

## Economic & Political Roundup

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A collation of recent insights on markets and economies taken from the comments made by chairmen and investment managers of investment companies – have a read and make your own minds up. Please remember that nothing in this note is designed to encourage you to buy or sell any of the companies mentioned.

### Roundup

Gold had a very strong month, with concerns over the US's inability to curtail the spread of COVID-19 and the emergence of a second wave of infections in Europe, impacting sentiment. Weakness in the dollar was the other major theme.

### Global

#### Increasing concerns over inflation

Simon Barnard, the manager of Smithson, explains why that in addition to central and government stimuli, changes in unemployment help to explain why global stocks have performed so well. Brunner's manager, Matthew Tillett, notes that were a sustained economic recovery to materialise, it would be of most benefit to lower quality cyclical stocks, where cash flows and balance sheets have been severely strained during the lockdown. Paul Niven, manager of F&C, expects the acceleration of pre-existing corporate and consumer trends to be one of the pandemic's lasting legacies. The manager of Alliance Trust raises concern over the prospect of inflation, as a result of the creation of new deposits by central banks.

Herald's chairman, Ian Russell, says that though valuations have risen precipitously within technology, comparisons to the internet bubble of 2000 are not accurate, as many companies today are cash generative.

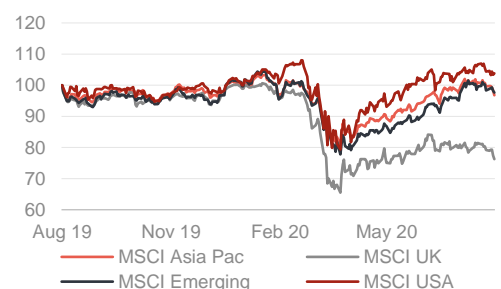
Securities Trust of Scotland's manager, Mark Whitehead, believes that with 10-year government bonds across the developed world delivering near or below zero yields, companies that are able to continue paying dividends look likely to generate substantial returns.

Exchange Rate	31/07/20	Change on month %
GBP / USD	1.3085	+4.9
USD / EUR	0.849	(4.5)
USD / JPY	105.83	(1.5)
USD / CHF	0.9129	(3.5)
USD / CNY	6.9752	(1.3)

Source: Bloomberg, Marten & Co

#### MSCI Indices rebased to 100

Time period 01/08/2019 to 31/07/2020



Source: Bloomberg, Marten & Co

	31/07/20	Change on month %
Oil (Brent)	43.3	+3.0
Gold	1975.86	+11.6
US Tsy 10 yr yield	0.5282	(21.8)
UK Gilt 10 yr yield	0.104	(50.7)
Bund 10 yr yield	(0.525)	+32.6

Source: Bloomberg, Marten & Co

## UK

James Henderson and Laura Foll, managers of Law Debenture, reflect on the many uncertainties that remain, as the UK eases its lockdown.

The economic contraction could turn out to be at least twice that of the 2008/2009 financial crisis

Patrick Harrington, manager of Value and Income, says that the outlook for equities has rarely been as difficult to foresee. He explores a number of themes, including cancelled dividends, an economic contraction that could be at least twice as steep as the 2008/2009 financial crisis, and the galvanising impact of an unprecedented injection of liquidity by central banks around the world.

Douglas McDougall, chairman of Independent Investment Trust, says that the long-term implications of unprecedented fiscal and monetary stimuli on the longer-term health of economies is difficult to assess.

The actions of other companies have made it easier for some firms to reduce or suspend dividends

The manager of Aberforth Smaller Companies questions the intentions behind the decision by a number of companies to cut or withdraw dividends. It is argued that some decisions to pass dividends have been made easier by the actions of others.

Ciaran Mallon, manager of Invesco Income Growth, believes that in most cases the cancellation or reduction in dividends has been prudent.

Dan Whitestone, manager of BlackRock Throgmorton, reflects positively on the acceleration in corporate spending on digital transformation to the benefit of digital ready businesses and/or businesses that enable the digital transformation.

Hospitality and aerospace are a long way from recovering

Chelverton UK Dividend's chairman, Lord Lamont of Lerwick, says that while certain sectors will recover more quickly over the coming months, the final part of any recovery will take longer, as specific sectors such as hospitality and aerospace will need longer.

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## Global emerging markets

The manager of ScotGems says that the discrepancy between growth and value seen in developed markets has been no different in the emerging world.

There are tentative signs of recovery in some markets

Maria Luisa Cicognani, chair of Mobius, notes tentative signs of recovery are starting to appear in a number of countries.

The manager of Aberdeen Emerging Markets provides a detail overview of market performance and trends across several regions, including Eastern Europe and Latin America.

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## Biotech and healthcare

Paul Major and Brett Darke, managers of BB Healthcare, discuss the main themes in healthcare over the pandemic period. They note that as individuals and investors, we must reach an accommodation with SARS-CoV-2; it could be with us for some time to come. Currently, they say that this view does not feel like the base case assumption.

It appears increasingly likely that COVID-19 will be with us for some time to come

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## Other

We have also included comments on North America from Gabelli Value Plus+; Asia Pacific from Invesco Asia; financials from Polar Capital Global Financials; debt from TwentyFour Income and Chenavari Toro Income; renewables from Greencoat UK Wind; commodities and natural resources from BlackRock Energy and Resources Income, and UK property from Ground Rents Income.

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Global Investors

## Global

(compare global funds [here](#))

### Simon Barnard, manager of Smithson – 29 July:

Many commentators have expressed incredulity that, in the face of the social and economic threats that COVID-19 still poses, it is possible for the stock market to be approaching the levels it was at pre-crisis. As ever, it is impossible to know the true reason(s) why millions of people have made the billions of decisions to get us to this exact price level. But two potential reasons could include the central bank and government stimuli, and the recent rate of change in economic activity, as measured by unemployment.

In what is becoming a central theme to these shareholder letters, as it is in finance, the actions of the Federal Reserve and other central banks around the world are likely driving the increase in asset prices during this period of uncertainty. It is probably no coincidence that the market reached its trough on 23rd March, the day the Fed announced it was "committed to using its full range of tools" and promised to print more money, buy more securities, and provide more financing to businesses during the course of the pandemic. It was perhaps on this day that market participants realised that central bank support would be enduring and unlimited for the period of the crisis and started to believe that interest rates would be lower for much longer than they previously thought. To explain how this translates into asset prices, I quote a previous Smithson shareholder letter below:

*"In finance, one of the most fundamental laws we have is that the level and movement of interest rates will almost universally affect asset prices, with higher rates pulling down prices like the force of gravity, to use Warren Buffett's simile. The Fed's communications regarding lower rates have therefore caused market participants to start valuing the earnings streams of companies, and therefore their shares, at higher levels. This will affect companies not just in the US, but all over the world, because not only do we operate in highly integrated global financial markets, but US interest rates also happen to be used as a reference rate across all of them."*

A secondary factor that may have led to the fast recovery of share prices is the progression of unemployment. In most cycles, stock market movements precede a change in economic activity such as employment, falling before a recession, and starting to increase just before employment picks up again. This time may not have been much different, just with a significant compression of the typical timescale. There is no doubt that we initially experienced swift and disastrous job losses, with unemployment in several countries approaching 20% including furloughed employees. This would certainly contribute to a sharp decline in the stock market. However, from the early low point, successive employment statistics started improving, with people going back to work as countries relaxed lockdown measures. In many other recessions, this has coincided with an improvement in share prices, as market participants start to anticipate a return to economic growth. The fact that we reached maximum unemployment in only a couple of months may therefore also have been a factor in share prices sustaining the rally after the initial rebound.

