ALBERT E SHARP

INVESTMENT MANAGEMENT & STOCKBROKING

MARKET COMMENTARY

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Double Dip Dilemma

Most regions saw a continued recovery in equity markets during the course of May, with the US now back into positive territory, year to date. The UK continues to lag, due to its heavier exposure to banks and oils. Asia has been mixed, with India struggling more than most, although the SENSEX rallied hard in the last few weeks of the month as COVID-19 restrictions were eased earlier than some expected. Japan however has had a storming month, boosted by a favourable currency movement. In fixed income, bonds were broadly flat although some government inflation-linked issues saw yields squeezed further as demand remained high. Commodities continued their volatility with the crude spot price almost doubling following its parlous negative futures position several weeks ago. Sterling closed lower for the month, but is still notably higher than the nadir of $1.15 earlier this year and with the potential for a no-deal Brexit looming ever closer, there is scope for renewed volatility as the story unfolds and regains airtime.

In conversation with clients there is a definite concern that the bounce back has been overdone and when we all go back to work, the reality of the situation, i.e. mass unemployment and the effects thereof will hit home and markets will suffer a double-dip. Another topic that has emerged is a concern over the "death of Buffett-style investing" following a number of press articles recently and the divergence of 'value' and 'growth' stocks. We think the two subjects are linked.

The back page chart shows that, in sterling terms, the bounce back since late March has shades of grey and the UK, though well off its lows, is still under water. What this also doesn't tell us is that there is a clutch of high-profile names including Carnival, Royal Bank of Scotland (RBS), Rolls Royce and Centrica that are still down over 50%, year to date. Conversely any overseas exposure has been helped by a generally weaker sterling, in which case internationally diversified portfolios will have benefitted. This is particularly the case in the US with the tech-heavy NASDAQ up well over 10% year to date.

This might seem very peculiar given that we are headed for the worst recession for over 100 years. Data regarding unemployment, government debt and retail spending, for example, worsen by the day. Indeed at the time of writing, the NASDAQ has hit an all-time high at precisely the moment that the US recession has become official. So why are stock markets moving in an opposite direction to the broader economy? The short answer, as Sean Markowitz at Schroders reminds us in a useful article here, "Equity returns across all companies and countries barely have any correlation with economic growth historically … the opposite is true of stock prices and earnings."

He goes on to observe that the initial fall in the S&P-500 was close to the anticipated drop in earnings for 2020, but now that the outlook for 2022 is only 11% lower than they were at the start of this year, "After the recent rebound, that 11% drop in earnings forecasts is the rough equivalent of the move in the stock market."

In other words, the stock market is forward-looking and has a knack of sniffing out a recession in advance. According to National Bureau of Economic Research since 1950 the average lead time of the S&P-500 moving into bear-market territory and a recession arriving was 7.9 months. Clearly, this coronavirus-induced downturn is an exception given the surprise nature of its impact. Following an initial period of panic when there was no visibility as to how this crisis would play out, a sense of relative calm eventually returned in early April as confidence regarding expectations of future corporate earnings improved – as a result, markets rallied.

And which companies fared the best? Since the low on 16th March, the big names in technology such as Apple (+73%), PayPal (+67%), Microsoft (+61%), Amazon (+42%) and Facebook (+35%) have enjoyed a great run, unlike JPMorgan (-5%), Chevron (-22%), Ford (-27%) or Hertz (-100%). Covid-19 is clearly an opportunity for some companies and a threat to others – the fact that the winners cluster in the technology category is largely coincidental.

Maybe it is most important to remember that the stockmarket is not a reflection of the economy. The tech names mentioned above comprise almost one fifth of the S&P-500 (a market capitalisation-weighted index), yet only represent 4% of GDP. Small businesses – the major victims of the pandemic – account for over 40% of GDP and have zero representation in the indices. The same can be said in most countries for that matter.
In which case, leaping to conclusions can be dangerous. Worries that your local high street is going to be a ghost town is no reason to start selling your shares in Amazon. That said, you might take the view that Amazon shares are overpriced, but that is a totally separate conversation. In the table overleaf, we attempt to see how valuations have changed.

