London&Capital

WHERE NOW FOR THE GLOBAL ECONOMY?

Global Macro & Market Outlook
Third Quarter 2020

PARTNERSHIP INVESTMENT CHOICE PRUDENCE

London & Capital's approach to investing is the same as our approach to our clients.

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CONTENTS

INTRODUCTION

Pau Morilla-Giner
Chief Investment Officer

Financial markets have rallied since April, with investors growing more confident that economies will turn around quickly from the fallout caused by the pandemic. Their optimism has increased in recent weeks as various countries have started to ease lockdown restrictions and tentative signs of stabilisation have emerged. Daily activity trackers from the likes of Google and Apple show most developed countries edging towards normality, halving the declines suffered during their March and April lows. China is back to January levels, though the country's unique policy circumstances (regarding lockdown and stimulus) mean it might not be a template for elsewhere.

Huge job losses will inevitably have an impact on consumption, which is at present being mitigated by massive fiscal stimulus. Indeed, fiscal deficits are off the charts: in the US, the deficit is expected to reach US $4 trillion this year (20% of GDP), without even taking into account the various spending programmes winding their way through Congress. 90% of that increase is being financed by the US Federal Reserve, which has become the ATM of the US Treasury.

This should push the US 'shadow' rate (which takes into account the impact of its unconventional easing) below the previous trough of -4.7% in real terms by the year end, down from the current -3.3% (yes, there is a negative sign at the beginning of those numbers!).

While benchmark interest rates are unlikely to fall below zero, we expect the Fed to adopt a Japan-style yield control curve policy if inflation undershoots its target significantly in the coming months (spoiler alert: it will).

The Eurozone had initially been more conservative in its approach, but a new EUR 750 billion rescue programme (a mix of grants and loans), to be funded through a commonly issued bond, is a big first step towards fiscal integration of the single currency region. Even if the plan is watered down, the Franco-German programme could change the EU's medium and long-term economic prospects.

While emerging market economies are likely to suffer less of a drop in growth than their developed counterparts, world growth could be down circa 4% this year (a peak-to-trough drop of 8%), which would be double the fall seen post-Global Financial Crisis.

The rebound in risky asset prices owes plenty to the very aggressive easing implemented by global Central Banks, with the Fed clearly the pace setter. The injection of liquidity from the Fed in recent months has elevated its balance sheet by more than US $3 trillion, and we should expect the balance sheet to near US $10 trillion by the end of the year (or 50% of GDP).

Where the Fed has moved the needle for risk appetite is through its backstopping of credit markets. Stemming a credit crunch in the very important area of capital markets (the Fed's actions have triggered an avalanche of debt sales from companies since March) certainly helps the equity market, particularly the weakest links. This has the potential to wake up the 'animal spirits' of investors that are desperately looking for places to park their assets.

Crucially, not only do we have the biggest money printing experiment ever, but also bank balance sheets are robust enough to transmit this through to credit creation (unlike during the 2008-09 crisis).

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KEY MACRO RISKS

Record-breaking action from governments and Central Banks is paying off; every day we get fresh signs that the global economy is on the recovery path. Markets around the world have embraced the good news with gusto. And therein lies a big risk for the coming weeks and months.

There is no question that economies are improving, but they are doing so from a very depressed level and there is still a very long way to go. Daily activity indicators show that, even after a significant rebound, the US, EU and Japan are still around 10% below January levels. Besides, May data from China showed a relatively fast rebound on the supply side of the economy, but a much slower take-off in consumption, suggesting a Nike swoosh-shaped recovery rather than the much-reported V-shaped one.

Against this background, developed market equities are down less than 2% since the start of the year. That creates a dangerous disconnect between markets and macro.

Many companies are using debt to bolster cash buffers and offset massive revenue shortfalls. If economic growth picks up quickly this will be deemed to have been a wise way to avoid temporary liquidity problems turning into a crippling solvency risk.

If growth disappoints, the economy and markets will have to cope with a massive debt overhang that results in even greater Central Bank distortions of markets and lower growth potential. There will be widespread debt restructurings too, and disorderly non-payments.

Let's assume a nearly perfect V-shaped recovery of S&P 500 earnings in 2021 from their collapse in 2020: 25% contraction this year (from 160 to 120) followed by a 25% rebound the next (from 120 to 150). This means that the index is priced at nearly 19x 2-year forward earnings (PE ratio). The long-term average 2-year forward PE is 15x, and multiples higher than 18x have been reached only once before (during the dot-com bubble).

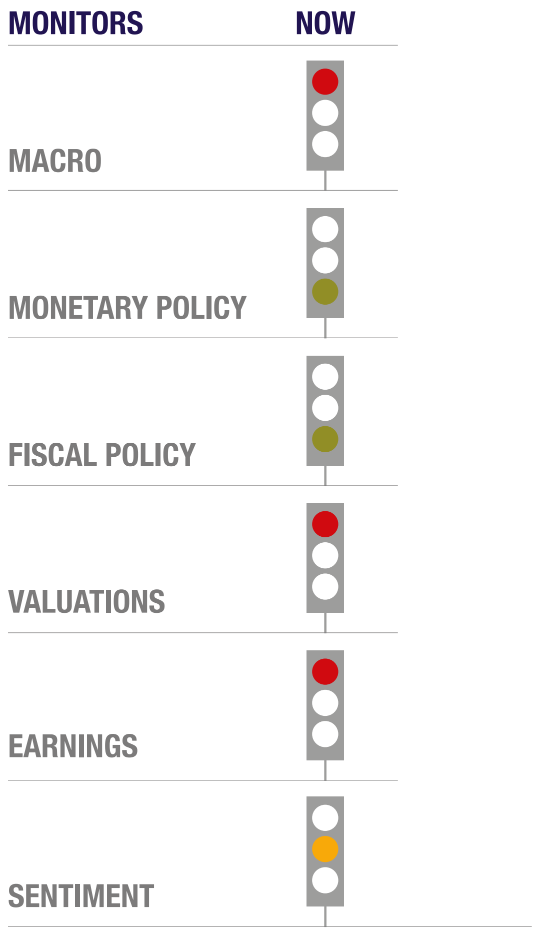
Markets are pricing in a permanent decline in the cost of capital rather than focusing on income and earnings, which is boosting valuations. Dispersion of valuations is extreme within asset classes, but the relative rankings of both equity regions and sectors are similar to pre-COVID-19 levels.

