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Are the bears in hibernation, or just napping?

The groundwork has been laid for a rapid recovery, but significant risks remain

The global equity benchmark has climbed almost 40% since its March low and is now around 10% below its all-time high reached in January. On some measures, equity investors are today demanding less compensation for the risks to 2021's expected corporate profits than they did at the start of the year, before most of us knew what a coronavirus was. That's not because expectations for 2021's profits set a very low bar; the consensus among analysts is that 2021 profits will surpass 2019's – a full 'V-shaped' recovery. We know that many of our clients find that quite mystifying. After all, don't plenty of questions remain about the long-term impact of COVID-19?

Listening to the 'bull' case

Optimistic investors focus on the government stimulus, which has been nothing short of stunning. New fiscal injections continue to be announced or amplified. The speed, scale and scope of the policy response is important because the greatest historic failures to recover from a major shock – such as the US at the end of the 1920s, or Japan in the early 1990s – are characterised by their absence. Our analysis suggests that most economies can afford the stimulus – we've written before about how government debt is easy to misunderstand.

The only constraint is inflation. As we detailed at length in our April Investment*Update*, inflation is a risk to be monitored closely, but one to which we assign a low probability. Historically, pandemics have tended to hit demand for goods and services more than their supply, which is disinflationary. China has repeated that pattern as it has recovered this year. Printing money to stimulate the economy is not new, it was used extensively over the last 10 years and yet for most of that time inflation has struggled to get near most central banks' 2% target. For persistently high inflation to occur, we should ask is the desire to invest really likely to suddenly increase relative to the desire to save as a result of this crisis? Only then would today's interest rates – the market mechanism for bringing desired saving and investment into balance – be too low to maintain stable prices.

As well as stimulus from treasury offices, central banks have flooded economies with money. Interest earned from holding cash is minimal, and equities are thereby made *relatively* more attractive. The US Federal Reserve (Fed) has injected $2.9 trillion (13.5% of US GDP) into the financial system since the end of January; the Bank of England £210 billion (8.2% of UK GDP). And there's more to come. Quantitative easing programmes have been increased in the UK and the Eurozone; the Fed has huge amounts of spare capacity in its lending facilities should distressed companies or investors require funds.

In short, ample liquidity has propelled financial markets, reduced financial stress, prevented liquidity problems from making good companies insolvent, and increased the likelihood of a decent recovery. If the recovery falters, there's plenty more money central banks have already earmarked. Market bulls say this underwrites the economic recovery and their investments.

And the start of the recovery has exceeded expectations, especially May's retail sales. For the US, we've made use of some innovative high-frequency datasets (from providers of payment, job-posting and mapping software, for example) to track the recovery in real-time. These indicate that the retail recovery continued to be strong in June.

Guarding against the 'bear'

Ample liquidity and a great start to the recovery introduce what we call 'upside risks' to our base case. Where we see value, we think it makes sense to add selectively to more cyclical (economically sensitive) companies with high-quality balance sheets and cash flow statements. We are long-term investors, after all. While cyclical sectors have underperformed significantly since the January peak in the market, companies within these sectors which rank highest on measures of quality (such as interest coverage or liquidity ratios) have actually outperformed the broad market.

Overall, however, we believe there are significant risks to investment returns over the next six to 12 months. Another leg down is not a certainty, but it should be guarded against by defensive positioning and favouring companies that display 'growth', 'quality' and 'defensive' characteristics.

We do not believe that markets are offering sufficient compensation for the still elevated risks to tomorrow's earnings. Calculated with expected 2021 earnings, PE ratios (prices relative to earnings) in most markets are much higher today than they were at the start of the year. Should 2021's earnings really be discounted back into today's prices at a much lower rate than they were in January? For sure, some of this is about the fall in the 'risk-free rate' due to monetary policy, but our

measure of the equity risk premium – the extra compensation over and above that on offer from government bonds – is also back to around the 2018/2019 average.

Few economists expect the aggregate demand in major developed economies to regain February's level of output in 2021. Indeed, the International Monetary Fund (IMF) revised down its forecasts substantially at the end of June, citing damage to industry as a result of lockdown, and decreased productivity as businesses ramp up hygiene and social distancing protocols. The IMF expects advanced economies' aggregate output to fall by 8% in 2020 and rise by 4.8% in 2021.

