QUARTERLY INVESTMENT LETTER

JULY 2020

STONEHAGE FLEMING

THE INTERNATIONAL FAMILY OFFICE

EXECUTIVE SUMMARY

- **Headline equity market returns since the end of March paint a 'crisis averted' picture of the COVID-19 pandemic.** Having suffered one of the sharpest declines on record, falling c. 35% in about a month, the broad stock market has staged an equally eye-catching recovery

- **The economic contraction experienced in the second quarter is likely to prove to be the deepest since the Great Depression of the 1930's.** As the US unemployment rate spiked to 14.7% in April, few would have expected such a resilient market reaction. Our thoughts are below:

  - **Different market sectors are reflecting different, yet rational, levels of COVID-19 disruption.** The overall market has benefited from strong returns in technology and healthcare stocks, while 'real economy' stocks (industrials, financials, energy, retail) have struggled to sustain a recovery from their (deeper) lows

  - **Vast fiscal and monetary stimulus has been a formidable tailwind for risk-assets.** It is estimated that c. 5% of global GDP has been injected into the financial system through central bank balance sheet expansion. Investors have been reassured that a 1930's style deep and long lasting depression is unlikely

- **After such a strong market recovery in the second quarter a second wave of virus infections could be the trigger for renewed volatility.** We certainly do not rule this out. However, we believe there is good reason to consider **another disorderly market reaction to be unlikely**

- **Like in 2008 a global crisis coincides with a US Presidential election this year.** President Trump's approval rating has fallen sharply and a change in leadership is not unlikely. As the campaign heats up we expect higher volatility in both voting intentions and capital markets

- **We continue to 'tune' positions rather than 'time' the market.** Looking forward we expect a bumpier path for risk-assets – **higher volatility and a more gradual recovery, rather than an uninterrupted upward trajectory.** We are reflecting this outlook in our portfolios in the following ways:

  - **Emphasising quality, adaptability and sustainability**

  - **Maintaining high levels of liquidity and diversifying assets**

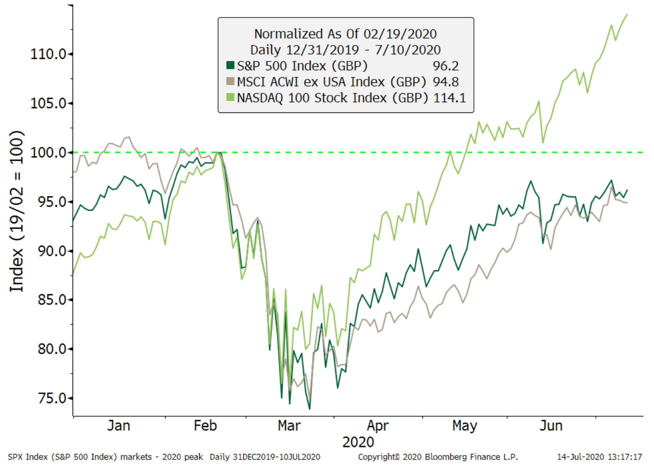
  - **Avoiding investments reliant on leverage and strong economic recovery**

- **While portfolio values have recovered meaningfully over the past three months, and market disorder has transitioned to a perceived calm, we are more vigilant than ever.** We continue to monitor developments closely and scrutinise our underlying allocations with rigour.

We wish you all a safe summer.

INTRODUCTION

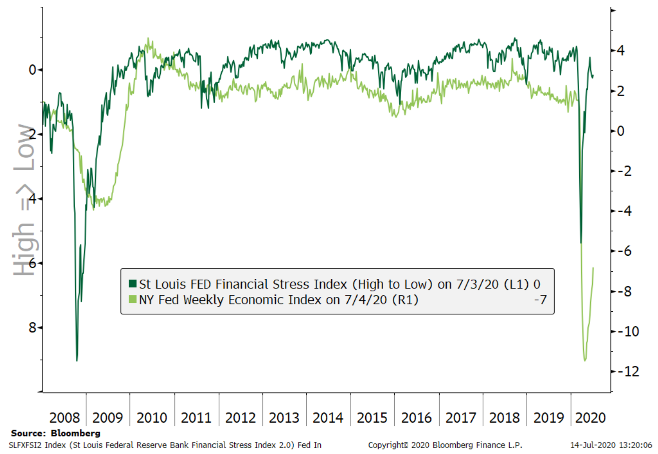
Headline equity market returns since the end of March paint a 'crisis averted' picture of the COVID-19 pandemic. Having suffered one of the sharpest declines on record, falling c. 35% in about a month, the broad stock market has staged an equally eye-catching recovery. Global indices are now c. 5% from their 2020 highs and, as shown below, the technology-heavy US Nasdaq 100 Index has surged higher and delivered positive returns for the last 6 months.



