STONEHAGE FLEMING

GLOBAL EQUITY PERSPECTIVES 6 APRIL 2020

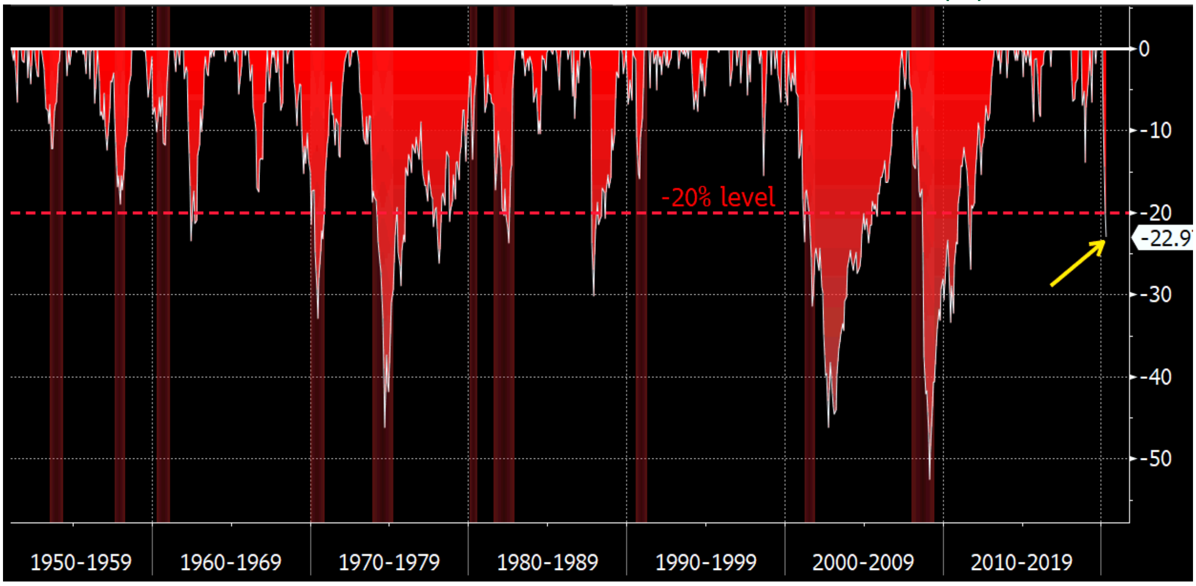
"You can't predict. You can prepare."

Howard Marks

1. THE BEAR MARKET

Depending on the investor's definition, we are most probably currently in a bear market.

S&P 500 – Drawdown from Most Recent Peak Level (%)



The general definition is that a bear market is triggered by a -20% drop from its most recent peak level. Other definitions include a duration of over a year for full recovery. Nevertheless, all the seven previous -20% events since 1950 took more than a year to recover in full – and created good investment opportunities.

Russell 2000 Index & Drawdown (%)

It is striking how quickly the small-cap Russell 2000 index dropped to the -40% level this time. This level historically signaled an approaching bottoming out process also for the S&P 500. We would, though, be careful to now already form such impressions on this chart alone.

