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UK equities: Operation Dynamo to the rescue?

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Investors have been rocked by extreme market moves since the beginning of the pandemic and we are operating in a world of extremes. But what does the future hold for UK equities?

When global markets rolled over in mid-February, investors would have been hard-pressed to persuade anyone of the speed or gradient of the plunge that followed as the economic toll of Covid-19 lockdown was rapidly discounted by the market. Despite the apparent suddenness of the move, it notably occurred some weeks after the virus had first emerged in the Chinese province of Hubei, leading the great bull run to succumb to what US hedge fund manager Paul Singer aptly described as the "slowest moving black swan in history"[1].

Was that it?

In response to the total collapse in the markets, the first upward pulse was always going to be spectacular and we have indeed gone on to witness one of the sharpest rebounds on record, as global markets surged. We appeared to have experienced a "Dunkirk moment" as the central banks and a flotilla of government support schemes sailed to the rescue to seemingly avert economic catastrophe. While the full extent of our policymakers' very own "Operation Dynamo"[2] remains to be seen, as equity investors we have been left wondering …was that it?!

For our part, while we are also taking some reassurance from the level of policy support, we think it would be premature to declare victory for markets – and we question whether the potentially bruising economic path into next year is indeed fully discounted. However, we do not pretend our edge is in calling market turning points and can certainly see the current rally moving higher from here. Indeed, a euphoric "melt-up" could ironically mark the top of this initial rebound, as shorts are covered and the last of the pessimists are pulled in.

[1] Paul Singer, Elliot Letter, 16 April 2020.
[2] Operation Dynamo was the codename of the rescue operation launched by the Royal Navy during the evacuation of Dunkirk in 1940.

We recall that after the March 2000 sell off, markets rallied to new highs before falling away from June. This time, if the resurgence back towards all-time highs is be sustained, it strikes us that the economic outcome will need to be more “V-shaped” than appears warranted by the balance of probabilities.

The price for policy support

The policy response has certainly been phenomenal in its scale, far outweighing the intervention that occurred back in 2008-09. Had the government and central banks not stepped in as swiftly and immensely as they did, global markets and economies would be facing devastation at present. This has clearly led many investors to adopt a mentality of “the Fed have our backs” no matter what happens next. But with this level of intervention comes quandaries, such as the moral hazard of keeping solvent the armies of so called “zombie” companies that can’t cover their debt servicing costs with operating cashflows. Moreover, for all the temporary respite provided by the stimulus, it has only delayed the pain that will start to hit home as the support is withdrawn.

As a price for securing their survival, UK corporates have accepted stringent cost-cutting measures, and we fully expect the equity raises seen in recent months to continue. This environment, against a backdrop of rising unemployment and diminished GDP, will prove a stern test for the consumer and business confidence needed to sustain the economic recovery that we all want. Our sense is that this will be a phase requiring leadership from the government and not the central banks.

What could the final phase of the downturn look like?

So if we must first cross the valley before climbing back towards the sunlit uplands, what could take us into the final phase of the downturn? In our view, this could arrive post the expected rebound in Q3 GDP growth that follows the deep contraction of Q2. And where the Covid-19 crisis delivered us a severe supply shock, it could well be the demand shock that takes us into the deflationary bust of the final phase.

Unemployment in the US has reached levels not seen since the 1930s[3], while in the UK we have yet to see a similar step change, but the tapering of furlough support will gradually reveal the true extent of those unfortunately without paid work. Tightening credit conditions could see an unwind of the excess of the past 10 years. UK public debt has already surpassed 100% of GDP for the first time in more than 50 years and is certain to move higher[4]. The task of repairing this debt pile is one of the drivers behind our view that following the short, sharp deflationary shock of this recession we could be set for the first sustained period of “super-normal” inflation for more than 30 years. While cognisant of this sea change in the investment backdrop, we are optimistic that such a scenario could deliver a firm tailwind for the dwindling cohort of value investors.

While we commend the many investors who have in recent years very successfully sought “herd immunity” in Big Tech-led quality growth names, we are unconvinced of the risk/reward they offer at today’s valuation multiples. This extreme crowding effect has, however, ensured any nascent rally in more value-oriented names has found few friends in the market!

An interesting historical parallel we have alluded to before in this context is the infamous Nifty Fifty, another cohort of highly popular shares that were seen as gilt-edged return compounders. As they entered the bear market that wore on through 1973-74, it is notable that the Nifty Fifty group continued to outperform the rest of the market right until the very final phase of that down market. In this case, these high-quality companies continued to rack up profits and grow returns – but crucially the inflation-ravaged economic backdrop left investors uncomfortable paying such extreme valuation multiples for the privilege of owning the shares.

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[3] https://www.theguardian.com/business/2020/may/08/april-jobs-report-us-unemployment-rate.
[4] https://www.ft.com/content/57974640-8bea-448c-9d0b-32f34825f13e.

The long-term outlook

Taking a longer-term view of how current events could shape the future, we subscribe to the view that the Covid-19 crisis has primarily been an accelerator rather than a change agent. What was inevitable has simply been rushed forward at a greater speed, including: deglobalisation as China and the US de-couple; the shortening of supply chains; and the rise of e-commerce and digitisation. China's structural headwinds were beginning to tell on its economic project but have never faced greater pressures as the cold war with the US gets colder.

In constructing our UK equity portfolios for long-term outperformance, we acknowledge secular trends but think it is crucial to maintain optionality by also owning companies that do not necessarily conform to widely championed themes. Looking back to the global financial crisis, some of our greatest successes came from businesses that may not have been digital innovators or leaders in e-commerce. What they *were* able to do was prudently manage their risks and navigate through the crisis despite being largely spurned by the market.

We are operating in a world of extremes that have only been amplified through the crisis. And despite our somewhat gloomy economic comments, we are excited by the range of opportunities presented by the extreme valuations out there. It's not just a matter of "good" and "bad" companies – reality is far more nuanced than that. As stewards of our clients' capital, our focus is as ever to remain level-headed and avoid being ricocheted by one extreme motion of the market to another. To that end, we will be sticking to our DNA as patient, conviction investors and continue to use short-term volatility to build on our long-term track record of delivering attractive risk-adjusted returns.