The second wave

- **2020 First Quarter Market Commentary**

Where should we begin? The rhetorical question begs a response of 'at the beginning'; the problem is that we do not know where that is. We have all moved with extraordinary speed from reading stories of a new form of pneumonia in a part of China probably few of us had heard of, to the suspension of daily life as we know it. It is bewildering. It is therefore no surprise that investment markets are indeed bewildered. So let us try to make sense of what is happening and what may come about as 2020 progresses.

Only time will tell if the near global acceptance of the concept of 'lockdown' was the right thing to do. The experience of the early adopters – notably China – is that it can, at least temporarily, inhibit the spread of the coronavirus. It is also causing terrible economic damage. It is extremely difficult to try to put both of these into a mathematical equation. To do so would risk putting a monetary value against a life. We all hope, of course, that lockdown is indeed saving many, many lives. It has also placed an icy grip on the economies of most of the world.

Everything depends on the progress of the coronavirus. In the shorter-term, we all know how the disease will progress in Europe, the United States and elsewhere. That is not up for debate. The issue is what happens as the world, led by China, starts to lift restrictions. On the one hand, this may be a relatively smooth process, without a second wave of infections. On the other, it may be the snake that takes us back to square one. It is this threat of a second wave of the virus that will determine both our daily lives and the direction of investment markets.

In the absence of this second wave, there are good grounds for a degree of optimism. Isolation will come to an end and businesses will, tentatively, restart. Share prices will rise; not back to January's levels, but probably higher than at present. Bond yields will also rise (meaning that prices fall); again, this is unlikely to be by much, but it will be noticeable. The central banks will be able to rein back on their promises of unlimited money-printing and we shall all nervously climb back onto the horse that had so dramatically ejected us from our saddle.

A second round of infections, in contrast, would take us down a very dark road. Lockdowns would be extended, or reintroduced, and the economic damage multiplied. We would also reason that the world's patience for enforced isolation and widespread financial ruin would pretty quickly run thin. The likely response to that would be the deployment of troops and martial laws. These are roads none of us would wish to be on.

The response by the world's central banks has been genuinely impressive. Lessons have been learned from the mistakes of the Great Financial Crisis. First, the balance sheets of the retail and commercial banks are much stronger than at any time in the previous 10-15 years. Second, these banks are now being encouraged to expand their balance sheets, rather than the disastrous enforced shrinking of them that so exaggerated the post-Crisis recession. Third, the central banks have let it be known that they will make unlimited finance available, should it be needed. This is crucial: the banks need to have the confidence that they all have access to ready money. That way, the credit markets continue to function – in complete contrast to 2007/08. Without the Great Financial Crisis, we may not have been in a position to survive the lockdown.

Even on an assumption of a best case outcome, we should not expect equity markets to return to their pre-virus levels in the near term. We had long argued that those heights were justifiable if the global economy remained benignly dull, with low and steady inflation and growth. That assumption has been firmly torpedoed. The policy response to the virus (note it is governments' policy, not the virus itself) has reintroduced a hugely volatile and uncertain economic cycle. This in turn will dictate a lower valuation for equities than we have seen for a while.

Then we have to consider the unknown risks of the simply extraordinary amounts of money that the central banks have promised. Yes, these will grease the economic cogs in the short-term, but at what risk? Will this finally bring about the return to inflation that so many have feared for so long? Of course none of us knows, but it is a new and additional risk in the post-virus world.

The values of our Portfolios have fallen over the quarter; at the upper reaches of the risk scales, the falls have been significant. The more cautious Portfolios have held their values much better, as intended. In all portfolios, we moved to limit risk ahead of the worst of the market falls, primarily by reducing our equity weights to the minimum for each mandate. There have been notable safe havens – gold and sovereign bonds stand out – while the fall in sterling has been a welcome boost to our investments outside the UK. We have tried to focus our equity holdings on companies with proven resilience and strong balance sheets: those best placed to ride out a temporary unprecedented drop in sales.

There is a greater challenge in maintaining income. Many companies have cut or even passed their normal dividend payments as they protect their own ability to pay their bills whilst sales are so low. It is our natural hope that this will prove to be a relatively short-lived phenomenon, but we cannot escape the reality that providing income from portfolios will be uniquely challenging this year.

The virus will change the world, even if we recover quickly. It has exposed fragilities in business models that neither we, nor others, could have appreciated. Whether for good or bad, we will rely even more on technology versus the physical. Technology's fragility in turn is its reliance on electric power, meaning an even greater need for reliable and local sources of this. The virus will also bring a greater appreciation of the virtues of local sourcing of good and services in general, especially food.

We come to the possibly unsatisfactorily simple conclusion that there is a world and life beyond the coronavirus. We just do not know how long it will take to get there, nor how bumpy the road is that takes us there. Hawksmoor has always been a cautious and prudent investor; we will continue to balance the need to protect the values of our clients' investments with the opportunities that always arise with such severe market disruptions. And finally, we thank all our investors for your ongoing support, especially in these uniquely challenging times.

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