WARNER MATTHEWS
ASSET MANAGEMENT

Warner Matthews diaries – Second Quarter 2020

Asset Allocation Musings:

Maintaining the opening gambit of a song title that fits the current climate should have been easy this quarter. The options are boundless with so many unprecedented events occurring around the world. It was tempting to highlight a song title that subtly referred to the deflationary mood in the UK ('How much is that Doggie in the Window?' answer: less than it was last week Patti Page…). However, the lyrics to the Beatles classic, 'Yesterday', seemed more apt. It seems that due to the Government's lockdown/isolation measures we have all become amateur epidemiologists and we are all armed with adjectives that best describe the situation: unprecedented/unusual/uncertain/unparalleled et al…

It is no understatement to say it's a challenge to remain upbeat on all things financial when the speed at which change occurs is fast moving. It may just be that this narrative is "out of date" by the time you get to peruse our thoughts. Our observations will focus mainly on where we stand at the moment in terms of global stock markets and whether this downturn will be "V", "W", "L", "U" or even Nike logo shaped. It will be a turbulent ride. However, we are reminded that the Great Depression of the 1930's led to a vibrant US economy, glued together by a renewed sense of commitment and togetherness. So, despite the clouds remaining dark in the near term, we should not forget Franklin D Roosevelt's famous line, "We have nothing to fear except fear itself…", i.e. danger is around us, but fear is just inside us. If I had the space afforded me, I'd begin to paraphrase R. Kipling's poem, "If". Perhaps, instead, I should learn it off by heart and teach it to my children…!

What's on our Minds?

How did we get here?

I think it is best to contextualise how this financial crisis has developed. Prior to the outbreak of this epidemic, our view was that the world economy itself was very sick indeed. Many of the dominant markets, such as Japan, the UK and the US, are infected with significant levels of debt. In essence, the fallout we have seen across markets was, in our opinion, long overdue. The legacy of the 'cure' in the aftermath of the Global Financial Crisis of 2007/08, namely Quantitative Easing (QE) and the slashing of interest rates, has served only to force up asset prices, without much underlying fundamental asset value increasing. A crisis bourn from excessive debt was 'fixed' with the addition of further debt, through the act of QE by the world's Central Bankers. Prior to the arrival of Covid 19, economic growth across the world was beginning to stutter as interest rates were moved higher. The oil shock arrived in early 2020, which although a boon to consumers, ultimately acts as the lubricant on economic growth. The US-Sino trade war augmented the slowdown. So we believed the stars were aligned for a market "pullback" based on these facts. It is therefore incorrect to state that the pandemic was the sole cause of the current malaise.

We had been highly circumspect in accepting the stock market's ascent, resulting in our building ever defensive asset allocations in your portfolios during the past 2 years or so. These defensive strategies have played out well for you. I acknowledge that our job is to make you money, so it rests uneasily to have to say that your investments have gone down in value since mid-February, when markets started to gyrate violently. However, because of the defensive positions we have adopted, they have fared relatively well in this recent turmoil. As I have said to you in the past, our determined ethos, in the world of QE and zero or even negative interest rates, is capital preservation. In a recession, the asset manager who loses the least is the winner.

Taking Stock – a Bull and a Bear view as we stand at the crossroads of uncertainty…

In the last month, we've witnessed the most rapid decline in history on the S&P 500 index. We've also seen the biggest daily percentage gain and second largest percentage loss in almost 90 years, so you may be wondering what the future holds? Here are some reflections both from a glass half full and a glass half empty perspective: -

Glass Half Full:

- The sheer size of the rescue packages, combined with the speed by which they have been introduced and the global coordination should ensure the economic damage will be limited. It may not be immediate but by the end of the year things may look "normal". It is akin to the head of the European Central Bank in 2012 declaring he (Draghi) would do "whatever it takes" to alleviate the immediate crisis and preserve the Euro. Back then this was sufficient in eliminating the fear factor. There is no doubt that President Trump, in a re-election year will pull out all the stops to engineer an election victory; in the immortal words of President Clinton's election campaign: "it's the economy stupid…"

