4 SHIRES

ASSET MANAGEMENT

Investment Commentary

Fourth Quarter 2019
&
First Quarter 2020

Introduction

Welcome to the 4 Shires Investment Commentary for the final quarter of 2019 and the first quarter of 2020.

Since our December British election update the world has seen increased stress from the Covid-19 Coronavirus outbreak in Hubei province in China offset by an outline agreement between China and the United States on trade.

The falling oil price has also hit markets as Saudi Arabia and Russia haven't renewed their production cuts agreement. Both countries plan to flood the market with cheap crude.

The final quarter of 2019 saw markets rally strongly and, as the new year dawned, slip back slightly. The US Federal Reserve Bank moved to a neutral stance, having cut interest rates to 1.75%, and also re-launched quantitative easing in October 2019, providing the liquidity needed for the year-end rally. The recent sharp sell off during Q1 2020 is covered in our markets update.

The new British government is determined to loosen the fiscal spending purse strings, and drive investment and infrastructure spending at the expense of balanced budgets. However, the government's year is likely to be dominated by the Brexit trade negotiations.

Globally, labour markets are tight and more government expenditure could exacerbate this situation and lead to a pickup in wage growth. That in turn could lead in the short term to higher inflation. Markets are very sensitive to any withdrawal of the easy liquidity from ultra-low or negative interest rates. These factors are likely to set the pace during 2020.

We hope that you enjoy reading this latest Investment Commentary.

Jeremy Le Sueur
Managing Director

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Contents | Page

Markets & Investing

Compliance & Regulation

COVID-19 Coronavirus

With the spread of the most recent pandemic virus, Covid-19, aka the Coronavirus, across Hubei, then China Europe and now the US, there have been concerns over the impact on the global economy in addition to the human cost.

There have been 4,028 deaths since the New Year (as at 10 March) and overall numbers that have been infected are approaching 113,000. The virus is a respiratory virus that has been particularly lethal to those suffering from pneumonia, diabetes, asthma or those with weakened immune systems. The actual death rate experienced so far is hovering around 3% to 4%, meaning over 96% so far have recovered. Despite the insistent and panicky headlines, the virus has so far been less lethal than SARS (Severe Acute Respiratory Syndrome) which had a mortality rate of 9.6%.

The economic effect of nearly 70m people in Hubei in lock down, and the extension of the Chinese New Year holiday has caused significant manufactured product shortages. China is the source of large quantities of goods, including components. It is the latter that is causing concern around the world, as finished goods are often finally assembled overseas or domestically. Factories around the world, as well as in China, have had to reduce their shifts or even stop production. This has been exacerbated by the just-in-time manufacturing techniques that mean companies hold relatively little inventory. The silver lining to the cloud with regards to manufactured goods is that demand is traditionally slower after Christmas.

It is likely that the current concerns over Covid-19 Coronavirus will slowly dissipate. Fear over such infections stems from the post-World War 1 Spanish influenza outbreak, that killed circa 50m people in the countries that had participated in the war. The cause of the virus was the result of live animal storage in close quarters at the main arrival and departure hub for the Western front.

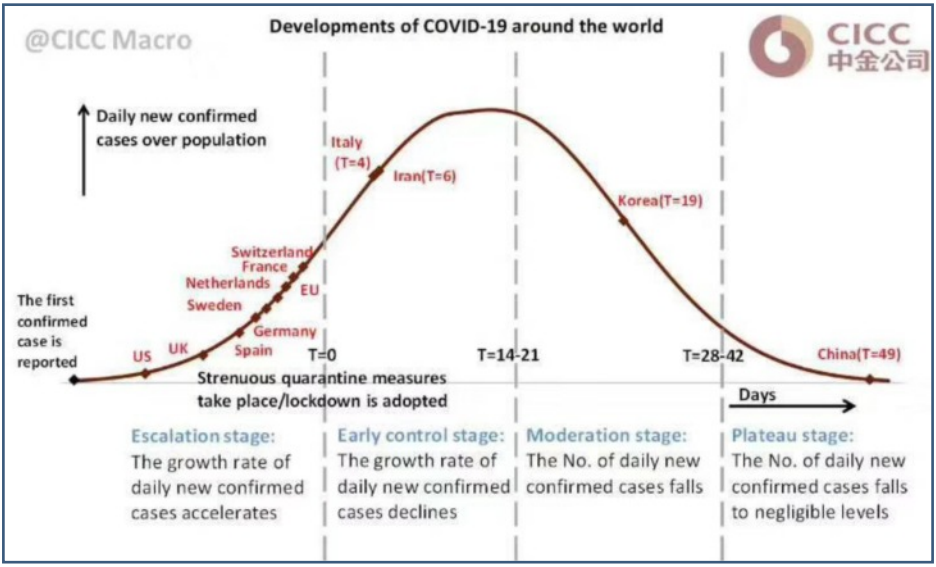
When humans are exposed to animals (in large numbers) that are kept in bad conditions it is feasible that animal viruses can jump the species barrier.

This was what happened in 1919, and this is what has happened in 2020.

Until China reforms its live animal markets, the potential for these new viruses to develop and enter humans will remain. Fortunately, many of the lessons about transmission from the 1919 outbreak have been learned in the West, but still need to be learned in China.

