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BEFORE WE CAN GIVE HOPE, WE HAVE TO DEFINE REALITY

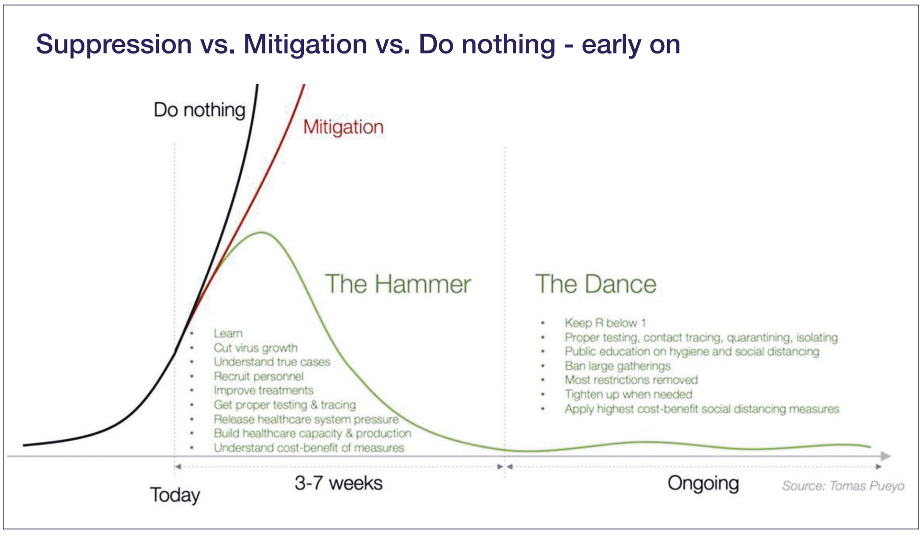
The first real pandemic in 100 years, the bursting of a credit and asset bubble that everyone believed in, and the incredible speed of the reversal has left many people bewildered, confused and grasping at straws.

It is natural for human nature to look for hopeful outcomes at a time like this, as it takes a long time to adjust emotionally and psychologically to the secular change that is now taking place.

Napoleon liked to say that “the role of a leader is to define reality and inspire hope.” But before we can give hope, we have to define reality. And the best way to define reality is to study what will not come back in full. This is what this note will mainly cover.

Before we do that, though, some good news: world economies are beginning to walk the path towards unwinding lockdowns: after the hammer (strict lockdowns to limit contagion and avoid overwhelming public health services) comes the dance: measures designed to balance getting lives back on track (to great extent) and spreading the disease, one of economy vs. healthcare.

Pau Morilla-Giner
London & Capital’s Chief Investment Officer



It all turns around the R (transmission rate). Early on in a standard, unprepared country, it is somewhere between 2 and 3 which means that during the few weeks that somebody is infected, they infect between 2 and 3 other people on average.

If R is above 1, infections grow exponentially into an epidemic. If it's below 1, they die down.

During the Hammer, the goal is to get R as close to zero, as fast as possible, to quench the epidemic.

Once you move into the Dance, you just need your R to stay below 1.

IN ORDER TO DO SO, THE FOLLOWING POINTS ARE USEFUL TO KNOW:

- If people are extensively tested, they can be identified even before they have symptoms. Quarantined, they cannot spread anything
- If people are trained to identify their symptoms earlier, they reduce their overall contagiousness
- If people are isolated as soon as they have symptoms, they reduce their overall contagiousness
- If people are educated about personal distance, mask-wearing, washing hands or disinfecting spaces, they spread less virus

In terms of the risks of a second wave, some regions will see outbreaks again, others will not for long periods of time. Depending on how cases evolve, we will need to tighten up social distancing measures or we will be able to release them.

It is unlikely, though, to have a repeat of 1918, when the second wave was much worse than the first one:

- Densely crowded venues like clubs, concert and sports arenas are likely to remain closed or dramatically curtailed until a vaccine/effective treatment is found
- Hygiene standards are now much higher as people are much more aware (may this continue)
- Mask-wearing has become normalized across much of the globe. Most masks do not offer much protection to the wearer, but they do reduce the chance that an infected person will spread the disease to others

WHAT WILL NOT COME BACK?

In this section, we will identify areas of the economy that will be particularly affected by the Pandemic. When I refer to "not coming back", I mean in the short to mid-term (i.e. in at least 5 years if not more).

1. Consumer spending levels will not come back
Much attention is given to the pace at which economies should reopen, and so little at the behavioural impact on consumers.

