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Coronavirus
Questions and Answers

Q and A with Sanjay Rijhsinghani

Sanjay Rijhsinghani, Partner and Head of MPS, provides answers to key questions surrounding coronavirus and the impact on global markets. These answers may be helpful when you are having critical conversations with your clients.

Has the market 'priced in' coronavirus?

As we now know, global markets are struggling with the problem of 'pricing in' the various uncertainties posed by coronavirus:

- how fast the virus spreads;
- the severity of the virus;
- what further restrictions will have to be imposed by Governments;
- what will the ultimate global impact of the virus be; and
- can any of the adverse global impact be offset by fiscal and monetary policy?

Until the epidemic is sustainably slowed, these uncertainties will remain. What we need to see is what we have witnessed in China and South Korea – a fall in the rate of acceleration of accumulated cases.

What else is affecting global markets?

Whilst, understandably, we all seem to be fixated on coronavirus, there are other areas concerning the markets – namely, the fall in the oil price and the threat of a global liquidity squeeze. Fortunately, Central Banks across the globe have been quick and proactive in addressing the latter. The fall of oil will undoubtedly have a detrimental impact on a number of industries in the short term, though over the medium to long term this should benefit some of the large oil importing nations such as China and India.

After such a prolonged bull market, should we not have foreseen a correction?

A lot of you have heard me say (in the recent past) "bull markets do not die of old age." It is true that since the onset of Quantitative Easing (QE) and the low interest rate environment adopted post the financial crisis, portfolios have enjoyed a supportive climate and such tailwinds resulted in attractive gains amongst both equities and fixed interest securities. As we entered 2020, corporate earnings were still beating analyst expectations, interest rates remained low, dividend yields were attractive (relative to bond yields and cash deposits) and whilst not everything that was hoped for, the Chinese/USA trade deal was better than a no deal. Post Boris Johnson's resounding victory, a new post Brexit impasse was dawning and new trade negotiations beckoned and offered hope. Price to Earnings ratios (P/E), the yardstick for value, whilst not looking cheap did not look too expensive either (some would even argue they looked cheap when taking in to account inflation, interest rates, and bond yields). All these factors were complimentary and underpinned indices. We even felt that this year (2020) should enjoy global GDP growth at levels that were higher than what we saw in 2019 – especially as a number of uncertainties that concerned markets in 2018 had been addressed in 2019, paving the way for some healthy global growth this year.

When news of coronavirus initially surfaced, why didn't markets react?

When news arrived in January, the virus appeared to be relatively localised to one region of China and was not causing widespread paralysis throughout that country. With that in mind, the vast consensus believed coronavirus

could be contained. Whilst there was talk of supply side disruption, it was not deemed to be a catalyst for huge economic disruption on a global basis.

The acceleration of alarm, panic and subsequent financial market turmoil came when the virus and the speed of contagion reached European shores, with Italy showing western economies how virulent it was. Throughout history, markets have shown how dispassionate and callous they can be, with monetary (interest rates) and fiscal (tax and spending) policies providing support despite human suffering. It is worth noting that whilst coronavirus dominates market thinking, the spat between Russia and Saudi Arabia surrounding the price of oil compounded the negative sentiment. This provided another layer of concern, particularly as the oil companies are significant constituents within the FTSE All Share, thereby exacerbating market falls.

After the initial declines in global indices, the Federal Reserve intervened and markets in the US recorded a positive return in the week they initially lowered interest rates. This indicated that using economic levers, such as interest rates, would act as some form of prop for markets. The subsequent speed and volatility of market movements post that initial reaction naturally made us address our thinking. Throughout many periods of economic and political stress, history again shows that retaining internationally diverse companies in sound sectors of the global economy bears fruit as the turbulence passes. Once a specific holding, or numerous stocks, are sold the timing of re-entry is notoriously difficult as concerns and reasons to delay will always persist. In times of increased volatility, the adage "it is time in the market as opposed to timing the market" which again has proven to be the most advantageous strategy to adopt. We still hope/expect that Governmental 'bazooka' policies will lend some support to markets in coming weeks.

Why should we not sell now?

Essentially, markets are panicking because investors are struggling to model future cash flows, both over the shutdown period (potential of three months or more) and beyond. It is important to note that the companies held in your portfolio are predominantly those with high recurring cash flows, those with strong balance sheets and lower levels of leverage which should be able to weather the economic stress we are likely to endure over coming months.

Whilst in theory, selling out of portfolios now and re-entering when there is more certainty is a good idea, timing the market is extraordinarily difficult. To illustrate this point, the below chart demonstrates the impact of missing the best 10 days of the FTSE All Share Index over a 20 year time frame, proving it is time in the market that is beneficial in the long run.

Will dividends be cut?

Unfortunately, we do believe we will see a wave of dividend cuts.

