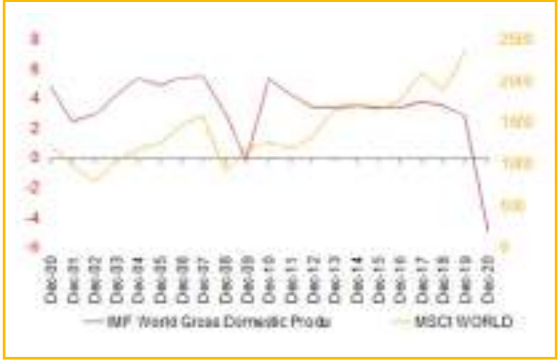

Chart Source: IMF, OECD, Refinitiv

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Covid-19: Recovery and anxiety (continued)

At the same time, it supresses market risk, a practice which could prove especially helpful at a time of unprecedented pressures for the real economy. Put simply, when faced with a once-in-every-four-generations global pandemic, which could take an even worse turn at any time, the last thing policy makers would want is to have lines forming in front of ATMs too. Thus markets act as a supporting mechanism to the economy, rather than a reflection of it.

Having said that, risk suppression does not mean the absence of risk altogether. When we buy equity, shares of a company, we share in the profits. Further viral waves could hurt companies and supply chains more permanently. If there are no long term profits and prices go up on the single virtue of an institutional investor creating demand, then investing turns into an opportunistic asset inflation game, and yes, there is a point at which the disconnect with the real economy might end. Similarly, when buying government or corporate debt, we do so with the faith that this debt will be repaid to us. Zero interest rates and institutional buying help refinance all debts, especially national ones, as Modern Monetary Theory allows for countries to print as much money as they need to pay off their debts. Nevertheless to this practice there are breaking points as well. If operational earnings are very low for a long period, and debt and equity financing becomes the only way to keep an enterprise going, reasonable investors will eventually decide to opt for investments with real organic growth or tangible real assets. And the limit of monetary expansion for the state is the inflationary threshold, beyond which all money printed comes with a direct price tag for consumers. Money printing is a mechanism that is supposed to buy time for the real economy to recover, not substitute it in its entirety.

In the next few pages, we will analyse the current state of the global economy and the possible shapes of the recovery, the specific implications for Britain, in light of a possible hard Brexit as well, the reactions and forecasts for financial assets, as well as a list of all the risks on our radar.

A second wave is risky

Global earnings collapse

Source:

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Covid-19: Recovery and anxiety (continued)

The global economy

The global economy is currently experiencing the fastest contraction since the Second World War. According to the IMF, global aggregate output is set to contract at a record 4.9% in 2020, as opposed to a 1.7% contraction during the Global Financial Crisis, assuming a second wave does not result in further contraction. Economic performance varied greatly across months, sectors and countries. February saw the first strains because of virus fears, especially in Europe. Meanwhile in China, especially in Hubei province, the virus was in full swing. March was really the first month of sharp contractions across the board, as lockdowns were initiated across the globe and wider supply chain disruptions began. April was the month that probably featured the worst economic performance in modern history, especially for developed markets as the virus was hitting Europe. Meanwhile China was recovering, as reports indicated that strict lockdown conditions had paid off, and Wuhan was beginning to reopen. However, emerging markets as a whole were not impervious to European and US woes, as, even if the virus was not rampant in many countries, significant capital outflows hurt local economies, especially Turkey. In May, data suggested that the global economy was still contracting at a fast pace, however at a markedly decelerating rate relative to the recent past. June data, which featured a full reopening of many European economies and a paced reopening of many American States, indicated that economic activity was picking up on pent-up demand. However, new orders remained weak across the board, a result of caution and lack of demand, indicating that while many companies have reopened, they were mostly working off their backlogs. Capital expenditure has been deferred or cancelled across the board.

Throughout the duration of the crisis, labour conditions remained weak and varied along the lines of policies selected to combat unemployment pressures. In the US, the choice was made to finance the unemployed, which led to a sharp hike in jobless claims and registered unemployment reached 14.7% in April (the number was down to 11.1% in June). Conversely, unemployment figures in Europe and the UK remained low, near 4%-7%, as European countries elected to subsidise employment, paying companies to furlough and retain workers.

Global Economic Collapse

IMF Global GDP Forecast

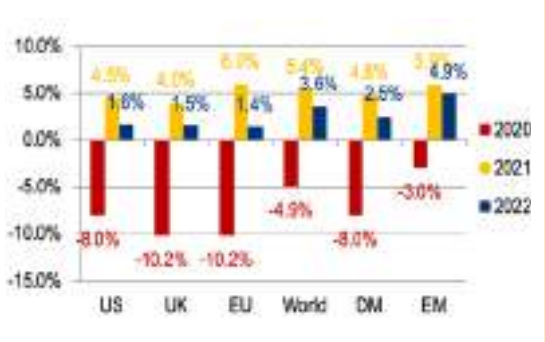

Chart Source: Markit,

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Covid-19: Recovery and anxiety (continued)

Thus, unemployment pressures as fiscal stimulus subsided were downwards in the US and upwards in Europe.

