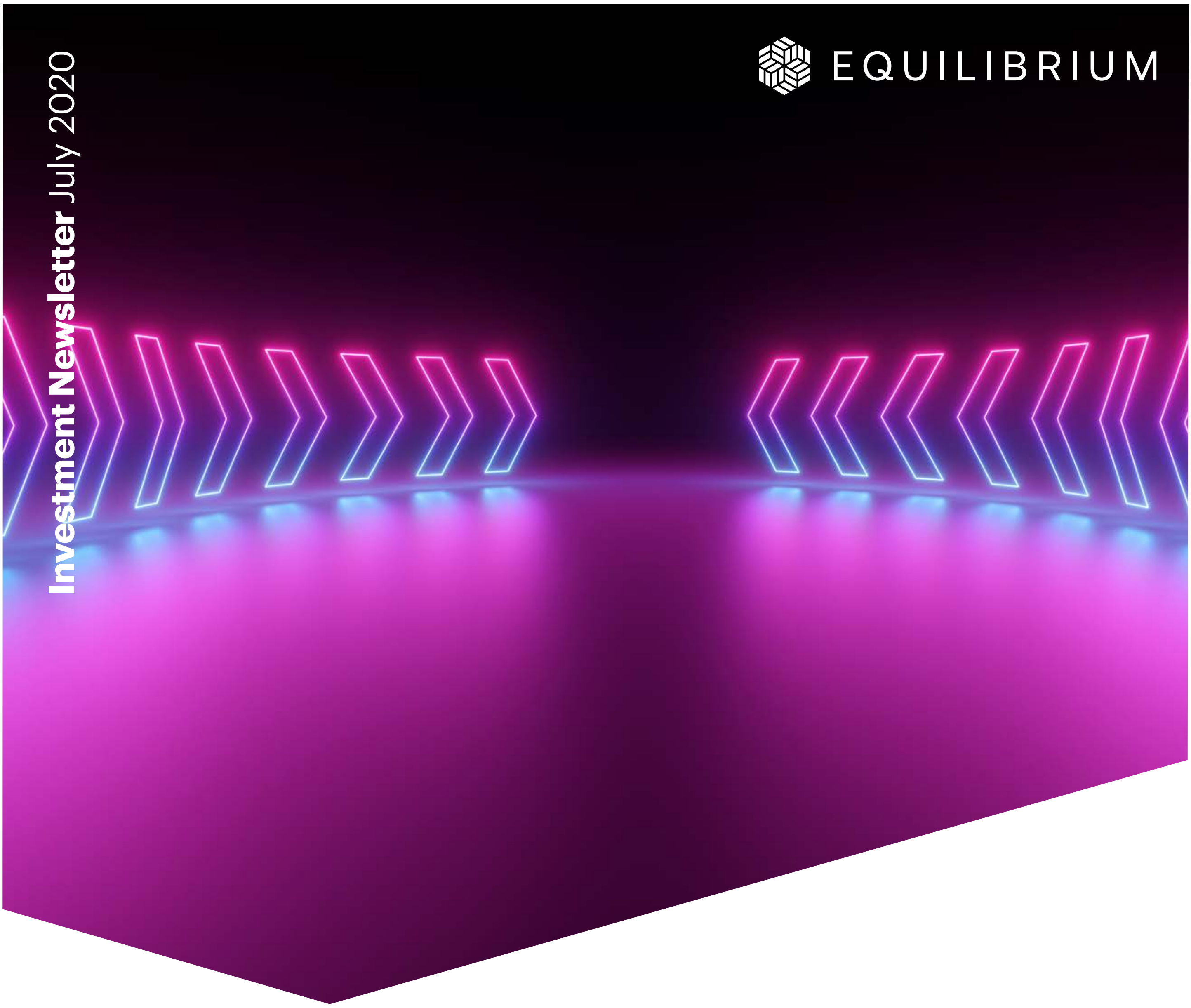

Investment Newsletter July 2020

Back to the future

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This is it. You've got it nailed. You've had four interviews and now it's just the formality of the final interview. You've got your smartest outfit on and you're ready to take on your dream job for life.

It's only five minutes to the new office, and you are briskly walking across the bridge. Then you hear a baby cry below. You peer over the bridge wall to see the drowning infant. If you are late, the job will be lost – what to do?

Of course, you jump.

To behavioural psychologists, this is known as the 'identifiable victim effect' whereby we give much greater aid to a specific person (or 'victim') enduring hardship compared to a large, vaguely defined group with the same need.

If we go back to the bridge, a cold hearted economist would argue that it would have been better if you had walked on, completed the interview, secured the job and then donated a % of your pay to a children's charity which would have saved many lives (the 'vaguely defined group').

Dan Ariely, a professor of behavioural economics, believes the recent pandemic has been a stark example of how this effect has borne out.

