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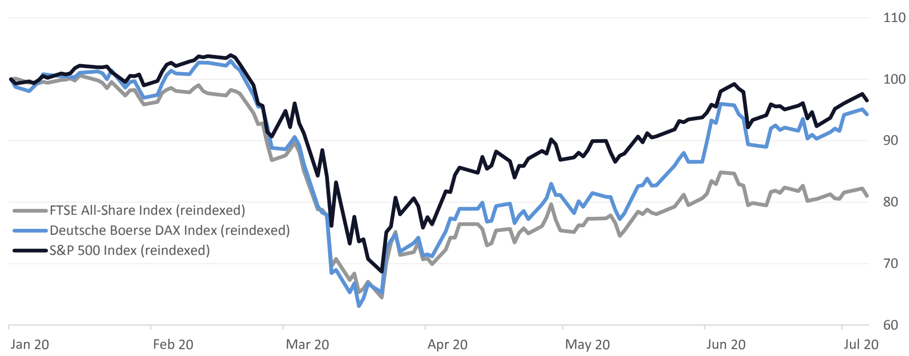
HOTTINGER GROUP

GLOBAL INSIGHT

Overview

- Sentiment towards the UK real estate market has clearly been impacted by the coronavirus crisis.
- In our **feature article,** Alex Ross, Fund Manager at Premier Pan European Property Share Fund, looks at the impact of Covid-19 on UK real estate securities market .
- In summary, whilst sentiment and uncertainty will continue to dominate short-term share prices in this sector, the resilience of the key real estate fundamental, income yield, will be the driver in longer term share price returns.
- In our **Macro View**, we cover the slowdown in economic activity and the policy response to the crisis.
- We believe we are now at the point where the developed world is at its most vulnerable trying to balance the need to reopen against the real threat of a return of the virus.
- In our **Investment Outlook**, we assess activity in the second quarter and the position that financial markets find themselves.
- As the major regions headed towards recession, with millions sadly losing their jobs, almost every asset class made a positive return.
- The question is whether the switch towards working for home and the boost it has given to technology sector is now fully priced into valuations.
- Equity valuations are more elevated than three months ago and earnings susceptible to disappointment if global GDP does not return to pre-crisis levels until 2022 as we suspect.

The performance of the UK stock market in 2020 relative to the German and US markets



Source: Bloomberg

Inside this issue

Economic Highlights

- The European Commission on May 27 proposed EUR750bn stimulus package
- Expect 2nd quarter UK GDP growth to fall 16% quarter-on-quarter.
- US May consumer spending was down 19.2%.
- IMF is forecasting growth in China for 2020 to be +1% year-on-year.

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Based upon information available up to and including 10th July 2020

Key Issues in Charts

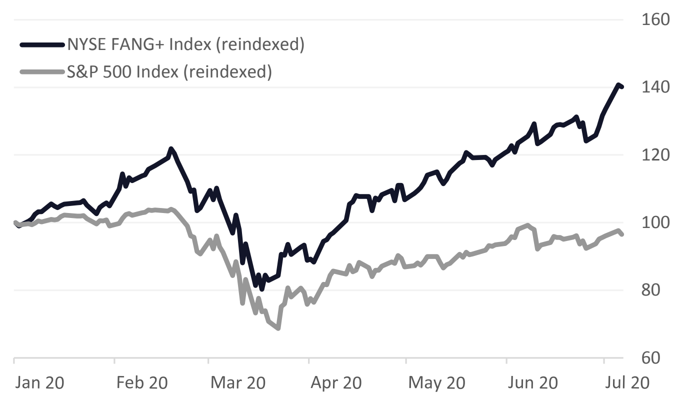
WTI Crude futures prices since the start of 2019

Source: Bloomberg

- The price of Brent Crude oil sank to $22.74 per barrel at the end of March, hitting lows not seen since the financial and oil price crises of 1998-1999.
- Oil price has recovered substantially from the crash in March
- An April super-contango when front month prices were much lower than the future price has flipped back to the normal backwardation of prices in June.
- ·Optimism over the return of economic activity in China and the reopening of the developed world is tempered slightly by fears of a 2nd wave in the US as daily cases rise significantly.

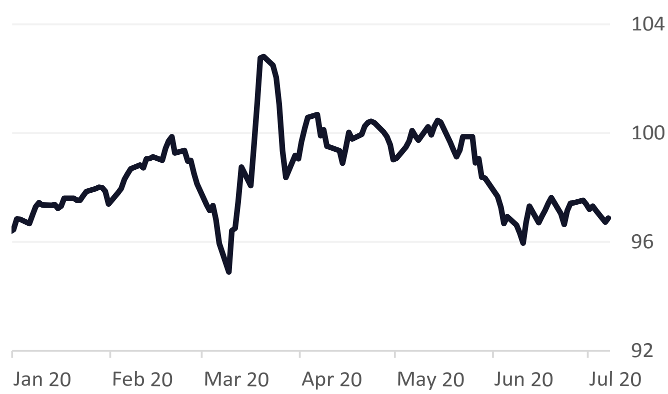
The performance of the FANG+ relative to S&P 500 market

- The FANG+ index was set up to represent the broader set of new technology stocks currently reshaping society at a significant rate.
- The rally in the US has been firmly led by big tech which has been one of the big winners of working-from-home.
- Throughout lockdown growth has outperformed value as investors seek the long term winners due to the disruption to the traditional work place and consumer behaviour.



