Quarterly Market Overview
1Q 2020

<u>April 2020</u>
MWC Group
Anu Agarwal
Member of the Investment Committee

Overall Macro Environment

> ***"Buy stocks as you would buy groceries: when they are on sale"***
>
> *Christopher Browne, Value Investor*

COVID-19 has brought about events that possibly 99% of those alive today have never imagined, let alone experienced, not just in terms of illness and possibly loss of life, but also in terms of the hardships caused through the enforced lockdowns. Any number of superlatives can be used to describe what we have all witnessed and experienced this last quarter, and specifically, this last month, not the least of which are the fastest bear market in history and also the shortest (if you count the 20% rebound from the lows of the Dow Jones Index in the last full week of March).

We will endeavour to not sensationalise what is a truly remarkable series of events (but we do not promise, as there are some truly staggering numbers involved). Instead, we thought that we would commence this Quarterly Commentary with a couple of entries from this scribe's personal diary, to illustrate the thought processes that were at work during the rout of policy responses to the crisis which led to the rout in the financial markets.

Diary Notes

Date: 4th March 2020. **THE BEGINNING**

The market swoon at the end of February represented the degree of fear of the as yet unknown consequences of the Coronavirus. The one thing that the markets hate is uncertainty and is a point that should not be taken lightly. The markets absolutely hate uncertainty and in the face of uncertainty, will always fall!

Putting aside the human cost, as heavy as it may be, the economic cost is as yet largely unknown. As the data over the coming months and quarters reveals the global economic impact, the markets will adjust accordingly. Consider, however, the size of the impact. Consider that China went into lockdown, that the World's 2nd largest economy turned the lights off for a month! We believe that the impact will be severe, but relatively short-lived. We think that the restart of the gigantic economic machine that is the Chinese economy will take time but that it will recover and ultimately return to the previous levels of activity. Whether that takes a few quarters more or less is hardly the point. The bigger question is whether the lockdown will fundamentally change or permanently damage the Chinese or Global economy? We think not.

Consider all of this with respect to the effect on your investments. Will their values move sharply up and down in the near-term? Probably. Has the economic damage caused by the Coronavirus fundamentally or permanently changed the larger global economy? Probably not. If you look back to a chart of the Nasdaq & S&P500 Indices, the magnitude of the recent falls is small compared to the drops in the Nasdaq after the bursting of the dotcom bubble or those of the S&P during the Global Financial Crisis. In both cases, the fear was at extreme levels and it felt that the world was about to end. In both cases, the markets recovered and moved on to reach greater highs. Perhaps 5 years from now, the current turbulence will be seen exactly for what it is: nothing more than turbulence. Perhaps 5 years from now, the current falls will be seen as being nothing more than ripples on an otherwise larger and longer-term wave.

Date: 18th March 2020. **WHEN TWO BLACK SWANS COLLIDE**

We are as astonished as we are not surprised by recent events. The outbreak of COVID-19 was as unpredictable as was the World unprepared for it, and in both cases the adjective is: totally.

In financial terms, a 'Black Swan' is an extremely rare and unforeseeable event that has the potential to cause significant damage. The size of the damage as a consequence of COVID-19 and the government response of ever-greater restrictions on personal movement has yet to be determined, but the scale of this black swan will be truly global. The other black swan is the recent falling-out between erstwhile best buddies, Saudi Arabia and Russia and their respective threats to flood the oil markets with increased production at a time when demand has already fallen sharply and is expected to remain supressed while the lockdowns persist. The scale of this one is also Global, and the size is up there with its brother. When these two collided (took place at the same time), the shock waves that were created were some of the strongest felt by the financial markets in a very long time: call it a magnitude 8 earthquake on the financial Richter scale, if you will.