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### Matthew Tillet, manager of Brunner – 29 July:

The speed and extent to which COVID-19 has changed daily life is hard to overstate. Similarly, its impact on the global economy has become one of the primary concerns for financial markets. After closing 2019 at all-time highs, the first five months of this

year have seen global equities post both their sharpest downturn and swiftest recovery on record. This rollercoaster ride has been driven by two opposing forces. Governments around the world have responded to COVID-19 by implementing national lockdowns. These have saved lives, slowed the spread of the disease and prevented health services from being overwhelmed. But they have also brought large parts of the economy to a standstill, with the result that most major economies have reported record GDP contractions during the lockdown periods. In response, central banks and governments have unleashed a tidal wave of monetary and fiscal stimulus. Lower interest rates and quantitative easing have been matched by a fiscal response, including generous furlough schemes, which globally now stands at 8.3trn USD, equivalent to 10 per cent of world GDP. These measures have prevented widespread bankruptcies and allowed investors to look through a year of depressed earnings, effectively placing a floor under equity valuations.

The policy response appears to be working - global equity markets have lost just one percent over the past six months despite experiencing one of the worst economic environments. Some commentators have interpreted this as the stock market discounting a rapid V-shaped recovery, however the reality is more nuanced. The dispersion in performance and valuation at a sector level has been pronounced. Companies most likely to be impacted by reduced economic activity, such as Energy, Financials and Industrials have seen substantial share price declines and valuation de-ratings. In contrast, Information Technology and Health Care stocks, both clear beneficiaries of an increasingly online and health-conscious world, are in many cases trading at new all-time highs. The performance of the stock market reflects this, with the latter group accounting for an ever-increasing percentage of the overall market. COVID-19 has driven a huge divergence in performance across the stock market. Companies with resilient business models that are immune to or beneficiaries of the crisis have performed extremely well and in many cases are significantly above pre crisis levels. The pandemic has had the effect of speeding up many digitalisation trends as stay at home orders have forced consumers and corporates to adopt digital technologies more rapidly.

### Outlook

Since late March, global equity markets have staged a strong rally. A tidal wave of central bank liquidity, combined with government lifelines, has kept all but the most structurally challenged companies afloat. The steady easing of lockdowns in developed markets, regular news of a developing COVID-19 vaccine and some tentative signs of pent-up demand have all boosted markets further.

Such equity market optimism defies several headwinds. Absent a COVID-19 vaccine, the threat of a "second wave" means some form of social distancing - and suppressed economic activity - is likely to endure. Already elevated unemployment numbers may thus be compounded further when government-funded furlough schemes end. US geopolitics also have the capacity to surprise negatively, whether domestically in the form of racial tensions or internationally through disputes with China.

The strong recovery in equity markets in the face of a deteriorating earnings outlook has resulted in a sharp increase in stock market valuations. The rally has disproportionately benefited defensive growth industries, such as Information Technology and Health Care, while cyclical sectors like Energy and Financials remain underwater. COVID-19 has thus extended a decade-long divergence between growth (companies delivering consistently strong earnings growth) and value (companies which appear cheap relative to their fundamentals).

Looking forward, the key question is to what extent economic and corporate fundamentals can sustain a rally which thus far has primarily driven by liquidity. It is encouraging that most major economies have bounced from the April low point,

however this is to be expected given the severity of the lockdown induced contraction. At a corporate level, earnings expectations are becoming less negative, with some US companies guiding towards 2019 levels next year. In Europe, a Franco German stimulus programme has boosted expectations that unified monetary policy will find a fiscal counterpart.

A meaningful and sustained economic recovery - should it materialise - would be of most benefit to lower quality cyclical stocks, where cash flows and balance sheets have been severely strained during the lockdown. We are conscious that many such companies are lowly valued and therefore have the potential to rally significantly in this scenario. However, such shifts tend to be short lived in nature, dwarfed in importance by longer term secular trends such a demographics and digitalisation.

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**Paul Niven, manager of F&C– 27 July:**

Having seen one of the sharpest downturns in history we have now witnessed the fastest and steepest recovery in equity markets. These events correspond to the deepest recession of modern times and the largest stimulus packages ever deployed by governments and central banks across the world. Over the near-term there will undoubtedly be testing times in terms of economic, corporate and COVID-related newsflow. Longer term, markets are looking forward to better growth with recent data suggesting a decent upturn in activity that should accelerate into 2021. The recent crisis has fundamentally benefited many of the large technology related companies in our portfolio as, in common with prior recessions, we have seen a rapid acceleration of many pre-existing corporate and consumer trends. This will likely be one of the lasting impacts of COVID-19.

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**Manager's report for Alliance Trust– 23 July:**

The COVID-19 pandemic is not yet over. There is the possibility of a second wave creating further social and economic disruption. We do not yet know how quickly economies can recover; for how long governments can run up such enormous deficits; or the effect of central bank intervention in bond markets. There is a credible case for a speedy recovery; but just as credible is the possibility that weakness persists into next year and beyond. While the initial impact may be deflationary, via labour market weaknesses, the creation of new deposits by central banks could eventually lead to a rise in inflation, which could trigger a rise in interest rates and increase debt burdens considerably. Given the wide range of policy responses, now is not the time to make heroic bets.

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**Ian Russell, chairman of Herald– 17 July:**

It is perhaps surprising that the overall returns have been positive when COVID-19 has led to economic havoc, and technology is at the eye of the storm in trade tensions between China and the United States. Share price increases have led to the valuation rating of the portfolio rising from a p/e ratio of 21.4x at the start of the year to one of 25.3x Bloomberg estimates. Furthermore, analysts' forecasts rarely reflect share-based compensation, so valuations are really higher than they have been at any time other than the internet bubble of 2000. However, there is no comparison with that period as most investee companies are solidly generating cash. In addition, the challenge for investors in finding value anywhere makes these valuations less unattractive, and it is evident that there is more interest in the TMT sector. The caveat is that the economic outlook remains precarious, and forecasts are more uncertain than usual

**Mark Whitehead, manager of Securities Trust of Scotland – 1 July:**

We are confronted with rapidly changing data related to the social, political and increasingly financial impact of the response to the COVID-19 virus. The onset of significant travel restrictions and other social distancing measures, first in China and now replicated across over eighty percent of the world's population, in response to managing the public health fallout from the disease, will have serious consequences for economic and financial conditions. This has been reflected in asset prices, but further volatility in equity markets, as the severity of the economic and earnings downturn becomes evident, lie ahead for the next few quarters of the new fiscal year for the company, particularly if secondary waves of the virus force further lockdowns until a vaccine becomes widely available.

In terms of policy response, we have seen significant fiscal and monetary stimulus across many geographies in the form of interest rate reductions and a ramp-up of fiscal stimulus, with a focus on both mitigation of short-term challenges for business and a boost to long-term infrastructure investment with the promise of more intervention if needed to further stimulate activity. Given the lagged effect of stimulus, we would expect these measures to be impactful towards recovery as we exit 2020, rather than effective in mitigating the pullback in economic activity and corporate earnings over the coming quarters. We believe, however, that these measures should be factored in as we assess the medium-term earnings potential of the companies, we invest in.

During a period of such uncertainty, we are focused on two key areas. Firstly, the implications of the complex economic and policy picture on the capacity of our holdings to continue to generate free cash flow to support their dividends and business investment; here we believe that our focus in due diligence on dividend sustainability and stress testing will be significant. Secondly, we continue to look for opportunities to add to high-quality businesses that have the capacity to emerge through this period of significant uncertainty with stronger market positions and long-term business prospects, at attractive valuations.

Indeed, with 10-year government bond yields for all major developed markets at, or around, zero - which is the risk free rate against which investors have to make an overall return - investing in companies that have the ability to pay dividends and even grow them, could give investors substantial returns from these highly prized assets looking out twelve to eighteen months.

Some key themes for us include digitalisation, where the surge in cloud computing and data storage growth is structural and will of no doubt be a priority area for spending and capital expenditure going forward. We are also seeing massive growth in first-time gamers, a major new consumer base. Climate change will most likely be top of government agendas, as the lockdowns have highlighted how much less pollution is being generated across the globe.