Source: Bloomberg

The US Dollar Index Spot Rate



Source: Bloomberg

- The US dollar is the currency of choice in approximately 88% of all transactions globally as the world's reserve currency
- The spike in March represented a shortage of dollars outside of the US to satisfy the demand from corporations, financial markets and central banks alike.
- The price of the dollar against a basket of its major competitors shows that the price has normalised but whether the price will start to weaken to reflect the current doubts surrounding the spike in infections affecting the reopening of the economy remains to be seen.

Impact of COVID-19 on UK real estate securities market

By Alex Ross, *Fund Manager at* ***Premier Pan European Property Share Fund, Premier Miton Investors***

Sentiment towards the UK real estate market has clearly been impacted by the coronavirus crisis. Unlike in many service sectors, landlords have had limited direct support from the UK government, with the suspension of business rates for 12 months for the retail, hospitality and leisure sectors the only notable support. Furthermore, with the government also introducing an eviction ban until at least the end of September, a significant proportion of tenants have been able to withhold paying rents. With such rental income uncertainty, it is understandable that we have seen significant weakness in many stock market listed UK property sectors. However, it is increasingly important to highlight that not all property is homogeneous and there is likely to be a very significant divergence in real estate performance by sector positioning as and when we emerge from this crisis.

Landlords have had limited direct support from the UK government, with the suspension of business rates for 12 months for the retail, hospitality and leisure sectors the only notable support.

Nowhere is this more evident than when examining the prospective rental demand and valuation outlook between the retail and the logistics property subsectors. The immediate impact of the lockdown in the UK has seen a further significant increase in the market share of online retail, with many new users introduced to the benefits of online delivery. This structural shift to online retail and away from the high street has certainly been accelerated many years by this crisis and this will of course have major relative implications for both logistics and physical retail tenant demand in the short and long term.

The immediate impact of the lockdown in the UK has seen a further significant increase in the market share of online retail, with many new users introduced to the benefits of online delivery.

With physical retail shops closed for a number of months, many retailers' cash flows have come under distress. With the current ban on evictions, a number of these retailers have not paid their contracted rents whilst certain others have recently gone into administration. There is now clear evidence that the crisis will be used by many national retailers as an opportunity to reduce their store numbers and re-set rents to lower levels at stores they wish to keep, withdrawing from non-dominant locations to focus on a targeted retail footprint to complement their increasingly important online offering.

It should be noted that whilst online retail sales share is expected to increase materially further, the majority of retail sales remains in physical stores and click and collect from physical store is the most attractive channel for most retailers. So physical stores do have a future but there needs to be significantly fewer shops and rents will reduce significantly further on basic supply versus demand fundamentals. This hugely uncertain outlook for retail property has led to almost all retail property company's shares trading at deep discounts to their asset values in the equity market. Some companies may well require new equity to repair balance sheets as almost all retail property continues to decline in value and share price volatility is likely to remain highly elevated. However, within this malaise we believe there will be one or two long-term winners, namely those companies that own the retail real estate that retailers will likely wish to retain expo-

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sure to, such as Westfield London or dominant convenience retail let to the likes of B&M Bargains, Aldi, Primark etc.

In direct contrast to this, logistics buildings in urban locations are seeing strong demand as online retailing grows in importance.

In direct contrast to this, logistics buildings such as large warehouses let to Amazon and local delivery facilities in urban locations are seeing strong demand as online retailing grows in importance. International retailers and distribution companies require major distribution hubs across the UK, which are set up to provide the rapid delivery increasingly demanded by consumers for their online deliveries. As this often involves a high degree of automation within the building, these tenants are prepared to sign long leases with index linked rents to protect their capital investment in the building. This long term and inflation linked income stream looks increasingly valuable against a background of likely lower interest rates for longer and the possibility of inflation increasing in the longer term. Urban warehouses are also increasingly in demand, as the major distribution companies and the likes of Amazon seek storage facilities in urban locations to facilitate the final leg of the distribution chain to the consumer. The attraction here is the shortage in supply of such space, with a significant number of these warehouses having converted to higher value residential in the last 40 years as the UK's manufacturing base shrunk. With this structural demand from online retailing against very limited supply, pricing power is firmly with the landlord and rental growth is accelerating in this niche segment of the UK property market.

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Structural demand from online retailing against very limited supply, pricing power is firmly with the landlord and rental growth is accelerating in this niche segment of the UK property market.

As a result of the smooth transition of most of the workforce to Working From Home (WFH), the office market is now facing questions on demand for office space ahead. WFH has certainly proved popular amongst many employees and there is likely to be a much more flexible balance on working patterns in the office and from home in the future, according to individual preference relative to productivity performance, with younger workers in particular keen to get back to the interaction of the office environment. As such, we would expect to see a much more flexible use of a company's office space in the future, with employees typically rotating differing numbers of days in the office.

We believe there will be a flight to quality, with companies aiming to increasingly focus on employee well-being through modern, environmentally-friendly Grade A office space.

