ROCQ CAPITAL

Second Quarter 2020

2020 is a year in which it seems time has sped up, weeks feel like months and months feel like years. It was merely three months ago when investment markets were pricing in a significant global recession. However the reopening of economies as the perceived threat of coronavirus fell away somewhat, swift and dramatic policy response from governments and central banks, led to a sharp about turn in markets. Equities rallied dramatically with the US S&P 500 +20%, recording its best quarter since 1998 whilst the tech focused NASDAQ is now positive for the year. These numbers can easily give an impression that the average company is broadly fine. The reality though is that the index is a collection of significant winners and significant losers; the winners are thriving whilst the losers struggle to survive. Few are merely plodding along. Dispersion is enormous. The pandemic has accelerated change.

Economic data reflected the enormous impact coronavirus has had on major economies. In February the US unemployment rate hit a 51 year low of 3.5%. In April it recorded the highest level since World War II at 14.7% with companies quick to cut jobs as they were shut down. An exogenous shock such as a pandemic produces sharp moves in both directions as we have seen, with retail data showing a 17% month on month increase in May in the US, and 12% in the UK. Both remain significantly down year on year but the UK in particular had only just started to ease lockdown measures when those numbers were recorded.

Companies most affected – travel, airlines, cruises – rallied hard in the initial bounce but their recovery has stalled in recent weeks as it becomes clear that anything like normal levels of activity remains some way off. Meanwhile technology companies continue to produce astonishing numbers. Cyber security firm McAfee estimated a 50% increase in enterprise adoption of the cloud across all industries between January and April whilst video conferencing and collaboration tools recorded even higher numbers: Cisco Webex usage was up 600%, Zoom 350%, Microsoft Teams 300% and Slack 200%. Some of this falling away as employees return to their desk is inevitable but habits of working remotely and using video conferencing rather than travelling to meetings have been formed. Quality of life is being prioritised by workers and much of this growth in technology usage seems like it is here to stay.

Corporate bonds benefitted from central bank stimulus, returning liquidity to a market that had all but dried up at the end of the first quarter. Whilst not to the same magnitude as equity markets, an almost 10% rally in investment grade bonds and even more in high yield helped multi asset portfolios produce strong returns. Central banks have delivered a consistent message that they will keep borrowing costs low, if only to reduce their own costs as governments seek to borrow to fund deficits caused by fiscal stimulus demands. This in turn will help corporates to borrow cheaply to refinance debt or for growth. As an example the Bank of England increased its own quantitative easing program by an additional £100bn, which has anchored 10-year Gilt yields to well under 0.5%. In the United States, the Federal Reserve committed to buying both investment grade and high yield corporate bonds, support of an unprecedented level.

The reopening of economies helped drive demand for crude oil and saw prices almost double during the quarter, although they remain down 1/3 since the start of the year. As with equities, this was a historic quarter for prices, the largest gain in 30 years since the first Gulf War in 1990. In April however, WTI Crude prices fell negative for the first time in history as US demand had fallen dramatically and fears that storage capacity around

Cushing could dry up in May saw the owners of futures contracts offload enormous volumes as the contracts neared expiry and investors don't generally take delivery.

Despite focus on the global pandemic, geopolitical tensions simmered away in the background. Beijing announced plans to introduce strict national security laws over Hong Kong, bypassing the city's Legislative Council altogether. Many citizens, and Western democracies, fear the change will undermine the rule of law in the semi-autonomous territory and threaten the freedom of citizens. Both Britain and Australia made at least tentative offers of safe haven to residents who wanted to leave. Brexit negotiations continue, although major issues remain unresolved ahead of the year-end deadline, after which trade between Britain and the EU will default to WTO terms.

Outlook

Lockdowns globally are being eased – some more gradually than others – and in the coming weeks we will see how successful governments have been in containing this pandemic. There is no precedent for a pandemic in modern times to look back to. It seems unlikely that governments would be able to shut down economies as aggressively as they did earlier this year if there were another sustained outbreak. However in a second wave scenario, countries would be better prepared and be able to deploy mandatory PPE and test and trace much faster than previously.

A key factor in the strength of the economic recovery will be continued government support as businesses return to normal. Turning off the taps when activity is still substantially below pre-crisis levels will lead to a slew of businesses that had relied on support shuttering as they are unable to meet bills. We think support will last longer than first set out, particularly in the US with a presidential election looming in November. This will backstop markets and provide impetus for a new business cycle to continue to move along at speed.

After a brief hiatus to more historically 'normal' valuation levels when markets sold off in Q1, equity valuations returned to more expensive levels at quarter end, leading many market watchers to believe they are overvalued. It is important to remember that markets price in the future and not just the present. And whilst earnings for the next few quarters is uncertain at best, over the medium term the future for many companies is quite rosy. The dispersion in valuations between sectors and styles suggests though that the winners from the current pandemic will continue to be winners going forward. As we mentioned earlier, the pandemic has accelerated change and security selection will be more important than ever. We remain focussed on finding the best stock pickers who back their conviction with concentrated portfolios of the very best companies.

In fixed income, central banks raising rates in the short term seems improbable, however yield curves remain relatively flat so investors are not rewarded for increasing duration risk. As with equity markets, security selection and finding companies that will survive but earn investors a reasonable yield is the major challenge. A pickup in default rates seems almost a certainty so investors should value the safety of the best companies, even if their yields are significantly compressed. Sovereign bonds offer even less yield but in a risk off scenario will always be the place investors reallocate to so remain a key diversifier in portfolios.

Having held steady throughout the first half of the year with few changes made to asset allocations, other than cash increasing as we sold two equity funds that had underperformed, we feel comfortable with enough risk in portfolios invested into high quality assets to benefit from a continued risk on environment, but with ammunition available to take advantage of opportunities if markets do see another correction.

We are constantly reviewing positions in portfolios and considering any new risks or opportunities that may arise as a result of the unusual circumstances we find ourselves in.