GLOBAL EQUITY PERSPECTIVES 16 MARCH 2020

"Patience is bitter, but its fruit is sweet."

Aristotle

1. STILL THE VIRUS

The past week was one of the most volatile in many investors' careers, with the coronavirus issues continuing to weigh heavily on their minds. Thursday alone delivered a -9.5% return for the S&P 500 index after COVID-19 was officially declared a global pandemic, bringing the week to -16.6% at the close. President Trump declared a National Emergency on Friday making up to $50bn available to address the crisis. This triggered a +9.3% appreciation on the day to end the week on -8.8%. Nevertheless, both the S&P 500 and the MSCI World AC indices entered bear market territories by dropping -26.7% and -26.1% respectively since their peak levels in February.

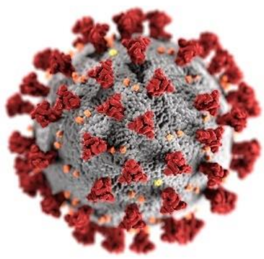
Investors welcomed the US administration's long-awaited leadership and hands on actions as with the National Emergency and its various support actions, organising pharmacies and retailers to assist with tests, closing their borders for many foreign travelers, considering further domestic travel restrictions and involving leading businesses (e.g. Google) to assist and find solutions. We summarise the new investment environment as follows:

<u>Causes of the Volatility</u>

- The spreading of the COVID-19 virus has truly gone global, with slow government responses especially in the West to either limit the spreading or arranging tests. This led to it becoming a pandemic with potentially hugely negative effects on most economies and company profits over the short term.
- The virus caused a slump in the oil price because of slower economic activity, initially in China. OPEC and Russia met to decide on limiting oil supplies to support the oil price. The latter then refused to sign on to Saudi Arabia's proposed cuts, sending the price down a third. Some see this as a strategy to wear out high cost US shale producers. Nevertheless, the low oil price causes increased credit risk in the oil and related industries, and a related spike in other corporate credit rates. This was a very untimely event in the context of already frail investor sentiment at the time.

<u>Comments on the Current Market Environment</u>

- China manages its coronavirus-related risks well. Their sharp reactions have already had positive outcomes with new infection numbers dropping rapidly and the recovery rate exceeding 80%. Many workers are returning to their place of work, although under some restrictions to prevent infections. The negative effects on supply chains are levelling off and starting to turn for the better. Some large manufacturers expect to be back in full production by the end of April. This is an important positive economic factor.
- The West is not as capable at managing their risks as effectively and has been slower to react. Nevertheless, travel restrictions have been implemented in some countries, federal budgets made available and many employees are now working from home. In many cases quite material negative economic and profit effects and (predominantly smaller) business failures can be expected. Federal support may be provided.



- The US's National Emergency declaration with its support budget, along with severe travel restrictions and co-ordination with the private sector reflect better leadership than before to address the virus head-on. This is a positive factor for investor sentiment.
- We expect poor company results for the first and second quarters, at least.
- Scientific research is already beginning to show positive results (e.g. in Israel and the UK). However, it may take long for the necessary regulatory approvals to be obtained.
- Modern media coverage will continue to highlight the virus-related issues much more effectively than with previous illnesses. COVID-19 coverage (number of mentions) is already 20 times the coverage of SARS and 27 times the coverage of HIV (the second and third highest illness coverage numbers). This can continue to harm investor sentiment.
- The arrival of Spring and Summer is expected to limit the spreading of the virus.
- The untimely spike in credit spreads has increased the risk for geared businesses, and harm investor sentiment.
- Russia and Saudi Arabia are both dependent on oil income to finance their national budgets and may have to reconcile their differences. It is also likely that the US may support their shale industry. This may benefit the oil price off its oversold levels and lower credit spreads, potentially favouring investor sentiment.
- The oil price may structurally be in a weak state for some time and can later have a favourable effect on all the major economies.
- With the strong action from the US government chances are growing for success in containing COVID-19 within a few months against the alternative scenario of an unmanageable health care system leading to a deep recession.
- The coordinated stimulus actions by central banks are very welcome.
- If the combination of all the above may still lead to a US recession, chances are growing for it to be rather short, with China by then probably close to full production.
- Until investors have more concrete information on the containment of COVID-19 and the oil price, capital market volatility is expected to continue (with the worst probably behind us).
- The very recent (mild) recovery in the bond market is a (mildly) positive sign.
- Investors have last week seen indiscriminate selling of shares, regardless of the quality or the longer-term prospects of the underlying businesses. This created good buying opportunities. We do not expect opportunities to disappear anytime soon and we prepare for a continuing 'bumpy ride'.
- We remain constructive about the longer-term prospects of our Fund's specific businesses.