Translation: at this moment equities seem, on average, priced for a best-case scenario/perfection.

Every day we get fresh signs that the global economy is on the recovery path… and therein lies a big risk for the coming weeks and months"

SUMMARY OF MACRO VIEWS

L&C uses a proprietary system to develop forward looking views across assets.



SUMMARY OF ASSET VIEWS

From an asset allocation perspective, we should remember four main lessons of the past:

- Crises accelerate trends
- Crises expose and penalise the weakest links most severely
- Winners are always those companies that survive through time
- Those who survive end up thriving as there is less competition come recovery time

An investor without clear objectives is like a traveller without a destination. We have built our asset allocation with resilience in mind, and we are very aware of our investment objective: to preserve and grow wealth on a steady basis.

We have built our asset allocation with resilience in mind

Cash – Overweight

Fixed income – Neutral

On the fixed income side, we are focused on sectors that entered this crisis in a position of strength (large banks and insurers, for example) 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.

Equities – Underweight

Within equities, the bias is towards companies that have the balance sheet strength and P&L resilience to see them through this crisis. Earnings will be all over the place this year, so the focus needs to shift from valuation multiples to the ability to sustain free cash flows and lower levels of debt. The environment continues to bode well for STAR stocks.

Gold – Overweight

We continue to include gold as part of the asset mix. For economies to recover, monetary and fiscal policy will have to fill a large output gap that is likely to persist for many years.

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.

However, what could support the gold price are 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.

Alternatives – Neutral

* Fiat currencies are government-issued currencies that aren't backed by a commodity such as gold.

DEVELOPED MARKETS OUTLOOK

Global economies have gradually begun to re-open, which is clearly good news, but there are significant longer-term challenges that will ultimately determine the pace and length of the recovery. As with the previous quarter, we will cover key issues that are shaping our asset allocation and expected asset returns.

How deep will this economic contraction be?

In the IMF's latest update, global growth is now expected to contract by 4.9% (representing a further 1.9% downgrade adding to the 6.3% cut from the forecast made in January), making it deeper than the Global Financial Crisis and similar in depth to the Great Depression in the 1920s. GDP is expected to fall by 8% in the major economies, with all countries set to suffer a severe recession in the second quarter and a milder recovery in the third quarter. Emerging economies are forecast to contract by 3%, held up somewhat by China but with a steeper decline in India and Brazil.

There has already been considerable economic dislocation, and this will most likely persist in some sectors for some time ahead. The IMF has also stressed the potential reversal in poverty reduction as the pandemic is having a larger impact across low income households, a point also raised by the Federal Reserve Chairman. Overall, the IMF estimates an unprecedented loss in potential output of almost $10 trillion, which means misery for many countries and people.

	ACTUAL GDP GROWTH	FORECAST GDP GROWTH		GDP GROWTH CHANGE FROM APRIL 2020	
	2019	2020	2021	2020	2021
World	2.9	-4.9	5.4	-1.9	-0.4
USA	2.3	-8.0	4.5	--2.1	-0.2
EU	1.2	-10.2	6.0	-2.7	1.3
JAPAN	0.7	-5.8	2.4	-0.6	-0.6
UK	1.4	-10.2	6.3	-3.7	2.3
CANADA	1.6	-8.4	4.9	-2.2	0.7
CHINA	6.1	1.0	8.2	-0.2	-1.0
INDIA	4.2	-4.5	6.0	-6.4	-1.4
AE	1.7	-8.0	4.8	-1.9	-0.3
EM	3.7	-3.0	5.9	-2.0	-0.7

Source: IMF World Economic Outlook June 2020

Is there any more clarity on how long this downturn will last?

The lockdown has now eased across most economies, and the early indications suggest that there has been a decent bounce back in demand but less so in factory output. The PMIs in various countries have bounced back towards the critical 50 level but are not in expansionary territory yet. Retail sales have risen sharply and there was a surprise gain in US employment. Additionally, indications from large auto makers such as VW, GM and JLR suggests a rebound in car sales in China, Europe and the US. The main question is whether this is just a temporary bounce due to pent up demand or whether it will be a sustained change in sentiment.

Unfortunately, one of the key determinants of whether this is a temporary or a sustained change in economic sentiment is wholly reliant on governments and scientists opening the economy at the right pace and for a more permanent solution to be found for the underlying health pandemic. If there is a workable solution and economies continue to normalise, the likely Q3 rise in growth can extend into a more meaningful recovery. Trying to guess which letter of the alphabet will best describe the shape of recovery (V, W, U or L) is a thankless and probably fruitless task in the absence of concrete information on the pandemic.

The main question is whether this is just a temporary bounce due to pent up demand or whether it will be a sustained change in sentiment

For what it's worth, the projected consensus quarterly growth profiles are eye-opening, with Q2 activity expected to decline by anywhere between 10 and 40% before bouncing back in the second half of the year by a similar magnitude. However, the full recovery may not take place until late 2021 or even early 2022. We are leaning towards the IMF projections and underlying analysis which is calling for a recovery starting in Q3 but with caution.

In terms of our asset allocation and asset returns, we prefer to focus on the effectiveness of the massive policy support that has been put in place across all economies and a few critical sectors that will give us a good signal as to the likely strength of the economies.

What sort of economic indicators will give greater confidence or indeed confirm a slow recovery?

We will focus on underlying trends in the labour market, confidence (manufacturing and services), order books, corporate earnings reports, trade data (including moves in bi-lateral relationships), mobility data and ultimately whether Central Banks and governments prematurely halt the significant support mechanism (see next question).