In terms of space requirements as a result, there is likely to be a reversal of the trend adopted by the likes of WeWork to increase density in offices, as corporates seek to reverse their strategy to reduce overall space requirements and costs through closely bunched work stations seen in much of today's generic office space. Indeed, we believe there will be a flight to quality, with companies aiming to increasingly focus on employee well-being through modern, environmentally-friendly Grade A office space with spacious workstation pods, natural airflows, outdoor space and strong transport links to allow the ease of occasional commuting from out of town homes. From a real estate perspective, vacancy of such quality space is currently around record low levels, so those companies seeking such quality space ahead will find rents resilient, whilst poor quality older office space is likely to see a material reduction in demand, which will be reflected in weaker rents ahead. Therefore, as with retail, it is imperative to use 'bottom-up' fundamental analysis on the type of office space offered by quoted office companies, and for those owning such quality space the share price weakness since the onset of Covid-19 defies their fundamental rental outlook. Furthermore, the strong management teams in the London office specialist REITs (Real estate investment trust[1]) have built strong balance sheets since the uncertainty caused by the lead up to the UK's EU Referendum in 2016 and we would expect them to opportunistically utilise these war chests on opportunities that will inevitably arise from this crisis.

Alternative real estate sectors, such as primary healthcare buildings, long income properties and self-storage have been growing in recent years, with these offering strong structural tenant demand and resilient income streams. This resilient income is well recognised by the market with share prices proving relatively resilient during the crisis, and we would expect these niche sub-sectors to continue to grow materially in the future with limited threat from technological disruption and evidently attractive demographic trends.

Expectations of long-term low interest rates for even longer is likely to generate significant demand for alternative income streams, particularly with government bond yields at such negligible yields. The key in real estate will be identifying where the rental income is sustainable. Where this is the case, that income will have become increasingly valuable to a wide range of domestic and international investors faced with diminished income streams from record low government bond yields, which is thus likely to support real estate asset values ahead for these companies. Outside of the previously discussed retail subsector, where share prices in a number of cases already reflect significant further valuation falls, the outlook for rents and values in the logistics, healthcare, self-storage and best in class offices remains firm and in many cases growing. Whilst sentiment and uncertainty will continue to dominate short-term share prices in this sector, the resilience of the key real estate fundamental, income yield, will be the driver in longer term share price returns.

[1]A company that owns and manages property on behalf of shareholders. A REIT can contain commercial and/or residential property.

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REGULATION

Macro View

Following the largest slowdown in economic activity since the Great Depression investors are left with some fundamental, unanswered questions: Will global economic growth return to pre-pandemic levels and if so when? Will it take the approval and mass production of a Covid-19 vaccine before this can happen? How much economic scarring has occurred from the damage so far? Could a second wave of the virus emerge in the developed world, potentially in the autumn? And how long can the disconnect between financial markets and the real economy continue?

Following the largest slowdown in economic activity since the Great Depression investors are left with some fundamental, unanswered questions

Now that the virus has taken hold in the developing world, where the national health infrastructures are less robust and isolation protocols harder to implement, it is expected that global growth will be negative in 2020. The IMF's World Economic Outlook June update projects global growth to contract 4.9%, 1.9% below its April forecast, before recovering to +5.4% in 2021. Overall, this equates to a drop of over 6% to the end of 2021.

$11trn

The G20 fiscal response is estimated to have been $11 trillion so far, or 13% of GDP, and central banks have cut rates around the world to the lowest global level on record. The expansion of central bank balance sheets is unprecedented as the monetary and fiscal response by governments and bankers is coordinated at a national level if not at an international level.

The most worrying development has been the significant rise in unemployment despite government support schemes and the fact that the inverse relationship between unemployment and equity prices seems to have broken down.

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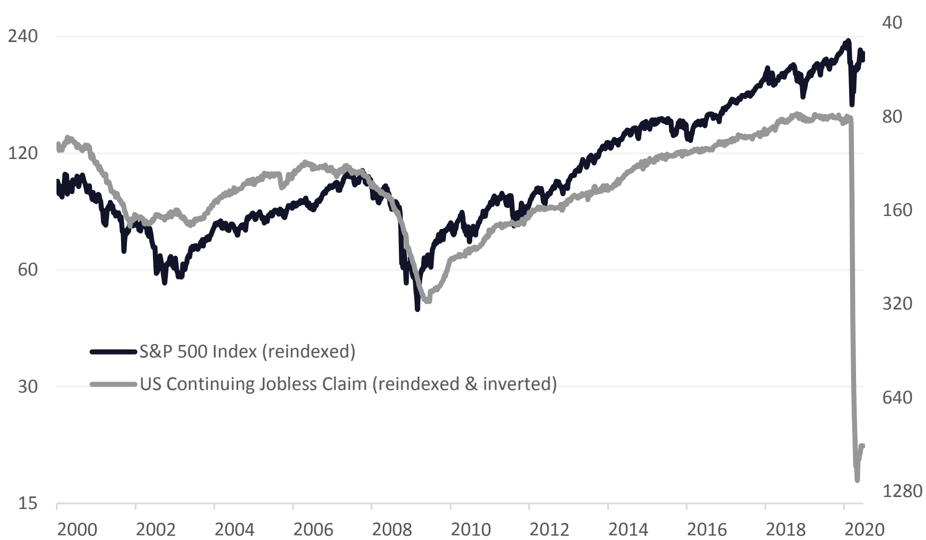
S&P 500 vs. US Continuing Jobless Claims