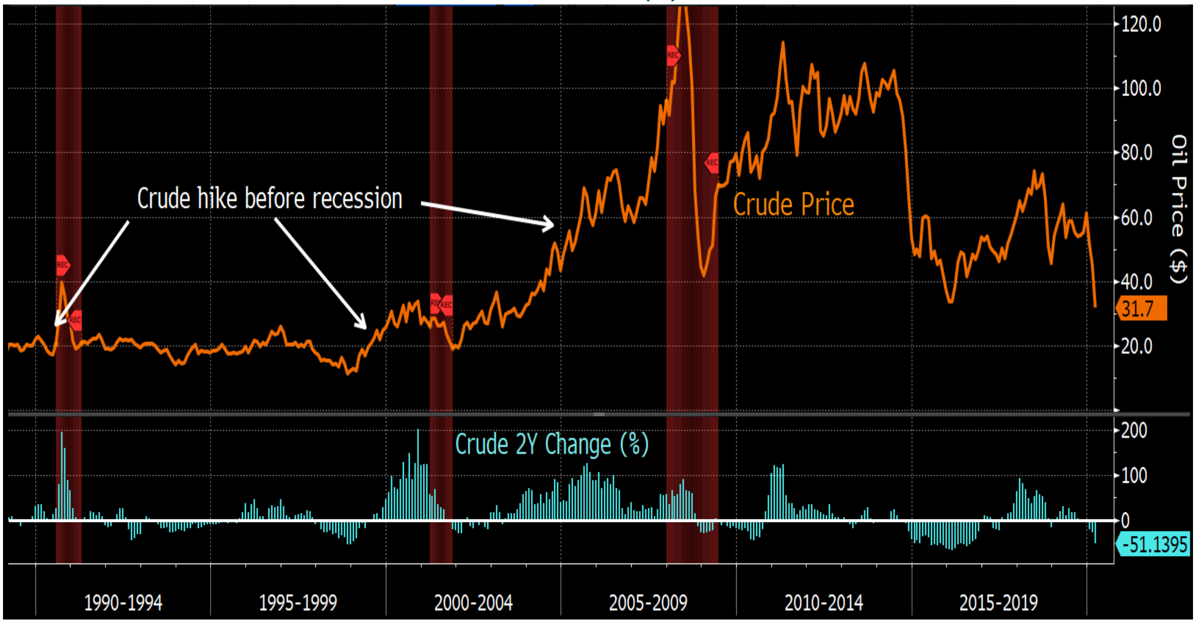
<u>Positioning of our Portfolio in the Current Environment</u>

- We do not advocate attempts to time the market – it too often leads to the wrong decision at the wrong time. For us it is more about spending time in the market holding the correct businesses, collecting growing dividends and building up cash exposure when market circumstances are unfavourable (as we have done for a while).
- Our overall approach has since inception been to own only high quality sustainably growing businesses.
- The portfolio is not directly exposed to more cyclical or commodity type of businesses. We do not own businesses related to oil production, and rather benefit from the low oil price.
- We steer clear of businesses with weak balance sheets.
- Whilst currently being in a particularly uncertain economic and business environment, we do not believe the longer-term outlook (and the value of our businesses) should be affected materially.
- We therefore do not plan any material changes in the portfolio, but may utilise particular switching opportunities into other quality businesses becoming attractively valued. We may also consider adding more names to the portfolio utilising the cash in the portfolio, doing so at a disciplined pace.