As I mentioned in my previous note, the personal savings rate of American households (i.e. the % of disposable income they save each month) went from around 5% to as high as 28% after the Great Depression (1929-1933).

It is impossible to predict an exact number, but it seems almost certain that consumers will not be willing (or able) to spend as much as they did before the crisis. For many millennials and Gen Z, one mantra will dominate spending habits from now on: "Never again will I be financially unprepared for a crisis".

Uncertainty will bring caution. Caution will bring frugality.

Consumer spending accounts for about 70% of Western Worlds GDP, so this will have a knock-on effect on Gross Domestic Product (GDP) growth rates.

UNCERTAINTY WILL BRING CAUTION. CAUTION WILL BRING FRUGALITY

2. Many jobs will not come back
A record (in the post-war era) 22 million jobs lost just in the US since March illustrates the scale of the evolving economic damage and its likely deep resonance. The US unemployment rate has risen to 15% (highest since records began in 1948). This year the US unemployment rate has swung from its lowest level in half a century to a peak not seen in eight decades (!)

As bad as it looks, jobs data alone does not capture the full force of the economic lockdown: another 5 million additional workers are now working part-time even though they prefer a full-time job, and the number of people outside the labour force grew by 6.6 million, showing many are currently discouraged to even try to find a job.

There is hope that many of these jobs will come back as the economy reopens, but the risk is that rising bankruptcies result in many furloughed workers being left on the sidelines.

3. Commercial real estate occupancy (and prices) will not come back
The 1930s was called a period of "insufficiency of demand" and that is likely the period we are entering.

Funding and building plans for the world famous Empire State Building solidified in 1928. Demolition of the old Waldorf-Astoria began on October 1, 1929, and the Great Crash followed three weeks later. When the building opened in 1931, less than 25% of it was filled. (it was not completely occupied until 1953, more than 20 years later).

Many businesses will be reassessing their needs for office space as lower economic activity means that many are over employed, and telecommuting could help them save money.

4. Levels of global tourism activity will not come back
Tourism is the Achilles heel of the global economy as it is so discretionary (By comparison, global tourism hardly existed in the 1930s).

It took US airlines 6 years to return to profitability after 9/11 and eight years for fares to return to what they were in 2000.

Travel and tourism accounted for 10% of global GDP and supported 10% of all jobs on the planet before COVID-19. Now, the pandemic has put as many as a third of these jobs, or more than 100 million positions, and some $2.7 trillion in GDP at risk, according to the World Travel and Tourism Council.

5. The venture capital-financed start-up boom will not come back
Austerity was already beginning to define the tech funding ecosystem even before COVID-19. A collapse in VC funding would have broad economic implications, dragging on everything from job creation to commercial and residential real estate to overall economic growth.

No new Massa Son of Softbank will come on the scene to catapult valuations to astronomical levels with his $100 billion Vision Fund. The image of billions made overnight in unicorns will fade as many enter much harder times. The start-up ecosystem fed on itself, and now it will unravel.

6. In-your-face luxury-goods spending will not come back
Conspicuous consumption will be more politically and socially unpopular as recession hits and flaunting high-end brands could even be seen as unwise.

As much as 20% to 30% of industry revenues are generated by consumers making luxury purchases outside their home countries. This means the outlook for luxury-spending is pegged to the outlook for global tourism, and particularly Chinese tourism.

In 2018, Chinese consumers took more than 150 million trips abroad and spent 50% more than the average international traveller. McKinsey estimates that purchases outside the mainland accounted for more than half of China's luxury spending that year. The pandemic is set to reverse this trend: flight reservations from China to Paris are down about 80% year-over-year as of February, March and April, and Chinese spending in Europe is down 85% compared to last year.

7. Foreign student exchange levels will not come back
Last year (and for the first time ever) most public colleges and universities in the developed world received a majority of their revenue from tuition rather than government funding. Much of this revenue came from foreign students, 72% of whom pay full-price. By the 2017-18 academic year, Chinese students made up a third of all foreign enrollment, up from 1% in 1980. Now, as Chinese students cancel plans and countries close their borders, the Coronavirus is triggering an enrollment crisis much sooner than anyone expected.

International education is now the fifth-largest US service export and one of the few areas where America actually has a trade surplus.

Also, nearly one-quarter of US unicorns had a founder who first came to America as an international student, so the implications could be widespread and long-term.

WHAT SHOULD ASSET ALLOCATION CONTINUE TO LOOK LIKE?

We cannot control (or predict) how long this crisis will last. Indeed, the world seems to be more uncertain today than at any other time in our lifetimes.