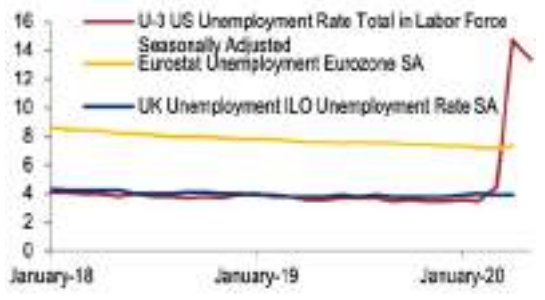
Lack of demand caused deflation more than inflation in most cases, as companies, especially those without pricing power, reduced prices in an effort to maintain market share in a dwindling market. Deflation pressures are apparent on both producer and consumer prices. US and EU CPI stagnated in May (0.1%), UK CPI was down to 0.5%, while Chinese production prices were down 3.7% for that same period.

Policy response to the downturn

Deflationary and unemployment pressures and lacklustre demand have prompted - and emboldened - central banks to significantly increase the pace of asset purchases. Global central banks have slashed interest rates across the board. The moves of the Federal Reserve, especially, are by far the most impactful, as it is the purveyor of the global reserve currency making it the world's de facto central bank, not to mention directly financing the world's deepest markets in New York, Chicago and L.A. Since September, Jay Powell's Fed has increased its asset purchases by roughly $3.3tn, while the ECB has pledged to add at least €1.35tn to the global economy.

Additionally governments have responded with unprecedented targeted fiscal measures to reduce economic pressures, in terms of direct funding of businesses, credit lines, money for healthcare systems, tax deferrals, etc. The overall fiscal response has been unprecedented. The US has pledged 14.3% of its 2019 GDP, the UK 21%, while Italy and Germany almost half (48%) of their GDP. China has pledged almost 5% of its GDP, however it is usually very successful in terms of the efficacy of spending government money.

Global Unemployment



Massive Stimulus

Chart Source: Federal Reserve, Refinitiv

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Covid-19: Recovery and anxiety (continued)

Scenarios Going Forward – The Shape of the Recovery

After the first wave has passed, and without knowing what a second wave might look like, or how possible it is, it looks increasingly likely that the modus operandi for nations going forward will be localised lockdowns. Having said that, travel will probably continue to be reduced for some time and supply chains will be weaker for that. These will be the staples of the recovery now well under way, according to the economic data from June. However, there are a number of factors that will ultimately determine the shape of that recovery:

1. The course of the virus
2. The impact of unemployment
3. The efficacy fiscal and monetary policy
4. The Chinese rebound
5. Supply chain pressures
6. Consumer mood and habits

1. The course of the virus

In most European countries, including the UK, the virus is manifestly in remission and in China it has all but vanished, for now. Mortality curves have come down and healthcare systems were able to cope with the extra load. The key question for investors is whether a second wave arrives and what shape it will take. India and Brazil are still in the upward part of the curve at the time of writing, while the US is experiencing what is either a second wave or a prolonged first wave. As analysts we have to acknowledge that while the narrative has improved (and thus consumer mood in part), there are still a lot of things we don't know about this virus. For one, whether antibodies will prevent further infections (and thus whether we will develop a natural immunity to it). One study suggested that antibodies drop 90% after three months. In terms of medicine and vaccination, we are still months away from a fully tested workable solution. Thus a survey of 511 epidemiologists, which suggests that the virus could be with us well into the next year, makes sense as a guide for investors. Investors will continue to add an uncertainty premium to risk assets (which means that it will require the continuation of significant monetary stimulus to remove that premium).

Virus is still a key concern

Covid-19 deaths UK/Italy

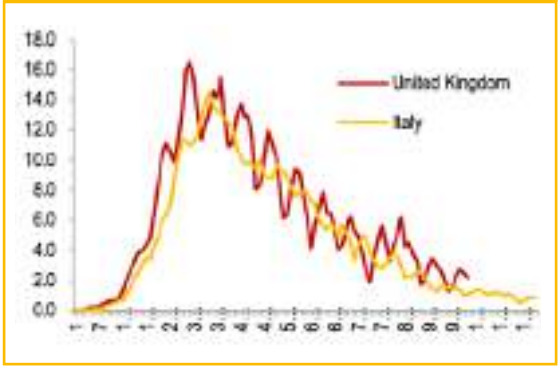

Chart Source: Johns Hopkins

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2. The impact of unemployment

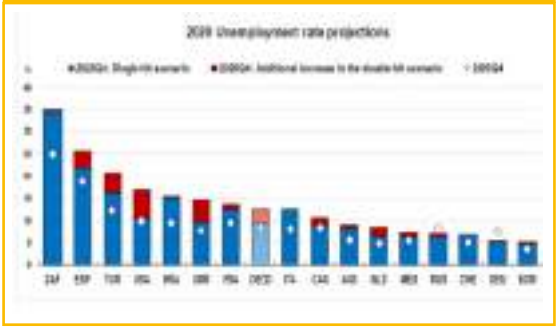
Unemployment is also key. While the US and Europe (including the UK) have attacked the problem from different angles, with the Americans subsidising unemployment and the Europeans subsidising employment, when the dust is settled and fiscal stimulus removed, the OECD projects 10% unemployment in the US, the UK and the average of OECD countries, and 15% in case of a second wave. For investors, what matters is a) the length of that high unemployment period, and b) what effect will fear of unemployment have on consumption. The latter is the more important and it will depend on whether unemployment takes over the economic narrative, or whether consumers will focus somewhere else.