Another reason why we are optimistic that this virus will see an end of infections and mortality is the weather. Viruses like the Covid-19 Coronavirus tend to degrade in hotter climates, and it is probable that this will take place. In addition, people spend less time inside in close proximity to others over the summer months. This may also spell bad new for the southern hemisphere as they move into winter over the coming few months. The Chinese government has said that the virus' infection in China has now peaked, showing that the disease can be brought under control in a two to three month timescale.

The graph below is the Global timescale experience of the rise, peak and falling away of infection rates. As can be seen in the graph, the infection rates will fall away quite rapidly. Hubei province only counted 19 new cases on 10 March 2020.

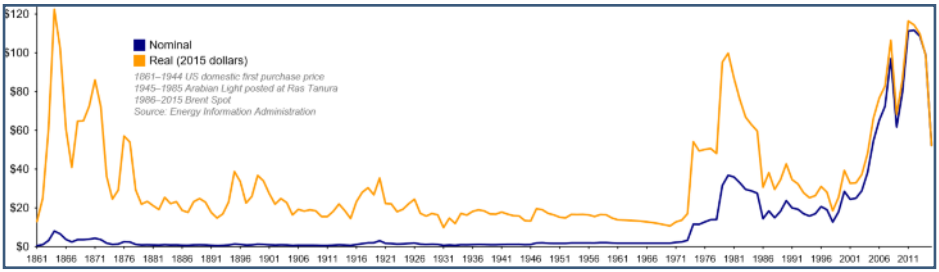


(*Source: CICC*)

Oil Price Fall

The oil market has also experienced the first drop in quarterly demand in over 10 years. With fewer journeys taking place in China, the world's number one consumer, demand has fallen. The drop of 435,000 barrels per day in demand relative to global daily production is small relative to the circa 100 million barrels of daily demand.

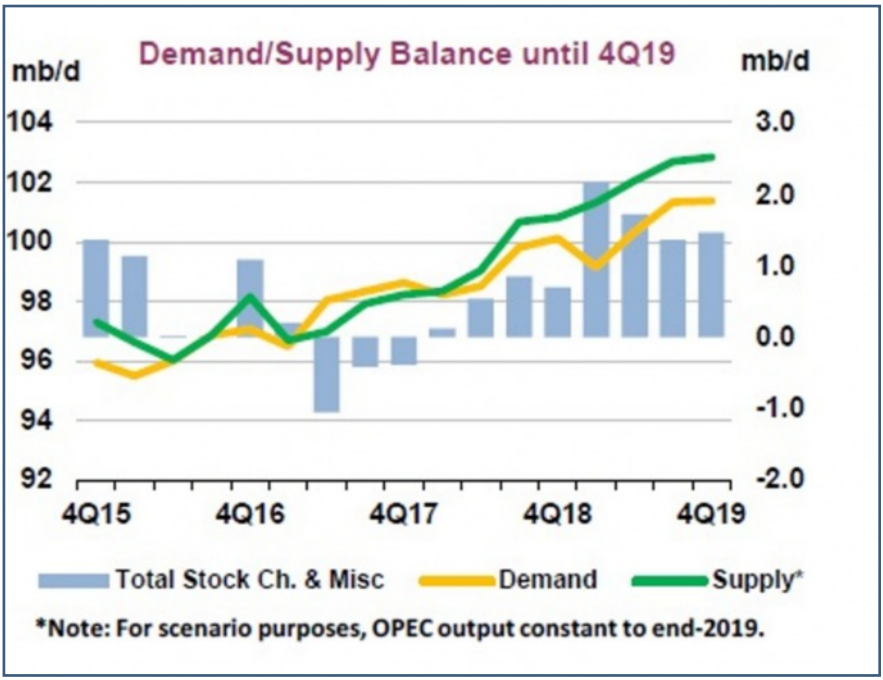
The earthquake announcement that Saudi Arabia and Russia would no longer abide by production curbs as part of the OPEC plus alliance caused the largest one-day oil price fall since the First Gulf War of 1991. To put this in context, the graph below shows the oil price from 1861 to 2015, both in absolute terms and inflation adjusted (to 2015 prices):



(*Source: Energy Information Administration*)

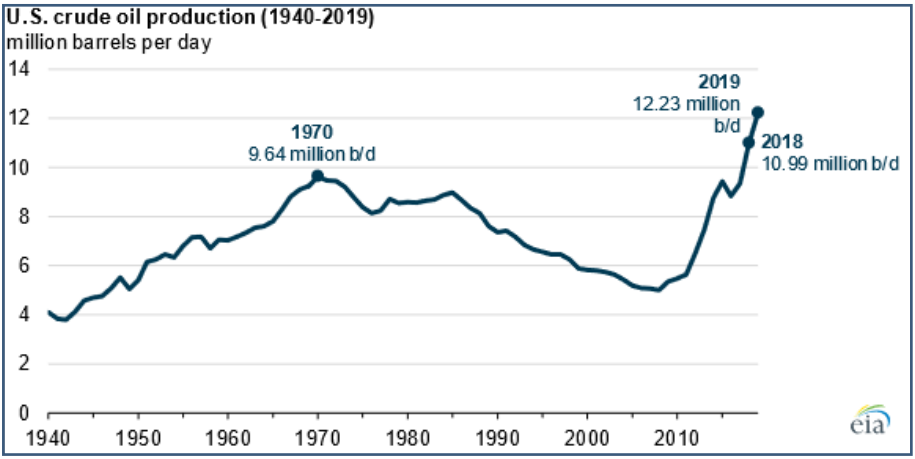
The current price of West Texas crude oil (as at 10/3/20) is circa $34 a barrel, having fallen from just $61 at the start of the year, or a drop of 44%. Much of that drop has come in the past week following the breakup of OPEC's March meeting in acrimony and recrimination. Saudi Arabia plans to increase daily production to 12.3m barrels from the current 9.7m barrels. This exceeds Aramco's sustained maximum capacity, meaning that oil would be provided to the market from Saudi reserves. Russia has said it could add another 0.5m barrels to the already oversupplied world market.