The ability to deal intelligently with uncertainty is one of the most important skills in life. Voltaire said it best 250 years ago: “Doubt is not a pleasant condition, but certainty is absurd.”

In the midst of uncertainty, we should always remember four main lessons of the past:

- Crises accelerate trends that were already coming, it turbocharges them
- Crises expose and penalise the weakest links the most severely
- Winners are those companies that adapt the fastest to crises and therefore survive them
- Those who survive end up thriving as there is less competition come recovery time

We have built our asset allocation with resilience in mind.

Within equities, the bias is towards stocks that have the balance sheet strength and profit and loss (P&L) resilience to see through this crisis: earnings will be all over the place this year, so the focus needs to shift from valuation multiples, the ability to sustain free cash flows and having lower debt levels.

On the fixed income side, we are focused on sectors that entered this crisis in a position of strength (i.e. large banks and insurers) and on other large employers that are best positioned to be self-sustaining through times of turbulence. These are the owners of their own destinies.

IS OUR CAUTIOUS EQUITY STANCE STILL DESERVED?

Yes. Financial markets have rallied since late March, with investors growing confident that economies will turn around quickly from the fallout from the pandemic. Their optimism has grown stronger in recent weeks as various countries have started to ease lockdown restrictions and tentative signs emerged of stabilisation in US and Chinese economies.

However, the world economy will contract by more than 3% this year, and corporate earnings could contract by up to 40% (much more than currently estimated by consensus forecasts). In 2021 we should see a bounce back on both fronts, but unfortunately the end result will still be that both will be a long way below the level they were at the start of 2020. This does not mean that equity markets cannot rise from here, as there are other factors that drive equity markets.

The relative attractiveness of equities vs cash is key as well. After all, you have to put your money somewhere and if your cash deposits are paying nothing, then equities may be attractive, they still have a yield after all the dividend cuts.

However, I do think there is a significant downside risk in equity markets in general given the current situation and outlook, so we should continue to be cautious.

ARE YOU STILL BULLISH ON GOLD?

Yes. The extensive monetary/fiscal stimulus measures that have been rolled out make any return to 'normal' financial conditions even more challenging than after the 2008 financial crisis.

Elevated uncertainty around the consequences of these global easing packages increases gold's attractiveness given its lack of credit risk and proven track record as a store of value.

Large increases in global public debt will force central banks to remain accommodative for many years. With such low yields, even modest inflationary pressure could prove painful for bond holders if real rates stay in negative territory. Low opportunity costs and relative invulnerability to any future rise in inflation will probably attract more interest from investors.

A big reason for gold's rise this year has been the decline in US 10-year real rates. With the Fed's limited appetite for negative rates and a plausible scenario of low inflationary pressure over the next few years, US real rates may struggle to fall much lower than their current levels. Coupled with the collapse in oil prices, US real rates may not play an active factor in a much higher gold price.

However, what could support the gold price is growing concerns about fiat currencies, which are set to continue to be debased as more printing goes on. This trend could even accelerate should some governments push for weaker currencies if and when their economies weaken after the recovery phase, because of potentially limited room for additional fiscal or monetary easing measures.

Gold bears no credit risk and is an effective store of value. As such, its appeal as insurance against any unintended consequences of massive monetary and fiscal expansion is unlikely to falter anytime soon.

BONUS DISCUSSION: UK NEGATIVE RATES IN SIGHT?

The governor of the Bank of England (BoE) recently said the following: "We know that we may have to draw on our tool kit at any point ... having that whole tool kit under review and assessed as the context changes is important". He added that the Monetary Policy Committee (MPC) is "looking very carefully at the experiences of those other central banks that have used unprecedented rate levels, and a number of them are actually publishing quite interesting assessments at the moment".

Translation: The BoE is considering negative rates.

The amount of global bond issuance that stands on a negative yield has, unsurprisingly, jumped to US$12.3 trillion. Now UK government bonds have joined the party, and the yield on the 5 year gilt fell below zero at the end of last week, meaning, in effect, that negative rates are already here.

If bond markets have got there, will the MPC follow? (after the recent two cuts, the base rate is at 0.1%, down from 0.75%).

The main reason for rates turning negative is the need to stimulate the economy by forcing the commercial banks to lend at low rates to generate activity in the economy and encouraging businesses and individuals to borrow/ spend. What is the point of having money on deposit if it is earning nothing? Go spend it, whether it is a company investing in machinery or advertising, or an individual buying a property or clothes.

Japan has been used to negative interest rates for some time now and it has not led to a boom in consumption. We shall see if this time the outcome is vastly different (probably not).

Stay safe.