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## Flexible investment

(compare flexible investment funds [here](#))

**The board of directors of Tetragon Financial – 31 July:**

Many market participants have written extensively on this health crisis and its impacts on financial markets, but we do believe that it is useful to share a few key observations here. Although equity markets have recovered significantly from the lows of March, most of the recovery in the markets has been led by a handful of stocks. In some ways, this is best evidenced by the fact that the Nasdaq Index recently hit all-time highs, while



small and midcap stocks in the U.S. are still down between 9-13%. One of the most unusual attributes in this crisis versus others is that many market leaders are actually benefitting from the pandemic. We also think it is worth reiterating the observations we made on valuations at the end of 2019. That is, with U.S. Treasuries trading near all-time low yields and 90% of developed market debt yielding less than one percent, the market might not be as expensive as it appears relative to interest rates. Furthermore, as previously mentioned, less-liquid and less-researched situations – in both public and private markets – have not recovered to the extent that broad indices would suggest to the casual market participant.

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**Richard Davidson, chairman of Miton Global Opportunities – 22 July:**

Asset prices almost everywhere have been impacted by COVID-19 and the de-rating of markets reflects uncertainty over future profits, credit defaults and the timing of the peak of the crisis. Even at this point, it is still too early to assess the long-term economic impact and the resilience of the company's portfolio, although signs are cautiously positive. General change within the sector continues to accelerate and the ongoing consolidation of wealth managers is continuing to lead to changes in investment company shareholder registers. In addition, as interest rates have just reached their lowest point in history, the attractiveness of alternative assets in the investment trust world has increased further.

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## United Kingdom

(compare UK funds [here](#))

**James Henderson and Laura Foll, managers of Law Debenture– 31 July:**

There is large divergence in economic forecasts from reputable analysts. It is not clear how consumers and corporates in aggregate are going to behave as 'lockdown' is eased. The consumers saving ratio has substantially risen while peacetime has never seen government indebtedness expand faster. Companies, given the increased cost of production as they comply with social distancing, may use an increase in demand to raise prices while the changes to trading patterns forced by the approach of Brexit are unclear.

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**Patrick Harrington, manager of Value and Income – 29 July:**

The outlook for equities has rarely been as difficult to foresee. On the one hand, the scale of economic contraction caused by the coronavirus could be at least double that caused by the financial crisis in 2008/09. Many companies have been severely affected by the virus lockdown containment measures and, in many cases, have stopped trading altogether. In response, a large number of UK companies have announced that they will be suspending dividend payments in order to preserve cash resources on their balance sheets. Large numbers have even resorted to cancelling previously declared payments, which is a sign of how fast the situation is changing. Corporate profit forecasts are meaningless at the time of writing and the dividend base of the market is subject to a high degree of uncertainty, although it is probable that UK stock market dividends will fall substantially in 2020. On the other hand, the scale of government responses around the world has been unprecedented. Measures including state support of wages, funding packages for businesses impacted by a lack of trade and

other support programmes have been announced with potential costs running into the hundreds of billions of pounds in the UK alone. Worldwide, similar measures worth literally trillions of dollars have been announced and governments will be running fiscal deficits at levels never seen outside of times of war. On top of this, central banks around the world have cut interest rates sharply and many, including the Bank of England, the European Central Bank and the US Federal Reserve, have announced new quantitative easing measures or similar asset purchase programmes, which have flooded the world with liquidity. This seems to have halted the decline in share prices for the time being, which have bounced off the bottom. Whether this proves to be of only temporary relief, or the start of the recovery will be dependent on the future path of the virus, the success or otherwise of efforts to contain it and the speed with which the lockdown measures can be eased. Nonetheless, following the stock market falls and despite the uncertainty regarding corporate dividend payments, share valuations on most measures are now low and judicious investment in companies able to survive without dilutive rescue fundraising should prove profitable from here.

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#### **Douglas McDougall, chairman of Independent Investment Trust – 28 July:**

The reaction of governments and central banks to the COVID-19 pandemic has been to pursue fiscal and monetary policies of unprecedented laxity. These have had the short-term effect of restoring confidence in stockmarkets, but their longer-term implications for the health of economies is difficult to assess.

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#### **Manager's report for Aberforth Smaller Companies – 28 July:**

The recession now under way is unusual in several ways. It is a consequence of the government's lockdown strategy to control the virus and so may be considered self-inflicted. The intensity of the contraction in activity is remarkable, with numerous macroeconomic data series showing the sharpest declines in generations. Moreover, the downturn, at least in the initial stages, was a supply-side event as businesses were commanded to close. The effect on demand remains to be seen and will be determined by the length of the lockdown, eventual redundancies and the willingness of consumers to reduce savings ratios from currently elevated levels.

In terms of their size and speed of implementation, the official support measures are as extraordinary as the recession itself. On the monetary side, interest rate cuts and additional quantitative easing programmes have played a part. The range of assets that central banks can buy has been broadened and, in the UK, debt monetisation is a reality, with the Bank of England directly financing government spending. Fiscal measures include tax breaks and the job retention scheme, which has, at least temporarily, prevented too sharp a deterioration in unemployment. Furthermore, through the COVID Corporate Financing Facility (CCFF) and the Coronavirus Large Business Interruption Loan Scheme (CLBILS), the Bank of England and the Treasury have sought to alleviate the liquidity squeeze confronting businesses.

Though these official measures have created breathing space, running a business against such a backdrop has been no easy task. The immediate priority for small UK quoted companies has been to tackle the liquidity squeeze that has resulted from the interplay of a sharp drop in sales – to zero for numerous businesses – and working capital cycles. While the official liquidity schemes and an easing of terms from existing lenders have played a part, there has been some reluctance to rely on government and many companies have resorted to the equity market for additional funding. As in 2009, equity investors have stepped up to ensure that fundamentally strong businesses can

continue to trade. It is plausible that the returns from the current crop of equity issues over the coming years can match those enjoyed during the financial crisis.

However, in the near term, one clear consequence of the downturn and liquidity squeeze is the most severe fall in UK dividends of the post-war period. At one level, it is entirely right that dividends should be cut: equity is the riskiest form of corporate funding and is the first to take the strain in extreme conditions such as those experienced so far in 2020. However, the reasons for some of the dividend cuts are dubious. It is perplexing that companies robust enough to continue to pay dividends should feel social or governmental pressure to cut. It is also perplexing that some decisions to pass dividends have been made easier by the actions of others. The frustration expressed here should not be mistaken for irresponsibility – Aberforth never encourages a course of action that is detrimental to the long-term value of a company. Rather, the managers believe that dividends impose capital discipline on businesses and are an important component of long term returns for the ultimate beneficial owners of equities. Reinstatement of dividends at appropriate levels will be a fundamental element of the recovery from COVID-19.

### Outlook

COVID-19 has cost thousands of lives and the threat of subsequent waves of the virus remains. It has also challenged societies and economies. Beyond its direct financial impact, lockdown has exacerbated pre-existing issues, such as relations between the US and China, tensions within the US during an election year, existential questions for the Eurozone and populist unrest. Monetary and fiscal support programmes have mitigated the initial economic damage, but the extent of the eventual recovery in demand is uncertain: unemployment is likely to rise as businesses cut costs once furlough schemes end, which may affect the willingness of households to run high savings ratios back down.

Prospects for the UK seem particularly unclear. This is reflected in sterling's leadership in the foreign exchange unpopularity contest, with 7% drops against both the dollar and the euro in the first half. Several of the attributes that have made the UK an attractive economy in which to invest seem under threat. Dividends have been slashed, pre-emption limits have been relaxed, the government has greater influence on the corporate sector and rules are being set informally without clear legislation. As temporary adjustments to cope with the impact of COVID-19, these are understandable, though a greater role for fiscal spending was likely even before the onset of the virus. The concern is that they herald more lasting changes at a time when the UK's future relationship with Europe and the future openness of its economy are moot.

Of course, these are risks – they may not come to pass. Indeed, it is rare that the stockmarket does not have something to worry about. Admittedly, COVID-19 is a different type of risk compared with others experienced in recent years. At least in its early stages, its pathology was unquantifiable, and nothing shortens investment horizons like being forced to contemplate mortality. However, the world's reaction to the disease serves as a good reminder of where people – their efforts structured through societies and companies – excel. The significant advances in the understanding of COVID-19 in just a handful of months, along with economically costly but effective measures to control its spread, demonstrate human adaptability and ingenuity. Notwithstanding current outbreaks in parts of the US, it is not unreasonable to believe that any subsequent waves of the disease can be much less severe than the initial outbreak.