The chart overleaf shows the supply demand graph of the oil market in the last 4 years up to the end of 2019. Since mid-2018 the oil market has been oversupplied by circa 1m barrels a day, despite OPEC's expanded cartel quota system.



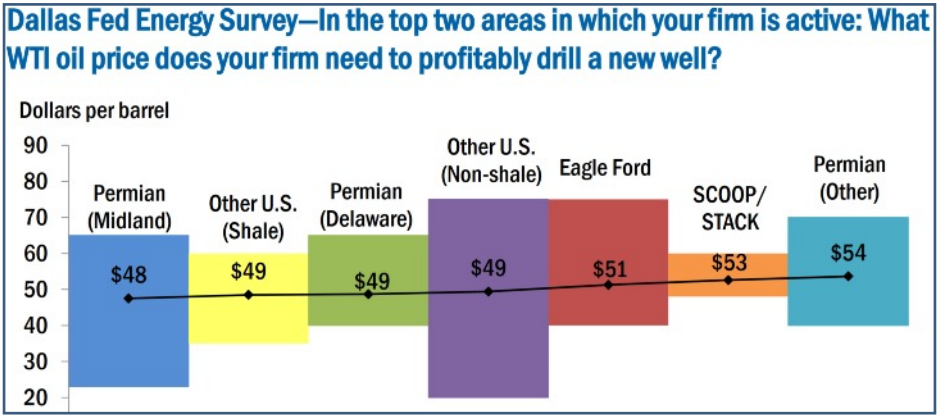
(*Source: Oil & Gas Journal*)

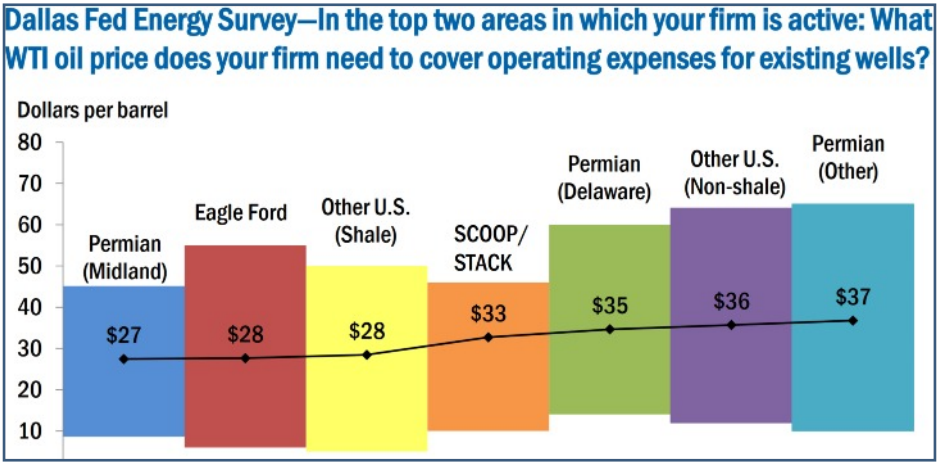
Much of the extra production has come from the United States, and the graph below shows the revival of US oil industry in production output:



(*Source: Energy Information Administration*)

The US shale oil breakeven point has been coming down fast. New shale oil wells are profitable at around $50 per barrel. However existing wells can now be profitable at between $25 and $35 per barrel according to the Dallas Federal Reserve Bank:

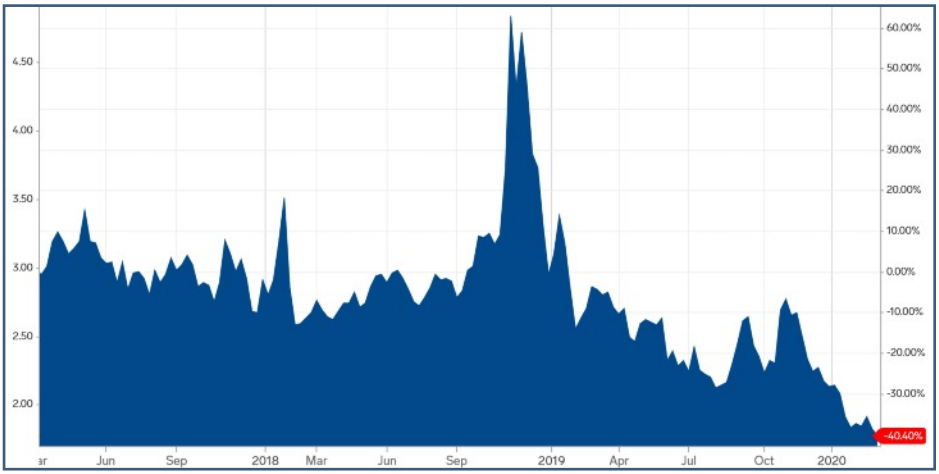




(*Source: Dallas Federal Reserve Bank*)

What this shows is that the US can keep shale production going for a while and make money so long as oil prices are over $30 a barrel. Interestingly, the life of a shale oil well is shorter than a conventional oil well, meaning new wells must be dug periodically to keep production going. This means a period of sustained lower oil prices under $30 per barrel could cause US production to fall.