THE 'GREAT DISCONNECT'

The economic contraction experienced in the second quarter is likely to prove to be the deepest since the Great Depression of the 1930's. As the US unemployment rate spiked to 14.7% in April, few would have expected such a resilient market reaction. This 'great disconnect' between capital markets and the real economy has left many market commentators scratching their heads.

We show this below, comparing the level of US financial stress, (capturing changes in stock prices, yield spreads, and interest rates), with weekly economic data from the New York Fed. While financial stress has recovered to pre-crisis levels, the economy remains deeply depressed.



One of the most commonly asked questions we currently hear from our clients relates to this 'wall street vs main street' disconnect. Our thoughts are below:

Winners take it all

The immediate conclusion drawn from the above chart is that equity investors are 'pricing in' a V-shaped economic recovery, and failing to reflect the corporate challenges resulting from the COVID-19 pandemic. However, it is important to look closely at the market's component parts.

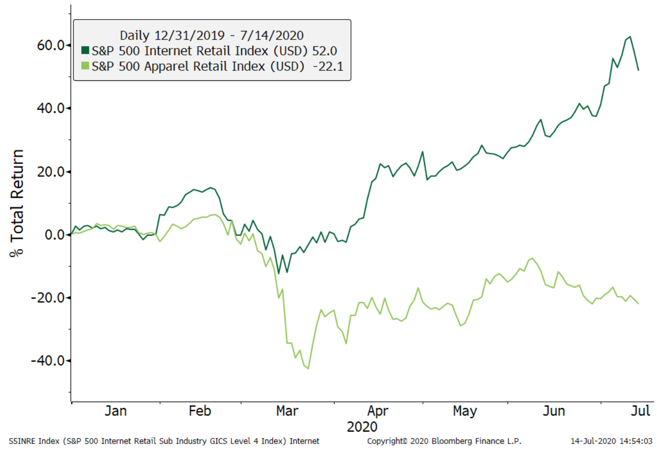
What is unusual about this crisis is that the stocks that led the market in recent years, and sit at the top of market-cap weighted indices, are the ones that proved most resilient in the past six months. For example, leading into the 2008 financial crisis, energy and construction companies delivered strong returns, yet were at the epicentre of the turmoil that unfolded, and investors' confidence in these industries was badly impaired for several years. The same can be said of the 2000 crash and the technology sector. However, the 2020 COVID-19 crisis is unlike those of the past two decades – it is an exogenous shock rather than the result of economic or financial imbalance. As such, the impact on the market behaviour is also unusual.

> This crisis represents a tailwind for recent market leaders, with the laggards now facing an almighty challenge to catch up.

As consumers' time spent at home has increased dramatically, technology giants have a natural advantage over traditional businesses, particularly in retail and entertainment. This trend was already well established, and the so-called 'FAANGs'[1] have been outperforming broader markets for most of the past decade. Elevated valuations already reflected compelling earnings growth. COVID-19 serves as its acceleration that has pushed their share prices to ever-higher levels. Microsoft, for example, reported revenue growth of 15% in the first quarter (an increase from the recent trend) with CEO Satya Nadella claiming, "We've seen two years' worth of digital transformation in two months."[2] Amazon is another natural beneficiary, seeing increased cloud spending, and acceleration of e-commerce and online delivery.

1 FAANG is a frequently used acronym for mega-cap technology businesses; Facebook, Amazon, Apple, Netflix and Google.
2 Source: Financial Times

At the same time, 'old economy' stocks, where revenues are reliant on the physical consumer, have struggled to sustain a meaningful recovery from (deeper) lows at the end of March. We show this below, comparing the performance of traditional US fashion retail with internet retail[3] this year.



