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HOW INVESTORS CAN MITIGATE A SECOND WAVE MELTDOWN

As governments across the globe gradually ease lockdown measures, investors are turning their focus to the shape of the economic recovery. While cautious optimism has reignited investor sentiment, markets remain in a precarious position. Further positive data signals would sustain the rebound, but a second wave of infections could send markets spiralling downward.

Constructing portfolios for the possibility of both scenarios is a delicate balancing act. However, an emphasis on quality risk assets, combined with protectives hedges, can safeguard investors to the downside while maintaining exposure to market recovery.

CAUTIOUSLY CONSTRUCTIVE

We are confident the coronavirus crisis will not lead to a sustained depression over the next 12 months. With the continued support of governments and central banks, we believe the loosening of harsh lockdown measures will allow positive economic dynamics to resume at the beginning of the summer. However, it will take several quarters for GDPs to recover from a more than 10% drop in most developed countries.

The recovery will be driven by the resumption of domestic demand and service sectors across developed economies – as human needs manifest themselves and good and services can once again be consumed. On the other hand, it is much less clear what will happen to industrial activity, where the impact may be more sustained. This means the recovery will be uneven, with certain sectors and countries slower to bounce back.

In March, equity markets went into panic mode, pricing in a deep recession and creating a deep disconnect between the performance of the economy and the markets. Markets have now realigned to a more positive outlook for recovery, with risk assets at reasonable valuations. The danger with this is any negative news could trigger a further decline. Equity markets are thus open to two-way risk – to the upside and to the downside.

QUALITY IS COMPULSORY

As the future of markets hangs in the balance, and with the prospect of an uneven recovery ahead, the need to be highly selective is paramount. We were quick to reduce portfolio risk at the onset of the pandemic in March – substantially

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decreasing equity exposure in our multi-asset portfolios. Since the end of March, when indicators started improving, we have slowly been increasing risk – focusing on high-quality assets.

In the bond market, credit spread widening is providing an attractive entry point for corporate investment grade credit – where strong balance sheets bode better than high yield in times of economic uncertainty. We upgraded the asset class to a strong preference, purchasing two new active funds. In fixed income – unlike for equities – the largest weighted issuers are not always the best performing, hence our preference for active managers.

With high dispersion in equity markets, we are sticking to high conviction calls which were already benefitting from tailwinds pre-Covid – tech, healthcare and consumer goods. Whether the current crisis causes profound structural changes or merely accelerates pre-existing trends remains to be seen. Either way, these sectors are poised to profit. For instance, a structural shift is likely to necessitate further investment in tech, while a return to normal would equally support the prior trend of increasing tech demand.

On the other hand, we are not attracted to significantly fallen value stocks, with rates set to remain at historical lows for the foreseeable future and energy demand likely to stay suppressed as climate objectives come to the fore.

LONG-TERM LANDSCAPE

The structural factors which have been containing inflation for the last decade – such as increasing productivity and slowing demographics – will not disappear overnight. Nevertheless, a move away from globalisation and the possibility of increased trade tariffs in specific sectors could push some prices higher. In fact, we think the market is too pessimistic in this regard and inflation will likely exceed expectations in the medium term.

For this reason, we favour inflation-linked bonds to government bonds. In the US and most European countries, the implied inflation level and current prices for these assets are very low. If inflation rises in the medium term, the price of these bonds will benefit.

Over the long term, nominal rates should remain low due to continued central bank action, and we believe real rates might even fall lower. This expectation informs our portfolio positioning and drives three key calls. Not only do lower real rates support our preference for inflation-linked bonds, they are key to our supportive stance on gold and our support of equities valuations, which allow investors to pay a bit more for high-quality companies with good visibility and strong balance sheets.

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