The disruption due to COVID-19 to life and supply chains in a globally interconnected system is large but its duration is uncertain. If we look at the experience in China and South Korea, the containment measures needed to quickly and effectively contain the virus were both severe and appear to have been largely successful. If we look further west, we think that the initial reaction was that it was yet another Asian 'thing', that it would remain confined to the region much as SARS and other outbreaks did, that the impact would be local and short-lived. All that changed the day we woke up to find the thing sitting on our doorsteps.

In Europe and North America, although the lower population densities would naturally lend themselves to slower rates of infection, the unwillingness of Western governments to impose the kind of draconian containment measures that might be needed to 'nip it in the bud' will ultimately mean that the impact may well be less than in China, but the duration could equally be for longer. To return to the earthquake analogy, at the epicentre of the earthquake the peak of the shock wave is the highest, but for the shortest duration of time. As the wave travels out, the peak drops as the length, or duration, grows. The overall damage is more or less the same, but one is short and sharp with the other being more drawn out.

In terms of the bust-up at OPEC+, the imminent flooding of the oil markets by Russia and Saudi Arabia, despite the halving in the oil price continues to drive the price of the black stuff ever lower. If Russia's aim plays out, the market will rebalance itself through market forces as artificially supported higher-cost production is driven out. If this leads to a freer market, then we are all for it. To flood the oil markets at a time when there is reduced demand caused by the lockdowns is akin to a totally avoidable man-made catastrophe which happens anyway mostly due to man's belligerence and often through sheer stupidity. If, however, that catastrophe is the desired outcome, then we feel that the result will be highly successful: if the internationally traded price of oil remains at the current levels for more than a few months, we think that it will sound the death-knell for high cost producers in general and US shale production in particular. The industry will likely not be entirely eliminated, but the survivors will be forever changed.

Policy Response

We are not surprised at the relatively slow pace of policy response in the west. The west is largely managed by democratically elected government, which by its' very nature cannot respond as quickly as more authoritarian regimes can. Without wanting to create a political manifesto, the incentives in certain political circles encourage 'grandstanding' over taking hard, but pragmatic, choices: choices that may reduce the electability of the 'offending' politician. And it is the same concerns of electability that will continue to drive the decisions that will be taken in the future when it comes to lifting the restrictions on personal freedom to move about and go back to work. We can well imagine that the government-imposed restrictions will persist well beyond the time that the virus has receded, and the danger greatly lessened. After all, who would risk lifting the lockdown and the next election if that caused even one more death?

Politician bashing aside, what has the policy response been? Large swathes of Europe and the Americas are now in lockdown, as is India and are many other countries. National lockdown seems to be the only response to containing the spread of the virus. It is hoped that the sharp falls in economic activity due to the lockdowns will be adequately offset by the monetary and fiscal easing. At the very least, it is hoped that these twin stimuli give investors and communities alike some breathing room for a healthcare solution to be implemented.

The size of the twin stimuli is unprecedented. Period. Extending the monetary playbook from the GFC, the central banks have again cut interest rates to zero and resumed quantitative easing (printing money) at a scale that dwarfs all those other previous instances combined. Indeed, this time around, there is no limit to the amount of money that can be printed. Going even further, the US Federal Reserve appears to be buying corporate bonds in a move that is beyond their remit and would normally be illegal. However, the real version of that particular story is that it is not the Fed doing the buying of the corporate bonds, but a Special Purpose Vehicle (SPV) owned by the US Treasury, with the Fed providing funding to the SPV. In essence, the Fed is giving the Treasury access to the printing presses!

In Europe, the situation is not too dissimilar, but so far without the blatant handing over of keys to the printing presses.

Consequences:

- **Inflation**

You may have asked yourself why inflation did not manifest itself after the GFC? The answer is because the policy response to that shock and every shock thereafter has remained until now, purely monetary, i.e. central banks cutting interest rates and pumping money into the financial system. So, this is where the inflation manifested itself as you can see in the prices of assets such as bonds and equities, for example. To counter the economic shock resulting from lockdown, governments around the globe have been forced down a path that they have long resisted since the GFC – that of providing fiscal stimulus. We alluded to such a situation in our 3Q19 commentary, however we never imagined the magnitude of the stimulus and could never imagine the reason it would eventually be provided.

