NLP Financial Management Ltd

Coronavirus Update

12 March 2020

Background

As many are aware, the first quarter of 2020 has been a difficult time for financial markets, in most part due to the global outbreak of the coronavirus. Although the first cases of Covid-19 were reported to the World Health Organisation at the start of the year, markets initially were largely unfazed by the sharp increase in cases and deaths until the virus began to spill into the Western World. Indeed, the S&P 500 even reached a record high level on 19 February. The UK market was not quite as buoyant at this point but was only down 1% from the start of the year. What has since occurred is a mass de-risking of portfolios from market participants which has seen some of the worst days for stocks since the Global Financial Crisis of 2008.

As Italy entered a complete lockdown and cases in European powerhouses Germany and France reached the 1000 mark, investors ran for the exit door and towards the proverbial safe-haven assets of UK Gilts and US Treasuries, pushing yields down to historic lows. The causes for the sell-off at the start of this week were however two-fold, as Russia and Saudi Arabia entered into a war of words surrounding the production of oil, with the former refusing to cut production levels and the latter responding by slashing its export prices. This disagreement led to the price of oil to slump by 20% on Monday, further compounding the negative sentiment flowing through investors. This culminated in the biggest rout for markets since 2008, with US stocks plunging more than 7.5%, while London's index of top shares ended the day nearly 8% lower. Overnight, the S&P 500 and Dow Jones both fell heavily and officially entered bear market territory, defined as a fall of 20% or more from the previous high. Market sentiment was impacted by the US travel ban on 30 European countries, paired with a lack of news on any significant fiscal stimulus.

Determining how serious a threat to global GDP and financial markets coronavirus will be over the longer term is at this stage very difficult, but is likely to be materially significant. At the time of our initial article on the Covid-19 outbreak, 78,000 out of the almost 81,000 cases were in China. Two weeks later, only 6% of the 43,538 new cases have come from the region. Reports suggest that 30-40% of factories in the Hubei province are now open and people are starting to return to work again. The impact on China’s production this year will be huge but possibly short-lived.

There are no indications of the breadth or brevity of infections in the West, but there are no doubts that businesses will suffer. Yesterday morning the Bank of England announced a 0.5% cut to the base rate, the biggest single cut since the Global Financial Crisis (March 2009), and the Chancellor unveiled a £30bn package to help guide the economy through the outbreak. Without accounting for the impact of coronavirus, the Office for Budget Responsibility are forecasting lower GDP growth of 1.1% in 2020, but will rise to 1.8% in the following year. Expansionary fiscal policy will be necessary for economies worldwide to avoid slipping into a recession.

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Our View

Last month the investment committee at NLP Financial Management decided to take action by reducing our exposure to Asian and Emerging Market equities, as a means of alleviating the impact of the outbreak on performance. Since then a decision was made to further de-risk our core portfolios (except Adventurous) by exiting a position in Japanese equities and a UK equity fund focused on cyclical businesses. The two funds we took out of the portfolio have come off significantly thus far in 2020 but there is scope for more downside. The Japanese economy had already contracted by 7% at the fourth quarter of 2019. With limited fiscal or monetary tools available to them due to ultra-low rates and already-excessive debt levels, they will likely suffer as a result of reduced trade with China. The UK fund which we decided to exit is mostly made up of businesses which we believe could struggle this year. Their exposure to oil and mining companies, as well as banks could lead to prolonged losses as demand for oil falls and interest rates head south.

The proceeds from this move have been parked in cash, short-dated bonds and gilts, as we believe it will be important to protect the portfolios as much as possible in the coming months. The importance of holding risk-dampening assets such as bonds, alternatives and cash allocations in times of heightened market stress cannot be overstated, however it will not prevent volatility entirely. The Balanced portfolio is -7.9% since the start of the year (gross of fees to the end of 11.03.2020), whilst the MSCI UK Index is -21.5% for the same period. Holding liquid assets such as cash and short-dated bonds gives us the ability to invest when the market furore has abated and significant opportunities present themselves. We are however remaining highly cautious over the short-term with the aim to protect your wealth as much as possible on the downside.

Charlie McCann

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