L&C INVESTMENT UPDATE – Q&A

Over recent weeks the global economy and financial markets have experienced an unprecedented shock. In recent times there has never been a situation like COVID-19, which has resulted in, not a slowdown in the global economy, but a lockdown.

Financial markets have struggled to process these uncertainties and although there is hope that this does not last long, it will mean significant disruption as a large part of the World's economy goes into hibernation.

This will cause financial stress for businesses, economies and consumers. However, there has been a rapid response from Governments' and Central Banks' to try and ensure unnecessary financial stress is avoided, triggering a downward economic spiral. Essentially, there is commitment to a "whatever-it-takes" approach of financial stimulus in order to bailout the real economy.

Financial markets face three key challenges that require separate targeted policy responses. In the short-term, for markets to stabilise investors will need to be more confident these have been addressed.

1. Public health crisis

Many governments have adopted a policy of aggressive suppression in order to slow the spread of COVID-19. Hopefully in time this approach will be successful, but it is uncertain how long the lockdowns will be in place for and therefore how deep the economic shock will be. In order to stabilise, financial markets need to be more confident in the effectiveness and duration of government measures.

2. Global Recession

There will be a severe recession in the first half of this year, but without a full understanding COVID-19's trajectory it is difficult to estimate whether it will extend further. In order to support the economy through what will be a very challenging period, governments and central banks have launched an unprecedented package of fiscal spending and monetary policy support. If successful these measures will help to offset the economic shock and prevent cascading risks that would deepen a recession (i.e. surging unemployment, debt defaults etc).

3. Financial market stresses

The COVID-19 shock has triggered a wave of investor selling in many asset classes, not just equities, and this in turn has exposed several financial market vulnerabilities. A surging US Dollar and poor liquidity in bond markets have compounded fundamental concerns and increased market volatility. Central Banks have already responded and started to ease these pressures by increasing the availability of US Dollars globally and launching asset purchase programmes to buy government and corporate bonds.

Equities

Global equity markets have experienced the most rapid crash in modern history, a fall of 34% in under a month.

The true earnings damage for companies remains to be seen, but current market expectations are for unprecedented quarterly declines in the second quarter of 2020 followed by a rapid recovery for the rest of the year.

How are we positioned?

– Our strategy is focused on the most defensive part of the equity market i.e. strong balance sheets and resilient revenue accounts. Despite indiscriminate selling from investors, these names have performed better than the overall market.

– Given the difficult and uncertain backdrop our equity team has been stress testing all London & Capital (L&C) equity holdings to ensure that their balance sheets are strong enough to survive the months ahead, when revenues for many will be significantly impacted.

Is this a good opportunity to increase equity allocations?

If so, where?

– In time there will be an equity market opportunity. The sell-off has left valuations depressed and historically this has been a good indicator of strong longer term returns for equity investors.

– Once the markets can see a route map to normalisation then share prices could recover rapidly. However, this market needs to find a base before longer term investors return and currently there are risks of a false dawn.

– Taking advantage of the opportunity will likely take place in 2 steps:

Step 1 - Increasing allocations to our existing STAR companies or a sub-selection of the most defensive. Given the near-term outlook, the focus for investors should be in high quality franchise business that can get through this challenging period and maybe even come out stronger. A strong balance sheet is essential, and these types of businesses are already represented in the London & Capital STAR equity holdings.

Step 2 – Longer term Recovery Basket: This sell off has been indiscriminate and has resulted in some good longer-term opportunities in high quality franchise businesses with strong balance sheets who will survive despite a big hit to revenues; some are trading at very depressed share prices. Once the recovery takes hold, we will look to invest in deeper recovery plays such as Starbucks, Burberry and Uber.

Fixed Income

Bond markets have come under pressure from both the economic shock of the Coronavirus, but also difficult liquidity conditions.

Following the launch of several Central Bank support programmes, liquidity conditions have started to improve with credit spreads narrowing and government bond volatility subsiding.

How are we positioned?

OUR CORE HOLDINGS ARE FOCUSED IN THE FOLLOWING:

Banks and insurance companies

The largest and most systemically important financials have come into this crisis in a far stronger position than they were in, in 2008, with regulatory enforced increases in capital that will help weather the current shock. Given their critical role in supporting the real economy they will likely be supported by policy makers.

Major utilities

They are an essential part of the economic infrastructure and from a strategic perspective little has changed given the high degree of certainty around earnings and cashflow.

Global corporates

These are major employers and critical to domestic economies. Mark-to-market price volatility is likely to remain high, but our strategy continues to be driven by macro/policy considerations and credit/balance sheet fundamentals. As the price adjustment has been abrupt, we expect the reverse once signs that the worst of COVID-19 has passed.

Our internal stress analysis have tested revenues for banks and earnings for corporates by severe amounts, and our findings are that balance sheets for all the credits we own have ample ability to service obligations and survive the difficulties of the next few months.

When will bond prices stabilise?

We are following several factors that will gradually help:

1. Coronavirus figures peaking
2. Stability returning equity markets
3. Improving market liquidity
4. Investor confidence that government support will lead to an economic rebound
5. An end to ETF selling
6. An understanding that banks are not the battered entities of 2008
7. Traders and investors adapting to new working practices
8. Breaking the stigma of companies accessing additional credit