Source: Bloomberg & The Felder Report

As economies start to re-open it is likely that the worst economic distress is behind us as Treasury Secretary Stephen Mnuchin told CNBC on June 11, shutting down the economy for a second time is "not a viable option". It is our judgement that the financial cost of continued lockdown has been deemed to far outweigh the threat to human life. This leaves many countries who were hoping to eradicate the virus before the start of the summer tourist season with little option but to have the population make its own decisions or risk devastating a major part of their economies.

Shutting down the economy for a second time is "not a viable option".

US Treasury Secretary Stephen Mnuchin

United States

As we entered the month of May US industrial production was estimated to be down 15.2%, consumer spending was down 19.2% and the unemployment rate was -14.7%. The resumption of economic activity following lockdown was best indicated by the surprise jump in May non-farm payrolls by 2.5m when many were forecasting losses of double that and an unemployment rate of 20% instead of the actual rate of 13.3%. Consumer and manufacturing sentiment surveys were more positive and May auto sales recovered strongly. Following 1st quarter GDP growth of -5% Barclays estimate 2nd quarter growth to contract 40% quarter-on-quarter before rebounding strongly in the second half of the year (Barclays Global Outlook June 2020).

15.2%

19.2% ***MAY***

14.7%

At the Federal Open Market Committee June press conference Chair Powell declared "we're not thinking about raising rates. We're not even thinking about thinking about raising rates. What we're thinking about is providing support for this economy". The fact that the majority of Fed governors believe that targets set by the committee for their twin objectives for growth and inflation are unlikely to be met until late 2022 probably means rates are on hold until at least 2023. The Fed has already increased the size of its balance sheet from \$4trn to over \$7trn over the past quarter through buying US Treasuries, mortgage-backed securities and corporate bond exchange-traded funds (ETF's) supporting corporations, small business, municipalities and other parts of the economy. On June 15 it announced that its Secondary Market Corporate Credit Facility would start buying individual corporate bonds, as well as ETFs, basically underwriting corporate borrowing and the corporate bond market.

"We're not thinking about raising rates. We're not even thinking about thinking about raising rates. What we're thinking about is providing support for this economy".

US Fed Chairman Jerome Powell

The multi-trillion-dollar fiscal response passed through a divided congress in a matter of days including the Paycheck Protection Programme which offers loan forgiveness in order to keep people employed and was designed as a direct incentive to small businesses. The importance of this \$669bn programme is underlined by the fact that congress passed an extension under the Flexibility Act on June 4 which will see the scheme run until December 31, 2020. A further \$750bn "Phase Four" stimulus package will likely be passed towards the end of the summer.

PPP \$669bn

US states have been gradually opening up throughout June despite the differing successes of Covid-19 containment and Texas, Arizona, Florida, and California in particular have seen a significant increase in daily new cases. In fact, daily cases across the US have crept rapidly back to 55,000 as citizens fail to take social distancing guidelines seriously. Although the US will not go back into lockdown, we have yet to see a negative consumer response to heightened infection rates as seen in other economies.

June saw the start of the Presidential race as Joe Biden began to engage with the media. Only two sitting presidents since the second world war have failed to gain a second term; Jimmy Carter and George HW Bush and both faced elections during recessions. Biden’s lead in the polls is significant but there is still a long way to go until November.

UK

UK GDP contraction of 7.5% this year.

Initial hesitation by the UK government saw the country go into lockdown later and increased cautiousness has seen the UK emerge slower than its European counterparts. In particular the 14-day quarantine period, now lifted, significantly impacted international travel, confusion over school re-openings and uncertainty over the lifting of various restrictions has slowed the post lockdown economic bounce. Barclays now expect 2nd quarter GDP growth to fall 16% quarter-on-quarter and a contraction of 7.5% this year (Barclays Global Outlook June 2020).

The slower pickup in activity may also be attributable to the impact of trade talks with Europe on the economy. Discussions between the two sides started again in June with the UK refusing to countenance an extension to the transition period. Chancellor Merkel takes over the revolving Chair of the European Commission in July with the resolve to agree a free trade agreement by the end of October for ratification at the Autumn summit. Confidence is growing that a compromise is possible, however, the economic impact is likely to be significant whether an agreement can be reached, or trade continues under WTO rules. There are six rounds of talks between June 29 and August 21 followed by a meeting of EU leaders on September 13 by which time serious progress must be made.

The Bank of England moved swiftly to support the Treasury’s fiscal response to the pandemic and at its June Monetary Policy Committee meeting approved another £100bn tranche of its asset purchase agreement. The BOE has to consider the potential fallout from a chaotic end to the transition period so is likely to be working in tandem with the government with a likely new package in the autumn.