One of the features of bear markets since 1987 has been that despite indices falling, companies on the whole maintained their dividend payments. Those companies who did erase or cut their dividends tended to be sector specific, like the banks in 2008 or the telecom stocks in 2001. A feature of UK markets is the heavy reliance on

dividends, as opposed to the US, where more earnings are retained by management and subsequently reinvested for future growth.

This time around more than £400m of expected pay-outs have already been abandoned by FTSE350 companies with many more likely to follow suit. The consequence of cash flows drying up, even if temporary, will be companies operating at a loss. It will be during this time when businesses look to their credit facilities and cash reserves. Management teams will likely be forced to suspend or cut dividends, which are paid in cash, to ensure reserves are not depleted. Not all sectors/companies will be affected to the same degree, which is why our analysts are providing regular updates on balance sheet strength and dividend cover.

The significant fall in the price of oil since the Saudi Arabia and Russia spat further places a huge strain on the profits of oil companies and make a dividend cut by Royal Dutch Shell and BP almost inevitable. How long before dividends pick up again depends on how long and severe the impact of the virus will be on global growth. Arguably, if (for whatever reason) the virus 'disappears' within the next 4 to 6 months, we could see quite a rapid recovery in corporate dividends.

As matters become critical, what are you going to do now in portfolios?

Financial markets are markets of anticipation, looking not just at the immediate impact but trying to gauge future outcomes. In times whereby emotion overrides rationality, markets tend to overreact, be that on the way up (think of the dot com boom) and on the way down (market fall of 1987). Whilst it is an easy strap line, history shows that investors have to remain calm and rational.

We therefore continue to hold our nerve, retaining a mix of asset classes and keeping faith in companies with sound balance sheets and in sectors which we still believe offer attractive medium and long term outcomes. The combination of bonds, cash, absolute return funds, etc. has provided portfolios with diversification, hence sheltering the portfolios from falling as much as UK and global equity indices.

We also expect that the combination of fiscal and monetary stimulus, along with the prospect that interest rates may not rise for many years, will help stabilise markets. It is unfortunate that Governments like that of the US have not announced big and strong enough stimulus packages. At times like this, with the 'rule book' not meaning a thing, we expect Governments of major developed nations to announce a 'one-time' stimulus of around 25% of their respective GDP. This, we believe, will provide workers with around 6 months' pay, and companies with interest free loans for at least a year. So far, the commitment (stimulus package) from various Governments ranges from 10 to 15% of GDP.

Is this crisis different to other market falls?

Yes, it is. Having been employed in financial markets since 1993-4, I have never seen a medical event lead to such social, financial and market turmoil. In 2003, SAR's spread around the globe but by the time it was contained, it had infected approximately 8000 people and killed almost 800. It did not have the reach or widespread disruption that the Coronavirus has had so far.

Throughout history, prolonged stock market falls have tended to originate from speculation (2001), excessive leverage (1929), interest rates and inflation (main reasoning for 1987), political risks and punitive tax regimes with panic then setting in. A medical pandemic creating global turmoil is unprecedented.

How long will markets be in the doldrums?

We want to provide assurances, but to predict with any certainty would be unprofessional and would merely be words to placate. However, by looking back at previous bear markets (falls of over 20%) and with the human emotions of greed and fear remaining constant, whatever generation one resides in, it may provide clues and help answer the question.

It took approximately four years for indices to recover from the 1929 crash, two years from the selloff in 1987 and some four years post the financial crisis of 2008. It is important to remember that index levels and monetary values of portfolios are two different things. As mentioned above, the diversity of investments within portfolios should insulate and lessen falls when compared to the global indices mentioned by the media. As an aside, such falls in global indices are a powerful argument against low cost tracker funds and support a more active management approach to investment portfolios.

What industries will thrive once coronavirus is under control?

Whilst our day-to-day lives will return to some semblance of normality, once the impact of the virus eases we foresee a further acceleration in the trend of digitalisation. Businesses, like ours, have managed to continue as normal with

the majority of the work force at home. This is thanks to strong IT infrastructure, which was already mobilised for a shift to working remotely and us going 'digital'. We therefore are focusing efforts on those companies who have correctly focused on enhancing their products and offerings by going digital. This trend is not just played through obvious IT companies (such as Microsoft, Apple or Adobe), but any business which is seeking to evolve with the times.

Elsewhere, digital streaming, food delivery, online gaming, education and medical platforms have all seen a surge in demand during this troubled time as behaviours change. The last decade has witnessed the rise of Artificial Intelligence (AI), robotics and the embracement of sustainability. As we enter the third decade of the twenty first century, we can expect further industries to thrive as the world reflects on the sheer speed, as well as the economic and personal consequences, of the Coronavirus pandemic.

Globalisation has been beneficial for worldwide economic growth, but the massive impact of coronavirus may for example, lead to countries wishing to become more self-reliant. Whilst the crisis has and will cause many problems, it will also create opportunities for innovation and it is important that we can identify companies who will benefit from changing behaviours.