In a sense, trends in the labour market data will be critical and will reflect both the mood of companies and also provide a clear guide to just how secure the Q3 recovery in growth is likely to be. The surprise jump in US non-farm payrolls was welcome, but weekly initial claims suggest a patchy recovery and there have been indications that as government support is tapered people are being laid off. Whereas just three months ago the discussion was all about tight labour markets, wage growth and full employment, we now face double digit unemployment rates and already a spate of permanent lay-offs. The US is generally a very good example of potential trends, with official Fed projections looking at double-digit unemployment well into 2021. Indeed, full employment is unlikely to be a concern for some years.

Beneath the hood, there are many sectors – such as retail, travel, hospitality, tourism, energy and other commodity-related areas – that fear a permanent shift in consumer behaviour and an inevitable hollowing out. These sectors are big employers and will lead to a major dislocation.

The US is generally a very good example of potential trends, with official Fed projections looking at double-digit unemployment well into 2021

Of course, sectors that have been nimble or in the right place have been winners and may well create jobs, but this will require both re-training and a fundamental mind-shift. It should also be noted that in almost every economy, school and university leavers will continually swell those numbers looking for jobs. We are maintaining our focus on sectors and companies that are important both for governments and consumers, namely utilities, banks, consumer staples, technology, telecoms, medical care and large scale auto and energy.

We will fervently follow quarterly corporate earnings reports even more than normal. These will give an excellent insight into underlying demand, any supply chain disruptions, labour market trends and future capital expenditure plans. We will also understand better how companies will utilise both the direct liquidity injection from Central Banks, fiscal support from governments and debt levels following the surge in debt issuance since early April. So far, the larger companies that we focus on have provided an upbeat message, but we shall see as we move forward.

GLOBAL MACRO & MARKET OUTLOOK Q3 2020

What kind of support has been provided and will it be sustained?

The positive news is that policymakers across the globe responded aggressively to offset the impact of the lockdown and are set to add to the stimuli. Independent economic experts have calculated that the combined global fiscal and monetary support is now approaching almost 40% of global GDP, with more action still likely post-lockdown. This is not surprising as governments had to offset the forced lockdowns they had initiated.

Monetary Policy: There has been a positive multi-faceted response by Central Banks.

1. **Interest rates:**
   Interest rates have been cut to the lower bound by the Fed and the Bank of England, while many other major Central Banks have kept rates in negative territory. We have seen interest rate cuts of almost 1% across the globe, with advanced economy rates down by just over 1%. The Federal Reserve responded with two emergency cuts taking rates close to zero (to the lower bound), which may well be breached in coming months. Other key Central Banks followed suit, cutting rates close to zero or, where they were already in negative territory, by introducing lower tier levels. Forward guidance is clear – rates will remain static for a prolonged period.

   The Fed has been as clear as ever that they will sit tight until growth returns on a sustainable basis, inflation moves back towards target and the labour market moves towards full employment. In fact, Chair Powell has been at pains in recent weeks to stress that they have learnt the lessons from the previous two years when, even with full employment, wages failed to accelerate as expected but the lower paid did see an improvement. These guiding principles suggest rates will remain where they are well into 2022.

2. **Asset purchase programmes:** Central Banks have unveiled new and enhanced asset purchase programmes. The Fed has announced unlimited buying of Treasuries and Mortgage Backed Securities. They have added corporate bond purchases including ETFs to their rollout. Variants of the Fed package have been unveiled by all major Central Banks. Estimates suggest that the balance sheet of the major Central Banks may well double to 60% of GDP.

3. **Credit facilities:** Credit and liquidity facilities have been made available to ensure the smooth functioning of markets. Banks have been provided with enormous facilities to ensure credit flows to hard pressed consumers, and businesses remain unimpaired. It is important to note that this flow of liquidity is not to shore up bank balance sheets (as in 2008/2009).

4. **Loan schemes** Company lending mechanisms, such as the Fed's main street lending programme which has capacity of up to US $4.5 trillion, are in place across many countries.

5. **Yield curve control (YCC)** YCC will increasingly come into focus. In a move like that of the Bank of Japan, we would expect major Central Banks to keep longer-dated government yield levels in check as any rise would be detrimental to the wider economy. Clearly, short to medium maturities will remain depressed by rates being anchored at either zero or in negative territory. However, longer-dated yields will reflect underlying economic conditions and rising debt issuance, and this is where YCC will be highly effective. Yes, this does mean a high level of intervention, but this was inevitable as soon as economies were locked down, there is a moral and economic necessity to bail out consumers and companies.

Fiscal policy

This is also multi-faceted, but will play a more central role in the coming quarters. It is also the area that may lead to an error if there is a premature desire to seek austerity and reduce debt levels.

1. **Direct fiscal easing** This was led yet again by a near US $2 trillion loosening in the US and the likelihood of a further US $1 trillion package. The global fiscal loosening now stands at US $11 trillion (IMF estimate) up from US $8 trillion in April. This amounts to a discretionary loosening amounting of almost 10% of GDP. The global fiscal easing is over 8% of GDP, with more to come. There is direct and targeted support for consumers (income support), business (tax breaks and grants, loans and rebates) and employers (tax breaks, grants, loans and income support measures).

2. **Loan guarantees** Loan guarantees will support businesses but also consumers. The US programme amounts to almost 20% of the GDP at US $4 trillion, whereas the German equivalent is even bigger at 25% of GDP. Italy's support is approaching 50% of GDP. Further measures are in the pipeline.

There is a moral and economic necessity to bail out consumers and companies

Both policy levers will have to remain in place for a prolonged period. First to remove the massive output gap that has emerged and second to ensure a more sustained recovery path

3. **Bank liquidity**
Central Banks are guaranteeing liquidity for banks to ensure that they can use the strength of their balance sheets to support businesses and consumers. The scale of the lending programmes is enormous and inevitably it has stumbled largely due to the unprecedented demand. Regulators have also eased on requirements to allow greater forbearance allowing consumers and businesses to delay payments without suffering credit impairment.