The gas market has also not been spared the falling prices experienced by black stuff. The graph below shows the 40% drop in the benchmark Henry Hub gas price over the past 3 years.



(*Source: Markets Insider*)

Most significantly, the oil and gas market is going to be affected by the changes to the world as the response to climate change accelerates, a process known as 'de-carbonisation' of the economy.

Fewer barrels of oil will be required, initially in developed countries, but spreading to the developing world over time. This reduced demand means that over the next 20 years hydrocarbons will no longer be needed in such enormous quantities.

Demand growth will turn to contraction (European demand is already dropping) and oil and gas companies will have to purchase replacement assets with the cash flow that has been paid out in dividends.

This makes the historically defensive oil majors more akin to start ups, consuming their own capital by reducing debt and investing in new, low carbon, energy assets. This will make their earnings highly sensitive to the oil and gas prices going forward. There is a serious question about whether the oil majors are still investable at this point.

Our view is that any rally will see us exit the oil majors and deploy elsewhere. Oil and gas exploration companies could easily cease to be born as existing oil companies stop exploring and run off their existing fields. This could cause periodic price spikes if energy supply falls faster than demand, but these will be unpredictable and only short-term trends against the backdrop of falling oil prices.

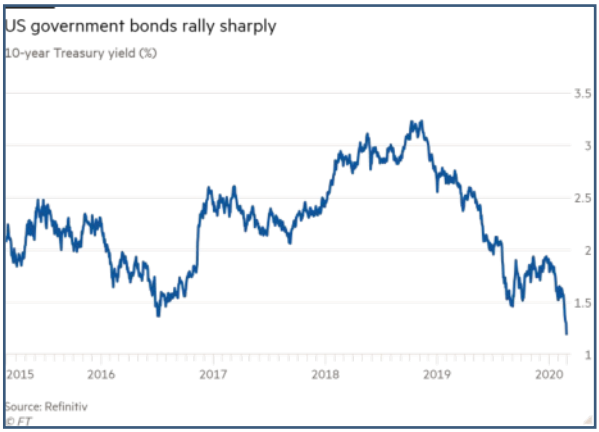
Market Update

The recent dramatic falls in global stock markets at the end of February and in early March have taken investors by surprise. The advance of the Covid-19 Coronavirus has been named as the cause of the market decline. Markets over the week up to 28 February 2020 have seen substantial falls not seen since the financial crisis, and they have fallen further in March:

Region	Index	Change on week	Historic P/E ratio	Yield (%)	10 yr govt bond yield (%)
America	Dow Jones	-12.4%	19.2	2.4	1.16
	S&P 500	-11.1%	20.6	1.9	
Europe	FTSE 100	-11.1%	15.4	4.7	0.44
	Dax	-13.0%	23.9	3.1	-0.51
	CAC	-11.9%	21.1	3.2	-0.29
Asia	Hang Seng	-4.3%	11.0	3.7	
	Nikkei 225	-9.6%	19.8	2.0	-0.16

(*Source: Alpha Terminal/Financial Times/Investors Chronicle*)

The bond market also saw a significant rally as investors sought safe havens. Gold rallied through the week ending 28 February 2020, although it did sell off on that Friday. The chart opposite shows the rally that has taken place in recent weeks on the US 10 year Treasury yield.

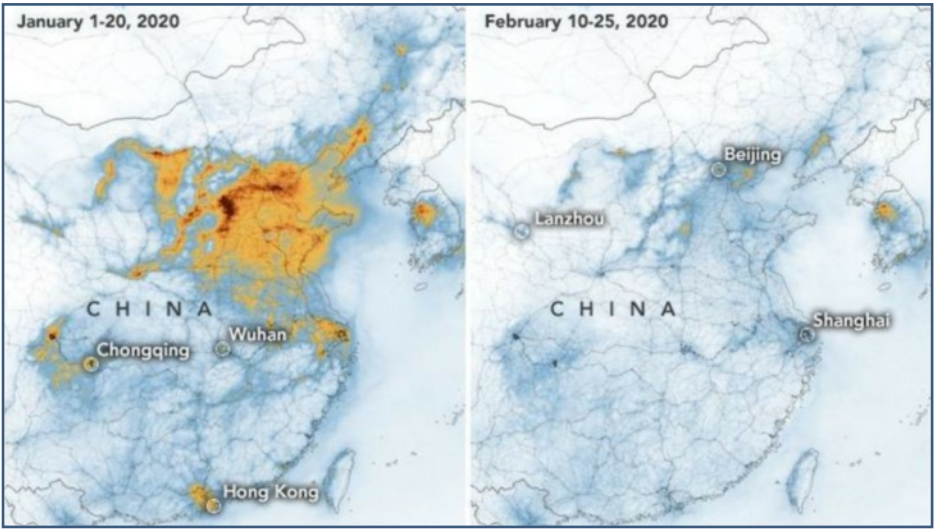


(*Source: Financial Times*)

Against this backdrop, what are the valuations in the market? The table shows that equities look expensive on a P/E ratio for most markets bar the UK and Hong Kong but look exceptional value on a dividend yield basis relative to government bond yields. Outside the US, most major markets are yielding over 10 times what the bond market is, and inflation is higher than bond yields, meaning investors are getting negative returns after inflation. Bonds have been used as a safe haven asset against market volatility.