3. Policy response

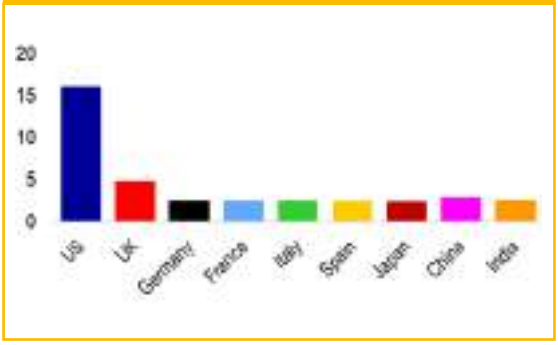
We have outlined the size of the response above. There are two key questions facing investors. For monetary stimulus the question is: how long and how much? Global stocks peaked in the second week of June and have been trading at roughly those levels for a month. Not incidentally, in the same week we observed that Fed balance sheet assets had peaked and begun to dwindle. Thereafter the Fed, which had been buying mostly short-term securities it can easily let expire, has reduced its $7.16tn balance sheet by about $160bn. Thus, as new money stopped flowing, stocks stopped climbing, in line with our longer-term view that asset reflation, not fundamentals, are driving this market. It is natural for the Federal Reserve to taper purchases at this point. After all, we just witnessed the fastest hike in Fed assets in history. At this point, we see no evidence of a sharp contraction in asset purchases, and neither do the markets, or else we would have certainly witnessed a rout in global stocks. The Fed is very careful to communicate its intentions, and the current message is that "we can do a lot more than this", an equivalent to the more historic "whatever it takes". As long as markets don't see evidence of a "stealth" quantitative tightening, a huge surprise right now, we believe that the drawdown in asset purchases will be short lived. If, by this time next year, company profitability has been restored to long-term trends, it is then that the markets could possibly countenance some further reductions in the Fed balance sheet. On the fiscal front, the question is: "How much and how efficient?"

At this point, we have to acknowledge that Chinese state capitalism has an edge on allocating government assistance more efficiently than western liberal democracies. Which is why, on the fiscal front, we would expect China to fare comparatively better than the West.

Unemployment projections



M2 vs 6 months ago



China PMIs

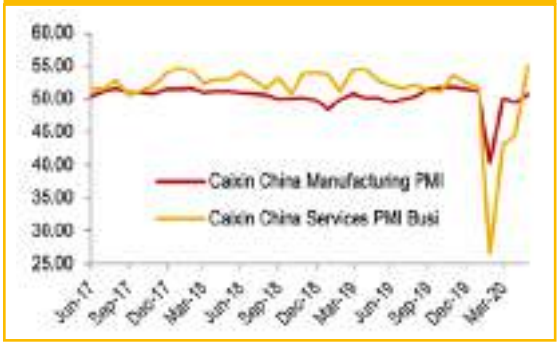


Chart Source: OECD, REfinitiv

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Covid-19: Recovery and anxiety (continued)

3. Policy response (cont)

Having said that, and while money will get lost in the cracks, the targeting of infrastructure (especially in the UK) and the Green New Deal could be important not only in shaping the economic recovery but the economy going forward as well. We expect that, despite already high debt levels, governments will have to provide more fiscal support going forward, while trying to share as much of that burden as possible with central banks.

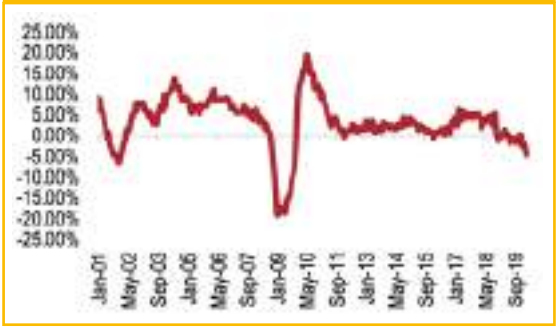
4. The Chinese rebound

We have already alluded to the idea that China might be quicker to recover due to more efficiently (and strictly) fighting the virus and its ability to better use state mechanisms to allocate assets. Data so far has pointed to a "V-shaped" recovery in China, partly because the problem was contained in Hubei province and partly because the political system and culture allow for strict government controls. Overall we expect that China, still an export-oriented economy, will suffer from dampened global demand. Still, the question for investors is that of unemployment. The Chinese state altered it GDP target for the first time in decades, to focus on unemployment. The basis of China's State run economy depends on its ability to provide jobs for everyone. The task was already difficult before the current crisis, as China was quickly shedding manufacturing jobs in favour of a more service-oriented economy. We believe that investors will be closely looking at those numbers to determine not just the ultimate shape of the Chinese recovery, but also the viability of its regime.