Yet consensus forecasts expect profits to significantly exceed 2019 levels in 2021. This is very optimistic, especially when you consider the effect on energy sector earnings from a low oil price, the effect on financial sector earnings from zero-interest-rate policies and ultra-low bond yields across maturities, and the effect of social distancing on an already beleaguered retail sector. Of course, we believe many of our favourite companies are well placed to increase market share or productivity faster than the broad economy. But not the whole market. Since the 1970s, many companies have grown faster than the economy by decreasing workers' share of income, but that's less likely in the current political climate, and with many institutional investors, pleasingly, shifting to more responsible investment.

The risks to the recovery

It is important to realise that whether the recovery turns out to be swift and decisive (V-shaped), or slower or more stuttering (U or W-shaped), the data in the current, earliest phase will look more or less the same. In other words, we shouldn't take for granted that two months or so of good data means that an optimistic scenario is definitely on the cards.

There are three major risks to an optimistic scenario: (i) high inflation, requiring policymakers to abandon their stimulus measures; (ii) a 'second wave' of the virus, and another lockdown; (iii) persistent unemployment, with a detrimental feedback loop via high precautionary saving.

We've addressed concerns about inflation. We think a second wave is more of a risk. These are commonplace in influenza pandemics, where subsequent waves can be progressively worse, such as the 1918 Spanish flu or the 1968-70 flu epidemic in the UK. But coronaviruses have not tended to mutate in the same way: SARS in China in 2003 had no major second wave. And scientists have said the mutations to the SARS-CoV-2 virus that causes COVID-19 have been numerous but rather *small* so far, leaving its severity little changed.

The good news is that we aren't seeing a tick up in the European countries that people worried came out of lockdown too soon, such as Denmark, Austria or Spain – and Spain reopened factories in mid-April. The bad news is that we have seen a significant surge in new cases in southern and western American states, sending the US aggregate daily new case rate to a record high. This is not solely about more testing; the proportion of tests coming back positive and the number of hospitalisations are also rising sharply.

It's possible that a second wave isn't accompanied by a full lockdown, either because the public's preferences have changed or because the government is better able to contain the virus without one. But it's a risk. Our simulation of the UK economy, using a 45-sector breakdown, suggests that going back into lockdown for just one more month would be devastating, making it very likely that a large proportion of the lost output would become permanent.

The other big risk to the economic outlook is that unemployment will stay higher for longer. UK unemployment data is published with a considerable lag, but we estimate from the data on universal credit and other claims that the headline unemployment rate is likely to be around 8-10% at present. With 8.7 million workers furloughed and 2.3 million self-employed receiving income support, government schemes have done a monumental job at curbing unemployment so far. But there is a risk that, as they are withdrawn, some firms might have no choice but to dismiss staff, if indeed they can survive at all. The unemployment rate would rise by c.1% for every 3% of the workers currently furloughed or receiving self-employment support who become unemployed.

The latest Bank of England Agents report and the Decision Makers Panel survey contain some rather worrying signs of what might be to come. The Bank's Agents found a very large proportion of companies intending to reduce employment over the next 12 months, far in excess of the signal sent during the depths of the financial crisis. The Decision Makers Panel suggests company executives are radically altering their hiring plans relative to what they would otherwise have been. The 3-month/3-month rate of change in the vacancy rate is -20%, it didn't exceed -5% in the financial crisis. Whether these are temporary aberrations in the survey data or the start of a real trend is difficult to say at this stage, but it adds to the argument that persistent unemployment is a risk that we should be guarding against.

All three of these risks could increase the rate of corporate failure, which we expect to increase regardless in the next six months. Wirecard captured many headlines in June and we expect a few more high-profile defaults to occupy financial journalists. This shouldn't necessarily be taken to mean that the risk of a strong recovery is receding; corporate failure is a lagging indicator of economic health. But it is a reminder that investors should focus on quality, cash-compounding companies for the time being. The old Warren Buffet saying comes to mind: "You only find out who is swimming naked when the tide goes out." And with all of that

government support, the tide is taking a little longer to go out.

The outlook varies by location, so we'll finish with some thoughts on recent regional developments.