Europe

The level of unemployment may still hold the key to the ability of economies to bounce back and while the flexible labour markets in the US assisted the post Global Financial Crisis (GFC) recovery the rigid social security structure of European economies seems to be providing more support to the labour force during this pandemic. The majority of European countries went into early full lockdown preferring to try and preserve jobs through subsidies. The system adopted by many countries, known as “kurzarbeit” in Germany, has firms promise

The level of unemployment may still hold the key to the ability of economies to bounce back.

not to lay anyone off but to share the work, while the government makes up much of the lost income. This was seen as a more effective use of funds, allowed the countries to remain in stricter lockdown, and are showing early signs of being able to maintain falling numbers of new cases. Following a 1st quarter contraction of 3.8% Barclays are expecting GDP growth to fall 13.4% quarter-on-quarter in the 2nd quarter thanks to the united fiscal and monetary response of EU countries (Barclays Global Outlook June 2020).

EUR750bn

"Next Generation EU" Stimulus Package

The European Commission on May 27 proposed EUR750bn stimulus package to help the European Union recover from a recession brought on by the coronavirus pandemic. The package named the "Next Generation EU" is the biggest in European history including the post-World War II Marshall Plan. The proposal is to offer about €500 billion as free grants to member states, while €250 billion would be made available as loans to help repair the single market from the economic blow.

Furthermore, the proposal for a EUR500bn stimulus fund financed by jointly issued government debt is a significant moment for Germany with its resistance to debt mutualisation, and a major fillip for ECB flexibility in the sharing of funding risk, although it is yet to receive full support.

At first glance Japan seems to have survived relatively well from the coronavirus.

Japan

At first glance Japan seems to have survived relatively well from the coronavirus with much of this attributed to traditional social protocols that would help prevent the spread of the virus even though the country did not enter full lockdown. This is surprising judging by the ageing demographic and the population density in Tokyo and has led some to question the under-reporting of cases through limited testing.

3rd consecutive quarterly contraction in GDP growth estimated to be -24.1%

However, Japan was already showing negative GDP growth due to the implementation of the Consumption Tax in October 2019 leading to a 3rd consecutive quarterly contraction estimated to be -24.1% quarter-on-quarter in the 2nd quarter 2020. The expected boost from an increase in tourism due to the 2020 Olympics will now have to wait for the re-scheduled 2021 Tokyo Olympic Games.

A slower recovery post-pandemic is therefore expected.

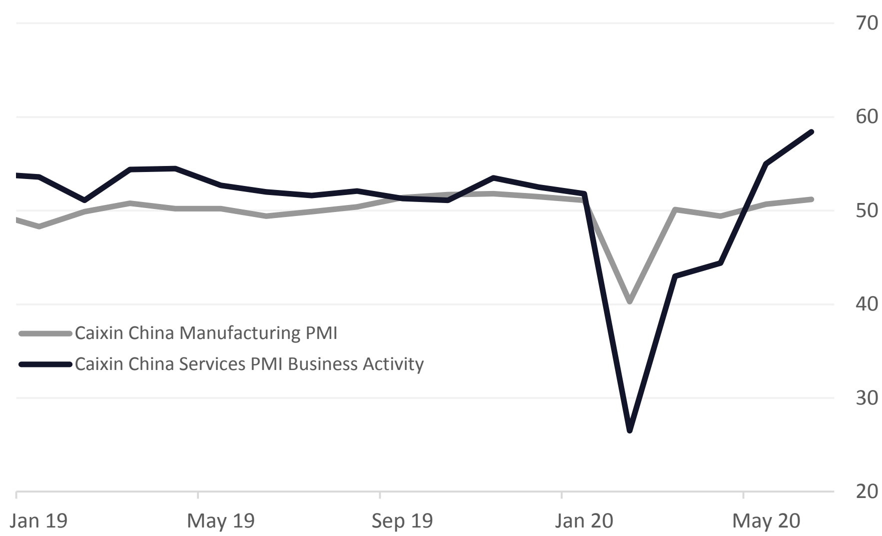
Japan's response to the economic threat of Covid-19 came through two supplementary budgets each equating to approximately 20% of GDP aimed at supporting the medical systems, struggling companies and employment subsidies. At its June policy meeting the Bank of Japan increased its fund provision for corporate finance support from JPY55trn to JPY90trn. A slower recovery post-pandemic is therefore expected due to a decreased overseas demand for exports, threatened further by the possibility of a 2nd wave of the virus.

China is likely to be fortunate enough to see positive growth in 2020.

China

Having been the original epicentre of the virus, and therefore ahead of the rest of the developed world in reopening, China is likely to be fortunate enough to see positive growth in 2020. Following a strong contraction of 6.8% in the 1st quarter, GDP growth is estimated to bounce 3.5% year-on-year in the 2nd quarter. China has benefitted from the global demand for medical supplies and IT equipment but is likely to see economic activity sustained as the developed world begins to re-open. Furthermore, the Chinese economy has bounced back

Chinese PMIs since the start of 2019



Source: Bloomberg

The Chinese economy has bounced back sharply with manufacturing and service sectors once more in expansion territory .

sharply with manufacturing and service sectors once more in expansion territory and the property market activity also strong.

