4 SHIRES
ASSET MANAGEMENT

Investment Commentary

Spring 2020

Expert Asset Management

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4 SHIRES
ASSET MANAGEMENT

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Introduction

Welcome to the 4 Shires investment commentary for Spring 2020.

The recent market turbulence from the Covid-19 pandemic has caused large falls in global financial markets, particularly the equity markets and commodity markets.

The spread of the virus around the world has shut in large parts of the world's economies and caused individuals and companies great distress. The falls have been followed by substantial rises in share prices, although they remain below levels seen at the beginning of the year.

This commentary covers the main changes to the economy and the outlook for corporate profits as a result of the pandemic, and our view of the expected trajectory over the coming 12 months.

In the investment outlook section, we show how historically it has always made sense to remain invested and that disinvesting at low points in the economic cycle can substantially lower your investment returns over the long term

We hope that you enjoy reading this latest Investment Commentary. If you have any questions or would like to discuss the content in more detail, please do not hesitate to contact us.

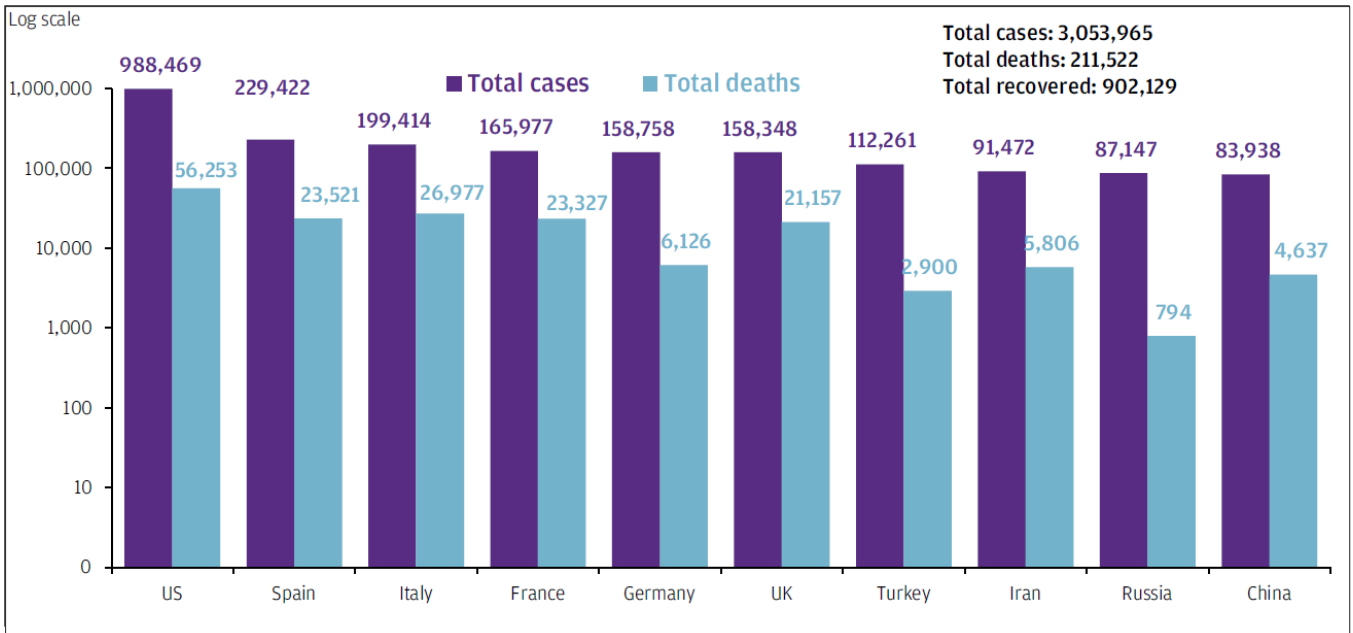
Jeremy Le Sueur
Managing Director

COVID-19 Update

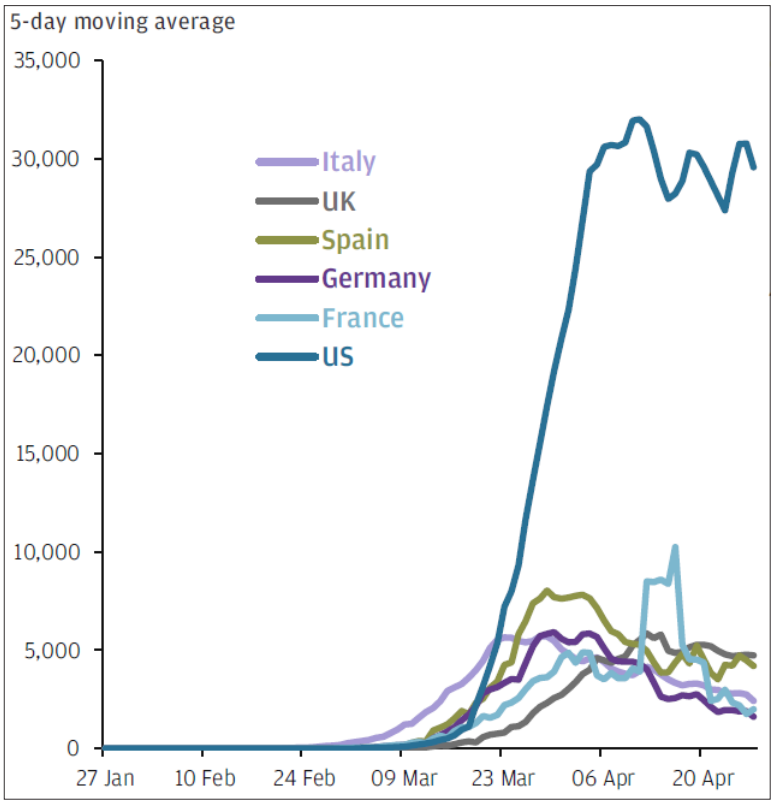
The trajectory of the virus spread in developed economies has started to slow down. Infection rates are declining, and death rates are following suit.