Mohamed El Erian, erstwhile co-Chief Investment Officer of PIMCO, once the largest US bond fund management firm, has said that what the world is facing is both a demand and a supply shock. The demand shock is from consumers and companies unwilling to spend or invest respectively. The supply shock is coming from the world's inability to deliver product. Demand has been weak in several economies, particularly in Europe. Germany's last quarter showed a drop in GDP, and anaemic growth in countries that didn't reform after the global financial crisis, e.g. France and Italy.

What is a supply shock? The picture below (*Source: NASA*) shows the change in nitrogen dioxide levels across China over the past 2 months. Pollution has effectively disappeared. The picture graphically indicates what a supply shock is – i.e. a lack of factory activity and manufactured goods:



(Source: NASA)

The markets have not just fallen, but they have fallen rapidly, indeed never have markets fallen so much over such a short period of time. Part of the reason for this is the rise of passive funds that are unable to hold cash and act as a buffer to markets, in the same way that active fund managers can. In addition, the newer players in the market include high volume algorithmic computer trading that trades with very short-term time horizons. Both of these factors have increased short term volatility and exacerbated the market fall.

These dramatic falls need to be put into some context of how much markets rose over the past year. Most US indices rose over 25% and most markets rallied strongly, if to a lesser degree.

The key question is will there be sufficient demand in the world economy? The central banks are unable to stimulate economies, meaning the burden is likely to fall on governments via fiscal policy, meaning increased spending. Our view is that this is key to the stock market in 2020 and will probably be a turning point. As of 10 March Trump is proposing a major fiscal stimulus. Boris Johnson and the new budget of Rishi Sunak (see below) will see a large increase in the annual budget deficit, thereby stimulating the economy.

The effect of the Covid-19 Coronavirus will pass, and the effect of a lower oil price is in effect a reduction in the cost of business. Emerging markets will feel the benefit of the latter so long as they are not oil exporting countries, and for those oil exporters the effect will be very damaging. Budgets across the oil producing world will be under pressure, and nowhere more so than in Saudi Arabia, which requires an oil price of $90 to balance the books. Russia can balance its books with an oil price of $30 and it has built up significant foreign currency reserves over recent years.

For investors and clients, the key is not to panic and sell. Markets are likely to bounce in 2020 as the Covid-19 Coronavirus epidemic recedes. Government stimuli and lower oil prices will boost demand, and supply will recover by the summer 2020. Valuations of equities look better value than they have done in several years, and especially good value in the UK.

The UK Budget

At the time of writing this the chancellor of the exchequer, Rishi Sunak, has barely sat down. The government has announced a £600bn, five year, expenditure boost that will benefit the NHS, infrastructure, the environment, housing amongst other smaller areas. There will also be large contingencies available for fighting the Covid-19 Coronavirus.

The main highlights are:

Infrastructure

As always, the devil is in the detail. The £600bn expenditure on infrastructure is only £83bn of newly announced investment, lower than the £100bn promised in the Conservative manifesto.

The main areas to benefit will be:

- Roads – £2.5bn will be spent on potholes and £27bn on roads
- Railway infrastructure in the North of England and HS2
- £5bn will be spent to increase the broadband speed

COVID-19 Coronavirus

£30bn will be earmarked for expenditure on several areas:

- Statutory sick pay will be extended to 14 days and self-employed workers will also be able to claim
- Companies in the leisure industries with rateable values below £51,000 will see their rates bill cancelled
- £5bn will be made available to the NHS in the form of emergency funding to cope with the crisis

Personal Savings & Taxation

- National insurance threshold to rise to £9,500 from £8,632
- Pension taper threshold rising to £200,000 from £110,000 will help high earners, notably hospital consultants
- Pension lifetime allowance will rise to £1,073,100 in 2020/21
- JISA limit to more than double from £4,368 to £9,000 in 2020/21
- Increase in national minimum wage of 6.2% in 2020/21

Companies

- Entrepreneur's lifetime allowance relief to be cut from £10m to £1m
- Companies eligible for small business rate relief to get £3,000 grant
- £1.4bn for science institute in Weybridge
- £900m R&D for research into nuclear fusion, space and electric vehicles
- VAT to be scrapped on digital textbooks, newspapers and e-books
- No beer, cider, wine, spirits or diesel fuel duty rise
- Increase in R&D tax credit from 12% to 13%