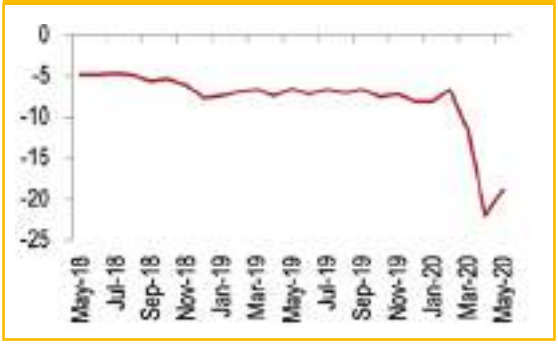
5. Supply chain pressures

A key question will be the shape of supply chains. While massive stimulus may ensure the viability of companies comprising these chains, CEOs will still have to determine which parts of their operations are profitable and where income might be more precarious. As trade conditions around the world have deteriorated sharply and travel restricted supply chains around the world have been damaged and it remains a question for investors which parts of them will be repaired. Going forward we expect some supply-side inflation (more evident in the UK), as well as shortages of non-basic goods for some economies. Should trade conditions rebound (a function of the virus as well as "trade wars") then these disruptions should be minimised. But if trade remains tepid, investors should be ready for much wider breakdowns in global supply chains, which could have a domino effect on companies and consumers.

Global Trade Volume



EU Consumer Confidence



US Consumer Confidence

Chart Source: Markit, WTO, Eurostat, Univ. of Michigan

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6. Consumer mood and habits

The reason why GDP is so hard to predict is that most economies, especially western economies, are mostly reliant on consumption, which often comprises as much as 80%. While some forecasts can be made on consumer discretionary items, consumer mood is notoriously fickle and hard to predict. A prolonged quarantine may result in fear of consumption, but, as happened in Britain's opening weekend, it might also result in pent-up demand for beers in the pub. Consumption will be affected by how the narrative will develop in two key variables mentioned above: the course of the virus and unemployment. Evidence so far has shown that consumers aren't very willing to change their daily habits in fear of the virus. Travel and leisure are the exceptions to that, but we expect that feeling to be transitory as well. We would be much more focused on whether the unemployment narrative will become a prevalent feature of the overall economic narrative. If that happens, we would expect consumption of goods and services, even capital goods, to remain tepid. As of July 2020, this has not happened on a wide scale.

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Covid-19: Recovery and anxiety (continued)

Scenarios

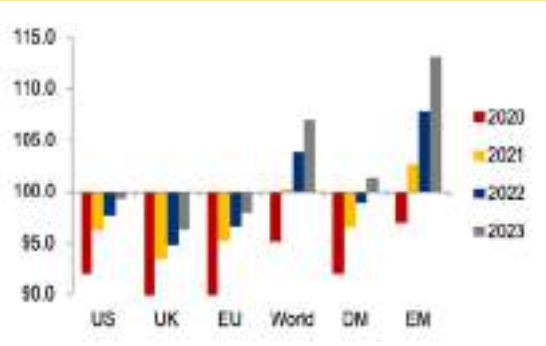
Base - 65% likelihood

Our base case scenario, in line with IMF predictions, is a sharp slowdown throughout H1 2020 and a paced recovery thereafter. Currently, the IMF's economists suggest a paced recovery of economic activity in 2021, which would return world output to a par with 2019 GDP by 2023-24 for developed markets and late 2021 for the developing world. A four-year-cycle constitutes a "U-shaped" recovery. A second wave would see that recovery prolonged in "W" fashion. In both of these scenarios unemployment remains above the 2019 levels and consumption tepid. We would assign a 65% probability for those scenarios to be realised, although we would be slightly more pessimistic about the emerging market space, as they continue to experience severe capital outflows.

Optimistic - 20% likelihood

The data for June suggest a "V" shaped recovery. While it is still a possibility, at this point we feel it's simply pent up demand, not a full swing back up. PMI data suggest that new orders are weak and companies are mostly working off their previous backlogs. Additionally, OECD data suggests a lot of slack in all global economies, thus productivity is bound to remain low. Unemployment pressures are bound to increase as government funding for companies is scaled back. Japan, which is China's closest trading partner and a dependable gauge on the Chinese economy, continues to see a sharp contraction in factory output and orders, suggesting that demand pressures are bound to continue. Global trade conditions were tepid before we entered this crisis, and they are not expected to abate as the US Presidential Election season enters the final stretch. On top of all these, while we acknowledge that the virus narrative has changed for the better, we are also cognisant that our own fatigue over the issue may only change policy responses. At this point none of these can avert a second wave of massive infections, and thus renewed lockdowns. Still, we can't completely rule out the possibility of consumers surprising to the upside (which was the case with the Brexit referendum), or a cure becoming available in the next couple of months, which would see a resumption of global trade and travel. We would assign a 20% probability to a "V-shaped" recovery from this point onward.

When shall we return to 2019 GDP?