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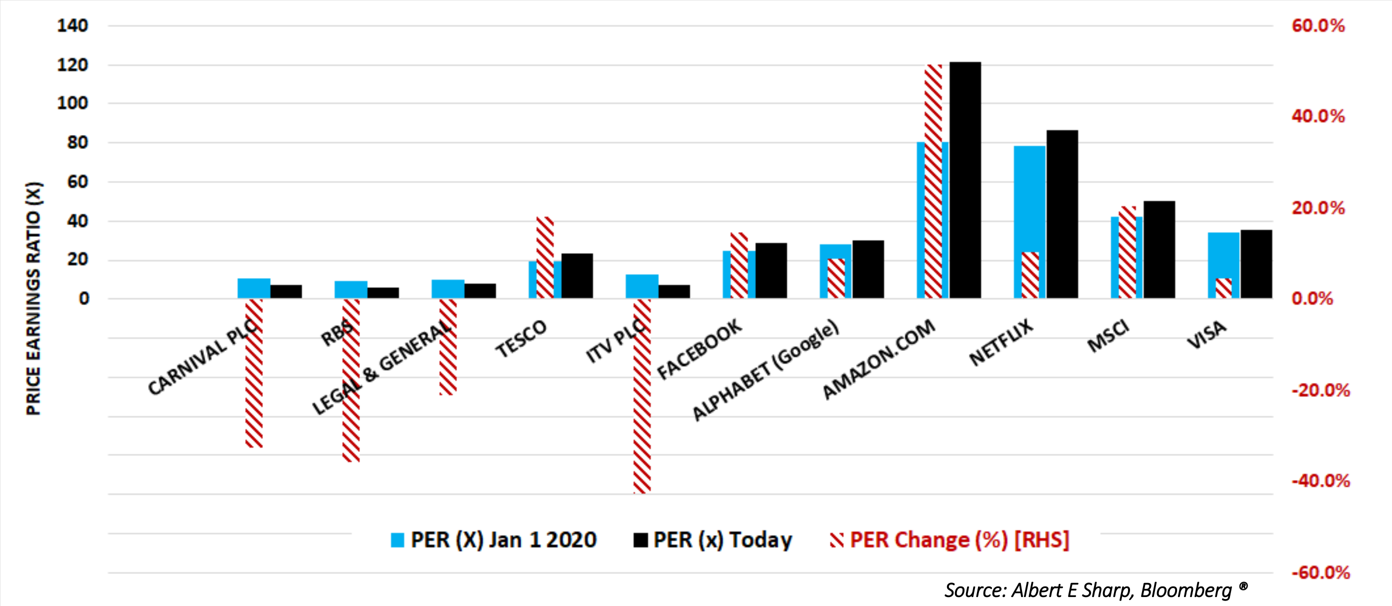
Covid-19 Premia and Discounts: The Importance of Resilience



What this highlights is that since the beginning of the year, some companies have seen their valuation expand, as measured by the historic price earnings ratio (PER) and others contract. A higher PER today suggests that investors are now prepared to pay more for a given level of earnings. For example, Amazon started the year on 80x 2019's earnings and is now trading on 120x 2019's earnings, i.e. 50% higher. The question to answer here is whether or not Amazon's prospects have been so enhanced that the shares warrant being marked up by such a large amount.

Admittedly, using the P/E ratio is a very quick and dirty method of analysis, and factors such as return on capital, reinvestment rates and debt financing (if any) should come into this. Suffice to say that the deeper one digs, the US names chosen above tend to fare considerably better on practically every count. What seems certain is that the companies on the right of the chart look set to not only survive Covid-19, but flourish and the valuations reflect that to some degree. In the event of a second wave we would argue that these shares will hold up best once again, partly because they did so well the first time around.

The conclusion that we draw from this is that companies who can easily demonstrate resilience are being rewarded as reflected in the share price right now. It is tempting to call it a *Covid-19 premium* due to the events of the last few months, but we would argue that it goes deeper than that.

This resilience tends to be a function of being able to provide a mass-market product or service with limited competition, due to brand strength or intellectual property, for example, supported by a first-rate management team.

In other words a high quality business model. We think it then becomes quite easy to spot the high-quality companies in the list from the less resilient companies, which one might say are seeing a *Covid-19 discount* built into their share price. Again, we are tentative using this terminology because it suggests that these premia or discounts might be fleeting or temporary in nature. Crucially, when a company can demonstrate an enduring competitive advantage, the premium should also be enduring. In our model portfolio service, this basic concept is at the core of our investment philosophy – stick to quality. Not only has the principle put us in very good stead during the coronavirus crisis, but also for as long as we remember, empirically demonstrated by our historic performance record.

