

The Eye of the Storm

Published on: 20 March, 2020 | Author: Investment Team

You may have noticed that we have positioned portfolios very defensively at present with high allocations to Stabiliser assets and cash. This is to preserve values in the short term as we are experiencing a sudden, material shock to global economic demand which was not expected and appears to now be longer-lasting than any of us could have predicted only a month ago.

At times such as this it is necessary to distinguish the economic impact of the global pandemic for investors from the very visible price movements across markets. Prices are affected in the short term by multiple factors, including investor sentiment, programmatic trading and leveraged investors becoming forced sellers to meet margin calls. The huge swings in prices, particularly of equities, which markets are currently exhibiting do not necessarily reflect a fundamental change in the viability of all companies, the net impact of a period of economic stress offset by government support, or even the extent of selling by long-term investors. Equity pricing may currently be discounting a decade's worth of recovery from the credit crisis of 2008 but is not necessarily consonant with the outlook for economic recovery once the temporary exogenous shock of Covid-19 has been removed. Currently, this is an economic shock, not a systemic failure of markets as was the case in 2008.

Since 1987, it has been apparent that stock market gains are eked out slowly over years and are lost suddenly in weeks. In the 9 preceding crashes to the current one, markets have dropped by between 1/3 and 1/2 in days and weeks. Recoveries have been measured in months, except on two occasions: December 1999 when markets did not reach their old highs until 2007, and from July 2007 when markets did not reach their previous highs until May 2016.

By contrast the Asian/LTCM Crisis was over in less than a year and famously in 1987, the market finished the year up 7%.

Depending on the scale of the response from the central authorities it is likely that the market reaction will fall between the two – quite possibly, toward the latter. Bear in mind that:

1. In the “dot-com” period that ended on December 31, 1999, valuations lost touch with the underlying economy. Share prices appreciated far faster than underlying GDP and the gap between share prices and GDP had never been higher – this does not characterise the recent market.
2. In 2007/8, there was a real risk that the global payments system would fail, bringing down the world economy with it. An inability to pay in a modern market economy stops economic activity completely. This time around, nobody is seriously suggesting that the banking system is fatally compromised. Risky lending and sub-prime bonds are concentrated in “non-systemic” parts of the financial architecture.

There is no doubting the severity or the gravity of the present crisis but unlike most of the previous crashes alluded to above it is a “real-economy” crisis as opposed to a banking or securitisation crisis and moreover is susceptible to a science-based solution around basic hygiene, pharmacology and vaccination, although the nature of clinical trials will push the onset of a vaccine into 2021, probably.

Our view is that the world economy was already facing a number of risks but there was evidence that the slowdown throughout 2019 was beginning to bottom out. However, Covid 19 has changed the calculus for the time being. The key consideration now is that the economic shock caused by this pandemic does not become a financial shock which

manifests itself in more dysfunctional corporate credit markets. Debt levels have risen markedly over the past decade and we have been watching out for stress in these markets for a while.

Looking forward, the market falls have eliminated excess valuations on the basis that the world economy has suffered a “large but temporary” shock and not a permanent impairment to its productive capacity. Expectations are that, depending upon the scale of the response from fiscal authorities and contingent upon some positive clinical news flow e.g. a reduction in the number of new infections as seen recently in China, the aggressive panic selling of equities will reverse into panic buying of equities in well managed companies that will benefit from future economic growth. Valuations in some sectors look excessively low relative to the likely recovery of output in forthcoming quarters and it is important to remember this during periods such as this.

Consequently, subject to a bottoming out process, equities are now attractive and positions will be rebuilt following positive signals in relation to policy and clinical news flow as noted above.

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