UK GDP forecast

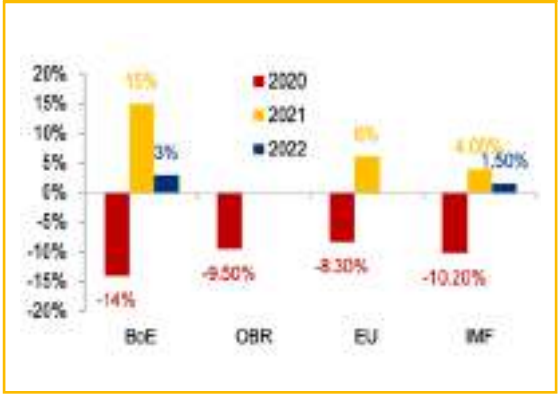


Chart Source: IMF, BoE, EU Commission, OBR

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Pessimistic - 15% likelihood

A so-called "L-shaped" recovery is a very prolonged downturn, which could see aggregate output below (tepid) 2019 levels for the better part of the decade. For this scenario to be realised, the world would need to experience more waves of the virus which would translate into very restrictive lockdowns, trade and travel policies. The economic downturn would be accentuated by high unemployment, which would exacerbate a vicious cycle of low consumer confidence and demand, which would then lead to more job losses. While this scenario is entirely credible (and some might argue it could be the main scenario), we feel that the size of the monetary and fiscal stimulus and the fact that countries have learned to live with high debt (in light of very small interest payments due to floored interest rates for a long time), should be enough to avert a '30s-like crisis. We would assign a low, 15% probability to that scenario.

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Financial Markets

As discussed above, financial markets, prompted by unprecedented monetary stimulus, were entirely disconnected from the economic malaise. While Q1 2020 was one of the two worst since 1988, Q2 was one of the three best, thanks to a confluence of stimulus, algorithmic trading and an improvement of data near the end of the quarter.

Equities

Equity valuations are at very elevated levels for 2020 projected earnings, which suggests that a) investors are more focused on longer term profitability which they believe will be unchanged and b) opportunity costs to owning financial risk assets are very low due to quantitative easing.

For the period, global stocks rose by +19.4% (+19.5% in Sterling). The best performing sectors were IT and Consumer Discretionary, while the worst performers were Utilities and Consumer Staples. Equities were trading at 23.6x forward earnings, 52.4% above the long term average. Gold rose +12.9% and oil prices rose +91.7%.

US stocks rose by +20.5% (+20.7% in Sterling). The best performing sectors were Homebuilding and Consumer Discretionary, while the worst performers were Consumer Staples and Financials. Equities were trading at 25.4x forward earnings, 55.5% above the long term average and 7.5% above the MSCI World. 10Y Treasury yields fell 1bps to 0.656%.

UK stocks have underperformed the rest of the world, rising by +9.1%. The best performing sectors were Housebuilders and Industrials, while the worst performers were Energy and Financials. Equities were trading at 19.1x times forward earnings, 41.9% above the long term average and 18.9% below the MSCI World. 10Y Gilt yields rose 18bps to 0.172%.

European stocks rose by +18%. The best performing sectors were IT and Autos, while the worst performers were Energy and Financials. Equities were trading at 22.4x forward earnings, 57.4% above the long term average. 10Y Bund yields rose 2bps to -0.454%.

Japanese stocks rose by +11.4%. The best performing sector was (unsurprisingly) Healthcare, while the worst performers were Utilities and Consumer Staples. Equities were trading at 18.3x forward earnings, 27.4% above the long term average and 22.2% below the MSCI World.

Emerging Market stocks rose by +18.3% . The best performing sectors were Healthcare and Materials, while the worst performers were Financials and Utilities. Equities were trading at 17.2x forward earnings, 43.3% above the long term average and 27.1% below the MSCI World.

Global stocks best returns 1988

Equity Returns (GBP) YTD

Chart Source: Refitiv

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Covid-19: Recovery and anxiety (continued)

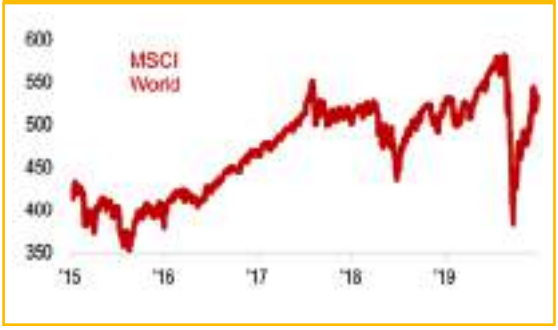
Bonds and Income

Bond yields remained floored, especially for government bonds, while corporate investment grade credits were trading near historic averages. The Federal Reserve and the ECB have suggested that they will be active in the credit space as well. Along with investment grade corporate bonds, which were trading on average at a 1% yield, high yield bonds peaked during the heights of the crisis, but at the time of writing they were trading near their historic average of about 7%. Given the amount of the stimulus, we would expect lower yields for "junk" bonds at some point in the future.

Dividend yields were much higher than bond yields, near 3-5%, but we feel that the numbers are deceptive, as they reflect last year's dividend. In reality, a lot of companies which have received public money to maintain employment levels, will be hard-pressed to maintain dividends, so we feel that actual income from stocks will be lower than what yields currently suggest.

In fact, we believe that income will remain challenged for some time going forward. Due to the high amounts of debt and sluggish growth, we feel that financial stimulus will remain in play for a significant amount of time. Thus, yields are bound to remain low in both credit and government debt. Equity income might become a more attractive proposition after 2021, assuming a recovery is well under way, but still, it comes with the much more significant risk of capital losses, which is not welcomed by income investors.