2. OIL PRICE

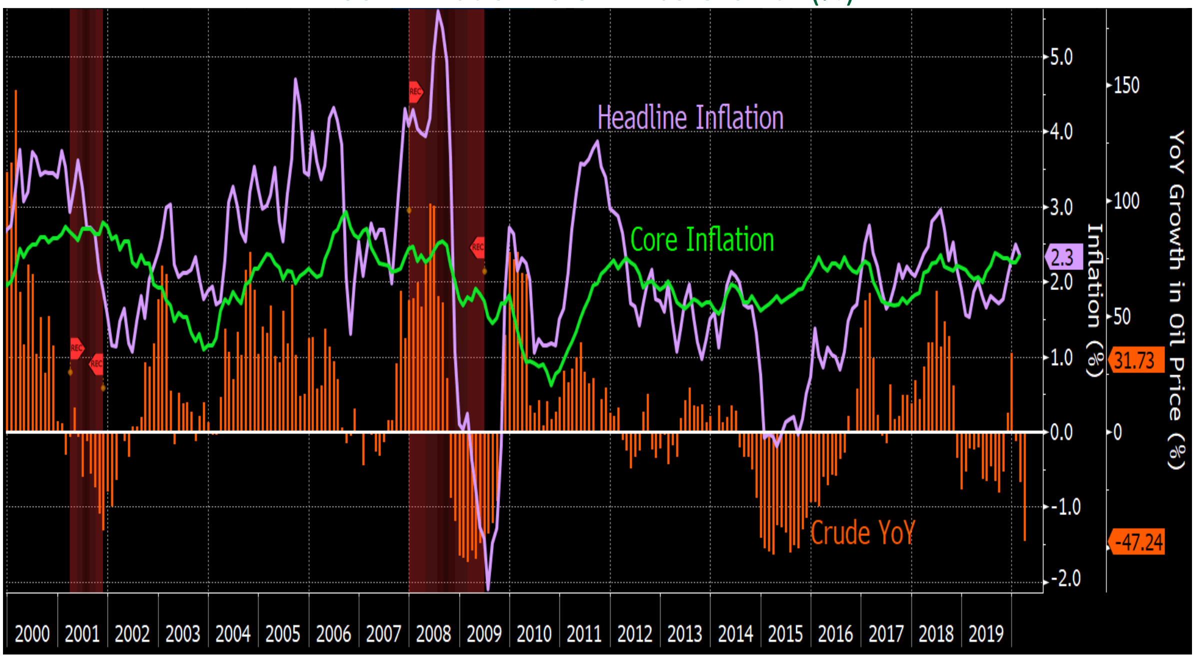
The oil price has become an unexpected and unwelcome factor along with the virus crisis.

Oil Price ($)



The oil price has collapsed to levels last seen more than fifteen years ago. It is currently less than half the price two years ago. It is clear what hardship that can cause in the industry on top of the virus issues to deal with. The responsible (and inevitable) thing for the major producers to do is to get back to the negotiating table. The US rig count has been dropping by a quarter over the past year already. The US government may consider supporting their shale producers.

US – Inflation vs Oil Price Growth (%)



A lower oil price is obviously beneficial to anyone not involved in oil production. It is way too early to consider such new benefits, whilst it is also true that most economies have already over the past two years been benefitting to a large extent from this factor. The direct relationship with inflation reflects in the above chart. This also puts a lid on interest rate levels.

More stability in the oil industry is an important factor for restoring investor confidence.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. March 2020. ***Past performance should not be used as a guide to future performance.***