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

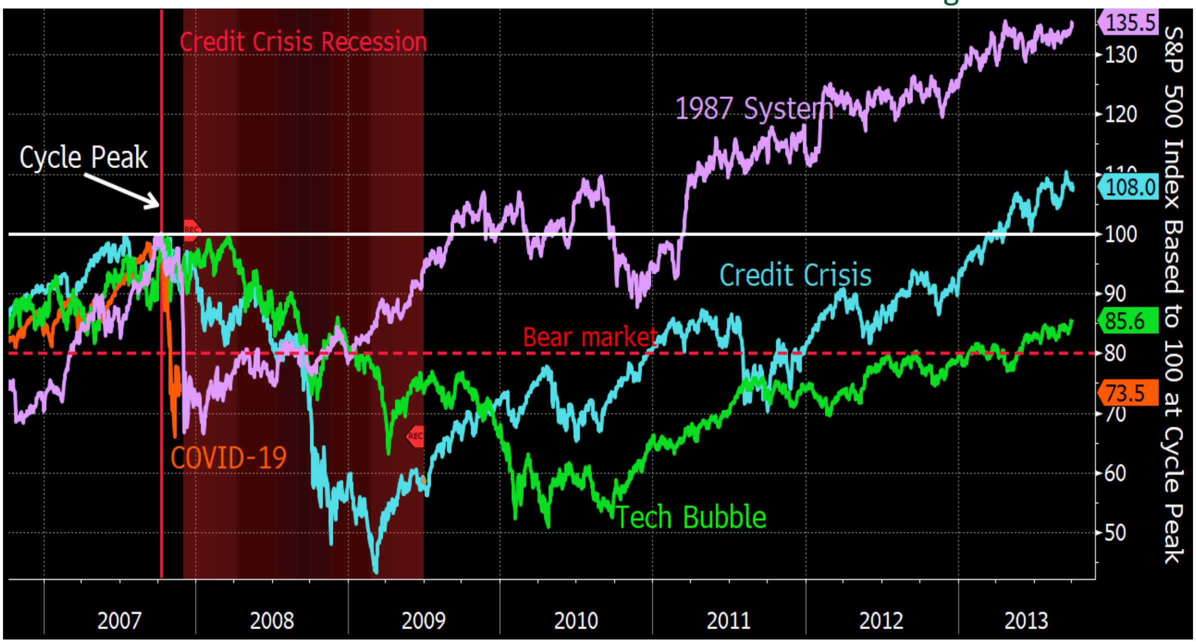
2. CURRENT MARKET TREND

The COVID-19 issues have had a clear effect on all major stock indices:

World Stock Market Indices – Based to 100 on 1 Jan 2020

The direction of travel is the same for all of these markets. It is, though, striking how stable the China index is and how clustered all the other indices are, currently in a negative trend. The discrepancy between China and the others is more than 13% in favour of China. Whilst this offers some hope for when the virus issues may stabilize in the rest of the world, the big question remains whether a second infection phase may be coming to China.

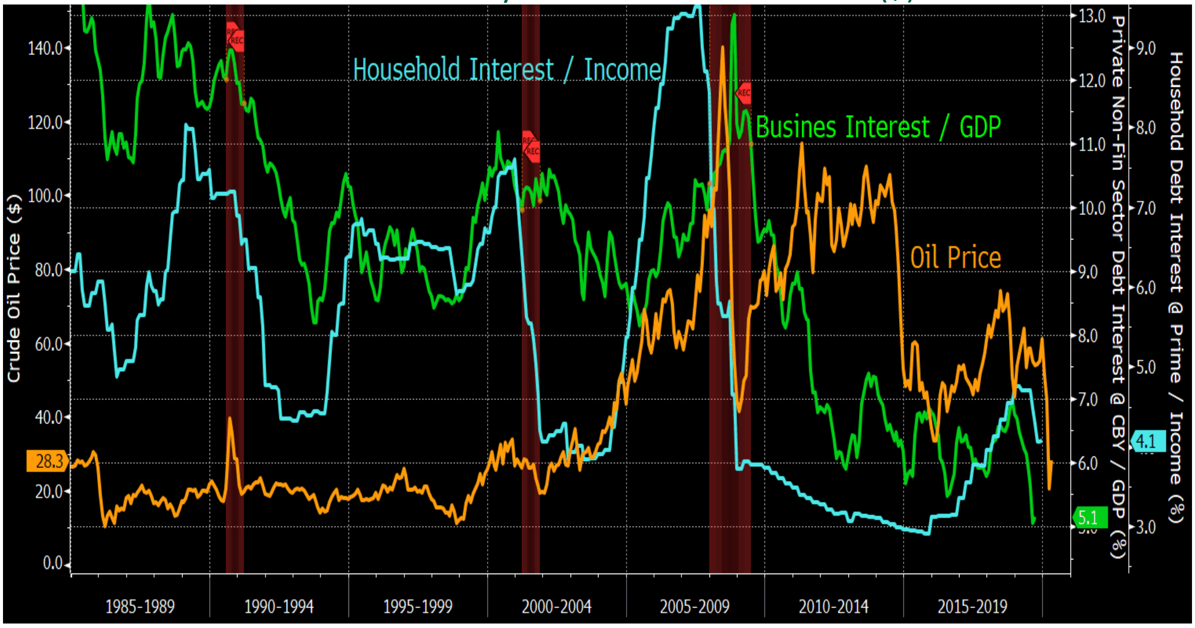
S&P 500 Bear Markets – Index Based to 100 at Preceding Peak