Global stocks back near highs



US inv. grade spreads

Chart Source: Refinitiv

02

Covid-19: Recovery and anxiety (continued)

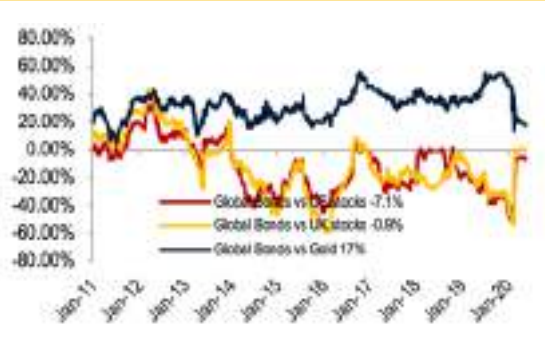
Bonds in the portfolios – Defensive Profiles

Low bond yields under a regime of semi-perpetual financial suppression beget the question: do we even need "fixed income" instruments (bonds) in our portfolios, when the "income" part is precarious at best? We have spent the last few quarters pondering that very question. So, we ran a series of tests to determine whether bonds at current yields continue to add to portfolios. The answer was, slightly surprisingly, "yes".

While investors might have to forego a part of their income, evidence suggest that bonds still serve a significant diversification purpose within a portfolio. Government bonds especially are still safe havens at a time of stress. Due to low and negative correlations, we came to the conclusion that bonds are still improving the risk-reward profile of a portfolio. A simple 60/40 (equity/bond) portfolio, had a much better risk-reward profile than a simple equity portfolio.

Still, investors who might be frustrated by low incomes, especially in the defensive range of portfolio offerings, often ask to change profile, for a more aggressive version. At this point it would be good to remember the virtues of discretionary portfolios. Risk profiles are not meant to be traded, like risk instruments. They reflect one's long-term attitude to risk. Our tests suggest that due to low yields, some of the more defensive portfolios could take on more risk, and thus opt for better returns. Instead of clients going through the erroneous process of changing profiles to ensure better returns, investors in general should let asset allocation do the work for them. Our own investment committee decided to increase the weight of corporate bonds within the portfolios, assuming slightly more risk (in a market where risk will be suppressed as central banks will be very important buyers) to increase the portfolio pay-out.

6m Correlations with bonds low



Bonds improve risk/reward

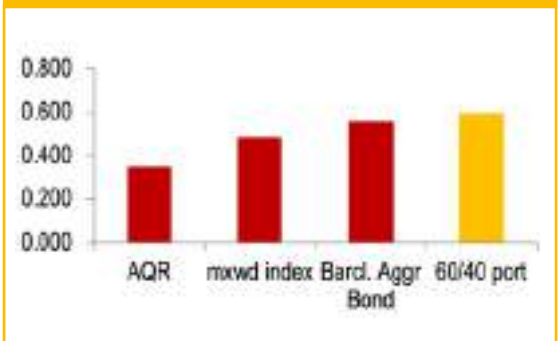


Chart Source: Refinitiv, Mazars

02

Covid-19: Recovery and anxiety (continued)

Volatility Going Forward

We feel that given the tepidity of the economic and financial environment, with both markets and economies looking for direction and a key positive narrative which would give a much needed sense of certainty, accommodative monetary policies which supress financial risk are bound to drive the market narrative for some time ahead.

Still, things are moving faster than in the past and create an illusion of high volatility. In Q2 it took just 22 days to enter a -20% bear market, double the speed of any previous bear market in history (in 1929, the second fastest incident, it took 43 days). It took less than a month for markets to recover to levels that it would have taken 23 months usually. So drawdowns are much faster and deeper, but so are the recoveries.

Medium term volatility is bound to be supressed, which is good news for investors, although we still expect the occasional bout of volatility in a market that is directionless. The velocity and breadth of those bouts are likely to be accentuated by algorithmic trading, which, however, does not seem to add to the overall volatility. Thus, until the market finds a clear direction, we would expect low volatility, but sudden downwards moves, say 5%-15%, which would have in the past been 2%-7%. Investors should learn to ignore these, unless they feel that risk suppression policies are no longer efficient.

Asset Allocation Decisions

In the face of these developments, our investment committee decided to keep top-level positioning unchanged and trust in the long-term properties of asset allocation. As mentioned above, we increased our weight in credit, reducing weight in Gilts, with overall bond exposure remaining the same. We remain slightly overweight equities and underweight bonds.

S&P: Number of days to reach -20%

S&P – Days with volatility over 4%

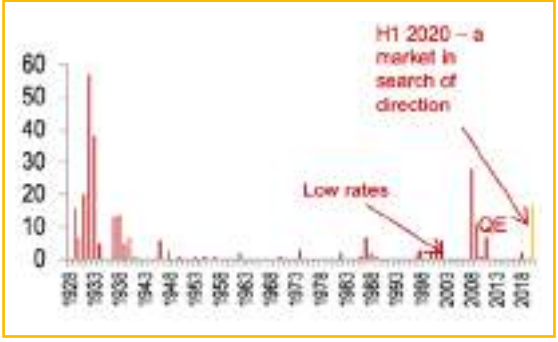


Chart Source: Refinitiv, Mazars

02

Covid-19: Recovery and anxiety (continued)

Risk

A question that keeps arising is: "If volatility suppression is set to remain a key theme for markets in the medium term, and volatility = risk, then are all risks gone?"

