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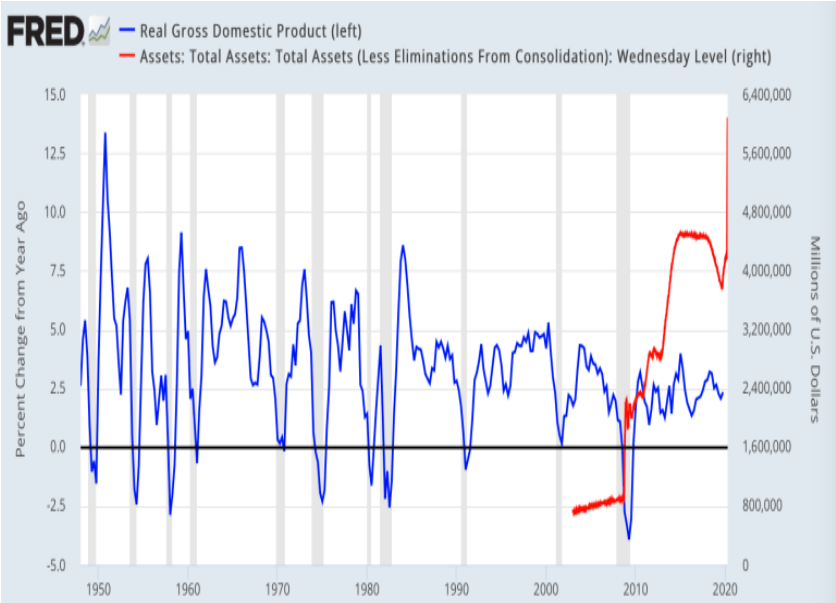
"Coronavirus" COVID-19 – update for Investors. 14th April 2020.

The broad impact of the Covid-19 induced correction, magnitude and implications has been covered in our previous articles. It is common knowledge that this exogenous shock is slowing the world economy. We are all cautiously hopeful for a vaccine solution although we understand this "silver bullet" available in mass quantities is likely to be months away. Economies rely upon a non-locked down world. When lock downs are lifted, perhaps partially to begin with, we can naturally expect markets to breathe a sigh of relief and deliver a strong rally. Taking a more objective view into what is likely could shed light on future market threats and opportunities. Only this time, it will be a new normal. We cannot emerge from this crisis naïvely believing the world will be the same - this extends to the investment world of course.

Since 2008 most markets performed strongly, fuelled by a central bank inspired strategy of financial repression. This distorted hitherto understood asset class correlations. With a renewed commitment from central banks to deliver "whatever it takes" and huge monetary stimuli being poured into markets we can anticipate an era of "QE4Ever". The scale of the extended quantitative easing measures being deployed could well bring a different impact to economies downstream. Liquidity provided by central banks has the desirable effect of holding down long-term interest rates, boosting the value of risk assets and providing enough "oil in the machine" to ensure smooth operation of the banking industry. A critical lesson learned from 2007 / 2008. Of course, these measures alone cannot fix the current economic problem. Finance ministers will be forced to relax fiscal policies to help stimulate demand for goods and services. We have seen the beginnings of this, but we sense there will be much more to come.

The chart shows the increase in the Federal Reserve's balance sheet. Levels are high and trending higher still. The Federal Reserve's latest actions announced late last week will help to nationalise municipal federal debts in a further attempt to prevent economic deterioration. This trend of balance sheet expansion is known as Japanification – as other major central banks ape the balance sheet of the Bank of Japan.



The academic Modigliani and Miller theory tells us that two companies, one with a capital structure supported by equity and the other supported by debt should offer an identical valuation where there is no tax or friction costs. Smart finance directors have been able to arbitrage the net impacts of quantitative easing over the past decade. With interest rates pegged to levels at or near to zero, companies have been able to borrow at incredibly low cost, allowing them to expand their areas of operation and enhance their EPS [earnings per share]. Taking this one step further, many firms

have used the enhanced cashflow to buy-back their equities from the market. This has in turn increased the share price of the firms in question, boosting executive share options and keeping investors happy. In numerous sectors this practise has driven markets higher in the run-up to the Covid-19 induced correction. As markets have fallen significantly and corporate earnings have at least temporarily been suspended, now the Modigliani and Miller theory once again comes into play. The extra ordinary measures introduced by the Federal Reserve are effectively bailing out the companies by buying the debt instruments issued to fuel corporate expansion. A real safety net, proving the economy is "too big to fail".

There is no limit to the extent to which the Federal Reserve can print dollars, although there is a downstream consequence which must be managed. The actions of the Federal Reserve impact globally due to the economic footprint of the United States and the US dollar being the world's reserve currency.

The United States cannot contemplate the implications of an economic reset – potentially allowing for a reordering of global economic power. This could mean commentators pushing depression theories are wrong this time. The downstream implications of "QE4Ever" could likely see the US dollar coming under sustained pressure. However, a lower value dollar allows for a more aggressive "America First" Presidential policy. Onshoring and near shoring are likely to be a growing trend and one that President Trump could sell heavily to a recovering electorate in a November Presidential poll. The Eurozone faces acute problems and the German economic powerbase may not have the fire power or the resolve to bail out other members of the Union.

Further downstream the resurgence of inflation is another side effect of excessive money printing and loose fiscal policy. This would have the positive effect of "inflating away" debt but would stimulate higher interest rates over time. This is all for the future, so what about portfolios and our positioning for a potential market rally?

The chart shows the extent of market falls and recovery so far for the S&P 500.

Alpha Beta portfolios benefitted from overweight cash positions as markets fell heavily and we took the opportunity to add to equities in a modest way once markets reached technically oversold levels. Federal Reserve actions have arrested falls so far and by providing overwhelming reassurance and markets have staged a strong rally. Alpha Beta portfolios have benefitted. Equities and investment

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grade fixed income have shown some recovery and the all-important VIX [volatility index] has fallen notably lower from all-time highs. The technical Bear Market definition has been removed by the recent rally. We are holding onto around 5% of cash within portfolios as some insurance against potential for a market relapse but will add to risk assets when appropriate to do so.

Our portfolio performance has been decent on a relative to peer group basis so far throughout the Covid-19 crisis. A cautious stance has paid off - vigilance and "*Risk First*" remain our watch words. We are encouraged Spain is relaxing its lock down with a partial return to work during the weeks ahead. Other nations may follow China and Spain's actions, but the United States remains adversely impacted as we write. Returning to an earlier point – economics rely on a non-locked down world, and until we see a stronger trend towards normalisation prudence remains at the forefront of our minds. We are well positioned for a further rally but hold some insurance against the potential for negative surprises, should they come. As we know, markets always turn ahead of the economics and earnings revisions and the belief we may be close to a peak in infection rates has created some optimism along with action from the Federal Reserve. That said, until the markets are certain, choppy times lie ahead.

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