Monetary stimulus is an injection into the financial economy (the markets), whereas fiscal stimulus is an injection into the real economy (you and I). If applied correctly, it will alleviate the worst of the economic hardship in directing the aid to those who will need it most. Currently announced fiscal stimulus by Europe and the US are running at upwards of 10% of GDP. These numbers are already staggeringly large (dowsing a large smouldering fire with petrol?), but the amount of petrol is expected to grow further still. If you inject money into the demand side of an economy, the additional money chasing goods and services will cause their prices to rise, in other words, be inflationary in the real economy. If the stimulus is large, the inflationary reaction is also likely to be large, but over time and not as an immediate jump in prices.

As the fiscal stimulus starts to work its way through the system and as the system recovers from enforced lockdown, the extra boost thus provided will add momentum to the speed of recovery that should sustain higher rates of demand growth over coming years. As supply responds to the increased demand and this response cascades down the supply chains all the way to the raw materials needed to produce the good and services, the inflation will ultimately manifest itself there, slowly at first but with gathering momentum as global recovery takes hold and accelerates. We may expect to see isolated pockets quite quickly after lockdowns end and first signs of more systemic inflation perhaps as early as the next few years.

- **Societal Change**

We suspect that time will show that had the policy response simply been to let the infection run its course, the health risk would not have been out of the ordinary from normal 'flu seasons and therefore the economic impact would have been immaterial. Government will nevertheless claim that the lockdowns were successful in preventing widespread infection and similarly demonstrate 'what wonderful, caring people you have elected'.

The impact of the lockdowns on society will be far-reaching and we believe some of the changes will be permanent. The multitude of ways that businesses and individuals have had to adapt their comportment is testament to human ingenuity and as the success of many of these new ways of 'being' are incorporated into daily activity, we foresee a much-increased incidence of teleworking, for example. We hope that the resulting improvement in work/life balances will reduce general stress in our daily lives and one happy outcome of such a scenario is the reduced commute to work and consequent reduction in pollution.

- **Oil**

As is to be expected, the whole situation is particularly fluid at this juncture. How the near-term machinations play out, we have no idea, but we do not foresee a long-term solution without the participation of the US in production cuts. US Antitrust laws prevent the industry from collaborating to reduce production, but they do not prevent the government mandating production caps on the industry, so the decision will have to be political. Were this to occur, the US would become a de facto member of a cartel.

Demand destruction of the order of 20 million barrels per day has resulted from the lockdowns. It will be a Herculean task to get agreement for global production cuts of that size. The best we can hope for is a large enough cut in supply to significantly reduce the speed at which global storage is filling up. Ultimately, when a producer can no longer move or store his product, he will be forced to stop production. The duration of the lockdowns will determine the duration of the demand destruction. Once that passes it will take time for the excess inventory to be run down and thereafter, we hope that market forces will predominate.

Takeaways for Investors

1. Neither the world, nor the market move in a straight line. In previous commentaries, we cautioned that trends revert to the mean and that reversals can overshoot the mean in the opposite direction. They would have to, for the mean to be derived. However, whether we have reached a bottom or there is more to come is anyone's guess, but such steep falls have historically proven themselves to have been attractive buying opportunities.

2. The trend is not yet over. We have had a severe curtailment of business activity, but not a complete halt. Think of a tank being driven into a wall: it might shudder from the impact, struggle to clamber over the rubble, but will get over it and eventually trundle away on its merry way. The twin monetary and fiscal stimuli should turbo-charge the recovery post-lockdown and engender strong economic activity that should lead to much higher levels in the stock markets in the years ahead and probably significantly surpassing recent highs.