We index the S&P 500 index to 100 at the peak preceding the most recent four bear markets (the 1987 IT System collapse, the 2000 Technology bubble, the 2008 Credit Crisis and the current COVID-19 pandemic) in the above chart. It is striking how closely the current bear market tracks the 1987 one in terms of the initial crash and the subsequent bounce. That event did not evolve into a recession at the time, though, and we would be careful to present it as guide this time. The point can also be made that the economic backdrop preceding the current bear market was the healthiest in all these examples. Investors know well the outlook depends squarely on the containment of COVID-19.

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

US – Interest Payment Ratios and Oil Price ($)

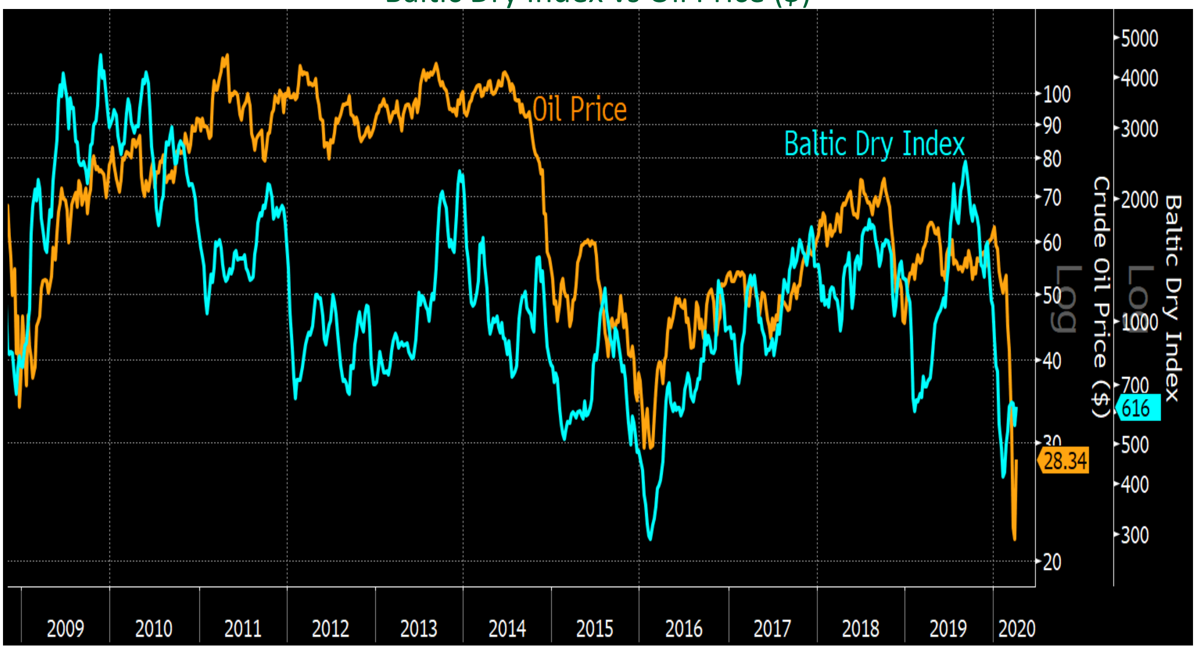


Our preceding statement of the economic backdrop is reflected well in the above chart. It is a busy chart, but well worth studying in detail. Both business and household interest payments (as ratios of GDP and gross income respectively) at the end of last year were substantially lower than those preceding earlier recessions. Along with this, the oil price in nominal terms is back at levels of the previous century. The combination of these two cost items currently at such low levels will be very supportive should the COVID-19 issues get addressed successfully.

3. OIL INTRICACIES

The collapse of the oil price following the failed negotiations between Russia and Saudi Arabia (to limit supplies) triggered the spiking of risks and high yield spreads in the overall corporate debt market. This contributes substantially to the volatility in the stock market.