4. **International organisations**
Unlike the Great Depression, we now have international organisations such as the IMF and World Bank who can use their resources to help the economies that need the most help. The IMF has made around $1 trillion available to emerging economies and is also likely to alleviate debt repayments and even debt write-offs where necessary.

5. **Infrastructure spend**
The next stage (post-lockdown) is likely to include tax cuts and large infrastructure plans including spending on technology, productivity enhancing production means and re-directing global supply chains.

Governments and Central Banks have responded quickly and aggressively. They have certainly provided the support for a quick recovery. Both policy levers will have to remain in place for a prolonged period, first to remove the massive output gap that has emerged (that may well take us well into 2022) and second to ensure a more sustained recovery path.

This does mean that difficult issues such as debt levels and elevated Central Bank balance sheets will have to be ignored, but so it must be. Fed Chair Powell recently stated in his testimony that the Fed shrank the balance sheet from 2014 onwards (as a percentage of GDP) by just standing still and allowing the economy to expand. This is an excellent lesson for all Central Banks and Finance Ministers: just allow economies to expand and it will do the job for you, enabling difficult decisions to be taken.

What is left to discuss in coming months and quarters?

It is still too early to discuss these issues but some of them (such as the faster roll out of new technology) will most likely feature in infrastructure plans.

We listed the following issues last quarter and they remain in the background:

- Will inflation emerge from the current deflationary shock?
- Will globalisation now face the biggest challenge, even greater than President Trump's rewriting of trade agreements?
- Will multi-nationals decide to re-orientate supply closer to home?
- Will the move to cleaner technology accelerate, considering the immense drop in global pollution levels?
- Will governments accelerate the shift to faster internet/ broadband technology to enhance productivity?

FIXED INCOME

GOVERNMENT BONDS

- By all accounts, sovereign yield curves should be steepening, but they are not
- A record pace of sovereign issuance is being met with equal amounts of Central Bank buying

As we suggested in our previous Macro Outlook (Q2 2020), the monetising of (government) debt is up and running in style. The explosion of government borrowing would, under normal circumstances, significantly steepen the yield curve. But we are in an extraordinary era of economic contraction and potential deflation, meaning there will be little difference between nominal and real GDP readings for the next few quarters.

Why is this important? Traditionally, conventional government bond yields tend to track nominal GDP growth, and real yields tend to mirror real GDP. In the absence of inflation coming back any time soon, this effectively reduces the term risk premium that normally creates an upward sloping curve. Add to this the recent statement by Fed Chair Powell that interest rates are likely to remain near zero until well into 2022, we end up with not only low risk-free bond yields, but also an environment of low volatility.

These are important inputs when valuing other asset classes such as corporate bonds as well as higher beta classes such as high yield debt and equities. In these unprecedented times, we are reassured by the depth of Central Bank balance sheets, especially those that are actively engaged in Asset Purchase Programme (APP) schemes.

GLOBAL MACRO & MARKET OUTLOOK Q3 2020

CORPORATE DEBT

- The past quarter has seen a record amount of corporate debt issuance
- Expect more of this over the next six months, most likely at a reduced pace

As we ended the previous quarter, the sole focus of both equity and credit markets was how the lockdown would affect corporate cashflows. Had the authorities not responded with the vigour they adopted, these cashflow concerns would have moved swiftly on to the household sector, which would clearly have presaged a deeper demand-deprived recession.

The various layers of loan accessibility announced principally by the Fed, and subsequently embraced by other global authorities, has given a much-needed reprieve for many companies to continue to honour their expenditure obligations during a period when the coming two quarters' revenues are going to be significantly lower. Of course, not all businesses will have received the same strong investor reception as many of the larger corporates; some smaller companies who don't have access to the capital markets may well find conditions more challenging going forward.

Nonetheless, as with the case for sovereign debt, the various APPs in the secondary markets have matched in value a significant amount of the record new issuance, so in net terms there has been little new additional supply. This has led to a sharp contraction in yield spreads across most credit sectors, though not yet back to pre-COVID-19 levels.

In these unprecedented times, we are reassured by the depth of Central Bank balance sheets ”

The powerful combination of investor demand and official buying cannot be understated: we expect further spread contraction over the next few months, but we will continue to be selective in the areas in which we invest.

Why does this backdrop matter so much? Not only have corporates raised cash, they have done so in maturities that are longer than those they would normally borrow. This provides credit investors with comfort that companies may not need to come to the market in such size over the next few months.

At this stage, we are focussing on those companies that are fundamental to the repair process of the local and global economies. The jury is still out on how and when consumer demand will return to end-2019 levels, so for now we are not looking to increase investments in the consumer discretionary sector (apart from focussed investments in certain large players in autos and energy). We see value in the industries that will need to play a key role in the repair process, which is the phase we find ourselves in currently. We will add level 2 sectors (i.e. more cyclical names) over time if and when the economy finds its feet and begins the recovery process.

At this stage, we are focussing on those companies that are fundamental to the repair process of the local and global economies

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Below we show examples of such sectors we are favouring

SECTOR	ROLE IN THE REPAIR PROCESS
Banks	Banks are the vital conduit to ensure “authority sponsored” cashflow finds its way to companies who face short-term liquidity strains. Regulators have significantly eased back on existing tight balance sheet constraints to allow this movement of cash flow without affecting bank ratios.
Utilities	Whilst the use of electricity has fallen sharply over the past quarter, households and businesses will depend upon utility providers to be fully operational when activity starts to pick up once more. In many cases, governments own equity stakes in these companies.
Pharmaceuticals	There has been little demand disruption for standard pharmaceutical products, and the battle against the virus is likely to provide an additional earnings lift to many of the giants.
Tech & Telecoms	As seen in equity markets, the concept of working from home has focussed much attention on the different ways people may work after the virus has been defeated. Tech companies are likely to be at the forefront of innovations to enable this over the years ahead.
Consumer Staples	Aside from the surge in food demand by households, retailers in consumer staples are likely to see steady earnings over the quarters ahead, as a potentially slow recovery in discretionary spending continues to support this sector.