3. The cost. Whether we want to or not we are entering the realm of MMT, or Modern Monetary Theory, which among other matters postulates for zero interest rates and infinite government debt: if you have no interest to pay on your borrowings, then borrow all you like, or so goes the thinking. This takes the experiment running since the GFC (and arguably since before then) to the next level where not only do you cut interest rates to zero and flood the system with money, now there is no limit to how much money you can pump in, either through monetary channels or fiscal ones. This is all good and well so long as there is someone out there who is willing to lend you money for nothing, but what happens when they start demanding a return? What happens if inflation gathers momentum? What happens when interest rates have to go up? From where will the money come to pay for the interest due? We do not yet know the potential answers to these questions. In many ways, if the stimuli are successful in achieving a sufficiently strong and lasting economic recovery, the increases in tax revenue may well help to pay for the current largesse and even deliver a positive return on investment for the Government.

4. The changes that the lockdowns will have necessitated will lead to many opportunities having been created. From the outset, we have been trying to forecast how the world will be different when we emerge from the current crisis. One area that already stands out is remote working, be it simply working from

home or providing medical advice by telephone or video call. Providers of video call services have already benefitted as will providers of the security solutions to facilitate such forms of working are a couple of examples to consider.

We leave you with a recent quote that we find appropriate:

> ***"We're buying business to own for 20 or 30 years...and we think that the 20- or 30-year outlook is not changed by the coronavirus."***
>
> *Warren Buffet, CNBC Interview, 24 Feb 2020.*

Data Table

April 2020

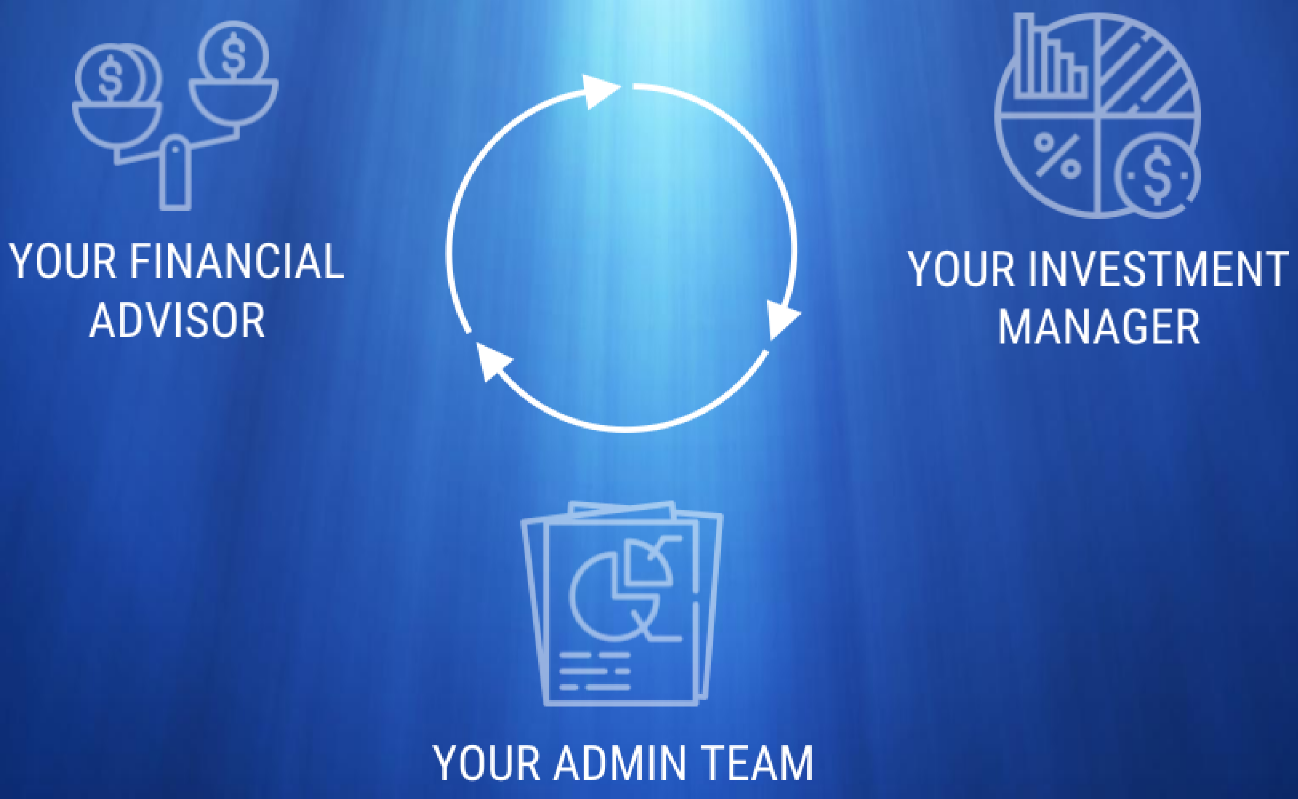
Stock Markets	Month	Q4 19	YTD	GDP YoY	Interest Rates	Inflation Rate
United States	-12.51%	-20.00%	-20.00%	2.30%	1.75%	2.50%
Europe	-16.25%	-25.54%	-25.54%	0.90%	0.00%	1.40%
Germany	-16.47%	-25.26%	-25.26%	0.40%	0.00%	1.70%
France	-17.21%	-26.46%	-26.46%	0.80%	0.00%	1.40%
Italy	-22.44%	-27.46%	-27.46%	0.00%	0.00%	0.40%
Spain	-22.21%	-28.94%	-28.94%	1.80%	0.00%	0.80%
Greece	-22.50%	-39.09%	-39.09%	2.30%	0.00%	0.90%
Switzerland	-5.18%	-12.20%	-12.20%	1.10%	-0.75%	0.20%
United Kingdom	-13.81%	-24.80%	-24.80%	1.10%	0.75%	1.80%
Brazil	-29.90%	-36.86%	-36.86%	1.20%	4.25%	4.19%
Russia	-9.92%	-17.63%	-17.63%	1.70%	6.00%	2.40%
India	-23.05%	-28.57%	-28.57%	4.70%	5.15%	7.59%
China	-6.44%	-10.02%	-10.02%	6.00%	4.05%	5.40%