In the meantime, it is clear that the virus has affected companies' prospects, some more than others. However, it is also clear that share prices have swiftly adjusted, some more than others. In the managers' estimation, many in the NSCI (XIC) and further

afraid have overreacted. Sentiment towards inherently profitable businesses, confronted by an extraordinary set of circumstances, has been damaged by fears for their very survival. This has taken valuations to extreme levels.

Beyond the medium-term recovery period, a familiar controversy looms. The outcome of the financial crisis proved deflationary, as austerity strategies were promptly implemented and as extraordinary monetary policies boosted asset prices but not consumer prices. A dozen years on, quantitative easing and other monetary tools are back in force, but the substantial fiscal stimulus has come against a backdrop of populist pressure. It is not clear that today's governments will prioritise austerity as their predecessors did. With the deflationary impetus from globalisation also in question, there would appear to be heightened prospects of an inflationary outcome. Inflation – or perhaps even merely the fear of it – would fundamentally challenge the investment strategies that have prospered for more than a decade. In turn, those that have struggled – such as the value style within equities – should find renewed interest.

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#### **Dan Whitestone, manager of BlackRock Throgmorton – 23 July:**

While the first six months of the year have certainly been a challenging period for equity markets in absolute terms, our outperformance of the benchmark has been a positive outcome. The economic backdrop remains highly uncertain given the ongoing COVID-19 pandemic. In aggregate the news flow surrounding the economic impact of the pandemic has steadily improved with many countries past the peak and while some are in the process of lifting restrictions, other countries are seeing a rise in the rate of infection, although this varies significantly by region and the situation remains fluid. Meanwhile, monetary support continues to provide liquidity to financial markets, and we believe most governments have already signalled an intention to use a wide variety of measures to stimulate economic activity. These actions have underpinned financial markets in general hence the rebound in most equity markets in recent months. We are continuing to engage with companies to understand the trends and impacts in the industries in which they operate, and how management teams expect to deal with this disruption.

Whilst there remains much uncertainty in the near-term, we are very positive about the long-term, and indeed our conviction and excitement for the outlook for specific companies and industry trends has, if anything, increased. We have read some truly remarkable company statements in recent weeks supporting some of these high conviction views about changing industry dynamics, notably our views on the acceleration in corporate spending on digital transformation to the benefit of digital ready businesses and/or businesses that enable the digital transformation. These suggest that the level of industry change is probably accelerating at this time, and so there are some important themes emerging that should deliver well for the company over the coming years. Other companies with a strong financial footing and a differentiated product offering should be able to use this market disruption to their long-term advantage as and when competitors and capacity exit the market.

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#### **Lord Lamont of Lerwick, chairman of Chelverton UK Dividend – 6 July:**

Our view is that in certain sectors there will be a relatively rapid recovery over the next few months as the lockdown is eased. However, overall, the economy will not return to where it was pre-lockdown. The final part of the recovery will take longer, as specific sectors such as hospitality and aerospace will need further time to get back to viability and the inevitable increase in unemployment will hold back the recovery.

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**Ciaran Mallon, manager of Invesco Income Growth – 3 July:**

Prior to the pandemic, there had been clear grounds for greater optimism signalled by a marked shift in soft and hard economic data. The uncertainty that had lingered over the UK since the 2016 EU referendum looked to be lifting and there were encouraging signs about the direction of the UK economy. As the scale of the pandemic unfolded, however, governments around the world restricted the movement of people which brought immediate and severe disruption to economic activity. Governments quickly launched stimulus measures on an unprecedented scale, whilst central banks cut interest rates to support economic activity. The strength and depth of the measures announced in the UK by the Chancellor and the Bank of England should provide material support to employment, income and bank lending to the real economy, which will be of great benefit in enabling many businesses to navigate through what will be an extremely tough period. In the short-term there is considerable uncertainty, and this has been reflected in equity market movements.

**Outlook**

It has become increasingly apparent that COVID-19 will have a significant and widespread impact on global as well as UK economic growth. The scale and duration of disruption remains subject to great uncertainties. The restrictions put in place since March to limit the spread of COVID-19 will naturally have a large impact on a wide range of economic indicators. As the effects of the virus start to fade, the measures implemented by the Government and the Bank of England will, in my view, encourage the stabilisation of economic activity in the second half of 2020 and the resumption of economic growth in 2021.

The FTSE All-Share seems to have shrugged off many of the concerns around the impact on future growth and earnings, the market deciding instead that the recovery will be more expeditious than previously thought, and the Index has rallied around 30% from its low point in March. There is no doubt that the stimulus measures put in place have had a significant impact and investors have pinned their hopes on a swift economic rebound. I think it sensible to pause and digest the fact that although the lockdown is easing and some activities normalising, the UK is still expected to face a severe recession.

The cancellation or reduction of dividends is an inevitable result of this crisis as companies seek to sustain liquidity within their businesses. Whilst one would prefer this not to be the case, in most instances it is prudent given the unknown length and depth of this disruption. As I have mentioned briefly earlier, the money set aside for dividends does not disappear when the dividend is reduced or cancelled. It stays within the business enhancing the balance sheet, ready for distribution at a later date should the crisis be shorter and less disruptive than imagined or should the management have turned out to be more conservative than was warranted. I believe that once the environment normalises businesses that have not been casualties of the crisis will quickly return to pre-crisis activity levels and thus will be able to restart their dividend payments.

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## North America

(compare North American funds [here](#))

### Manager's report for Gabelli Value Plus+ – 1 July:

As 2020 began, all seemed well in the United States. By all measures, the economy and consumers were healthy and prosperous. Very few had been paying attention to what initially seemed like an inconsequential virus outbreak on the other side of the world in Wuhan, China. Gradually, however, the virus spread, and America started to become more aware of COVID-19, as the first death in the U.S. attributed to the threat was recorded in late February 2020. On March 11, 2020, the World Health Organization declared the virus a pandemic, as it had spread to more than 100 countries. By mid-March, the U.S. was bracing for a contagion that would kill far more people than the last global pandemic, the 2009 Swine Flu. By the end of March 2020, the end of the fiscal year for the Gabelli Value Plus+ Trust, over 90% of the American people were living under stay-at-home orders from their state governments.

The beginning of the first quarter of 2020 witnessed the American economy setting numerous records. It was the longest economic expansion on record, a time period that goes back to the mid 1800's. It was also the longest stock market bull market on record. The American workforce had the lowest unemployment rate in over 50 years. However, all of this came to a very abrupt end in March. With the stay-at-home orders and the closing of the economy, over 15m workers were out of work by the second week of April, a figure representing over 10% of the workforce. That number increased to over 20m in May and has since begun to show signs of inflection. U.S. gross domestic product contracted by 4.8% in the first quarter, with expectations for a double-digit decline in the second quarter. Although it is hard to predict the severity or duration of this economic recession, it will certainly not be a mild one.

The government response to the COVID-19 pandemic has been unprecedented in its scale, both from the Federal Reserve and Congress. In terms of short-term interest rates, the Federal Reserve quickly slashed rates down to zero as the virus spread and added a massive amount of liquidity into the market. By early April, the Fed, through various programs, was committed to adding a staggering \$4.8trn to the economy. This figure represents about 22.4% of gross domestic product for the American economy. Congress and the President also swiftly passed legislation to add fiscal stimulus. The initial stimulus package amounted to \$2.7trn, or about 12.7% of the American economy. Taken together, the Federal Reserve and Congress added liquidity and fiscal stimulus worth about one third of the American economy. Depending on the course that the virus takes, there may be more government response. to come if bipartisan support is forthcoming.

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### Peter Dicks, chairman of Gabelli Value Plus+ – 1 July:

The US equity market has continued to rate growth stocks highly, as they have generally delivered strong share price returns. There seems little reason for the overall growth of technology development to slow, and this, combined with the potential lingering effects of the pandemic, may continue to limit interest in the value sector of the market, at least in the near term.