Source: IMF World Economic Outlook June 2020

GLOBAL MACRO & MARKET OUTLOOK Q3 2020

What are the risks to our credit strategy?

On face value, the step-up in corporate bond issuance will increase the debt metrics for many of these companies. Some ratings downgrades have already been announced by the ratings agencies, but in our opinion this misses the point: these extraordinary measures will be seen by issuers as temporary measures, and, prior to the lockdown, a common target for many large corporates was to reduce debt leverage ratios. We believe this target will remain on their agenda but will clearly take a little longer to achieve than had been assumed. In the meantime, the ratings agencies may well continue to downgrade some credits based on quantitative, not qualitative analyses, which may in some cases widen spreads on individual issues.

The other clear risk is if the global economy fails to gather some momentum in 2021 and beyond. This would result in lower revenue flow for corporates and may put upward pressure on debt to EBITDA ratios. We see this as more of an issue for consumer cyclical names, but there could well be some overspill into some of the sectors we favour.

The broad theme that we see for the next two to three quarters is a friendly environment for credit investors: low volatility in the risk-free rates, supported by strong investor and official buying.

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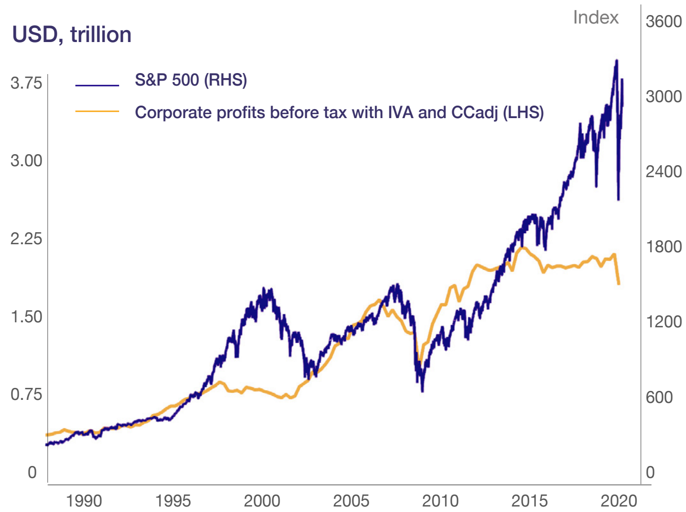
EQUITIES

Following one of the sharpest stock market sell-offs in history in February and March, the second quarter of the year brought one of the sharpest recoveries as investors became increasingly hopeful of a V-shaped recovery and a boost to equity prices from unprecedented amounts of fiscal and monetary stimulus.

This has created a distortion in equity prices' essential relationship with profits and earnings.

US Corporate profits and S&P 500



Source: Oxford Economics/Macrobond

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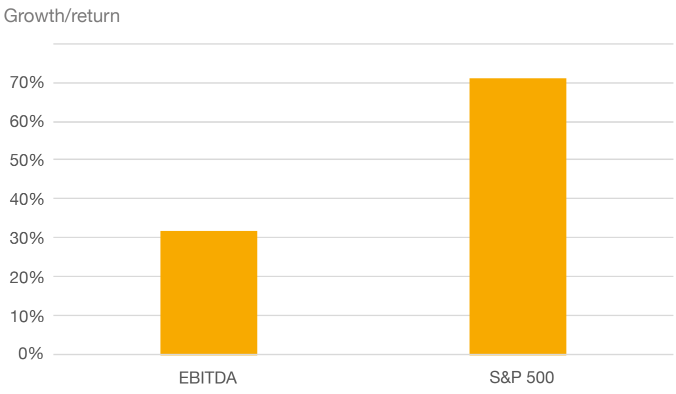
GLOBAL MACRO & MARKET OUTLOOK Q3 2020

INTRODUCTION
DEVELOPED MARKETS OUTLOOK
FIXED INCOME
EQUITIES
ALTERNATIVES
FX

S&P 500 growth/return from 2016 to 2021



Source: London & Capital

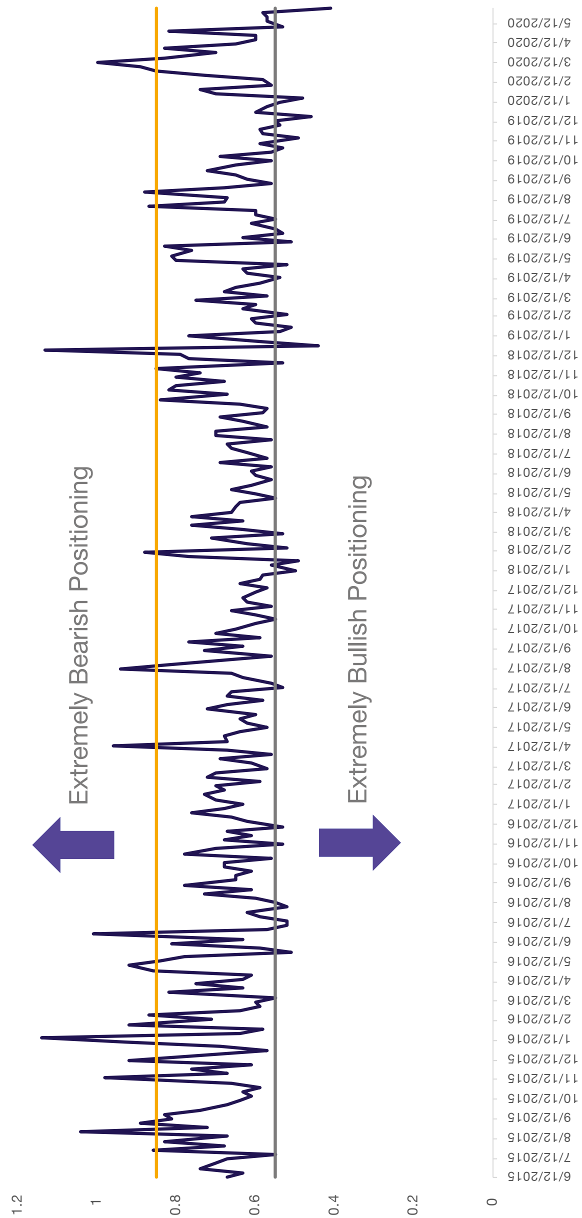
Furthermore, the market has shifted from excessive pessimism to extreme exuberance in just a few months. We can see this in the put/call ratio chart below, which is indicative of the positioning of investors.