Different market sectors are therefore reflecting different, yet rational, levels of COVID-19 disruption. For the technology and healthcare sectors (which combine to make up c. 40% of the S&P 500) earnings are expected to barely miss a beat. As shown in the table below, earnings per share for both these sectors is currently c. 1% higher than the end of 2019, and projected to continue to advance over the coming years. In a world where resilient profit growth is very scarce, and interest rates have plummeted, investors are willing to tolerate even higher multiples than pre-crisis. If we contrast this outlook with that of industrials, financials, energy and consumer discretionary companies (particularly when Amazon is excluded from this sector) expectations are that earnings per share will still be under the 2019 water mark in two years.

> If the market were indeed pricing-in a 'V' shaped economic recovery, we would see the most cyclically sensitive areas – financials, industrials, small cap, and 'value' – all leading the rally and reflecting a robust earnings recovery. Our analysis shows that this is not the case.

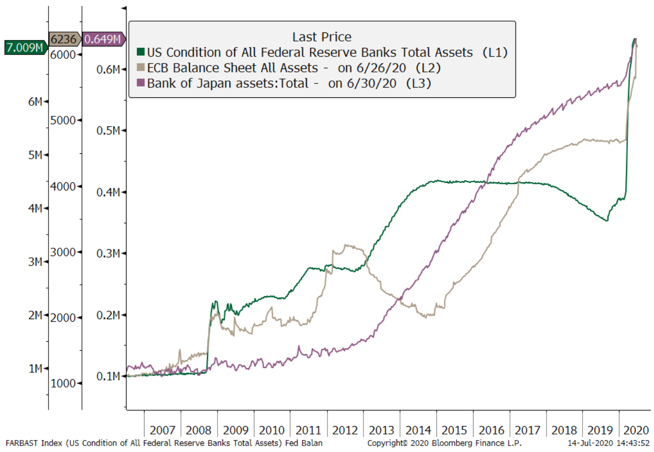
	% Return (end Dec 19 – end Jun 20)	% EPS change from end Dec 2019 (current)	% forecast EPS change from end Dec 2019 (forward 2 years)
S&P 500	-3.1	-6.9	7.3
Information Technology	14.9	1.3	24.8
Consumer Discretionary	7.2	-24.9	-1.5
Communication Services	-0.3	-0.5	19.2
Health Care	-0.8	0.7	38.1
Materials	-6.9	-4.1	7.3
Real Estate	-8.5	-3.6	-2.6
Utilities	-11.1	-0.7	-9.7
Consumer Staples	-5.7	-20.6	6.0
Energy	-34.9	-38.8	-65.5
Industrials	-15.2	-5.7	-9.8
Financials	-23.6	-13.7	-13.6

Don't fight record levels of fiscal and monetary stimulus

Earnings estimates offer us an insight into what market analysts assume the implications of COVID-19 will be for companies. However, the potential for reality to diverge from these projections is significant. **Corporate management themselves are still trying to assess the impact and have avoided future profit and revenue guidance in many cases.**

3 The S&P 500 Apparel Retail Industry Index consists of TJX, Gap, Ross Stores and L Brands. The S&P 500 Internet Retail Industry Index consists of Amazon Ebay, Booking Holdings and Expedia Group

This all makes earnings expectations, and valuation metrics which rely on them, far less informative than in normal conditions. **Investors are therefore likely to place extra weight on the policy environment to assess prospective return.** Without a doubt, the delivery of vast monetary and fiscal stimulus in the early phase of the crisis has been a supportive factor for risk assets. Much like in the immediate aftermath of the Global Financial Crisis in 2008, **the expansion of the Federal Reserve's balance sheet has had a direct and positive impact on capital markets.** In 2020, however, **the engagement in monetary easing has been quicker and more substantial that ever seen before.** We show the growth in total assets of the US Fed, the European Central Bank and the Bank of Japan below.