The counter argument is along the lines that investors maximise their returns by ensuring that their entry point is when valuations are at their lowest. Bombed out situations tend to be a perfect hunting ground for *value investors*, who like to see low P/E ratios and low price to book values. Now, we are not getting drawn into the growth vs value debate here, largely due to the fact that we regard this as a futile pursuit that falls at the very first definition. A value investor is someone who looks to buy shares in a company trading below its intrinsic value. This concept was developed by Benjamin Graham in the 1930s and has intuitive appeal to this day because surely *everyone* wants to buy shares in a company at a discount. By this definition we would regard ourselves as value investors too. The problem is that our portfolios contain many holdings in what are classified as growth stocks.

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Amazon is constantly referred to as a growth stock despite the fact that its reported earnings frequently exceed market expectations, leading to a subsequent leap in the share price. This is another way of saying that the shares have frequently been trading below their intrinsic value. Buying 'cheap' companies is only worthwhile if they revert to a higher fair value or, even better, become 'expensive'. By definition Amazon was cheap back in March 2016 when analysts were predicting $200bn net revenues for the year to December 2018, because in the event they topped $230bn, with EPS beating the 23 cents consensus forecast, coming in at 27 cents. Underestimating earnings at that time by 20% meant that the intrinsic value was not fully recognised, but because future cash flows were now expected at a higher level the share price went on to rise by 250%. However you look at it, in March 2016 Amazon shares were amazing value. But that doesn't suit the growth vs value narrative at all well.

Yet this hasn't stopped a steady stream of media articles declaring that value investing is now defunct. On 23rd May, Ali Hussain in the Times went one further with a double page spread asking "Could this be the death of Buffett-style investing". This was a deliberately provocative piece, successfully catching eyeballs, because Buffett was famously tutored by Benjamin Graham and went on to be *the* leading protagonist for value investing.

However, Hussain erroneously earmarked Neil Woodford, Mark Barnett and several other underperforming high-profile managers as Buffett-style investors. WRONG! This couldn't be further from the truth, not least because Buffett has continued to outperform the wider market for as long as one can remember and has seen his net worth increase by a third since March 2016, whereas Mark Barnett's Invesco Equity Income fund has fallen over 20%. Hussain could have made reference to the CFP SDL UK Buffettology fund, which by definition is based upon Buffett's investment style, but given that it is up over 70% over the same period certainly doesn't suit his argument very well.

It is of course feasible that we have a double-dip, a second wave of panic selling, but it seems most likely that this would be triggered by an unexpected, external event. And predicting something that is unexpected feels like an oxymoron, certainly a game we would not like to get drawn into. Instead if we stick to our system, maintain discipline and hold our nerve, this will see us through.

Peter Lynch, veteran US investor says that "In the stock market, the most important organ is the stomach. It's not the brain. It's a question of what's your tolerance for pain. There will still be declines. It might be tomorrow. It might be a year from now. Who knows when it's going to happen? The question is: Are you ready — do you have the stomach for this? Most people do really well because they just hang in there."