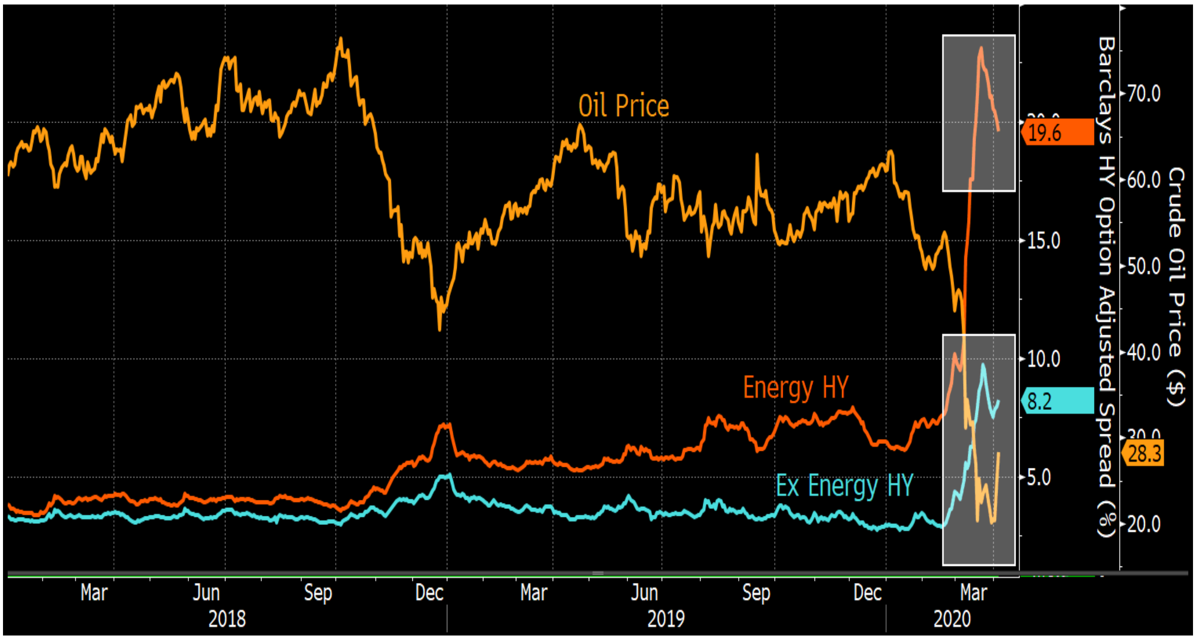
Baltic Dry Index vs Oil Price ($)



The result of these dominant suppliers pumping limitlessly has already flooded the market. Aramco, after a mere four months tapping the market in its IPO, is seeking a buyer with $10bn for a stake in their strategic pipeline. Storage capacity is getting filled, and as reflected in the above chart, tanker owners are pushing up their prices to carry cargo that is worth less. These issues are not sustainable and President Trump has effectively pushed these producers back to the negotiating table. Last week’s bounce in the oil price is indicative of a changing landscape in this context.

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

US – Corporate Yield Spreads vs Oil Price ($)