S&P 500 put/call ratio

These dislocations and extremes mean we remain cautious towards equity markets at current levels, a view which is reinforced by the stretched equity market valuations, which historically suggest lower returns to come.

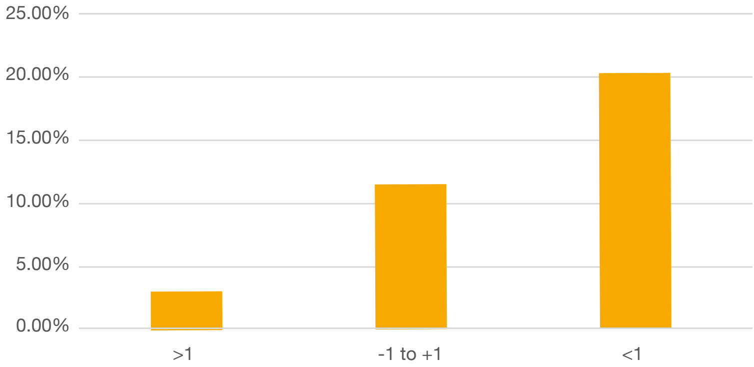
See graph on the opposite page

S&P 500 put/call ratio



GLOBAL MACRO & MARKET OUTLOOK Q3 2020

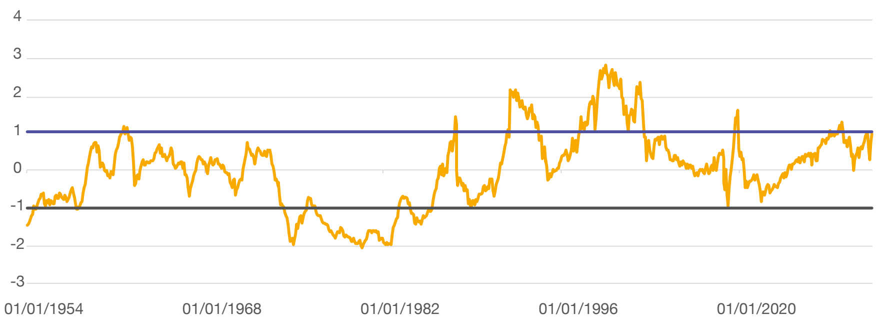
S&P 500 12 month average return based on standard deviations for longer term PE average



Source: London & Capital

The graph above shows the historical average 12 month return of the S&P 500 based on the market's average valuation (price to earnings ratio at the start of each 12 month period relative to its long-term average).

S&P 500 PE standard deviations from the mean

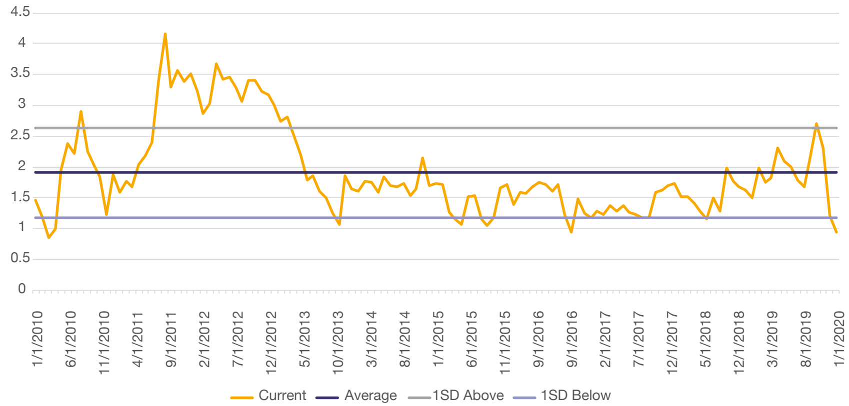


Source: London & Capital

The graph above shows the historical standard deviation of the S&P 500 price to earnings ratio.

Finally, the lower cost of capital or yield support argument looks to be priced into equities as equity earnings yields now looks expensive compared to coporate bond yields.

S&P 500 earnings yield v. US corporate bond yields



Source: London & Capital

OUR POSITIONING

This makes equity positioning challenging, as although the equity market looks fundamentally vulnerable, this phenomenon could continue for a while as Central Banks' money-printing pours liquidity into asset markets.

We therefore advocate some exposure to equities, albeit a small weighting. Within that equity exposure we favour keeping an element of balance in terms of value stocks compared to growth stocks. Although the longer term fundamentals are challenging for value stocks (i.e. low growth), the valuation gap is very wide between these two categories of companies.

However, we still firmly believe that it is crucial to have a quality bias and companies with strong balance sheets will have a multitude of options over the next two years which will allow for returns to shareholders, opportunistic acquisitions and organic expansion through investment. Conversely, companies with weak balance sheets will struggle and lose market share to their industry's stronger competitors.