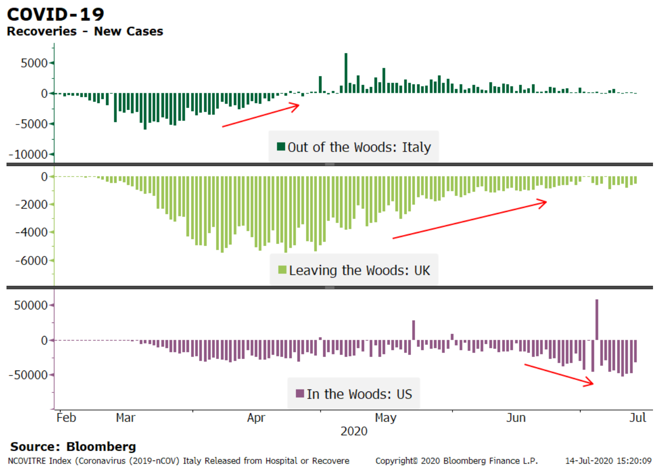
It is estimated that approximately 5% of global GDP has been injected into the financial system through central bank balance sheet expansion. In the US alone the liquidity injection totals c. $4.1trillion. When combined with fiscal policy initiatives, which serve to provide a safety net for businesses and consumers alike, **investors have been reassured that a 1930's style deep and long lasting depression is unlikely.**

THE NEXT PHASE

It is clear that the huge fiscal and monetary stimulus has created a 'bridge' over significant economic damage caused by COVID-19. This, together with a 'winner takes it all' environment for technology giants, has prevented sustained losses for headline equity indices. However, the next phase of the crisis is likely to look somewhat different. **As more economies reopen and attempt to mitigate the spread of the virus, market behaviour is also likely to evolve and follow a bumpier path.**

COVID-19

Of course, the market outlook is largely dependent on the future path of COVID-19. Whilst there are geographical variations, depending on the stringency of initial containment measures, **many economies are now gradually reopening with infection rates under control.** This is particularly the case in Asia and Western Europe, with the UK not far behind. Unfortunately, a number of large US states, such as California, Texas and Florida, continue to suffer rising cases and hospitalisations (see chart below).



Looking forward, the combination of over-zealous consumers and restrictions being eased too early pose a genuine threat of resurgent infection rates in the second half of the year. **After such a strong market recovery in the second quarter, this could be the trigger for renewed volatility.** We certainly do not rule this out. **However, we believe there is good reason to consider another disorderly market reaction, as seen in the first quarter, to be unlikely.**

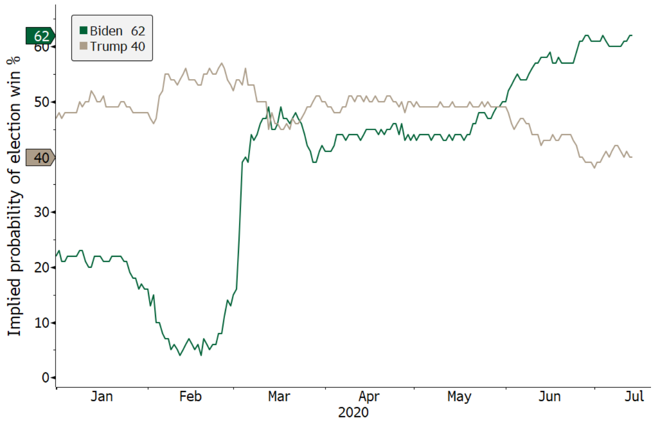
Firstly, politicians will resist re-imposing broad lockdowns, due to the devastating economic impact it would have. For better or for worse, investors will see through the rise in infection rates and focus on incremental economic gains. **Secondly, a uniform second-wave in infection rates is far less likely to occur,** as much of Asia and Western Europe have embedded mitigation measures such as social distancing and compulsory mask wearing. Evidence suggests that these measures can enable gradual economic reopening with localised outbreaks controllable if responded to decisively. **Thirdly, as medical professionals have learnt more about the virus itself** over the past few months and improved treatment options, the risk to life appears to have reduced. **This may also be down to an element of 'self-segregation'** with the most vulnerable members of society continuing to follow much stricter isolation guidance.

> Of course, forecasting the future evolution of the virus is impossible, as is the success of different regions in economic reopening.

Like all market drivers with multiple future paths, we consider different scenarios against which to make allocation decisions, rather than a single outcome. We continue to monitor these developments closely.

Political and social drivers

Like in 2008, a global crisis coincides with a US Presidential election this year, against a backdrop of critical US domestic issues. The pandemic has exacerbated social divides between those able to work from home and those who have seen their livelihoods suffer, many of whom come from ethnic minority groups. This has amplified anger over racial injustice and police brutality, leading to widespread protests and demands for change.