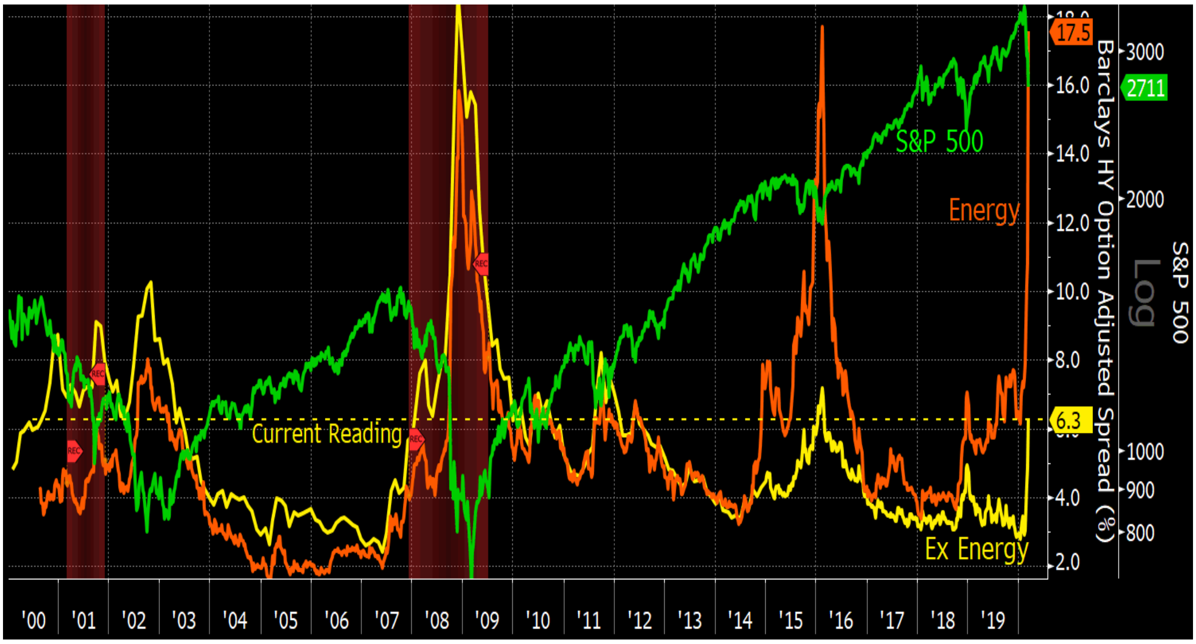
3. HIGH YIELD DEBT MARKET

The collapse of the oil price and its effects on many businesses related to its production, along with the negative cash flow effects from coronavirus on many other businesses, triggered a dramatic spike in the high yield market:

US – High Yield Spread (with Treasuries) % vs S&P 500

The spread has a clear historic inverse correlation with share prices. The current spread of 7.3% is at a historic elevated level, previously associated with an upcoming recession. We have, though, experienced similar levels (and higher) in 2011/12 and 2016 around European debt and US recession fears at the time. The current level is therefore not yet in unchartered territory.

S – High Yield Spread (Energy vs Rest) % vs S&P 500



The above chart reflects the spread of the Energy sector compared with the rest. Understandably, its spread by far exceeds the rest and at that level imply casualties in the sector and on their way. It is currently at historic record levels reflecting the stresses Russia and OPEC have caused along with the virus. The spread of the Non-Energy sector has also spiked to elevated levels, but still lower than its levels in 2011/12 and 2016.

The high yield market has not yet stabalised. The major oil producers have an opportunity to illustrate leadership for the global good of everyone.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. March 2020. ***Past performance should not be used as a guide to future performance.***