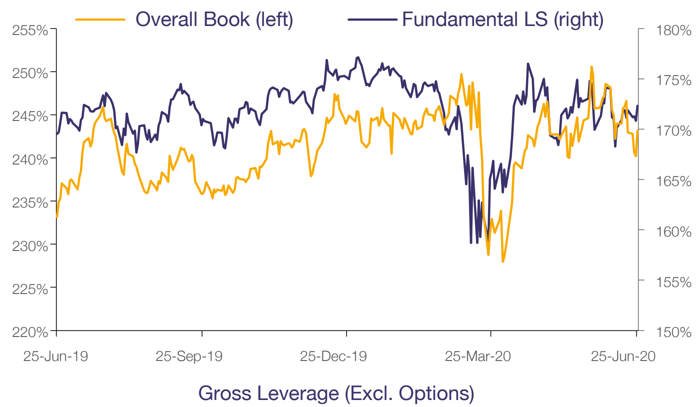
A sector which we have become increasingly positive on recently is the Healthcare sector. Many Healthcare stocks have visible earnings growth, their valuations are not stretched, and the world now understands the importance of good healthcare solutions. Although the US elections may create short-term volatility in the sector, both parties' approaches to Healthcare can easily be accommodated by the sector and profitability can remain solid.

Overall, we remain highly aware of the risks in equities from the current outlook but are also cognisant of being opportunistic if high quality stocks are marked down excessively.

ALTERNATIVES

The sharp bounce back in markets has helped the hedge fund industry recover its poise, with many strategies now down only marginally on the year. Any equity-based strategies that have bet on a sharp market recovery have certainly done well in the last few months. However, there have been a few casualties. Some over-leveraged relative value managers were forced to cut risk in Q1 and then failed to capture the upside in Q2. Heavily impacted areas, such as structured credit, remain at depressed levels, at least until greater visibility is in place on corporate cash flows and the level of bankruptcies. Despite significant market uncertainty, overall leverage and net market exposure has bounced back to pre-COVID-19 levels, signalling a level of vulnerability for broader hedge funds into any renewed market weakness.

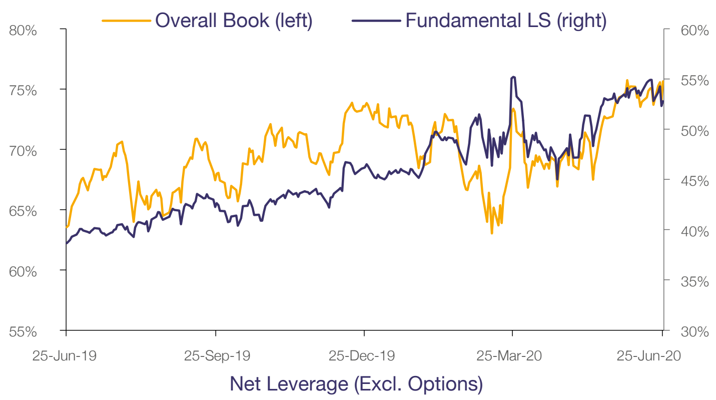
Leverage has quickly recovered from the March lows



Source: Goldman Sachs

INTRODUCTION
DEVELOPED MARKETS OUTLOOK
FIXED INCOME
EQUITIES
ALTERNATIVES
FX

While net market exposure is again extended



Source: Goldman Sachs

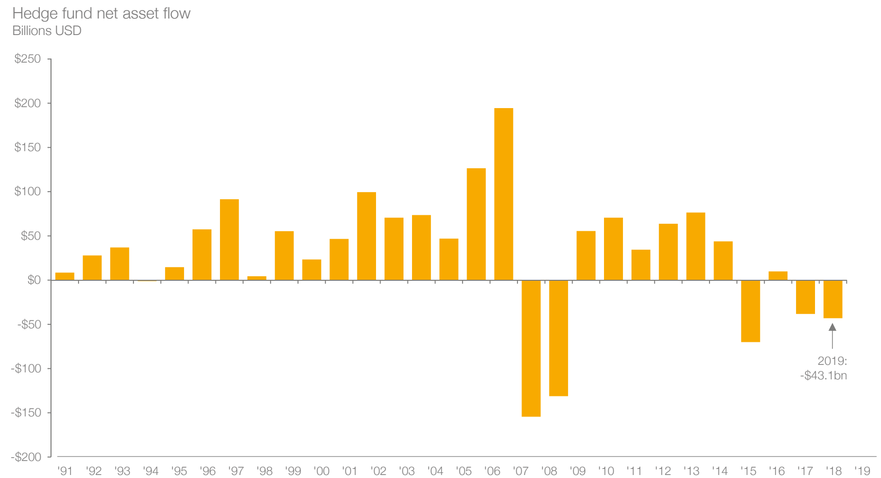
One recent development has been that a number of distressed and restructuring-based funds have kicked into gear, drawing down capital that had been raised but was sat on the side lines until now. Not all of this capital has been deployed; it's ready to jump on any new opportunities that arise in the coming months.

While the industry is carrying significant directional risk, we favour a more measured approach, utilising strategies that use little to moderate leverage and do not exhibit a high level of beta over time. That has given us the ability to outperform the broader industry this year and keep the downside contained. Following the strong market rally from the lows, and given that volatility and uncertainty remain elevated in the midst of the current pandemic and economic fallout, we believe the forward-looking opportunity set for true alpha-generative hedge funds is as strong as it has been for many years.

GLOBAL MACRO & MARKET OUTLOOK Q3 2020

Despite what we view as a favourable outlook, hedge fund investors continue to withdraw capital from the sector. For allocators that were positioned incorrectly and have suffered poor returns this year, the recent underperformance may have led to a reassessment of positioning; it remains to be seen how much of this will be recycled back into the industry. We do not view a smaller industry necessarily as a bad thing, with less capital competing for alpha generally being a welcome situation.