Source: PredictIt

PRITUS2D Index (US PredictIt 2020 Who will win the US Presidential Election Joe   Copyright© 2020 Bloomberg Finance L.P.   14-Jul-2020 15:11:23

President Trump's approval rating has fallen sharply during this period and a change in leadership is not unlikely (see above chart). A Biden Presidency, particularly if accompanied by a full Democratic sweep of the Senate and House of Representatives, may lead to higher taxes and tighter regulation in energy, financials and technology industries. Joe Biden is yet to choose a running mate, and his choice may be an important signal of policy intentions. **As the campaign heats up we expect higher volatility in both voting intentions and capital markets.**

INVESTMENT IMPLICATIONS

In our last quarterly investment letter we noted how *"Selling during a crisis can be beneficial in the short term, but often leads to adding back to risk-assets at a higher level when the outlook has improved. However, by carefully 'tilting' the portfolio to the strongest areas and those with the most attractive longer term prospects, we can add value along the way"*. **The sharp recovery that we have witnessed since then is a strong endorsement of this philosophy.**

Looking forward, we continue to follow this discipline, preferring to 'tune' positions rather than 'time'. **As mentioned above we expect a bumpier path for risk-assets – higher volatility and a more gradual recovery, rather than an uninterrupted upward trajectory.** We are reflecting this outlook in our portfolios in the following ways:

Emphasising quality, adaptability and sustainability

While the technology and communication sectors have already delivered strong returns, **we believe the opportunity in e-commerce, cloud-computing, cashless payments, online entertainment, and others, still stands.** Leaders in these areas have a strong competitive advantage. We have already highlighted Microsoft and Amazon, but the likes of Paypal, Visa and Equinix[4] also align with this theme and feature as top holdings by some of our managers.

> Sustainability (or ESG[5]) is another key structural theme. We access this trend through many of our core managers and through a recently launched dedicated strategy[6].

This 'quality growth' aspect of our equity portfolio has increased over the past year, and we have accentuated its bias following pandemic related tailwinds for these businesses.

We also continue to seek out opportunities in other segments of the market, which may be overlooked. In particular, we retain allocations to managers who are finding **adaptable companies in unloved industries that can gain market share in the new environment.** A good example is in the UK, where one of our managers recently introduced Go Ahead, the rail and bus network, to their portfolio. Transportation is clearly an industry at the epicentre of the crisis, however they note in a recent update that "*.... the market continues to underestimate the stability of Go Ahead's revenue base, with 75% either contracted or earned through management contracts. Meanwhile, we believe the government will continue to be supportive of the regional bus network in both the short and medium-term, as a key lever in any economic recovery. The business is trading at a discount to the replacement cost of its bus and depot network.*[7]"

4 An US investment company focused on data centres and cloud-based hosting solutions
5 Environmental, Sustainable and Governance
6 The Stonehage Fleming Global Sustainable Investment Portfolios
7 Source: ManGLG

Maintaining high levels of liquidity and diversifying assets

Government bonds now yield less than 1% per annum across the board, with $13.5trillion of global debt priced with negative absolute yields.

> While their diversification properties may motivate an allocation for some multi-asset portfolios, the risk-reward profile of long duration bonds is unfavourable. This justifies a preference for cash, which we hold at elevated levels. We have also recently introduced physical gold to many portfolios, creating a valuable hedge against shorter-term market turbulence and potential long-term consequences of this crisis.

Inflation inducing policies such as currency debasement are already regular talking points as a way to reduce the debt burden; a far more politically viable approach than severe austerity or default. This is likely a contributor to the recent increase in demand for the yellow metal, and whilst it is a volatile asset we believe this trend will remain for some time.

Avoiding investments reliant on leverage and strong economic recovery

We are currently avoiding allocating to investments that rely on a strong 'V' shaped economic rebound in the post-COVID-19 world. This limits our allocation to the banking sector, which faces formidable headwinds against a backdrop of flat yield curves and weak growth, as well as 'old energy' and regions with poor virus control prospects (i.e. Latin America, Africa).

In closing

While portfolio values have recovered meaningfully over the past three months, and market disorder has transitioned to a perceived calm, we are more vigilant than ever. We continue to monitor developments closely and scrutinise our underlying allocations with rigour.

We wish you all a safe summer.

SFIM Investment Committee
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