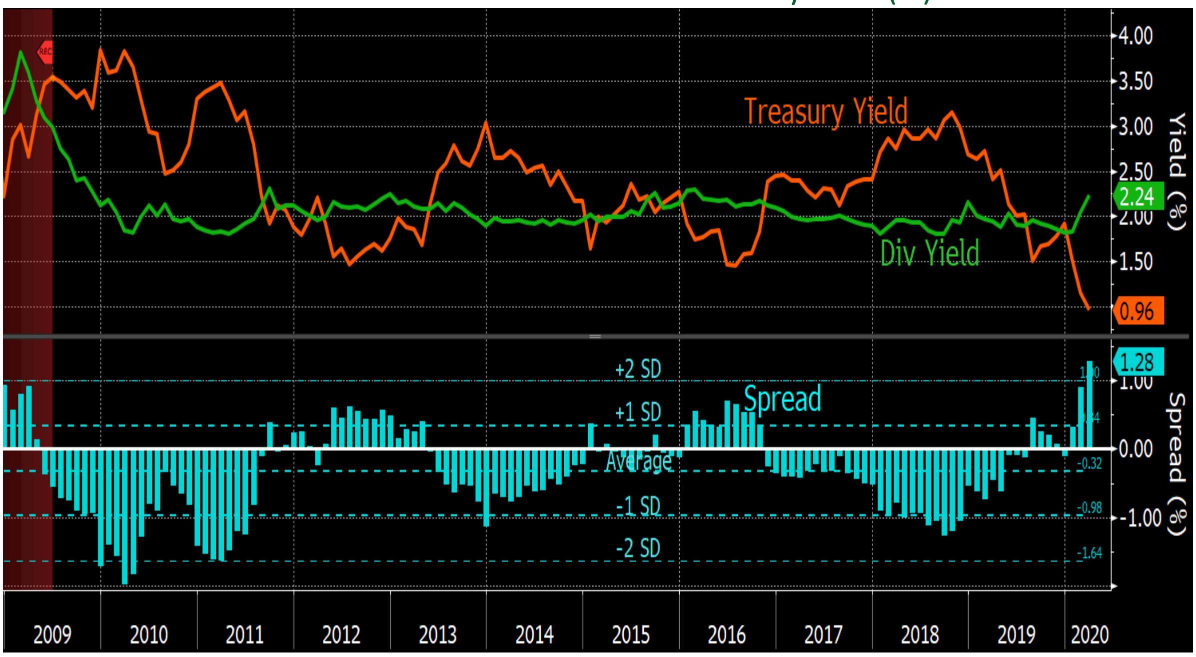
4. INCOME CONSIDERATIONS

Whilst we have uncertainty about the immediate earnings outlook, we have little doubt about our businesses' dividend outlook. It is worth considering relative valuations in this context:

S&P 500 Dividend Yield vs US Corporates Bond Yield (%)

The S&P 500 dividend yield has risen to 2¼%, a record level since the Credit Crisis. The corporate bond yield has also risen, but to a lesser extent. The spread of 1.1% is more than -2 standard deviations (SD's) from its average. With the conviction we have about dividend potential, this spread argues in favour of equities at the expense of corporates.

S&P 500 Dividend Yield vs US Treasury Yield (%)



The spread between the S&P 500 dividend yield is currently at a record level of 1¼%. This is more than +2 SD's away from its average since the Credit Crisis. This also argues in favour of equities, obviously on the basis of conviction in the dividend outlook.

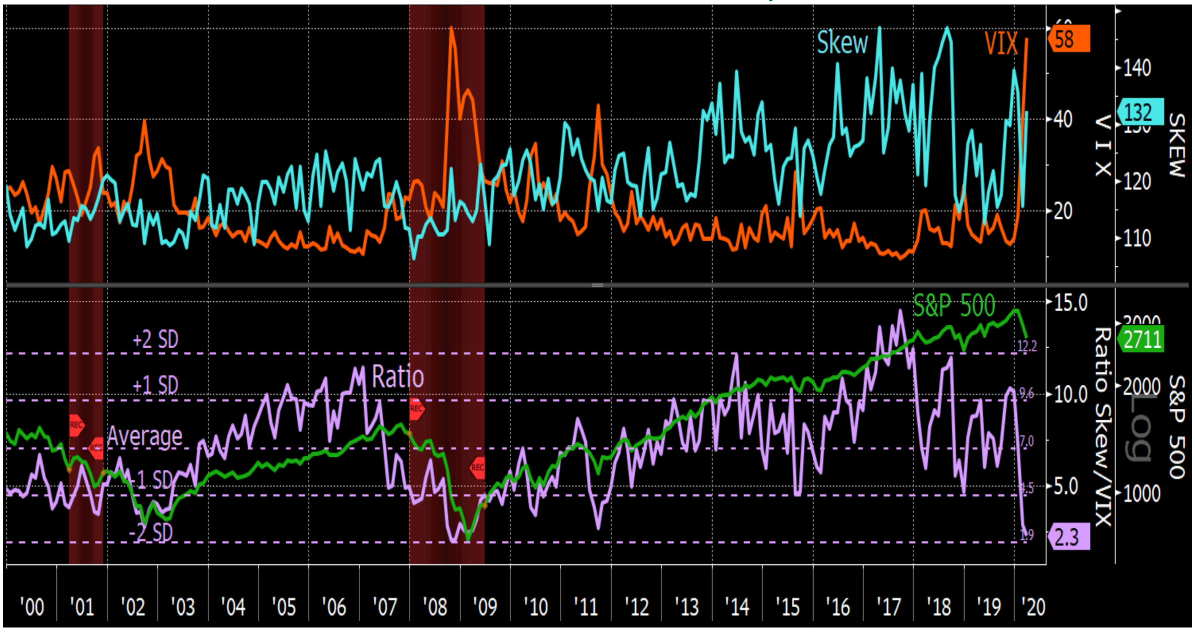
These points indirectly also warn about franchises with weak balance sheets that may experience cash flow constraints, thereby putting their dividends at risk.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. March 2020. ***Past performance should not be used as a guide to future performance.***

