Fund Managers Report 31st March 2020 to 30th June 2020.

An early lesson for many in the City is that capital markets respond to future expectations and not the current situation. Whilst the media reports the past and economists grapple with the present; markets are always looking to the future. For equity markets this makes earnings for 2021/22 the primary focus, while the medium term outlook for interest rates and inflation drive the bond markets, and in turn, each influences the other.

It was for that reason that we concluded our March report with the comment “in the longer term expecting a more pronounced recovery as the stimulus takes hold”. We expected a sharper V shaped recovery than many as focus moved to the future. We were surprised that a large part of the market was caught underinvested, which has had the effect of prolonging the rally and taking it further.

The reality in the real economy is far more complex, and likely U shaped, and we can look at this in turn at three different levels. The pandemic, the megatrends (especially from an Impact and ESG perspective) and the changing geo-political risk spectrum.

The Pandemic

For the first time ever the world faced a fast moving and deadly pandemic. Governments needed to act fast on limited and incomplete information, and inevitably we saw different responses, each with their own positive and negative merits.

The good news has been that things did not turn out anywhere near as badly as feared. Healthcare systems were not overwhelmed and although we see headlines of huge falls in economic growth and job losses, these have not been to the magnitude that was initially projected. This relief in the markets has formed the basis of the first stage of the recovery in global equity markets.

How the world moves on from this stage of the pandemic continues to dictate market expectations, and markets continue to respond to virus resurges, especially as societies begin to open up, but over time we expect these responses will become more contained. Focus is on how the economy recovers and the corporate reporting season beginning in mid-July. This is especially important as the last quarter will cover the full impact of the pandemic and lockdown, markets will have some real data on the impact to date (especially with banks and loan books) and some updated views from CEOs at the sharp end of the economy. How this matches the more elevated expectations in the market will be critical for direction over the coming quarter.

From an ethical and impact point of view there have been positive and negative ramifications from the pandemic. The environment has clearly benefited and some parts of society have learnt that new ways of living, meeting and working, with less travel, is possible. Although emissions are rising again, the peak should be lower. Another positive has been that many environmental projects are now seen not only as viable but also essential for modern infrastructure. This has been a driving force for higher growth expectations in renewable energy, electric mobility, meat substitution and clean technology, and a key factor in rising share prices.

On the negative side, western public transport has had to adapt and has suffered from fewer passengers, also its recovery may be slower as other methods of travel may be favoured. Likewise the pandemic has had a disproportionate impact on the developing world, impacting microfinance, something we see as a short term rather than a structural issue.

The Megatrends

Even before the pandemic struck, the fossil fuel, automobile, airline and commercial real estate sectors were vulnerable. These are major sectors where share prices have not recovered. The largest US shale group has filed for chapter 11, and many have been forced to write down their stranded assets. In contrast, renewable energy shares have fully recovered despite lower electricity process. Tesla, the trailblazer for electric cars, is now more valuable than Toyota, becoming the world's largest car company by market cap. The environment has clearly benefited, as has better food and especially meat replacement products, as meat processing plants have been hotbeds of COVID-19.

There will be some substantial changes in the way society operates, including the possibility of less consumption as people change the way they work. Ironically this may help countries like the UK, which were facing labour shortages in some areas as workers redeploy and more technology is embraced.

We expect the next quarter to be painful, as a number of jobs will be lost before new ones are created. Some social issues have also come to the fore, not just around inequality but also on the social aspects of work. Amazon, for example, have faced some strikes around labour conditions and for their reaction to whistleblowing. There will be a great deal of analysis to come about how companies have behaved during the pandemic, and this will be an interesting yard stick to compare ESG boxes that are ticked, to how they have acted in reality.

The Changing Geo-political spectrum

The crisis has accentuated and exacerbated geo-political concerns, highlighted by the vaccines and information flow in the crisis. The Sino-American trade spat continues and has moved into social media and technology. US-European relations are under strain, again with technology companies being the focal point as Europe looks to raise taxes in this area.

In essence the increasing dominance of technology is at the heart of tensions. Sped up by the crisis and at a time of significant political weakness in the US and Europe. The US election for November is now a very close call, and markets are only beginning to grapple with this. Political leadership in France has suffered a recent electoral blow and the German government remains hamstrung and is limping into its 2021 election with equal uncertainty. Meanwhile China and Russia are seeing their regimes consolidate power.

These tensions will continue to rumble on in the background and play out in certain sectors and companies, many unconnected to the areas we focus on. Although it is a risk that we need to keep an eye on as we approach some key dates (US election, Brexit) towards the end of the year.

Outlook

Exiting the current pandemic situation is about the only certainty we have for the coming quarter. Regardless of the virus, society will not remain in lockdown and this coincides with a number of key geo-political events in the last quarter of the year. Looking at equity index levels it would appear markets have priced in the recovery, but a deeper look reveals it varies from sector to sector, and in essence this correctly reflects expectations.

Our biggest short term concern is some of the most influential names in the markets (Apple, Amazon, Alphabet, Facebook, to name a few) are more vulnerable to some of the geo-political risks and high market expectations. This may make markets a little more volatile and may impact these sectors. Whilst these are not areas we are invested in, they will make the headlines and influence sentiment.

We have seen the environmental benefit from the lock down, and now environmental companies are sought after as they are one of the few sectors where genuine economic growth can be expected for the medium term. Over the coming quarter we expect social issues to come more to the fore. How companies behave and handle their staff, customers and other stake holders over the coming months.

Our focus over the next few months will be more cautious, something that underlies the higher cash levels we are holding, but we will also be more focussed on the key impact investment areas, where despite short term volatility, we expect longer term growth to accelerate.

Some key ESG and Impact issues

At the heart of how we invest remains being invested in companies that make a positive contribution to the environment and society. Although ESG has become a more significant part of the global markets, how it is applied can lead to different results.

A company can have a good ESG score, but that does not make it a good investment. This could be for straight forward financial investment reasons, and this happens quite often. More relevantly though it could be down to more qualitative reasons.

We have always regarded ESG data as good quantitative information but not enough to determine whether a company meets our, and importantly your, expectations. A recent example would be Boohoo. As a company it had the same ESG score as ASOS, but other sources we looked at rated ASOS higher and therefore for a while we invested in ASOS but not in Boohoo. The recent negative headlines surrounding Boohoo justifies our reliance on wider sources of ESG information. Another relevant example would be Amazon, it features in a number of ESG funds, despite the fact there are a number of significant social issues that mean we would not consider investing in it.

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