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## Asia Pacific

(compare Asia Pacific funds here [here](#))

**Ian Hargreaves, manager of Invesco Asia – 7 July:**

### Q&A with the manager

**Q** *What have been the major changes to the portfolio over the period?*

A The most significant change since the COVID-19 outbreak has been a reduction in our exposure to financials. Interest rates are likely to remain lower for longer and there is clearly potential for some asset quality deterioration. Having re-appraised the outlook we continue to have exposure to those companies in the sector that we believe offer value. Our focus is on very well capitalized banks that have the potential to absorb losses, particularly in under-banked parts of Asia like India. The market may be struggling to ascertain what the asset quality risk may be, but private sector banks have proven that they are able to handle what may come thanks to the strong profitability of their core business, while they also continue to have attractive medium-term growth potential taking market share from undercapitalised state banks.

Prior to COVID-19, we had been adding exposure to companies that could benefit from an improvement in growth momentum. However, we felt that the recovery would be more gradual than in previous cycles, as China was not easing as aggressively as it had done in the past. As such, we were keen to retain a well-balanced portfolio with exposure to companies that are less sensitive to the global manufacturing cycle. We found several opportunities that filled that criteria in India, where a soft patch in growth had seen the valuation of some high-quality well-run businesses fall to levels, we felt were compelling. Recent market weakness has provided us with further opportunity to add to some of these.

**Q** *Where else do you see opportunity?*

A We invest in a broad mix of Asian companies and new opportunities are constantly emerging. The portfolio's biggest positions are in technology and internet companies. These have performed very well in recent years and although not immune from general macroeconomic uncertainty, we see companies in this area emerging stronger, particularly those that continue to invest and innovate. There are clear cycles in technology, with the rollout of 5G, growth of AI and the 'internet of things' likely to have only been interrupted, with demand likely to recover. Working from home has also led to increased demand for PC-related equipment and cloud capacity. Chinese internet companies have benefited from an acceleration in the trend towards online shopping and gaming, and in recent years have demonstrated a willingness to focus on core-profitability, with some significant restructuring having taken place. These are enduring themes that are well represented in the portfolio and will remain so for as long as valuation levels permit.

Valuations in more cyclical sectors are low by historical standards and in many cases appear to be pricing in a more pessimistic outlook than we think likely. We have used the market downturn to narrow the focus of the cyclical exposure on sectors that we expect to experience a small impact on medium term earnings as a result of the economic downturn. We are also prioritising strong balance sheets as this offers an element of downside protection.

**Q** *What is your outlook beyond the next twelve months?*

A As governments start to lift restrictions, the global economy can start to get back to normal, supported by a demand recovery. This is likely to be a gradual process, with the risk of a second wave of infections a concern, particularly given that renewed

lockdowns would likely lead to a protracted global recession. We also need to remain mindful of second-order financial effects of the lockdowns, which could lead to broader solvency issues. However, history has repeatedly shown that investing in good quality companies at low valuations leads to very good subsequent returns. The policy response in developed markets has also been unprecedented in size and speed of implementation and will eventually provide enough impetus for an economic and earnings recovery.

Finally, there is potential for a re-escalation in US-China tensions, with the relationship between these two likely to remain tense for the foreseeable future. While we need to consider the potential impact of trends such as de-globalisation, as companies seek to ensure that their supply-chains are less reliant on China, we are also cognisant of the fact that the contest between these two super-powers may have positive effects on growth, innovation and productivity. For example, with both sides determined not to give up an opportunity to take a lead in science and technology research and development there is likely to be even greater levels of government investment in these areas. Innovative Asian companies stand to benefit, and we remain alert to new opportunities that may emerge.

**Q**      ***Why invest in Asia now?***

**A**      The current valuation of Asian equity markets is attractive not just in absolute terms, but relative to history and to developed markets, particularly given the region's better growth prospects. This is especially true since Asia's underlying economic and corporate fundamentals are generally sound. Most countries enjoy a healthy fiscal position, while governments across the region continue to actively pursue reform. At the corporate level, there has been a marked improvement since the Asian Financial Crisis as companies have by and large kept capital expenditure plans and costs under control. In part, this reflects lower structural growth, but it also demonstrates that Asian companies are more cautious, focused and better managed than they were historically, and suggests that better returns on capital are sustainable. In a less certain growth environment, it is also positive that there are few industries with significant excess capacity risk. Less capital-intensive companies have also been generating stronger free cash flow. The challenge has been how to better allocate that capital. With management facing growing pressure from minority shareholders to pay better dividends, there is an increasingly strong dividend growth story in Asia.

While Asia compares favourably to world markets in terms of valuation, dividend yield and free cash flow yield, our portfolio compares favourably with Asia on all these metrics.

Finally, although the current investment environment is challenging, it is likely that the Asian economies can continue to outperform over the medium term. The region remains the biggest driver of global growth, with strong structural trends such as rising disposable incomes, increased urbanisation and the growth of the middle class. These will continue to be key drivers in unlocking the vast potential of Asia's consumer demand, reducing its reliance on manufactured exports as being the primary driver of earnings growth.

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## Global emerging markets

(compare global emerging markets funds [here](#))

### Manager's report for ScotGems – 30 July:

The printing presses of central banks have gone into overdrive this year in an attempt to ward off the greatest economic and social uncertainties most of us have ever encountered. One of the very early consequences of this unprecedented action has been the widening of various distortions in stock markets. One such distortion is the large difference between stocks wearing the label 'value' and those preferring to don 'growth'. The discrepancy in performance between growth and value has rarely, if ever, been wider than it is currently. This is the case globally and emerging markets are no exception.

At the end of June, the price to earnings ratio of the MSCI Emerging Markets Index was 16x; the MSCI Emerging Markets Value Index was 11x; and the MSCI Emerging Markets Growth Index was 30x.

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### Maria Luisa Cicognani, chair of Mobius – 24 July:

Emerging markets have been hit hard by the crisis. The COVID-19 pandemic and the subsequent shutdowns all over the world have meant that countries have seen dramatic declines in their economies and a concomitant stress on government finances. In many cases exports have tanked, tourism has disappeared, and foreign investment has vanished. Many countries have been faced with very large reductions in foreign exchange revenues.

However, we are now starting to see a turnaround. Central banks and multilateral institutions have injected unprecedented amounts of liquidity into the global system. Furthermore, every day we are learning more about the virus and containment measures are becoming more targeted and effective. Countries are starting to ease their lockdowns and economies are getting back on their feet. International travel is also slowly and carefully re-opening.

No doubt there will be corrections along the way and the economic impact will be felt at least until the end of the year and possibly well into 2021. Uncertainties remain as we are still awaiting the arrival of a vaccine and are just starting to understand the scope of the economic repercussions on global economies.

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### Manager's report for Aberdeen Emerging Markets – 9 July:

#### Market environment

In the earlier months of the period (to 30 April 2020), emerging markets continued to make headway, with the Benchmark up 9.8% by the third week of January. The asset class then suffered a significant setback, declining 25.2% between 20 January and 23 March as the global spread of COVID-19 caused most countries to introduce social and economic restrictions, which severely impacted economic activity. Investors retreated to traditional safe-haven assets such as US treasury bonds and gold. In a number of emerging markets, the situation was compounded by commodity price declines and the associated impact of this on currencies. Most notable was the precipitous fall in oil prices (the price of Brent crude fell by 56.9% in sterling terms over the period). In response to the crisis, governments and central banks around the world, including virtually all emerging markets, implemented unprecedented fiscal and monetary

stimulus measures with the aim of ameliorating the economic impact of COVID-19. These measures spurred a rebound in investor sentiment and over the remainder of the period the emerging markets index rallied sharply to end an extraordinarily challenging half year down 8.0%.

The Emerging Asia index fell by just 1.1%, largely as a consequence of the resilient performance of index heavyweight China. Despite being the epicentre of the COVID-19 outbreak, China implemented aggressive measures to control the spread of COVID-19 quickly and effectively, enabling a gradual resumption of economic activity in the latter part of the period as the lockdown was eased. Remarkably, the Chinese stock market rose by 8.2% over the period. The other large North Asian markets of South Korea and Taiwan also benefitted from being "first in, first out" of the COVID-19 pandemic. Well managed pandemic response plans helped both countries deal more efficiently with the crisis than appears to have been the case in many other countries. Taiwan gained 3.5% over the Period while South Korean equities recorded a loss of 6.5%. Markets elsewhere in the region were less resilient, with India down 17.0%, amidst significant outflows from foreign investors and the perception of being behind the curve in its response to the virus outbreak. South East Asian markets also performed poorly with Thailand, the Philippines and Indonesia losing 20.5%, 25.4% and 27.6% respectively.