5. VOLATILITY READINGS

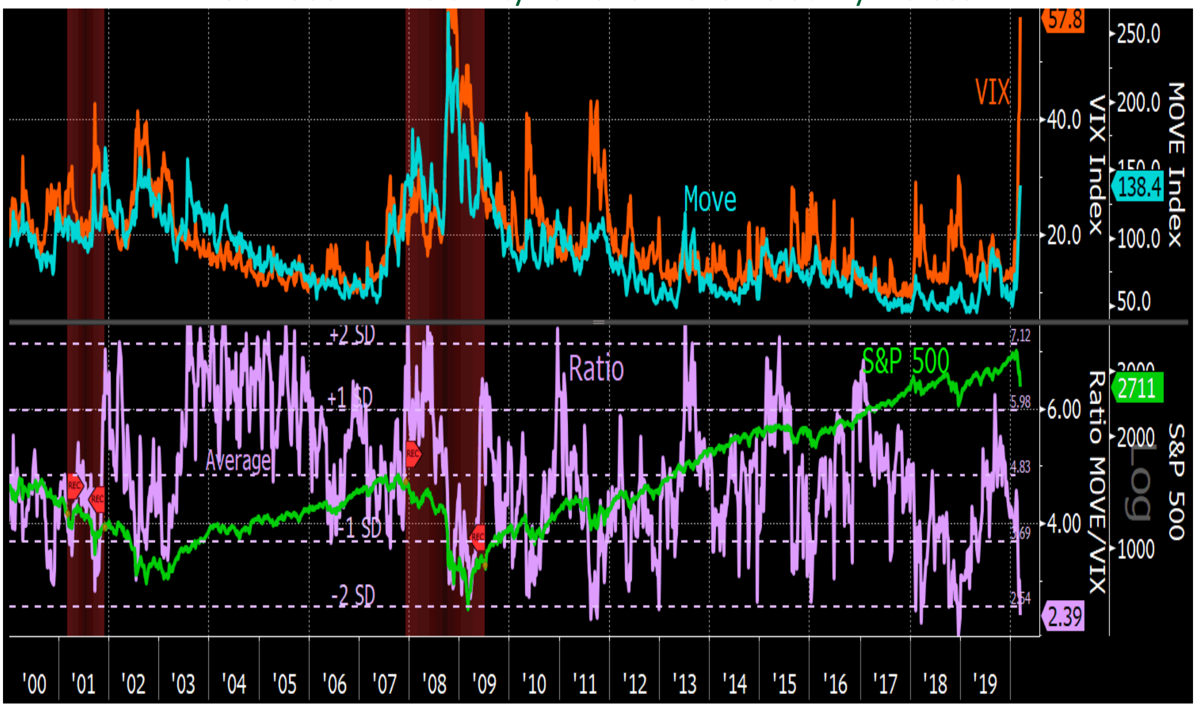
The current VIX equity volatility reading of 57.8 is more than +4 SD's from average and was last seen in the Credit Crisis. Whilst that reflected a buying opportunity at the time, we rather consider the VIX reading in the context of other volatility readings.

S&P 500 – VIX and Skew Volatility Indices



The Skew equity tail risk volatility index has also shot up. The ratio with the VIX index (the bottom section of the above chart) is currently at a -2 SD level, as it was in the credit crisis. The correlation of this ratio with share prices implies a buy call currently.

S&P 500 VIX Volatility vs Bond Move Volatility Indices



The bond Move Volatility index has also logically spiked recently. As with the Skew index, the ratio with the VIX index is currently at a -2 SD level, as what was the case in the Credit Crisis. These levels have historically predominantly called for entry point.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. March 2020. ***Past performance should not be used as a guide to future performance.***

6. TECHNICAL PICTURE

The following chart reflects the percentage of S&P constituents staying above their individual 200-day moving average:

S&P 500 vs Percentage of Constituents Above 200-day Moving Average

Only 12% of constituents have been able to qualify in this context. This is the lowest level since the Credit Crisis. At the time of the Credit Crisis it was implying a strong buy call (a bit early for the absolute best entry, but nevertheless a successful call).

S&P 500 vs Fear & Greed Index

The Fear & Greed index is currently at a record low reading, even lower than during the most recent two recessions. This also reflects a technically oversold picture. The red bar is, though, actually still a line only and may stay in negative territory for a while.

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Source: Bloomberg & Stonehage Fleming Investment Management Limited. March 2020. ***Past performance should not be used as a guide to future performance.***

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