- FIFO – first in first out – those countries that went into the COVID-19 crisis first have re-emerged first as the numbers of new cases began to fall. This is most apparent in Asia, where China and South Korea have demonstrated that proactive shut-downs had the desired effect. We are now witnessing a similar road map in Europe. Hence economies will again be revived after a short period of sleep. It is hard to argue that people, after a period of being housebound will not create significant pent up demand.
- The dramatic declines in stock markets across the world, combined with government and Central Bank action, have encouraged professional and retail investors to pick up bargains during the "sales" season. There will be more sales seasons in the coming months, so it should be seen as an opportunity.

Glass Half Empty:

- Health systems across the world were ill-prepared for this pandemic, ill-funded and short staffed. There are still countries with large populations that are entering the acceleration phase – namely India, Indonesia and Brazil where healthcare and medicine is less readily available. It is conceivable that the virus mutates and re-emerges in a more virulent form. Looking back to the Spanish Flu in 1918, the second wave was more deadly.
- It's the economy stupid – there is no question that economies around the world will contract at record rates in unison. Unemployment will rise rapidly as evidenced in the last four US unemployment readings (280,000 people seeking benefits to over 30 million in six weeks, a ten-fold+ increase). Putting economies into an induced coma means that people are unable to go about their daily consumption habits. This means businesses will lose revenues, their output will fall and that output may not come back to the same extent. An inspection of movement of people in China (through TomTom data) indicated that while movement is normalized during weekdays now that the lockdown has ended, the movement at the weekend has declined sharply. The new normal may make consumption patterns look vastly different.
- Solving the debt crisis with more debt – we long believed that adding more debt to solve an existing debt problem was illogical. The current range of packages (the US alone runs to over $2.5trn and counting) will increase debt levels beyond the conventional "safe" level of 50% (Debt-GDP). We are running low on countries whose finances look "safe". Corporate debt is more concerning and personal debt levels have remained elevated care of low servicing rates. The world is awash with debt and it's not having the desired effect. That is the movement of money in an economy, its velocity, has continued to fall in major economies, which has led to deflation.
- Are we heading for hyper-inflation? – Modern Monetary Theory (MMT) includes the option of directly handing money to citizens beyond what a country can reasonably afford. When government's head down this avenue they run the risk that their currencies lose "face". People don't want to hold a currency as its being debased and seek refuge in other assets. The conventional solution is to raise rates to encourage faith in the currency, but historically this rarely works.

Do all paths lead to Gold?

As you may have noticed in our newsletters to date, we were nervous and cautious about most asset classes and our mindset hasn't altered in the last month. However, there are always opportunities in market dislocation; for us that's Gold. So why should the yellow metal be a worthy candidate in your portfolios?

Firstly, with rising inflation, gold typically appreciates. When investors realize that their money is losing value, they will start positioning their investments in a hard asset that has traditionally maintained its value. The 1970s present a prime example of rising gold prices in the midst of rising inflation, whereas the dollar lost its value.

Secondly, investors typically look to gold for safety in times of political and economic uncertainty. Why is this? Well, history is full of collapsing empires, political coups, and the collapse of currencies. During such times, investors who held gold were able to successfully protect their wealth.

Lastly, it's not correlated to other assets you may hold such as stocks, bonds, currencies or real estate; it's a good diversifier. Don't take our word for it; many seasoned investment professionals and even Central Banks have been accumulating their physical gold reserves.

This report is for informational purposes only and should not constitute investment advice. Past performance is not a guide to future performance. No investment is suitable in all cases and if you are in doubt you should contact us. Market and exchange rate movements can cause the value of an investment to fall as well as rise, and you may get back less than originally invested. The views expressed are based on information believed to be accurate at the time of writing but no assurances are given.