A year ago, an alien landing on Earth could have taken the view that old and infirm people were not very well cared for given the state of many hospitals and care homes.

Fast forward to this year, governments are falling over themselves to offer all available support – the news stories highlighting individuals suffering from the virus have served to provide a graphic identifiable victim effect.

However, should the UK government have also considered the hardship on the large swathes of the population that lost their incomes; those who suffered with other health conditions or the children left without education? Should they have followed the Swedish example of no lockdown, with schools and many businesses staying open?

No homo eco

Behavioural finance also tells us that humans are people and not "utility-maximising factors of production" which is what classical economics taught us.

Hard lessons were learnt in the credit crisis when human behaviour markedly deviated from that expected of homo economicus and kick-started the greater application of behavioural science to economics which enlightened us to the short-cutting and frailties of the brain when confronted with decisions.

The future is not what it used to be

As we move out of lockdown, investors need to peer into the future to examine what may be lasting changes, especially from an economic and market standpoint. We try as much as we can to view the future through the prism of behavioural finance rather than opaque economic theory.

There will be a very wide array of changes touching many aspects of life and the economy, but here we will focus on just three.

1. Bigger government

Governments and central banks have rightly stepped up to the plate over the pandemic. However, their involvement in economies and markets is likely to persist for many, many years to come.

In the UK, remember the bailout of Royal Bank of Scotland during the credit crisis eleven years ago? The government still owns the company with a 62% shareholding.

Just in the last few weeks it has announced 'Project Birch' to make 'strategic investments' in at least six companies including Tata Steel and Jaguar Land Rover and expect many more bailouts in the coming months, including a possible sovereign wealth fund as a vehicle for the investments.

In the US, the central bank is currently buying up to $250bn of corporate bonds including those of Apple, a company with $245bn of cash on its own balance sheet.

The Japanese central bank has been buying corporate bonds for decades (and owns about half of the market) and has started buying equities on the Tokyo exchange. So far it has bought 7% of the stock market and holds another 8% in its pension fund.

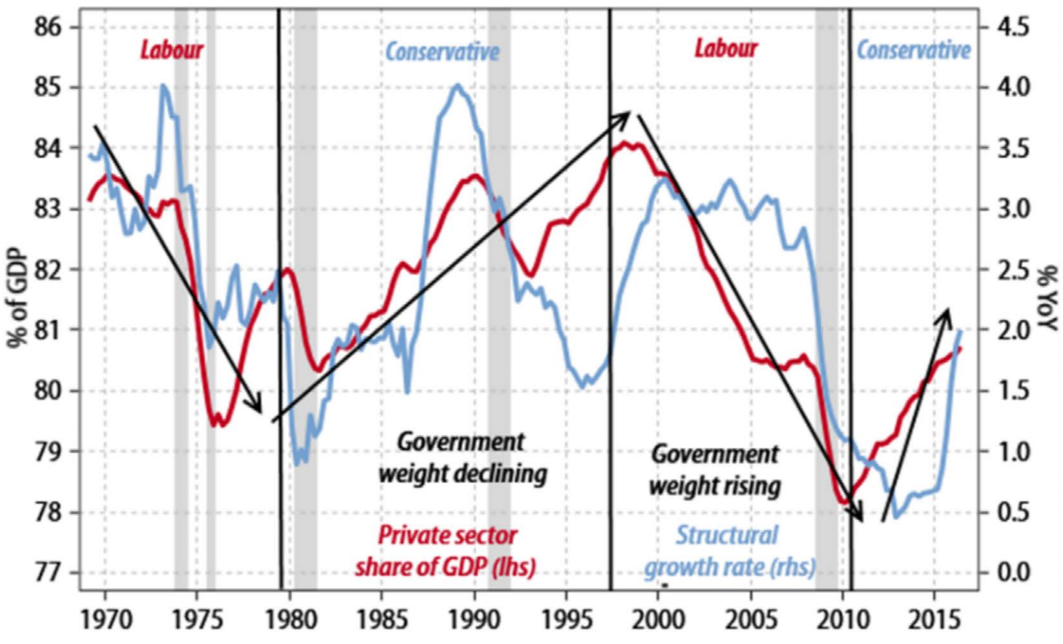
This is on top of the purchases of government bonds by central banks through their quantitative easing programmes – the Federal Reserve now owns 20% of US government debt whilst the Japanese central bank owns nearly half of all government stock. This management of the sovereign bond market is likely to lower bond yields (and thus returns on fixed interest) for a number of years.

This new statist approach, whilst offering a lifeboat to many businesses, has long-term consequences. The key issue for economies is that governments are not good allocators of capital as decisions are influenced by political considerations and vested interests.

These interventions cause distortions in asset markets and the history of economic growth under big government has been poorer than a laissez-faire approach, as chart one, from research company Gavekal, conveys.