Japan is relatively well positioned
Strong balance sheets carrying ample cash and reserves are easy to find in Japan, and explains, in part, why the Japanese equity benchmark has been one of the best performers in 2020. The outlook for dividends is more hopeful in Japan than many other regions. Since Prime Minister Abe took office in 2012 and instigated a sweeping reform programme with a particular focus on improving returns to shareholders, Japanese dividends have grown 108% compared to 42% in the UK and 49% for the MSCI World global benchmark. Indeed our analysis has found that compared to the UK, the US and the Eurozone, Japan has the lowest proportion of dividend payers with a coverage ratio (profits divided by dividends) less than 1, as well as the least levered dividend payers (and so the least susceptible to balance sheet problems causing payouts to cease).

Japanese stocks have also done well because the government has delivered the largest fiscal stimulus, when measured as *direct* fiscal spending and transfers (excluding tax deferrals, etc.). The Bank of Japan is injecting huge amounts of liquidity, as usual. And finally the Japanese benchmark has done well because of its relatively high share of technology stocks.

US: a catalyst for digitisation
We agree with the consensus that COVID-19 is likely to catalyse the digitisation of the economy. This benefits the US benchmark, which has an even higher weighting to technology than Japan. America's largest corporations, particularly the technologically advanced companies that dominate the Nasdaq exchange, have outperformed this year.

Some commentators profess that US technology stocks are in a "bubble". We disagree. A 'bubble' is defined as a surge in asset prices unwarranted by the fundamentals of the asset. Historically, bubbles have invariably burst with the first recession (remember Buffet's aphorism again). Today, we are experiencing such a shock, but the tech/growth stocks that are supposedly in a bubble are among the assets most likely to get through the crisis with their earnings potential intact. We do not believe this is the early 2000s all over again. The price-to-earnings ratio of the Nasdaq peaked at 92x earnings; today it's 31x earnings. We continue to favour the US for its greater array of growth opportunities and companies with high barriers to entry.

There are some regulatory risks, of course, as we've written about before. And, as with all US companies, they may have to pay more tax if presidential candidate Joe Biden gets elected.

Mr Biden's impact on the market is unclear at present. On the one hand he is likely to end the maverick approach to China and foreign policy that has weighed heavily on business investment, global trade and more cyclical parts of the global stock market since 2018. On the other hand, the Democrats' agenda includes raising corporation tax from 21% to 28%, higher minimum wages, more unionisation, and more regulation. But for these ideas to make it into law, they need to win all four "swing seats" currently held by Republicans in the Senate. That's a tall order. We'll write more on what a Biden presidency might mean for investors in our early July Investment*Insights*.

Europe steps in the right direction
There has been an unambiguously positive development in European politics. The proposed €750bn Recovery Fund is a milestone in that it reflects the acceptance by Germany of both fiscal transfers within the euro area and the use of the EU budget as a genuine fiscal instrument for economic stabilisation. It is absolutely a step in the right direction, and introduces some more potential upside into the outlook for Europe. But it is a temporary solution to an exceptional set of circumstances. It will only be truly stabilising – decreasing once and for all the risk premium demanded by investors to compensate for the threat of political disintegration – if it is extrapolated across time and space in a way that the text of the agreement appears to rule out in principle. Discussions around common debt issuance beyond the pandemic, or about the establishment of a European treasury to control the cost of funding of governments, appear to have receded from the conversation altogether. There is no mention of them in the outline of the deal.

UK: awful news is priced in
Again, politics is weighing on UK financial markets. A 'No-deal' Brexit has become more likely; at best a 'bare bones' free trade agreement (FTA) in goods is expected. Most independent economic researchers forecast UK GDP will be between 3% and 6% smaller in seven to 10 years if the UK and EU sign an FTA. The UK Treasury is even more pessimistic. We agree with them. To be clear, our pessimism is in no way a judgement on whether Brexit is right or wrong for the British people, in all of its many social and juridical facets. It is simply a narrow expression of the empirically grounded difficulty of substituting trade with countries further away for trade with one's nearest neighbours. And the UK really is far away from other potential trading partners.

We'll write to you again with more detail on Brexit and its implications. The good news is that our analysis suggests an awful lot of bad news is priced in for UK assets. Even under an almost unthinkably adverse fallout from Brexit, the pound still looks under-valued. This means, on a three to five-year view, there is more scope for sterling to appreciate than for it to fall, even though we expect a huge amount of volatility in the short term.

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