We don't believe so. Our key risks going forward are a - very probable - second wave and - much less probable - inflation.

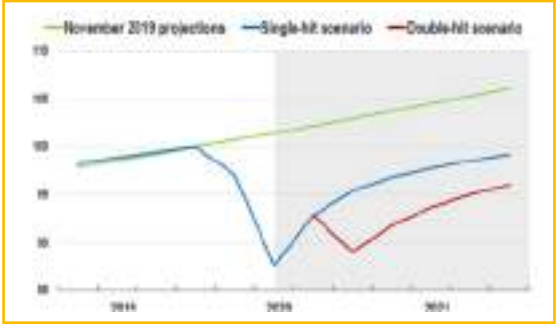
A second wave could take any form, from a localised event to a global event, from a weaker to a more powerful string. There might be more waves, requiring localised lockdowns, which can be very disruptive, or a cure might be made available in the interim. A second wave would surely further disrupt economic activity and could potentially instil a sense of permanency of this situation to consumers, further denting consumer confidence, reducing productivity and contributing to structurally higher unemployment.

As for inflation, although we do fathom some supply-side inflation pressures, overall sluggish demand usually creates deflation, rather than inflation risks. Still, if expansive fiscal policies break a 12-year secular stagnation cycle and inflation returns, it could severely disrupt the keystone of the current financial narrative, quantitative easing, as money printed would suddenly become inflationary.

Other risks include:

- Weaker balance sheets: Global bond yields might be low, and are likely to remain so for some time, but now companies find themselves with weaker balance sheets. Possible inability to raise new debt or refinance old debts, especially in the face of a sudden stoppage of operational cash flows, could have devastating consequences, especially for smaller-caps and companies teetering at the edge of the investment grade spectrum.
- The US election: In the US, apart from the coming recession, 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.
- Brexit: In the UK, the BoE suggested a 14% drop in GDP due to the COVID-19 crisis, which could be exacerbated in case of a no-deal Brexit.
- China: In China, investors will be looking closely to assess the pace of the recovery, to make sure that growth doesn't falter again.
- Europe: In Europe the crisis has renewed calls for a Eurobond, exacerbating centrifugal forces already in play in the region.

A second wave is risky



Inflation is expected to stay low

Chart Source: OECD

02

Covid-19: Recovery and anxiety (continued)

We feel that short-term systemic risks, especially virus-related, are dominating and that economic and financial liquidity may need more boosting. We need to wait for further clarity, as the world is currently in flux, before assessing the damage and further consequences of this new crisis.

GEORGE LAGARIAS
Chief Economist

03

Special subject: Britain and Brexit

The British economy and British risk assets have come under more pressure than their developed market counterparts. Britain experienced the worst number of Covid-related deaths per capita in the world. Aggregate output is set to drop between 9% and 14% in 2020. Services and construction are contracting at record pace, while manufacturing activity is reducing at a less severe pace. Consumer confidence saw the worst levels since 2012. Despite some forward-looking optimism, consumers were deferring major spending decisions for the time being. Unemployment levels have not risen significantly yet, since furloughed workers don't count as unemployed. However Markit jobs reports suggest some of the worst conditions for the jobs market since 2008. Inflation remained tame, while minutes from the MPC suggested pressures for the central bank to increase the pace of QE. At the time of writing, PM Boris Johnson had announced his intention to open up certain crucial sectors of the economy, prompting some essential workers to return to their jobs. Importantly, UK companies are experiencing significant supply chain disruptions, which could mean some short-term inflationary pressures.

Still, there's no clear narrative or consensus why UK risk assets are shunned by investors. We could be, thus, looking at a confluence of factors. The highest COVID infection rate in the world, with policy subject to a lot of criticism, is not helpful for the overall narrative. Second, UK indices are heavily weighed to industries that haven't really performed well during this downturn, like Oil and Banks. Conversely, investors didn't trust UK Tech companies, which in the US have really driven the rally. Third, the UK economy seems to be suffering a bit more than its global counterparts, partly because it's more sensitive to the global trade breakdown. Fourth, the possibility of a hard Brexit is again in the fold, making investors, who are now more risk averse than January, extra careful. A fifth reason could be that in the minds of international investors, UK large caps serve as their high dividend yield part of their portfolio.

While COVID will eventually pass, and some cyclicals like Oil will inevitably rebound at some point, as will the currency, we need to acknowledge that the extent of the damage of this period to the British economy is yet to be accounted for, and, with a hard Brexit looming, those more long-term investors could wait for a significant period before they decide to increase their weighting to the UK again.