Hedge fund flows



Source: HFRI, JP Morgan

While the industry is carrying significant directional risk, we favour a more measured approach

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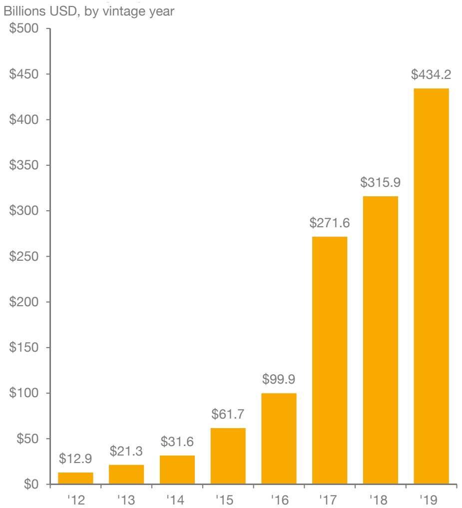
In terms of private markets, we still believe the current COVID-19 crisis will take time to feed through into valuations, but there´s no doubt that high valuation multiples that were prevalent at the beginning of the year will need to come down. Immediate funding from investors did take a pause in Q1, but we have subsequently seen several large private equity fund raises successfully close, as institutional investors look to take advantage of emerging opportunities. This has certainly been the case in the secondaries market as well as VC, where the technology and biotech sectors remain in favour and have been relatively resilient through the COVID-19 crisis. We certainly believe that now is an opportune time to deploy capital as vintages that invest following a crisis typically generate outsized returns. In addition to fresh capital, dry powder from recently raised funds remains at all-time highs. A reduction in this level would be a good sign of the industry finally stepping in to provide much needed capital at such difficult times.

Private equity dry powder



Source: Pitchbook, S&P LCD, JP Morgan

OUR POSITIONING

Despite the market volatility, our approach to alternatives remains consistent other than to add some new ideas where we have seen some opportunities emerge. We are complementing client portfolios with a highly select number of upper quartile liquid hedge fund strategies with a strong, long-term track record of alpha generation. The idea is to provide diversifying sources of return, capturing attractive alphas away from traditional long-only strategies.

London & Capital hedge funds are positioned to be broadly uncorrelated to markets, although the existing set of managers tend to have a variable net exposure with the ability to adapt to the prevailing market environment. With outperformance versus traditional risk assets and broader hedge funds this year, we feel confident we can deliver meaningful value for clients into any further market volatility.

Equity long-short

Our equity market exposure is centred around a leading equity long-short manager with a growth bias and variable net market exposure. The current defensiveness being applied to portfolio construction means that the strategy is navigating the current environment very well and we believe will remain a strong contributor going forward as a true stock-picking environment emerges from the crisis.

The idea is to provide diversifying sources of return, capturing attractive alphas away from traditional long-only strategies

GLOBAL MACRO & MARKET OUTLOOK Q3 2020

Macro

Macro strategies have the potential to benefit from global macroeconomic policies and the effect these have on rates, fixed income and FX. The most directional strategy in our hedge fund mix, is an EM-focused strategy utilising a combination of sovereign and corporate debt, rates positions and FX.

Event-driven

Arbitrage strategies with hard catalyst corporate events are enjoying a rich opportunity set and some complex situations which provide for added alpha. While a number of outsized opportunities that emerged in March were exploited by our event-driven manager, these have now dissipated, merger spreads remain elevated and deal flow has begun to pick up once more. We remain optimistic on the potential for the strategy.

Managed futures

We have recently invested into a new managed futures strategy with a systematic, short-term trading approach. This strategy is highly suited to environments with elevated volatility, marked by fast moves to the upside and downside as well as sharp reversals. Our chosen manager is therefore enjoying a rich opportunity set across equity, fixed income, FX and commodity futures markets globally.

Volatility trading

We have reintroduced volatility trading into the hedge fund mix as a higher volatility regime offers a very strong opportunity set for such strategies. We have selected a manager that expresses trades in liquid instruments with a market-neutral stance and has typically done very well in periods following extreme volatility events such as the one recently witnessed.

Private Equity

In Private Equity we have introduced a select number of idiosyncratic funds and direct investments involved in disruptive areas such as tech, biotech and longevity which should be less tied in to the current economic backdrop. However, we will be scouring the Private Equity market for ideas that may emerge from the current crisis, including secondary opportunities and turnaround funds. We are also focusing on delivering strong tax-efficient ideas for clients through a selection of EIS investments.

GLOBAL MACRO & MARKET OUTLOOK Q3 2020

FX

The surge in the US Dollar during March eased in April, and by late May the broad USD Index tipped lower. Swap lines provided by the US Federal Reserve to other global Central Banks in order to ease liquidity conditions and curb Dollar strength have proven successful, and in recent weeks the take-up of these facilities has fallen. Pressure on the Dollar against the Euro, Sterling and most other major currencies in late May was largely tied to the rotation seen across asset markets as investors embraced the global recovery story and cyclical assets.

As we suggested last quarter, the outlook for the US Dollar looks more challenging in the next couple of years as the global recovery gains traction. The US Dollar dominance of trade and finance flows typically lead to it behaving in a counter-cyclical fashion. After the financial crisis we saw the Dollar come under pressure as the global economy reflated and the Federal Reserve expanded its balance sheet at a faster pace than other Central Banks. At the time the US and the rest of the world were also happy to see abundant liquidity and a weaker USD. The set-up looks similar in this recovery, especially given the interest rate and growth differential reset that had favoured capital flows to the US in recent years.

There are several reasons to take a bleak view on Sterling at this time, including Brexit uncertainties, poor handling of the health crisis, the prospect of negative rates and forecasts for a weak economic recovery, but as we saw during May these may well be overshadowed going forward if a broader Dollar trend gets underway.

On the other hand, the prospects for the Euro appear to be improving. Early indications suggest Europe has done a better job of managing the virus after lockdown, on balance economic data has positively surprised and the prospect of a recovery package financed in part by joint liability EU bonds would be an important milestone in stabilising the Eurozone's future.

The Dollar lower view is widely held amongst investors, and market positioning has started to reflect this. Given the early position build-up and the significant uncertainty still overhanging the recovery (no clear traction yet), we should expect in the short-term to see any trend lower to be punctuated by squeezes higher on the back of virus, policy or economic disappointments.

The outlook for the US Dollar looks more challenging in the next couple of years as the global recovery gains traction

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About London & Capital

London & Capital is an independently owned wealth management company, providing private and institutional investors from across the globe with expert offshore and onshore investment strategies.

We are headquartered in London with a presence in Barbados and are regulated by the FCA (UK), the SEC (US).

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