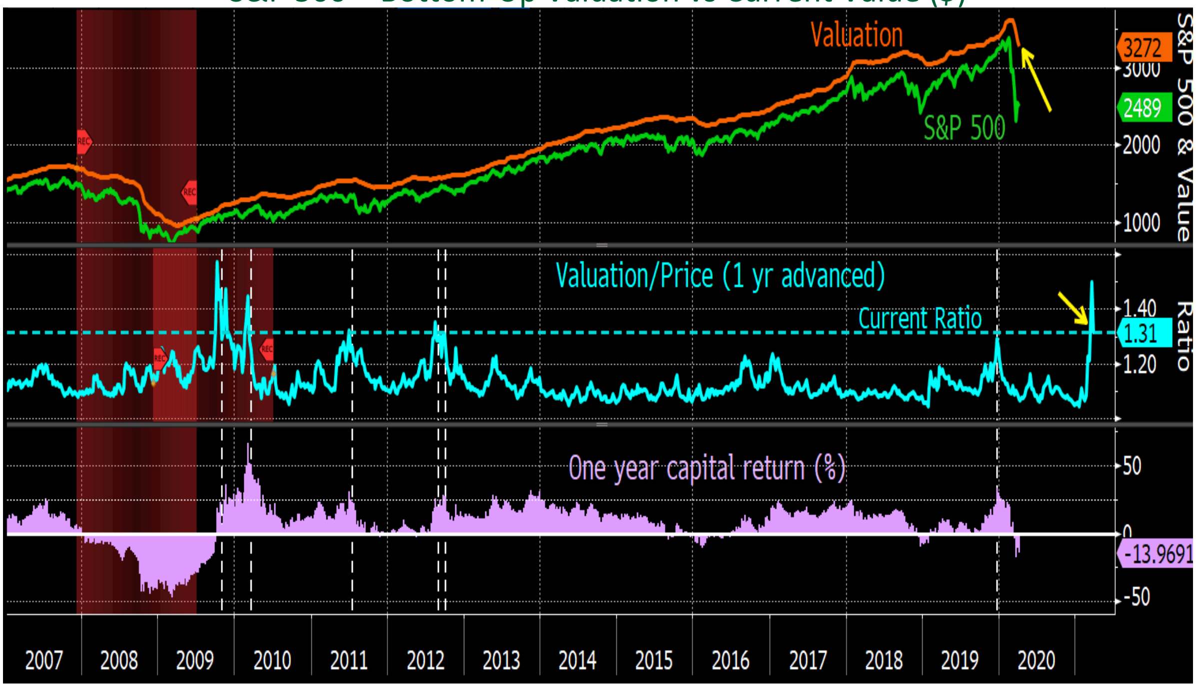


It is clear how the high yield spreads in the Energy sector are starting to roll over after it exploded with the failed negotiations. The rest of market high yield spreads seem to be following suit. If these trends can persist it can support lower volatility in the capital markets.

4. VALUATIONS

Analysts are in process of adjusting their company valuations downwards, even though the intrinsic value of any business should not be affected that much by shorter term issues. The bottom-up consensus valuation for the S&P 500 constituents has already been lowered by 11%.

S&P 500 – Bottom-Up Valuation vs Current Value ($)



The consensus valuation for the S&P 500 index currently is $3,272 (top section of the above chart). That is +31% above the index value (middle section of the above chart, the chart is advanced 12 months to correlate with the return in the bottom section). The corresponding historic returns have been +25% or more (see the vertical lines in the chart). We can most probably expect analysts to lower their valuations further. It seems, though, that the market has dropped to attractive valuation levels for those with a longer-term investment orientation.

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

5. GROWTH INVESTING

We believe the COVID-19 issues have delayed a global economic upswing by quite some time, and therefore that quality growth investing has further to go. It seems this conclusion is borne out by the following charts:

S&P 500 Value/Growth Index vs Copper/Gold Ratio

The Copper/Gold ratio persists with its downwards trend. This historically argued in favour of Growth investing at the expense of Value investing.

S&P 500 Value/Growth Index vs US Yield Curve (%)

The yield curve dropped back into a flattening trend. This historically argued in favour of Growth investing at the cost of Value investing.

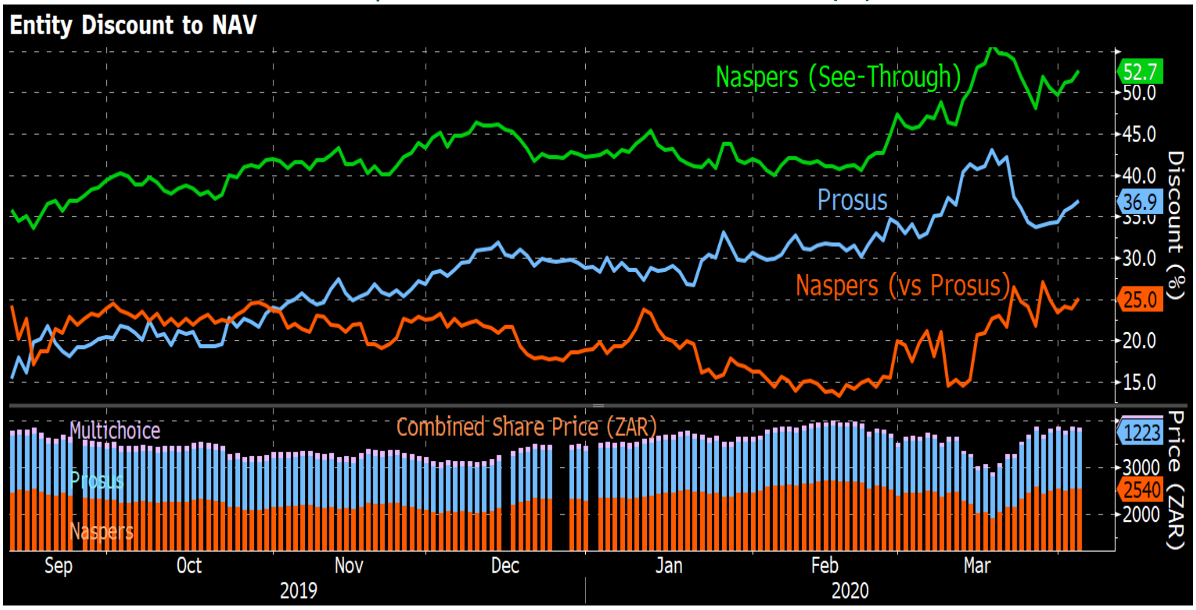
We do think many Value stocks have dropped to attractive levels, and that they may bounce once the market stabilizes. We, though, have more conviction of Growth's sustainability.