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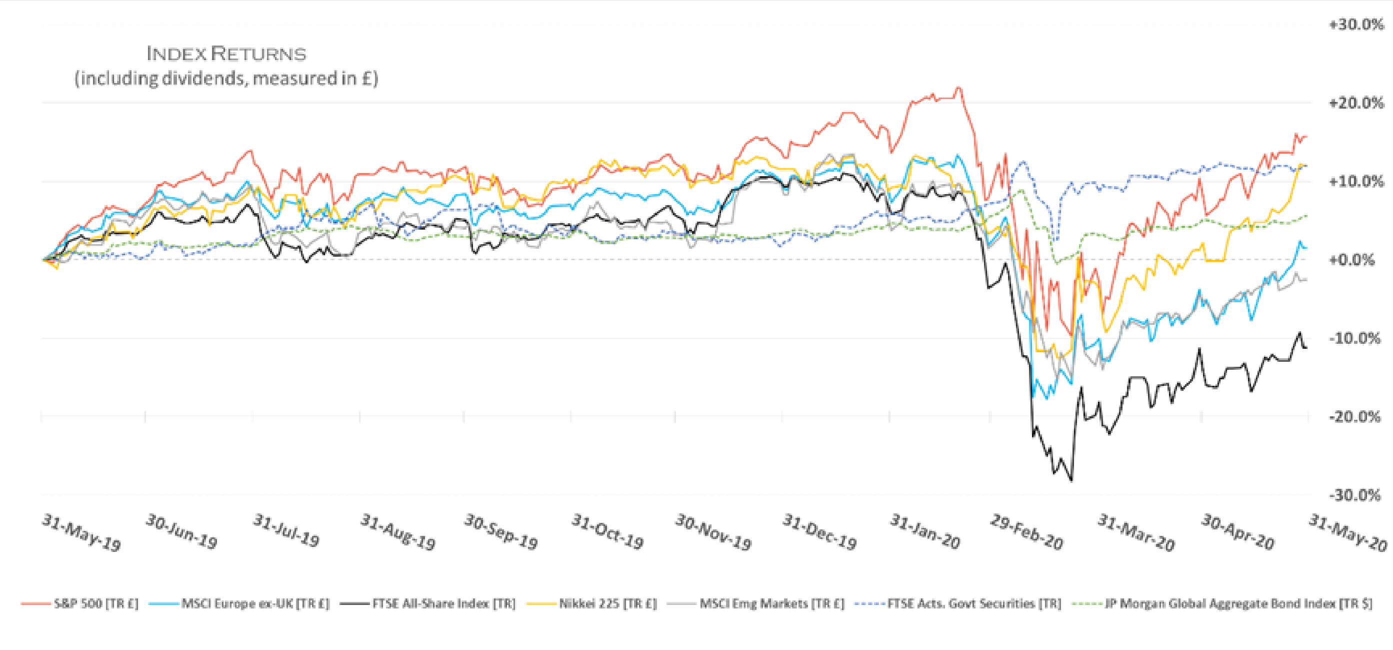
Index Returns

Index	Region/Asset Class	31 May 2020	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	6,076.6	+3.0%	-15.2%	-20.9%
UK Mid Cap	UK	488.1	+8.7%	-5.5%	-16.1%
UK Small Cap	UK	4,864.7	+3.9%	-12.4%	-17.9%
Dow Jones Ind Avg	USA	25,383.1	+4.3%	+2.3%	+4.0%
S&P 500 Index	USA	3,044.3	+4.5%	+10.6%	+12.5%
NASDAQ Comp.	USA	9,489.9	+6.8%	+27.3%	+27.5%
Nikkei 225	Japan	21,877.9	+8.3%	+6.2%	-1.5%
Euro Stoxx 50	Europe	3,050.2	+4.2%	-7.0%	-10.5%
CAC 40 Index	France	4,695.4	+2.7%	-9.8%	-13.0%
DAX Index	Germany	11,586.9	+6.7%	-1.2%	-8.1%
Milan Index	Italy	18,197.6	+2.9%	-8.1%	-16.5%
MSCI Emg Mkts (£)	Emg Mkts	535.7	+2.8%	-2.5%	-6.0%
IBOVESPA Index	Brazil	87,402.6	+8.6%	-9.9%	+13.9%
IMOEX Index	Russia	2,734.8	+3.2%	+2.6%	+18.8%
S&P BSE SENSEX	India	32,424.1	-3.8%	-18.4%	-8.2%
Shanghai SE Comp.	China	2,852.4	-0.3%	-1.6%	-7.9%
Hang Seng	Hong Kong	22,961.5	-6.8%	-14.6%	-24.6%
UK All Property	UK Property	121.5	-0.9%	-8.8%	-8.9%
UK Conv Gilts	UK Gilts	4,226.8	+0.0%	+12.0%	+16.6%
UK Index linked Gilts	UK IL Gilts	5,816.2	+4.7%	+9.2%	+18.7%
JPM Glob Agg. Bond ($)	Global Bonds	522.3	+0.4%	+5.6%	+8.9%
iBoxx Non-Gilt	UK Corp Bonds	373.9	+0.9%	+6.3%	+10.8%
WTI Crude ($/barrel)	Oil	35.5	+88.4%	-33.7%	-47.1%
LMEX	Base Metals	2,470.9	+3.3%	-10.6%	-26.3%
Gold Spot ($/oz)	Commodities	1,730.27	+2.6%	+32.5%	+33.3%
S&P Agri & Livestock	Agriculture	568.05	+1.4%	-18.9%	-26.8%
£1 = US$	Currencies	1.23	-2.0%	-2.3%	-7.2%
£1 = €	Currencies	1.11	-3.3%	-1.7%	-2.2%
£1 = Yen	Currencies	133.08	-1.4%	-2.7%	-8.0%



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