In Eastern Europe, the Middle East and Africa, the regional index fell by 19.5% with all constituent markets ending the period in negative territory. The Russian market fell by 21.6%, which reflected a sharp decline in oil prices over the period. A disagreement between Russia and Saudi Arabia in March over production cuts exacerbated an already weak environment for oil, given the COVID-19 related demand shock. In the weeks that followed, record oil oversupply and related storage concerns drove unprecedented energy price moves, causing US crude oil prices to turn negative for the first time in history in mid-April, although they recovered somewhat in the final weeks of the period on news that the major oil producing countries had reached a tentative agreement on lower production levels. Despite the weakness in energy prices, Saudi Arabia was the least weak market in the region, declining by 6.9%. In general, Gulf countries appear to have been reasonably effective in containing the virus, with stock markets in Qatar (-7.1%) and the United Arab Emirates (-16.4%) also outperforming the region as a whole. In Eastern Europe, equity markets in Hungary (-25.8%), the Czech Republic (-25.9%) and Poland (-30.0%) suffered from their locality within the European Union where the impact of the pandemic was significant and, with the exception of Germany, management of the virus' spread proved challenging.

Latin America was the worst performing emerging region, losing 37.2% as the spread of COVID-19 accentuated the economic challenges for the region. Brazil, the largest market in the region, lost 42.1%, as investor confidence was shaken by President Bolsonaro's dismissal of the potential health consequences of COVID-19 and the resignation of the Minister of Justice following the dismissal of the head of the Federal Police.

### Outlook

The primary driver of the recovery in markets from the March low point was the massive global fiscal and monetary policy stimulus implemented by policymakers. While this has served to alleviate investor panic in the short term, longer term considerations around the emergence from the COVID-19 pandemic and its ultimate cost remain. As countries begin to emerge from lockdown, economic activity will pick up quickly but not to a level that can rapidly replace the lost output of the first half of the year. Corporate earnings in emerging markets are clearly going to suffer and analysts' estimates of earnings for the year have declined significantly since the start of 2020. Dividends may also suffer cuts as companies prioritise balance sheet strength over returning capital to investors.

Governments globally will exit the crisis with increased levels of debt and difficult decisions to make in terms of how and when to unwind the measures already taken.

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## Biotech and healthcare

(compare biotech and healthcare funds [here](#))

**Paul Major and Brett Darke, managers of BB Healthcare – 21 July:**

### Macro environment

Last year's interim report began with a comment noting a market backdrop of a macro-dominated top-down thematic and a challenging valuation framework relative to history. One year later, writing from home in a world utterly transformed by the ongoing SARS-CoV-2 pandemic, there is nonetheless a sense of déjà-vu. We can but look back wistfully at the halcyon days of 2017, which to our mind is the last time we felt the market dynamic was primarily driven by corporate newsflow.

This has been a challenging period for everyone on both a personal and professional level. The stock market is, at any given point in time, a present value expression of our future hopes and fears. When considered in this context, its trepidatious vacillations are understandable, although not always rational.

We all speak of a 'new normal' emerging, but its true nature has yet to be revealed. Much of the political focus seems to be trying to get back the old one as quickly as possible, even though the unfolding economic wreckage of the first wave of this pandemic (never mind those yet to come) suggests this is simply impossible in the near-term.

Renewal can arise from this vicissitude, and we must all hope for Schumpeter's gale [*of creative destruction*] ushering in a modern-day New Deal rather than a tsunami that leaves nothing but destruction. Our over-arching investment philosophy is grounded in this optimistic perspective; that which is broken must be fixed and re-imagining what is possible can be a source of tremendous value creation for investors as well as wider society.

If nothing else, the pandemic has served as a lightning rod for healthcare, highlighting the fundamental structural problems with which it must grapple. In the crucible of chaos that began to unfold, new ways of working have been able to demonstrate their value and concepts that we have long trumpeted like electronic triage and alternative sites of care have seen their adoption accelerated far beyond our base-case expectations in this short timeframe.

The speed with which the medical community has characterised this novel pathogen, evaluated treatment protocols and standards of care and moved rapidly toward vaccine development should inspire us all (and we should all be proud too that the benighted UK NHS has led on some of these fronts). Once again, the incredible ingenuity of the human race when it works in a united and egalitarian manner demonstrates why science and reason should be at the heart of decision making. It should also leave us hopeful that, like Polio or HIV before it, SARS-CoV-2 will eventually fall into that category of infections that are potentially serious but largely manageable through a combination of successful vaccination or anti-viral therapy.

One can adopt a cynical view of the pharmaceutical industry's rapid mobilisation toward vaccine development and access to novel anti-virals and it will undoubtedly help defer some of the criticism that has emerged as a predictable part of the US Presidential

election narrative. Healthcare access is increasingly the axis of the political debate across the globe and more of it can only be a positive for the industry in the longer-term, regardless of how that is ultimately funded.

For many years, surveys of the public mood highlighted a conflicting desire for better healthcare with an unwillingness to pay more for it. This has begun to melt away, potentially ushering in a new era of significant investment in infrastructure and services that stands in stark relief to the wider uncertainties for the global economy. Never has it made more logical sense to be exposed to this sector from an investment strategy perspective.

### **Market performance themes**

Generally speaking, one can say that the majority of revenue generation in healthcare as a business comes from elective surgical procedures. These were curtailed during the pandemic so that resources (in particular, critical care bed space) was available for pandemic victims.

Hospitals suffered as their revenues were curtailed and likewise Med-Tech companies also struggled for a time due to reductions in planned capex for hospitals (and a re-focusing of procurement priorities toward beds, critical care equipment and PPE - that shiny new scanner "thingamajig" can wait), plus reduced surgical consumables due to delays in elective surgeries. Dentistry also suffered - rarely does anyone die from wonky teeth and people don't need much convincing to delay their routine annual check-up.

In periods of maximum uncertainty, it is understandable that investors want to stick to the "known knowns". Infectious diseases need to be identified so diagnostics is a good spot. Likewise, helping people to manage diseases like diabetes isn't going to be impacted (so buy healthcare technology plays like 'smart' pumps and continuous glucose monitors). Services and Tools are often provided on a contractual basis and so revenue downside is probably limited. Essential medicines will keep selling.

### **Outlook**

In the face of tremendous uncertainty, caution is our watchword. Whilst not prone to pessimism, it has served us reasonably well so far to plan for the worst and hope for the best. We have long argued that secondary outbreaks of SARS-CoV-2 are inevitable. This winter could be very challenging for global healthcare systems; it is hard enough in a normal winter without the burden of another virulent pathogen to contend with, although all this social distance might ameliorate the winter 'flu, as happened in Australia.

Looking beyond acute care resources and hospital capacity, it may also be challenging for wider society to continue to function if the merest sniffle is deemed to warrant self-isolation; can you remember a winter where you did not have some sort of cough or cold at a certain point of time? It is the normal way of things. Tendentially, we are more imprisoned by our own fears than the reality of the situation we face. In the end, we must, as individuals and as investors, reach an accommodation with SARS-CoV-2; it could be with us for some time to come. Currently though, that does not feel like the base case assumption priced into the equity market.

In all likelihood, the ongoing pandemic will be subsumed into an electoral narrative in the all-important US market. We see little to fret about in Biden's healthcare policy agenda and, in the longer-term, it is probably better for utilisation trends than another four years of Trump and the gradual winnowing of Obamacare. In the nearer term though, the reflexive "Republican = good for business, Democrat = bad for business" mantra may hold sway.

Our longer-term framework for assessing healthcare investments (and growth expectations for the various areas of the market) are unchanged through the pandemic; why would they be? The drivers are demographic after all. With this being the case, we

must be guided by these fundamentals and take profits in companies whose valuations soar to unrealistic levels in this pandemic parallax. Equally, one must resist the temptation to chase after superficially suggestive companies because it is in vogue. We may not get everything right, but if we stick to our framework, at least we can determine the correct course of action if things go wrong.