IMF expects growth in China to be

+1%

Year-on-year

The People's Bank of China (PBoC) tends to favour adjusting the Reserve Requirement Ratios (RRR) as its main monetary policy tool, cutting the reserve requirement ratio for mid-sized and small banks by 100bps, in two phases in April, releasing around CNY 400 billion to support the economy hurt by the Covid-19 pandemic. Again, in May, the PBoC announced that it had cut the RRR for big banks by 150bps to 11 percent, to facilitate bond issuance and support credit growth.

Due to the fact that the recovery is now underway the IMF is forecasting growth in China for 2020 to be +1% year-on-year although a local outbreak of the virus on June 11 in Beijing just shows that no country can be complacent.

China is now an integral part of the global economy and any attempt to reduce trade links will also harm western economies.

Another risk remains the international attitude towards China since the outbreak of Covid-19 led by the Trump administration and the on-going trade talks which continue despite the negative rhetoric. According to polls US citizens have been unimpressed by the central government's handling of the crisis and being an election year the White House has been deflecting attention away from its own shortcomings towards China and its relationship with the World Health Organisation (WHO). However, China is now an integral part of the global economy and any attempt to reduce trade links, increase tariffs or introduce levels of protectionism will also harm western economies.

Emerging Markets and China

Excluding China, the IMF June update expected emerging and developing economies to exhibit overall GDP growth in 2020 of -3% with all regions expected to show negative growth for the first time.

Excluding China, all developing regions expected to show negative growth for the first time.

Across emerging Asia, countries who have successfully dealt with the health crisis such as Singapore, Korea and Taiwan have benefitted from the increase in activity in China whereas the Southern Asian countries such as India and the Philippines where there is little room for financial manoeuvre have struggled with the human crisis and have only interest rate cuts as their main monetary tool.

Financial fears at closing down economies has led many to maintain a level of economic activity despite the human cost.

Elsewhere, financial fears at closing down economies has led many Latin American and African nations, most notably Brazil, to downplay the virus threat in order to maintain a level of economic activity despite the human cost. However, the effect on consumer confidence will no doubt lead to slower recoveries and the increasing threat of a 2nd wave.

Conclusion

As the world emerges from lockdown the true cost of the last quarter will become clearer and the level of scarring inflicted on developed economies more quantifiable. However, optimism regarding the recovery appears to be growing stronger as reflected in stock markets, despite the fact that it seems as if the crisis has levied permanent costs on the global economy.

As the world emerges from lockdown the true cost will become clearer and the level of scarring inflicted more quantifiable.

There are currently 17 reported vaccine candidates in human trials and the Trump administrations Operation Warp Speed has identified 14 to fast track with a stated goal of having 300 million doses available by January 2021. Currently, the fastest vaccine approval for an infectious disease that has been recorded was for Mumps and the process took 4 years. Most health experts suggest that Covid-19 will not stop spreading until 60-70% of the global population is immune allowing herd immunity to take place. Meanwhile, without a vaccine, improvements in treatment become more important with anti-viral drugs such as Remdesivir featuring prominently; increased testing and contact tracing need to intensify; and social distancing protocols may become the new normal.

17

Reported vaccines in human trials

We feel it is unlikely that the global economy will normalise until a vaccine is found. It is worth remembering that the number of Covid-19 cases globally is still rising and the full extent of the effect on the growth potential of the emerging world is yet unknown.

We are now at the point where the developed world is at its most vulnerable trying to balance the need to reopen against the real threat of a return of the virus.

We are now at the point where the developed world is at its most vulnerable trying to balance the need to reopen against the real threat of a return of the virus. Furthermore, as government support schemes begin to unwind the true cost of the last few months on industries, sectors, companies, and the labour force will become more evident, perhaps leading to further reflection on the likely path to full recovery.

Investment Outlook

The second quarter was dire for the global economy as the major regions headed towards recession after coming to an abrupt halt in March with millions sadly losing their jobs. Yet, against this backdrop, almost every asset class made a positive return as risk assets went on a tear while government bond yields remained anchored at low levels.

Central to the positive returns was the tide of liquidity unleashed by central banks and governments alike. For their part, governments stepped up to the plate, whether it be protecting jobs through furlough schemes in the UK or commitments to trillions of dollars in infrastructure programmes and business loans in the US. Yet, the most significant policy move could come from the EU, if the French and German governments are successful in creating a €750bn post-coronavirus recovery fund based on fiscal transfers to those members states worst affected by the pandemic. However, the so-called "frugal four" countries — Sweden, the Netherlands, Denmark and Austria — want the fund to be smaller and a greater part of the cash to be handed out as loans with strings attached. Nevertheless, if successfully introduced the fund could give the eurozone greater flexibility than before and lead to a strategic reconsideration of euro assets.

Having been quick to respond to the onset of the economic downturn in March, central banks extended their list of policy actions in the second quarter. The US Federal Reserve (Fed) expanded its balance sheet by more than $2.8 trillion, much of which has been used to buy Treasuries and mortgaged-backed securities.

Further, the Fed and European Central Bank (ECB) made their first ever forays into the non-investment grade corporate bond market through the purchase of the bonds of "fallen angel" companies, or companies that have been downgraded from investment grade to junk. More broadly, the pledges to buy riskier corporate bonds effectively placed a floor under the credit market and provided investors with a reason to buy, safe in the knowledge that the Fed and ECB had their back.