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

6. SECOND CHANCE

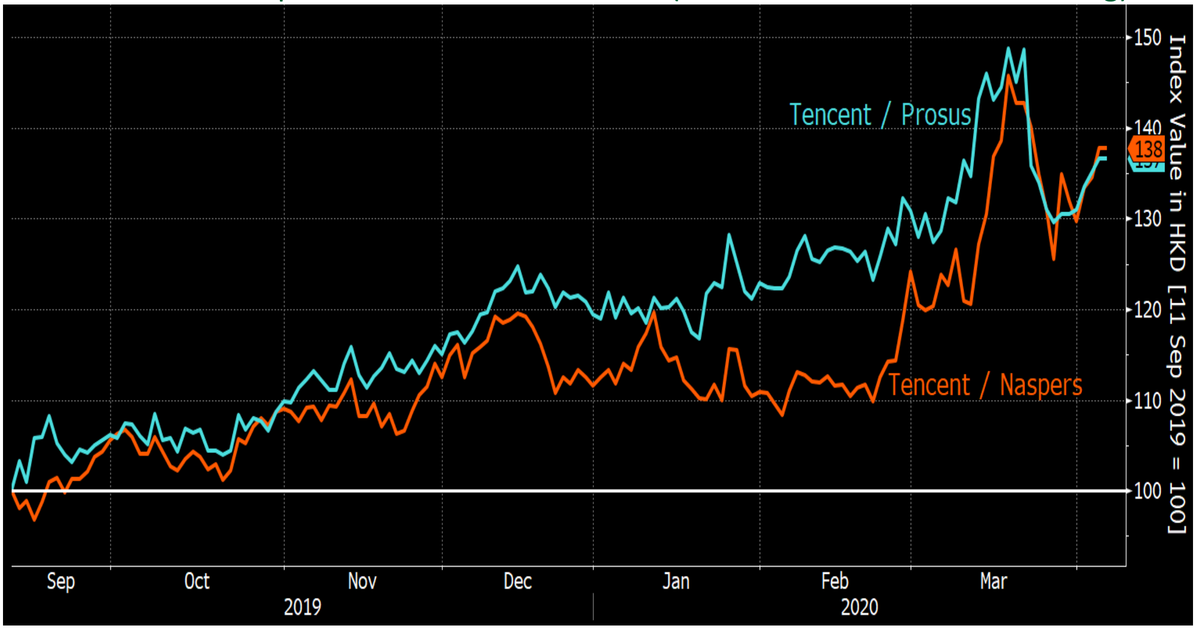
Prosus netted over $12bn by selling their stake in Flipkart and a 2% stake in Tencent in the middle of last year. They were questioned especially on the sale on Tencent shares. They subsequently made an unsuccessful bid for Just Eat earlier this year, confirming their conviction in food delivery. Just Eat merged with Takeaway.com in the Netherlands, with Prosus remaining with a substantial war chest.