Environment & Energy

- Plastic packaging tax from April 2022, charge at £200 per tonne if less than 30% is made from recycled materials
- Flood defence investment to be doubled to £5.2bn over 5 years
- £320m extra emergency funding for flood relief
- £800m to be spent on carbon clusters by 2030
- £640m on planting trees over 5 years

Regions & Homes

- £650m to provide 6,000 permanent homes for rough sleepers
- £1bn to remove dangerous materials from high rise homes
- £1.1bn for social housing in areas of high demand
- £640m extra funding for Scotland
- £360m extra funding Wales
- £210m extra funding for Northern Ireland
- £1.8bn devolution deal for West Yorkshire

Economy

- GDP growth to be 1.1%, 2020, 1.8% in 2021, 1.5% in 2022, 1.3% in 2023 and 1.4% in 2025
- Inflation to be 1.4% in 2020, 1.8% in 2021, 2% each year between 2022 and 2024
- Deficit to GDP to be 1.9% in 2020, 2.4% in 2021, 2.8% in 2022, 2.5% in 2023 and 2.4% in 2024
- Debt to GDP to be 79.5% in 2020, falling to 75.4% in 2024

Conclusion

The budget has a Keynesian, fiscal stimulus feel to it. Without doubt there is a clear need for infrastructure investment in the UK. Much of the science expenditure is to offset the loss of funding from the EU.

Protection for small businesses in the leisure sector may not go far enough or be too late. Many areas did not see sufficient investment, including a plan to hit our carbon emissions targets. On the whole, the budget was a confident first start for the chancellor in line with the Conservative party's election promises.

Portfolio Activity & Investments

The market has seen incredible falls in a short period of time, and despite the hiccup in economic fundamentals from the Covid-19 Coronavirus, our view is that markets ought to recover later in 2020. The overproduction in oil has come to an impasse, and when mixed with the de-carbonisation of the world economy over the next 30 years, we have had to react to its implications.

Up to 12 March 2020 we have sold out of **Royal Dutch Shell** (capital gains tax permitting), reinvesting the proceeds in **DS Smith**, the cardboard packaging company who will be a direct beneficiary of lower oil prices and changes to packaging rule due to come into effect in April 2022.

We also exited oil and gas company **Hurricane Energy** as current oil prices make their oil field loss making Having enjoyed excellent performance from **AstraZeneca**, we have recycled those profits into housebuilder **Persimmon** with a 10.5% yield and into **Hill and Smith**, who benefit from the spending on roads and infrastructure in the UK and US. Persimmon has circa 10% of the company's value in cash on the balance sheet, and demand remains strong for houses in the UK.

Internationally, we reduced positions in **China** and **Japan** due to our structural overweight in the region. We also sold our final holdings in online gambling business, **Playtech**, due to problems in Italy and China.

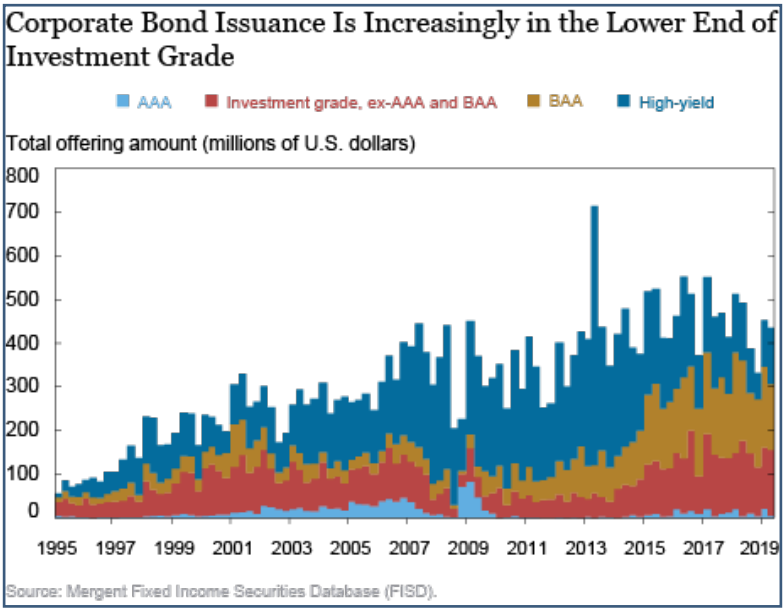
Following the demerger of UK listed **M&G** from **Prudential** last year, we sold out of M&G at 218p, versus the current 149p share price. We like Prudential's assets which are worth far more than the current share price. Activist investor Dan Loeb of investment firm Third Point has taken a $2bn stake in the firm to encourage a break-up of the business into its US and Asian parts.

Markets & Investment Outlook

BBB Bond issuance

In early January, the Federal Reserve Bank of New York posted a blog article about whether the explosive growth in BBB bond issuance by US companies over 2019 presented financial stability concerns.

