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B Capital Commentary and Outlook Update 3Q2020

After the severe and rapid bear market for equities that could quite easily be described as a crash, the last quarter brought a global sigh of relief for investors as prices climbed back out of the abyss in a stunning recovery which was accompanied by price rises across all asset classes. No doubt the sell off caused by the COVID-19 pandemic was exaggerated but the V-shaped ascent from the March lows has raised new questions for the next stage of the cycle.

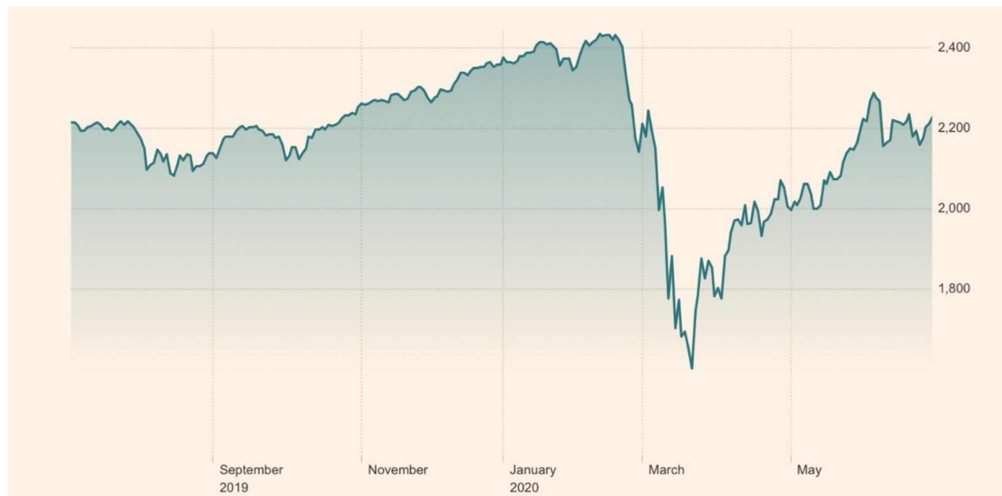

Fig 1 - MSCI World Index (12 months)

The Global Economy - Can It Jump Start?

Model portfolios have recovered almost all lost ground since the start of the year and in early June the S&P500 Index momentarily entered positive territory for the year, if only fleetingly, before dropping back in the last weeks of the quarter. European bourses are still some -14% negative for the year but also greatly improved from values two months earlier, and the MSCI Asia Pacific Index is negative mid single digits at the end of June. Overall the MSCI All World benchmark closed -7.14% down for the first half. Whilst negative, this performance across the regions especially in the US, is very good when placed in context with the news of the global economy. The momentum of price action of the equity markets even suggests that further gains may lie ahead despite the grim forecasts from central bankers around the world.

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The concern now is that prices are running ahead of the earnings reality. Even if investors are looking past the bad news of today and instead are looking to future earnings things are starting to look richly valued. Can we really say that the S&P500 should be close to the January peak when we know how things have changed so much for the worse? The IMF this week just reduced its outlook for the world economy, projecting that it will contract by 4.9% this year. The downward revision was across the board; all of the world's regions will suffer shrinkage. America's output is now expected to fall by 8%, Britain's and the euro area's both by 10.2% and Japan's by 5.8%. Most emerging markets will do little better. China, though, is forecast to grow by 1%.

Economists are always wrong. That's not to be rude about the profession but it is a fact that forecasting the future is no easy feat. With the COVID-19 pandemic still raging and possible stop-start restrictions on business and travel in the short term it is really guesswork as to what earnings in 2020/2021 and beyond could look like. If you haven't got the "E" for Earnings then the "PS" for Price per Share is impossible to validate. What are stock prices related to if no-one knows the earnings?

According to Factset, a data provider, by the end of June more than one third of S&P 500 companies (183) had withdrawn their EPS guidance for CY 2020. Most of these companies cited uncertainty around the impact of COVID-19 as the reason for not providing annual EPS guidance. So, with earnings either an educated guess or with no earnings estimate at all, it seems that stock prices are trading with a high degree of uncertainty but boosted by the Fed, ECB, BoE and other central banks' monetary stimulus. It worked in 2009 and has certainly pushed asset prices higher quicker than anyone expected today.

The concern is that the economy cannot catch up with prices and in the end the high correlation between EPS and price per share will revert. That could mean a correction of prices downward to meet the EPS reality. On the other hand earnings could be revised up sharply in which case the current rally in markets is less of a worry. This is where the forecasting becomes difficult as we simply do not know how the pandemic will evolve over the next year.

Outlook

It has paid not to be too gloomy though, as the global economy was in relatively good shape before the pandemic and as a result many more companies will survive and even thrive while some weaker ones will not prevail. In the US, for example, of the 49 companies in the S&P500 Index that have issued EPS guidance for Q2 2020 so far, 22 of them have issued positive EPS guidance and 27 have issued negative EPS guidance. One would be forgiven for thinking that all of them might be lowering forecasts. This data is surprisingly good and potentially a leading indicator that shows in fact that there can be reasons to think that the economic damage caused by the crisis may be repaired quickly. Clearly some sectors (hospitality, transport, energy, retail) are being heavily punished at the moment whilst some others (e-commerce, supermarkets, IT services, healthcare amongst others) have benefitted so there is a divergence happening as every month of the pandemic passes.

The actionable response to this is to remain invested but with added caution as the crisis has plenty of time still to play out. We recommended a rotation towards economies and sectors with more dynamism and technology enablement than others, reducing European exposure in favour of US technology expressed through the Nasdaq for example. We have been advising clients to tactically edge up the allocation to other assets that may benefit from huge money printing operations, such as gold and silver. If the so-called "second wave" of infections does come it will pay to have several strategic positions to weather the storm and provide balance.

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Overall, we think that increasing the dry powder as we head into the 'unlocking' phase of the pandemic makes sense so that by taking some money off the table after such as strong rally there is firepower to be ready for any negative surprises. We are still remaining long equities, and balancing this with more cash, high grade fixed income and gold/silver with the aim to be able to withstand new volatility. If things improve strongly, we will still participate, and our balancing trades may also still contribute positively. If however the markets catch a cold we are more defensive than in Q1 and positioned to counter against a second panic. With no real handle on future earnings it seems prudent to be less exposed at this juncture but ready to make the next call when the outlook is clearer.

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