In summary, we expect the market to make limited further absolute gains over second half of 2020, with a very real risk that elevated volatility returns again at some point. Healthcare should retain its position as a structural long-term winner versus other industry sectors.

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## Financials

(compare financials funds [here](#))

### Robert Kyprianou, chairman of Polar Capital Global Financials – 2 July:

The COVID-19 global pandemic has presented a unique combination of challenges that span science, public policy and economics, each one extraordinary in depth and impact. Together they have introduced consequences, risks and uncertainties on a scale not experienced in modern times. So much so that the validity of long established pre COVID-19 templates for how we analyse economic, financial and political responses and likely outcomes are being severely compromised. How will the lives versus livelihood conflict be resolved? What is the long-term impact of the once unimaginable scale of monetary and fiscal support measures being dispensed globally? How many of the changes in behaviour witnessed in response to the pandemic will be permanent? And what do these changes mean for a wide range of industries and services? In the recovery will capital and finance be allocated by the private sector or will it be directed based on social imperatives? These are just some of the questions that need to be clarified before any statements about the outlook can be made with any degree of confidence.

Answers to many of these questions remain highly uncertain. What is clear is that this crisis has had a significant negative impact on a number of key components that make up the financials sector in which the company invests, from banks and insurance companies to asset managers.

What is also clear is that, unlike the last crisis to hit global economies, banks are part of the solution and not the cause of the problem. Undoubtedly, they will find the environment in which they operate problematic. But they are generally in much better shape from a capital and operational leverage perspective than at any time this century. It is also apparent that regulators and monetary authorities understand the key role that banks will need to play to address the economic impairment currently being inflicted by the virus. Regulatory capital buffers have already been relaxed for example and certain central banks have made facilities available to limit the damage to profitability. In the 'whatever-it-takes' mindset that characterises the public policy response to the economic damage brought about by the virus, further supportive and protective measures for the financial sector can be expected.

The significant downgrading of a broad range of financial subsectors may be an understandable market response to the economic and financial fallout from the pandemic, but it is also one that is formulated on pre-COVID-19 templates. While we wait to see what new templates emerge our manager has responded by, on the one hand, strengthening the defensive qualities of the portfolio, and on the other hand

positioning it to benefit from some of the positive emerging structural changes presented to parts of the financial services community.

At the time of writing global equity markets have recovered sharply from their late March lows as markets look ahead to the recovery phase of the pandemic-induced economic cycle. A broad range of financial services sectors, in particular banks, will be beneficiaries of the emergence from the sharp economic downturn and from undemanding valuation levels.

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## Debt

(compare debt funds [here](#))

### Frederic Hervouet, chairman of Chenavari Toro Income – 30 July:

The drop in economic activity due to the COVID-19 crisis is widely expected to be followed by elevated defaults over the next 6 to 12 months. However, there are multiple factors specific to this credit cycle which will likely impact the level of default rates and the performance of CLO. Starting with the negative factors:

- A total or partial loss of revenues will translate into a significant reduction of EBITDA (with a disruption of the normal working capital cycle and high levels of payment reversals for some sectors) leading to a rapid deterioration of financial metrics, exacerbated by initially optimistic adjusted EBITDA forecasts. Many companies will struggle to access liquidity and existing resources could be exhausted quickly.
- As 87% of the European leveraged loans market consists of covenant light (cov-lite) loans, there is both limited control for lenders and ability to force sponsors to inject more capital, potentially leading to a lower recovery in the case of default.
- Unlike the previous crisis, borrowers will not benefit from lower interest rates.

However other factors, also particular to this cycle, are likely to mitigate potential defaults and losses:

- Unprecedented monetary and fiscal responses were quick, aggressive and relatively coordinated. Such remarkable policy measures flooded the markets with liquidity and will go a long way to support households and businesses impacted by a massive contraction of revenues.
- No maturity wall in the coming years for leveraged loans (no loans maturing in the Toro CLOs for instance in 2020 and 2021), which means there is limited refinancing risk.
- Cov-lite loans provide more flexibility and buy time for companies.
- Incredibly low rates for an extended period will act as a floor on expected recovery.

As global economic activity has been experiencing a deep trough, it is telling us little about the permanent or long-term damages and risks that lie ahead at time of the writing. On the other hand, the quick and commensurate policy response have prevented a negative feedback loop and credit markets seemed to be ready to rebound quickly from their March lows.

The effects of the shutdown on corporate fundamentals will become clearer in the coming months and at the time we write we expect the worsening fundamentals will

lead to continued pressure on companies' balance sheet, pushing CCC exposure higher while defaults spike and CLO junior cash flows are diverted.

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#### Manager's report for TwentyFour Income – 22 July:

The outlook is currently solely driven by the development of COVID-19 pandemic, which is likely to result in a global recession. The extent of the impact will be driven by the length of the global lockdown and the longevity of the impact of the economy. Specifically, for the ABS market the impact on fundamental performance will be driven on the consumer side by obvious factors such as unemployment rates, but also by the extent to which lenders permit forbearance to distressed borrowers. It is worth noting that while headlines have made it clear lenders are being encouraged to offer forbearance, this has typically been lender policy anyway and is normally the first step in an arrears management process. This results in a deferral of interest payments rather than the permanent loss of interest or a default. It is for this reason that liquidity and general reserves are structured into ABS deals.

Historically, in terms of corporate borrower risks, largely via allocation to CLOs, we have stress-tested transactions based on a dual approach of a severe recessionary scenario and assessing the level of underlying defaults that each tranche can withstand. As a result of the COVID-19 pandemic we have added a scenario that more specifically targets underperformance in sectors more directly impacted, including retail, tourism, and transport, among others. The modelling output points encouragingly towards the worst-case scenarios being interest deferral on a limited number of exposures within the portfolio, with such interest accruing and subsequently being paid in full with all principal also repaid. We do expect to see the leveraged loan market experience a material increase in CCC ratings, downgrades, which will hurt CLO equity, and likely keep CLO spreads wider for longer.

While we are currently seeing an increase in primary market activity, these are largely transactions postponed as a result of the recent market closure, and we expect supply to be materially lower than in recent years during the second half of the year. This is as a result of lower loan origination volumes in consumer lending, and also as the cost of incubating CLOs on bank balance sheet should become more expensive and harder to source. This lack of supply could support prices over a medium-term timeframe. However, should market sentiment become driven by either extension or gradual release from lockdown, we would expect that to be a more immediate driver of ABS pricing. In addition, it should be expected that there will be ratings downgrades as economic performance weakens.

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## Renewable energy infrastructure

(compare renewable energy infrastructure funds [here](#))

#### Manager's report for Greencoat UK Wind – 30 July:

There are currently 24GW of operating UK wind farms (14GW onshore plus 10GW offshore). In monetary terms, the secondary market for operating UK wind farms is approximately £70bn.

In June 2019, the UK parliament adopted a net zero emissions target for 2050, going further than previous legislation, which mandated 80 per cent emission reductions by 2050.

Decarbonisation of the electricity sector, primarily through renewable generation, will be critical to achieving this. The revised target is for 40GW of offshore wind capacity by 2030, supported by the CFD regime. We are also now seeing the development and construction of onshore wind farms on a subsidy free basis. We do not expect any material change to the company's business as a result of the UK exiting the European Union.

The key value driver affecting operating UK wind farms is the wholesale power price. In general, independent forecasters expect the UK wholesale power price to rise in real terms, driven by higher gas and carbon prices.

Short term power prices have seen extreme volatility as a result of the COVID-19 pandemic and associated lockdown.

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## Commodities and natural resources

(compare commodities and natural resources funds [here](#))

### Mark Hume and Thomas Holl, managers of BlackRock Energy and Resources Income – 30 July:

The mining companies continued their now-established track record of returning surplus cash to shareholders with companies such as Rio Tinto declaring final year dividends at the upper end of targeted pay out ranges. The gold companies have also shown a notable change in attitude towards dividends – for example Newmont hiked its dividend by almost 80% and guided that it would return around half of its free cashflow to shareholders through time.