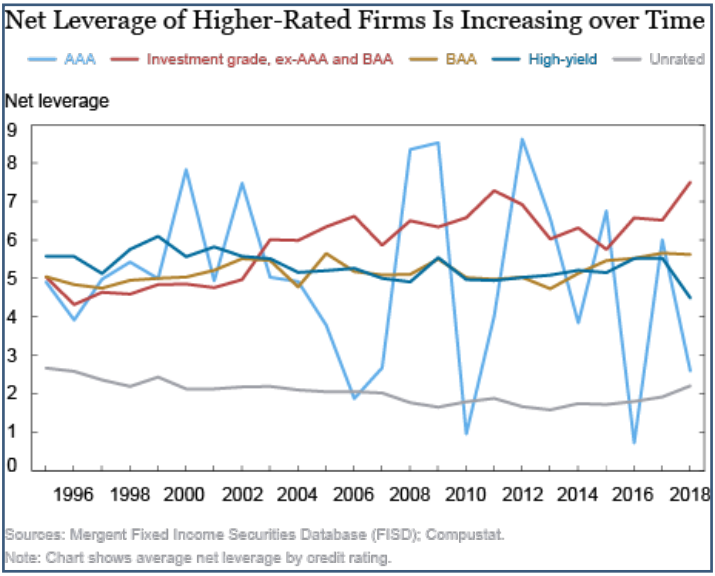
This is a theme we have been watching over the past few months, and you can see the high level of issuance in the yellow shaded area of the chart below.



(Source: Federal Reserve Bank of New York)

Companies have been taking advantage of persistently low interest rates to load up on cheap debt – which some argue offers a cheaper cost of capital than equity.

The increasing pile up of debt has itself led to downgrades in overall credit quality, with only 2 US companies retaining the coveted AAA rating (Microsoft and Johnson & Johnson).

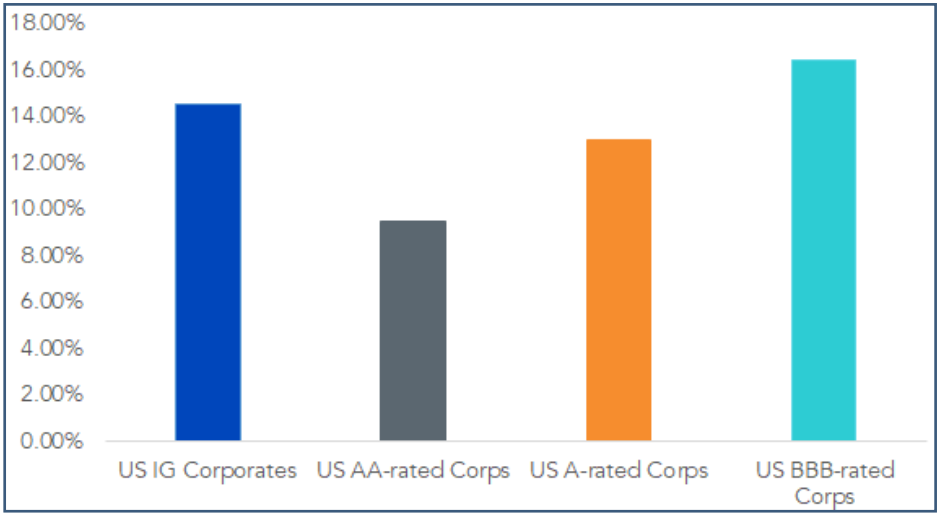


(*Source: Federal Reserve Bank of New York*)

BBB- bonds are the lowest rung of investment grade bonds. They sit one level above BB rated bonds, which are classified as so-called high yield or "junk" bonds. The risk to financial stability (as perceived by the Federal Reserve) is that in the event of widespread downgrades from BBB to BB, investors who can only hold investment-grade bonds will be forced to sell.

How likely is this?

The New York Federal Reserve Bank also identified that the leverage of BBB- rated firms was lower than both AA and A- rated firms (remember there are only 2 AAA- rated firms left now). This suggests that BBB- rated firms can service their debts and aren't at any immediate risk of being downgraded wholesale. Indeed, where there is risk, there is the opportunity for return, and BBB- rated bonds had the best performance of all bonds in the investment grade space during 2019, ahead of AA and A- rated bonds as shown in the chart opposite.



(Source: Bloomberg)

As part of our bond exposure, we hold the Liontrust Monthly Income Bond Fund for some of our lower risk clients. Whilst they have a high allocation to BBB bonds in their portfolio, they insure some of this risk away using a "credit default swap". All this means is that if the bonds default, the insurance pays out. By paying for insurance, investors achieve a higher credit rating of A- in the fund yet still benefit from the out-performance of BBB- rated bonds.