Japan	-10.53%	-20.04%	-20.04%	-0.40%	-0.10%	0.70%
MSCI World Equity Index	-13.73%	-21.74%	-21.74%			

Bond Indices	**Monthly**	**Q1 20**	**YTD**
Barclays Capital U.S. Aggregate Bond Index	-1.65%	1.78%	1.78%
Barclays Global Aggregate ex-USD Float-Adjusted Index (Hedged)	-2.98%	-0.57%	-0.57%
J.P. Morgan Government Bond Index Emerging Markets Global Core Index (Local Currency)	-12.16%	-16.29%	-16.29%
Barclays Global Aggregate ex USD 10% Issuer Capped (Hedged) Index	-2.50%	-0.18%	-0.18%

Currencies	**Monthly**	**Q4 19**	**YTD**	**Price**
EUR/USD	0.05%	-1.61%	-1.61%	1.10
GBP/USD	-3.13%	-6.34%	-6.34%	1.24
EUR/GBP	3.28%	5.11%	5.11%	0.89
USD/CHF	-0.47%	-0.72%	-0.72%	0.96
EUR/CHF	-0.41%	-2.32%	-2.32%	1.06
USD/JPY	-0.50%	-0.99%	-0.99%	107.54
GBP/CHF	-3.57%	-7.08%	-7.08%	1.19

Commodities	**Monthly**	**Q4 19**	**YTD**	**Price**
Gold	-0.94%	3.56%	3.56%	1571.31
Oil (WTI Crude, NYMEX)	-55.57%	-67.16%	-67.16%	20.05



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