Naspers & Prosus Discounts to NAV (%)



The above chart reflects Naspers and Prosus's discounts to NAV since the spin-off of the latter. Naspers's discount has widened over this period from ~25% to the current 52%, in essence because of the Prosus discount widening to 37%. The total value of the underlying entities has been stagnant in Rand terms over this period, despite the substantial devaluation of the Rand currency (the bottom section of the chart).

Tencent vs Naspers & Prosus Performance (indexed to 100 at Prosus listing)



Tencent has outperformed Naspers and Prosus by over a third since the latter's spin-off. This puts the spotlight again on their $10.6bn sale of Tencent shares last year. The current bear market plays directly into Prosus/Naspers's hands. They now have the war chest to revisit their conviction on food delivery, now much cheaper than at the time of their bid for Just Eat. Takeaway.com is going to struggle financing Just Eat's growth. Market circumstances are also ideal for the Naspers buyback management referred to earlier. COVID-19 has created the opportunities the group needs.

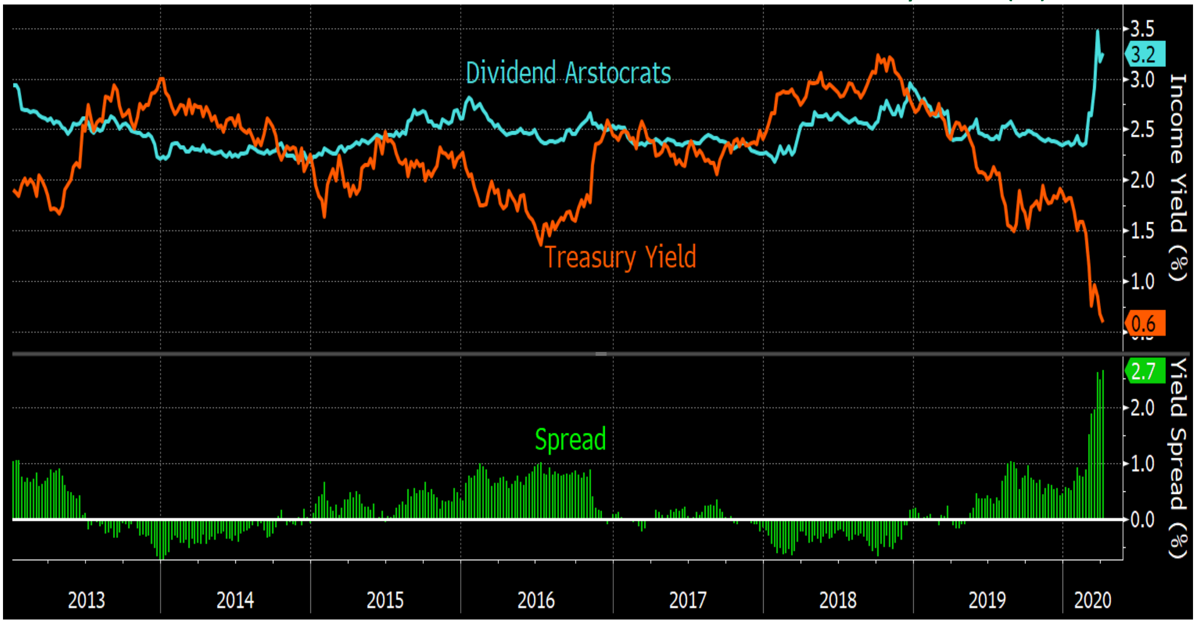
Source: Bloomberg & Stonehage Fleming Investment Management Limited. April 2020. ***Past performance should not be used as a guide to future performance.***

7. DIVIDEND INVESTING

The search for yield carries on relentlessly. Many companies are currently doing away with dividend payments and many surprises await investors in this context.

The spotlight now moves squarely to the Dividend Aristocrats. They are supposed to be the quality dividend growing constituents of the S&P 500. We expect them to try their level best to maintain their outstanding record. Should they succeed in doing so, an attractive opportunity awaits longer-term investors:

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



The gross dividend yield on the Aristocrats has increased to over 3% because of the negative market environment. This is +2.7% ahead of the Treasury yield (the bottom section of the above chart). This is a historic record level and seems to offer a good income investment opportunity switching from Treasuries.

Our thoughts are with everyone affected by COVID-19, be it directly or indirectly.

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