Investment Outlook

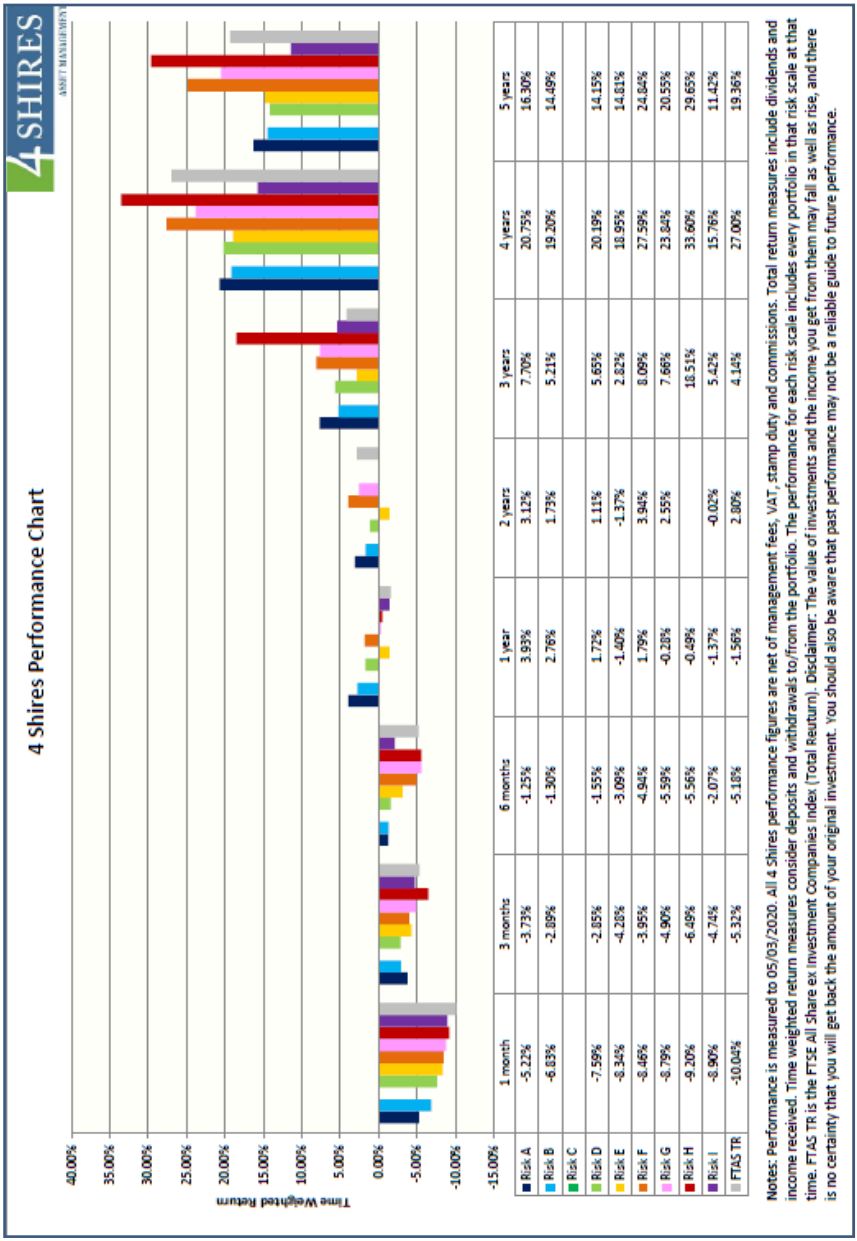
We remain invested in many solid companies with strong balance sheets and economies with good economic fundamentals. We have avoided companies with excessive leverage. We are alert to further opportunities in the markets as they present themselves.

We are all available to discuss the market at any time should you have concerns about your portfolios.

We strongly advise not selling at this point, and we are prepared for the present Covid-19 Coronavirus disruption to end later in 2020. However, stock markets often recover before the end of this disruption, and price recoveries can be as rapid as their declines.

Investment Performance

Investment performance to 5 March 2020 (S*ource: 4 Shires*) showing the average performance of all of the portfolios on each risk scale.



	1 month	3 months	6 months	1 year	2 years	3 years	4 years	5 years
Risk A	-5.22%	-3.73%	-1.25%	3.93%	3.12%	7.70%	20.75%	16.30%
Risk B	-6.03%	-2.89%	-1.30%	2.76%	1.73%	5.21%	19.20%	14.49%
Risk C								
Risk D	-7.59%	-2.85%	-1.55%	1.72%	1.11%	5.65%	20.19%	14.15%
Risk E	-8.34%	-4.28%	-3.09%	-1.40%	-1.37%	2.82%	18.95%	14.81%
Risk F	-8.46%	-3.95%	-4.94%	1.79%	3.94%	8.09%	27.59%	24.84%
Risk G	-8.79%	-4.90%	-5.59%	-0.28%	2.55%	7.66%	23.84%	20.55%
Risk H	-9.20%	-6.49%	-5.56%	-0.49%		18.51%	33.60%	29.65%
Risk I	-8.90%	-4.74%	-2.07%	-1.37%	-0.02%	5.42%	15.76%	11.42%
FTAS TR	-10.04%	-5.32%	-5.18%	-1.56%	2.80%	4.14%	27.00%	19.36%

Notes: Performance is measured to 05/03/2020. All 4 Shires performance figures are net of management fees, VAT, stamp duty and commissions. Total return measures include dividends and income received. Time weighted return measures consider deposits and withdrawals to/from the portfolio. The performance for each risk scale includes every portfolio in that risk scale at that time. FTAS TR is the FTSE All Share ex Investment Companies index (Total Reuturn). Disclaimer: The value of investments and the income you get from them may fall as well as rise, and there is no certainty that you will get back the amount of your original investment. You should also be aware that past performance may not be a reliable guide to future performance.

Important Compliance Information

In this section of the commentary, we would like to remind our clients and prospective clients of the following regulatory topics:

Risk Disclaimer

The value of investments and the income you get from them may fall as well as rise, and there is no certainty that you will get back the amount of your original investment. You should also be aware that past performance may not be a reliable guide to future performance. This document is not intended as investment advice.

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4 Shires Asset Management

Telephone: 01747 824600

Email: info@4-shires.com

Website: www.4-shires.com