In the US and UK there was much talk about joining Europe in the introduction of negative interest rates. Central bankers, for the most part, have voiced their scepticism but the extent to which they have ruled them out has varied. Bank of England governor Andrew Bailey said he was not contemplating negative rates in mid-May, only to say he would not exclude the idea a week later. His change of heart happened to coincide with a 3-year Gilt being issued with an average yield below zero for the first time.

Meanwhile, the Fed has remained resolute that it does not intend to take rates below zero, despite repeated protestations from President Trump, whilst explicitly stating that it is not contemplating raising rates. Yet, it is considering "yield curve control" a more arcane approach dating back to the 1930s involving using its balance sheet to target interest rates along the curve. It would probably prefer to keep a heathy level of steepness in the yield curve to assist the bank's level of profitability while not allowing longer-dated yields to rise too far in order to keep a lid on consumer mortgage rates.

As the major regions headed towards recession, with millions sadly losing their jobs, almost every asset class made a positive return.

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$2.8trn

The pledges to buy riskier corporate bonds effectively placed a floor under the credit market and provided investors with a reason to buy.

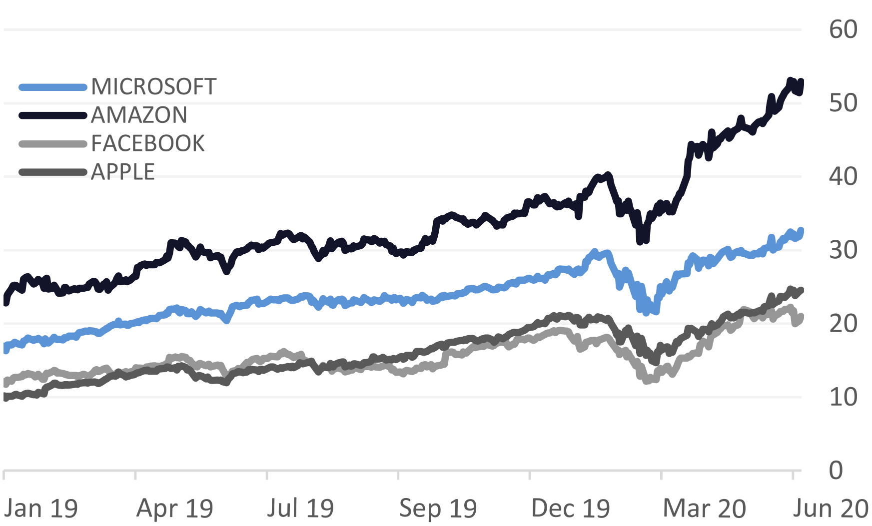
A new 3-year Gilt was issued with an average yield below zero for the first time.

With government bond yields anchored around zero, investors sought returns from riskier assets. US investment grade corporate bonds, as measured by the Bloomberg Barclays index, gained 7.3% during the quarter to return towards pre-crisis levels.

Stock markets outpaced corporate bonds with the MSCI World index gaining 19%. Even those sceptical of the rally joined in due to the 'fear of missing out', dubbed the "FOMO trade". The US led the way with the S&P500 ending the quarter 20% higher than its March 31st close and posting its strongest quarterly gain in more than two decades. The technology sector was particularly strong, gaining 30%, as many of its constituents from Microsoft to PayPal and Cisco benefitted from vast swathes of the population staying at and working from home. However, the broader picture was not so bright as 45% of S&P500 companies either lowered or suspended guidance during the Q1 earnings season with analysts expecting profits to fall by 20% this year, according to The Economist. As such, it would appear that investors have been prepared to write-off earnings for this year and trust that revenues will come through strongly in 2021. Yet, as a result of stock prices far outpacing forecast earnings, US valuations have increased to extreme levels and trade at a 45-year relative high compared to their global peers.

The question is whether the switch towards working for home and the boost it has given to technology sector is now fully priced into valuations. The last time 'Growth' stocks commanded such a premium over 'Value' was towards the end of the TMT boom and marked a period of outperformance for the latter. Absolute Strategy Research have highlighted how the performance of 'Growth' versus 'Value' is linked to the performance of Technology versus Financials. The former should benefit if credit is underwritten and the yield curve steepens

The next year forward P/E estimates for several Big Tech stocks



Source: Bloomberg

FOMO

S&P500 ending the quarter ↑ 20% higher posting its strongest quarterly gain in more than two decades.

As a result of stock prices far outpacing forecast earnings, US valuations have increased to extreme levels and trade at a 45-year relative high compared to their global peers.

The performance of 'Growth' versus 'Value' is linked to the performance of Technology versus Financials.

Technology might be priced for perfection

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while the latter might be priced for perfection (Absolute Strategy Research Weekly Wrap, 12th June 2020).

Trump VS. Biden

The US election will also figure large as we move closer to the November polling date. At the time of writing, the Democratic candidate Joe Biden has increased his lead over Donald Trump to a near record 23 percentage points, according to RealClearPolitics, largely as a result of the latter's questionable handling of the coronavirus. One of the main concerns is that a Biden victory could result in higher taxes. Goldman Sachs has estimated that a partial reversal of the 2018 tax cut, in addition to increases on other rates, could reduce the 2021 earnings-per-share for S&P500 companies by 12% and would hit all sectors. In addition, there is speculation over the pharmaceutical industry being hit by drug pricing pressures; the retail sector by the introduction of a minimum wage; and the technology sector by tighter regulation. Meanwhile, a second term for Trump could bring a re-escalation of tensions with China.