The energy companies provided a less positive dividend story during the first half of the year. Whilst some companies opted to use their balance sheet strength to maintain payments despite the very challenging oil price environment, many others took the chance to reset dividends lower. This happened in areas of structural challenge, such as the oil services sector where Schlumberger cut its dividend by 75%. Elsewhere, Royal Dutch Shell cut its dividend by two-thirds, which was the first time it has cut its dividend since World War II.

The energy transition companies under consideration for the portfolio did not experience anything like the financial squeeze the oil companies faced from the collapse in the oil price. Their dividends therefore look more likely to be maintained over the medium term. However, some, especially in Europe, may be under political pressure to limit dividend payments in favour of reinvesting as Governments are keen to see a green bias to any economic recovery. Overall, for the energy transition companies, their dividend yields are often lower than those in mining and conventional energy as they typically have greater growth opportunities.

### Energy

The International Energy Agency (IEA) estimates that average oil demand in 2020 will fall by over 8m barrels per day, equivalent to 8% of total consumption – making it the largest annual contraction in history.



The timing of this unprecedented collapse in demand came just as the world's major oil producers (OPEC and Russia) had failed to reach an agreement on supply at the group's meeting on 6 March 2020. This mismatch between supply and demand caused crude inventories to rise at record rates, in turn, driving Brent oil prices from an early January high of \$69/barrel to a low of \$19/barrel in late-April. Prompt action by OPEC and Russia (OPEC+) saw the group agree a reduction of almost 10m barrels per day effective from the start of May.

Elsewhere, US shale producers implemented one of the sharpest reductions in activity in history with the horizontal rig count falling from 701 to 271 over the period. This has translated into budget cuts from producers in the order of 50% on an annualised basis through the balance of the year. As a result, US shale output is forecast to contract by as much as 2m barrels per day through the second half of 2020 (a chart showing the supply and growth activity for US Natural Gas Liquids and the horizontal rig count since January 2015 is included on page 14 of the half-yearly financial report).

Taken together, these actions helped to drive crude prices back towards \$35/barrel by the end of the period and assuming OPEC+ remains focused on managing supply we would expect inventories, and therefore prices, to normalise in the first half of next year.

Turning to equities, the global energy sector fell 30% in the period with the larger companies faring better (-27%) than smaller companies (-50%). From a sub-sector perspective, the Midstream (Pipelines) and Downstream (Refining & Marketing) companies held up relatively better – falling by less than 20%. In contrast, Oilfield Services stocks fell by more than one-third over the period. Energy equities touched their lows in mid-March and have since rallied more than 50%. As at the end of May, the sector is still trading at more than 30% below where we started the period with global oil markets continuing to rebalance.

### **Energy transition**

Mitigating climate change is unquestionably the greatest challenge currently facing humanity. In the decades ahead, the entire global energy system needs to decarbonise if we are to limit emissions to tolerable levels. The decarbonisation of the energy system not only covers the power sector, it also touches transportation, buildings materials and petrochemicals all of which have, up until now, been great enablers of a better quality of life. Continuing to deliver affordable, clean and safe energy, whilst reducing carbon emissions presents an immense challenge. A shift away from hydrocarbons is already underway with coal's share of primary energy consumption, for instance, now at its lowest level in 16 years. Closer to home, policy makers are also stepping up their efforts. For example, in December 2019, the European Commission rolled out its "roadmap for making the EU's economy sustainable by turning climate change and environmental challenges into opportunities across all policy areas". The EU plans to hit "Net Zero" emissions by 2050 with the aid of a €7trn investment plan. Within this plan as much as 45% could be allocated towards the Utilities sector and will see a massive renovation wave of our buildings and infrastructure, the roll-out of renewable energy projects and cleaner transport. More detail is given in the chart on page 15 of the half-yearly report.

Although the direction of travel is clear for decarbonisation, the pace is not. Nevertheless, in recognition of the momentum building in the Energy Transition, the board announced at the 2020 AGM in March, that the company would be shifting its investments to reflect this transition. This shift was undertaken more formally on 1 June 2020 with a target neutral portfolio weighting for Energy Transition stocks of 30%.

### **Mining**

The mining sector mirrored similar trends as with the broader equity market, largely recovering its losses following a sharp selloff in March; by the end of the period it had recovered its losses. Within this though there was a wide differential between the

performance of the mined commodities, with the safe haven metal gold once again showing its value as a hedge against volatility and iron ore again benefitting from a favourable market structure.

Looking at the industrial mined commodities first, most of the base metals saw price declines in the first half and this contrasted against iron ore, which saw a price rise of over 15%. The chart on page 16 of the company's interim report for the six months ended 31 May 2020 shows China's demand (as a share of total global demand) for a sample of mined commodities and the price change from the start of 2020 to early June. China, whilst clearly impacted earlier by the virus, has looked to reverse some of the negative economic impacts by injecting stimulus. Whilst not of the scale seen at the start of 2016 and not entirely focused in resource-intensive areas, it has provided a material boost to steel demand (and hence iron ore demand).

The demand side is just one half of the story – it is important to look at the role of supply in the various mined commodities too. On the supply side, the highly concentrated nature of iron ore supply (both in terms of country of supply and number of companies responsible for it) has caused supply to be more vulnerable to disruption. The biggest source of supply shortfall relative to expectations has come from Brazil where the struggles of Vale (the country's biggest iron ore producer) to recover from the tailings dam disaster last year have been compounded by the country's slow response to bring the virus under control. These supply disruptions have coincided with China's strong stimulus-driven demand and have resulted in a tight iron ore market, hence the robust pricing. Also, the supply disruptions from Brazil (relative to expectations at the start of the year) are expected to continue through 2020, maintaining a relatively tight balance between supply and demand in the global iron ore market.

There has also been supply disruption in other commodities, but it has either not been as impactful on overall supply as seen for iron ore, and/or the fall in apparent demand has been even greater than the supply declines. In copper, there were quite a few temporary mine closures in countries such as Peru and Chile but following a number of weeks of suspension, production appears to have ramped back up.

The strong performance of iron ore is a material positive for the major mining companies, which are the core of the mining part of the portfolio. Unlike many other sectors in the market, cashflows for the major miners have remained strong in the first half of 2020 and look set to remain robust for the balance of the year. When combined with the strong balance sheets that the sector had at the start of the year, the stage is set for dividend payments to continue. This is reassuring for the portfolio and there is a possibility that as other sectors see dividend cuts or cancellations, the mining sector re-rates as the dividend yield attracts new investors.

### **Outlook**

From a conventional energy perspective, the recent collapse in oil prices has finally forced a dramatic downturn in US shale growth. The energy industry was already driving towards much needed capital discipline and this downturn has merely accelerated and reinforced this fiscal constraint. We believe that 2020 will mark the end of what has been a multi-year non-OPEC supply-driven bear market. As a result, OPEC's role will change from needing to cut output to balance the market, to adding barrels back – this will completely change the financial market's perception that the world is awash with oil. Put another way, despite the near-term challenges for oil markets, we are actually becoming more bullish on the sector on a 2+ year time frame and reaffirm our view that normalised oil prices will return to the \$60-70/bbl range – a view we have held since 2017. Our constructive outlook on the sector remains focused on higher quality, globally diversified energy companies that can not only benefit from rising commodity prices but can do so within the framework of the Energy Transition.

On the mining side, the key determinants of second half performance will be the duration of the steel / commodity intensive stimulus in China and the pace of recovery in economic activity in the rest of the world.

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## Property - UK

(compare UK property funds [here](#))

### James Agar, manager of Ground Rents Income – 6 July:

The COVID-19 pandemic is causing significant disruption to the real economy and mainstream real estate assets are currently experiencing falling income and capital values. Whilst we expect real assets offering defensive income characteristics to experience continued strong demand, the prevailing headwinds from Government reform and the ongoing CMA investigation continue to impact sentiment.

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# QuotedData

QuotedData is a trading name of Marten & Co which is authorised and regulated by the Financial Conduct Authority

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