GBP weak again

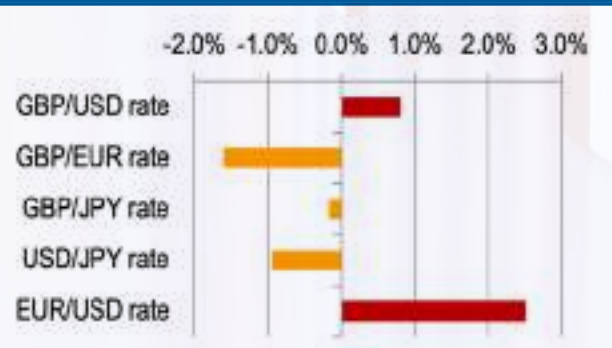


Chart Source: Refinitiv

03

Special subject: American elections and de-globalisation

American elections have been the subject of a lot of speculation. On the one hand, Mr. Trump is now a known quantity with markets believing that his continued presence in the White House would help keep corporate taxes low and stimulus high (regardless of which party holds the House of Representatives). Conversely, he is a force against multilateralism and a second Trump presidency, according to markets, could see the acceleration of the demise – or reshaping of - many global institutions, including the UN and NATO.

On the other hand, Mr. Biden is seen as more of a multilateralist. However, markets are worried whether a likely one term president could let his party embrace a more left-wing agenda, which could include higher corporate taxes and more regulation for Healthcare and Big Tech.

We believe that the differences between the two presidencies from an economic point of view (they could not be much more different on social policies) may not be as pronounced as they first appear. Both Presidents, under any congress, would probably opt for more fiscal spending, as the economy remains challenged. Both would be greatly helped by the Fed in this task. As for multilateralism, the truth is that NATO and the UN were challenged way before Mr. Trump's ascendance. As time is breaking down the post-WWII order, the functioning of some global institutions, if not the institutions themselves, is in need of dire reform. The WTO has often failed to enforce rulings or criticise members for unfair practices, and the WHO has often been criticised for giving in to political pressures. The IMF, for all its brainpower, remains unable to predict downturns and has often thrown good money after bad; so too the World Bank. The reassurance of American leadership during a Biden presidency, without pressure to reform, would still not help those institutions going forward. Nor would Mr. Biden probably be so quick to mend relations with China, before ensuring some assurances about the future. More than 70% of Americans, after all, agreed with Mr. Trump's aggressive approach to China, and many of these handed him victory in key 2016 and 2020 battleground states.

The difference between the two presidents would probably be in terms of decorum, social policies, and in terms of participation in institutions that still matter, like the G7.

As for de-globalisation, we believe it is not a matter of policy, for globalisation was not a matter of policy, but of technology and advancement. In a free country, when an entrepreneur has access to cheap goods from abroad, or cheaper production lines or the possibility to outsource some company functions, it would be a difficult proposition to stop them from obtaining these advantages. The key is the internet. We thing that as long as the internet remains a key feature of our daily lives and as long as newer generations are imbued with globalist ideas, current de-globalisation pressures are probably a bump in the road that should have been, in hindsight, anticipated.

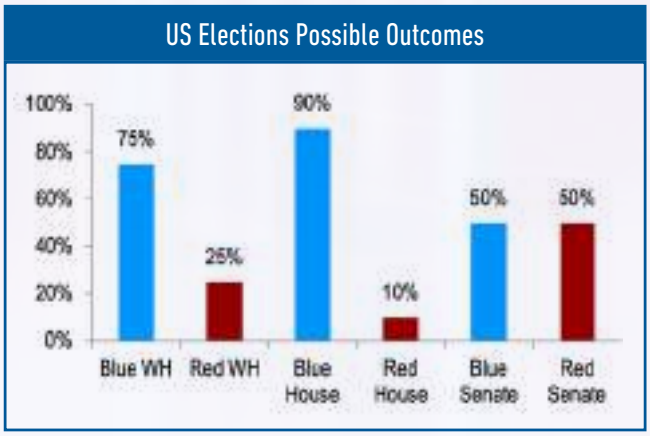


Chart Source: Cook political

03

Special subject: Europe

Europe has long been on the top of our risk list. The Eurozone, which after Brexit will consist of the crushing majority of EU GDP, is underpinned by an unfinished banking union and an unstable currency. The EU is often subject to late or decentralised decision making (as was painfully apparent when COVID-19 broke out), and, much like many other multilateral global institutions, many of its functions are often criticised as outdated.

For a long time we were near-certain that the common currency would cause the unravelling of the EU project, especially if ECB threats to "do whatever it takes" lost their potency with investors and traders. However, in the past few weeks a potential key development is near changing the game.

The key to European strength and unification has always been transfer payments and mutualisation of debt. Apart from the ECB's QE, which has already ushered some debt mutualisation, we never saw much progress in mutually issued bonds, until now. Germany has performed a U-turn and is now in favour, along with France, of some debt mutualisation and transfer payments to weaker countries. At the time of writing, some fiscally hawkish countries, spearheaded by the Netherlands, are resisting the idea of doling money out to the European South to fight the effects of COVID, unless it comes in the form of terms-based loans. The European South is vehemently resisting higher debt, especially if it comes with strings attached.

An EU conference over 17-18 July could prove to be a pivotal moment in European history and investors should be watching very closely.

More reading...

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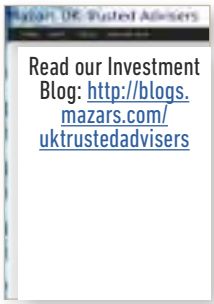
Investment newsletter

Quarterly outlook



Investment blog

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