The European response to the crisis has been relatively decisive and could enable the region to open its economies more quickly than the US.

In light of the above, it is understandable that Europe started to outperform the US towards the end of the quarter. The European response to the crisis has been relatively decisive and could enable the region to open its economies more quickly than the US, while the Covid recession could also be the catalyst for a recovery fund that could provide greater fiscal flexibility than before. Further, relative valuations favour Europe, not least due to its greater bias towards 'Value' sectors. The S&P 500 currently trades at an elevated 21.5 times forward earnings, compared with 18 times for the Euro Stoxx 600 (Financial Times, 30th June 2020).

Chinese stocks trade at a relatively attractive 14 times company earnings.

By comparison, Chinese stocks trade at a relatively attractive 14 times earnings. The country's main CSI 300 index lagged behind its US and European peers during the second quarter, posting a gain of 13%, but looks well placed from a fundamental perspective. China is the only large economy forecast to grow this year and, according to IMF, is expected to record the strongest rebound next year.

UK equities lagged their global peers with the FTSE100 gaining 9%, weighed down by weakness in the oil & gas and banking sectors together with a swathe of dividend cuts. BP announced billions of dollars of write-offs and impairments anticipating that the pandemic will have a long-term impact on energy demand, while Royal Dutch Shell cut its dividend for the first time since World War II after its quarterly earnings nearly halved. Meanwhile, the UK's largest banks bowed to pressure from the financial regulator to suspend dividends during the pandemic. For the broader UK market, estimates by Link forecast that income payouts will fall from £100 billion in 2019 to less than £50 billion in 2020, leaving equity income investors to look beyond the traditional high-yielding FTSE100 names or venture abroad.

A free trade agreement is crucial to the UK Manufacturing sector and would remove some uncertainty from UK assets.

Brexit continues to cast a pall over the UK market. The deadline by which the UK could have requested an extension to the transition period with the EU passed on 30th June, with EU chief negotiator Michel Barnier talking of "significant differences" and the UK Prime Minister threatening to walk away without a trade deal. Intensive negotiations will continue until 21st August before a leaders' summit in mid-September and a Council meeting on 15th - 16th October to sign-off on a final agreement. A free trade agreement is crucial to the UK Manufacturing sector and would remove some uncertainty from UK assets. The general perception is that common ground will be found, although this will be dependent on significant compromises being made on both sides, including state aid and 'equivalence' rules within the financial industry. And while Boris Johnson may threaten to walk away, the political risks of the UK failing to secure a deal with its biggest trading partner have risen as support for the government has waned during the pandemic.

The pandemic is forecast to shrink the American economy by 3% over the next decade.

As we enter a new quarter, many of the uncertainties of three months ago remain and the fundamentals appear challenging. Furlough schemes are temporarily protecting jobs in Europe while some 20 million Americans are already out of work, and the pandemic is forecast to shrink the American economy by 3% over the next decade, according to the Congressional Budget Office. Further, the infection rates are rising in certain parts of the world, notably the US, some regions are re-entering lockdown and medical professionals continue to warn of a second wave in the autumn with no vaccine yet on the horizon.

Health or Economy

Yet, during the past three months the emphasis from governments would seem to have shifted from prioritising health to prioritising the reopening of economies. Optimism about the recovery is growing, with equity valuations pricing-in more of a 'V-shaped' recovery, leading many investors to conclude that the equity market has become detached from reality. Those in the bullish camp generally recommend riding the tidal wave of monetary and fiscal stimulus. Morgan Stanley has also pointed to the aggressive cost cutting seen over the past weeks that has increased operating leverage and has the potential to fuel a rebound in earnings. They note that labour is the primary cost for most companies, and with unemployment in the US having spiked from a record low of 3.5% to 15% in just two months, cost structures are currently leaner than usual coming out of recession.

We remain more cautious as efforts to suppress the virus have imposed real and permanents costs on the global economy.

We remain more cautious as efforts to suppress the virus have imposed real and permanents costs on the global economy. Not all businesses closed will re-open and not all jobs lost or furloughed will be restored. Yet, equity valuations are more elevated than three months ago and earnings susceptible to disappointment, if global GDP does not return to pre-crisis levels until 2022 as we suspect. Within fixed income, we remain cautious on low rated companies (single-B rated and below), despite signs that the default cycle might be more subdued than initially feared. We have recently added to global corporate bonds through a fund which invests in medium duration investment grade names, thereby a picking-up yield over government bonds for limited risk. We have also added to European equities as the region would seem to have been relatively successful in reopening after lockdown, while valuation levels are relatively attractive and the successful introduction of a recovery fund would bring fiscal integration increasing the attraction of eurozone assets.

Equity valuations are more elevated than three months ago and earnings susceptible to disappointment if global GDP does not return to pre-crisis levels until 2022 as we suspect.

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