Ignoring the political aspects of the chart, it would imply the larger involvement by governments would go some way to crowd-out private sector growth.

Chart one: When the UK government has grown, growth has fallen



Shaded grey = UK recessions

Source:Gavekal. October 2016

2. Working on it

This is not unalloyed bad news.

As we know, income inequalities in most developed nations have become so acute that government action could be a catalyst for positive change.

Similarly, the furlough schemes introduced during the pandemic could be a precursor to a much broader level of support. The recent experience has highlighted the lack of social support in many countries, including the United States.

The greater need for income protection stems back to the credit crisis when the working population accepted lower wages as a quid pro quo for greater job retention. This followed in later years with lower income working practices such as zero-hours contracts and gig economy, project-based employment which resulted in much slower growth in incomes.

In the UK for example, in the fourth quarter of 2009, the average disposable income per head was £4,763 whilst in the first quarter of this year that figure was £4,893, a rise of only 2.7% in nearly 11 years. Chart two shows that not only has this growth been low but negative for the highest income groups.

If employees accept lower wages again to try to stay in a job, there will need to be a bigger social safety net.

Chart two: Change in household earnings since 2008

Note: Earnings = median equivalised household disposable income

Source:Office for National Statistics. March 2020

3. Lost property

We would all agree that the marginal business trip is likely to be killed off as the technology has shown that you can have a passable meeting without the financial and environmental costs of travel. However, humans are social animals and companies thrive on teamwork and co-operation which can be stifled in the virtual world.

That said, looking more broadly, we would expect shifts in working patterns to influence the shape of future commercial property demand.

We believe that secondary offices may well see a longer-term negative impact as companies adopt working-from-home and provide a greater range of customer services online and may not require a chain of offices to attain a nationwide or an international presence - we could therefore see more office-to-residential conversions.

As we all know, the move from high street to online shopping has been given a big boost by the lockdown – Amazon customers now spend $11,000 a second! However, the change to the retail market landscape is reinforced by aging populations and the trends for recent generations to prefer services and experiences to material possessions.

At present, around 80% of retail property rents are fixed with around 20% revenue-related (whereby the more they sell, the higher the rent and vice versa). This imposes a high level of fixed costs for retailers and some commentators are expecting this proportion to reverse. This would have important implications as property investments become less bond-like and more like equities which fluctuate with the sales fortunes of the retailer.

Model behaviour

We have adjusted portfolios to many of these changes with the sale of most of the property holdings; reduced positions in government bonds; increased investment in technology stocks and we are now undertaking a wider review of returns that we can realistically expect from all assets over the next decade.

The pandemic is new to us all and as we move through the stages of recovery, we will be particularly alert to new dangers and opportunities that present themselves – human traits and all.

General economic view

The declining incidents of deaths from the virus along with the strong policy response by governments and central banks have served to support economies, and asset markets have started to anticipate a return to growth.

We must be wary of any further 'waves' of the virus that may lead to another negative economic shock but otherwise the debate will centre on the pace of recovery as businesses restart trading. At the moment, the economic data is patchy and there may be a need for further stimulus to kick-start the economy if momentum falters.

We expect interest rates to remain low although inflation may see a temporary rise in the first half of 2021 if commodity prices remain above the very low levels reached in the last few months.

Equity markets

The UK's relatively high infection rate and rising risks over the Brexit-related changes at the end of this year make us less positive on UK stocks but the encouraging growth in several sectors and countries, such as certain emerging markets, provide plenty of opportunity for good returns from equity markets.

Fixed interest

Central bank intervention in bond markets will mean that interest rates will remain at the very low levels for a prolonged period. We see better value in corporate bonds which offer higher yields but clearly come with greater risks of default. As such, we believe that investing in actively-managed corporate bond funds will provide better returns with the necessary risk controls.

Commercial property

Key segments of the property market are likely to continue to see weak or negative returns. The shift to online shopping and away from the high street has accelerated as a result of the virus and the trend for more working from home is likely to slow demand for offices (and the businesses that rely on the passing traffic). Demand for modern warehousing facilities remains buoyant due to the growth in online sales.

Cash

With interest rates remaining at record lows, returns on cash will remain almost zero. We retain higher cash balances than usual as protection against further market falls and have diversified this into different currencies.

Balanced asset allocation

For a typical balanced portfolio, we are roughly neutral on fixed interest but remain underweight property. We are underweight traditional equity but are instead holding more defined returns. The overall risk/return profile of our portfolios is slightly above long-term averages given our positive long-term equity outlook.

These represent Equilibrium's collective views and in no way constitutes a solicitation of investment advice. The value of your investments can fall as well as rise and are not guaranteed. Investors may not get back the amount originally invested. We usually recommend holding at least some funds in all asset classes at all times and adjusting weightings to reflect the above views. These are not personal recommendations, so please do not take action without speaking to your adviser.