The graph below shows the total amount of Covid-19 cases and death rates in a range of affected countries. Please note that it is a logarithmic scale.

Covid-19 Cases and Deaths by Country



Source: Johns Hopkins CSSE, J.P. Morgan Asset Management. Cases include both laboratory confirmed and 'presumptive positive' cases. Data as of 28 April 2020.



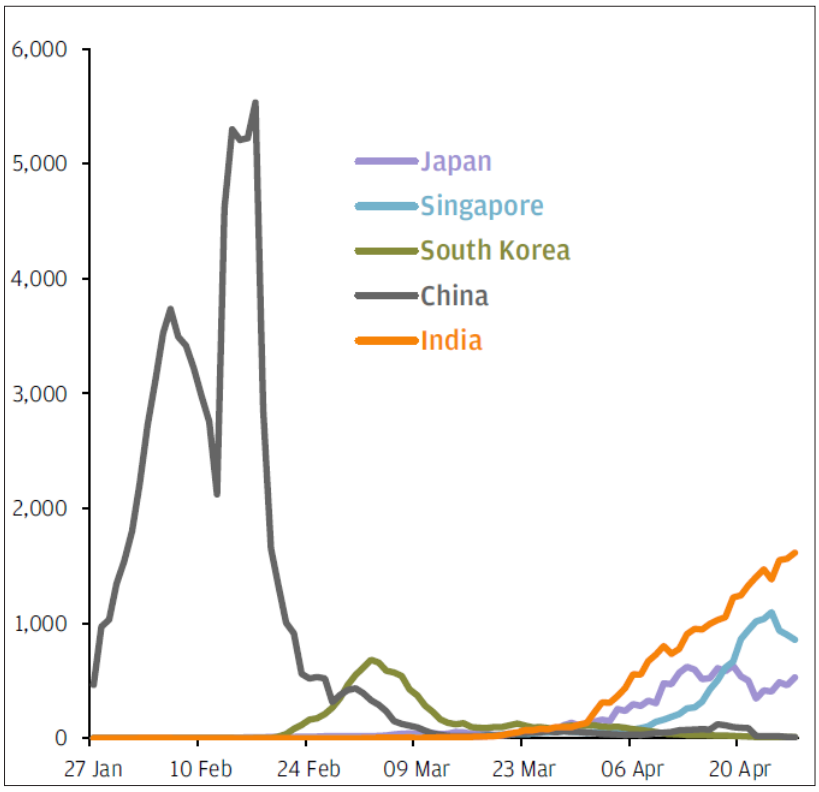
The chart on the left shows the daily increase in cases in Europe and the US.

While it is clear that European cases are declining, the pattern is less certain in the United States. Many states are moving to reduce lockdown restrictions ahead of the viral case decline being clearly established, which could engender a secondary outbreak of cases.

The chart on the right shows the daily increase in cases in Asia.

What is striking by comparison to Europe is the lower levels of daily infection (particularly in China) and the late stage effect of the virus in certain economies. This latter factor has seen a rise of cases in tiny Singapore, and more worryingly in Japan in late April.

Of greatest concern is India, where the current lockdown occurred later than in other countries and where public healthcare does not exist. Indeed there are signs of easing of restrictions in India.



The hidden problem is in emerging markets outside the major economies. Here there will be hidden death rates and little healthcare infrastructure to support the population. On the positive side the heat of some of those countries will likely eviscerate the virus over the summer months. The international community is right to be concerned over the spread of the virus in refugee camps.

As to a cure for the Covid-19 virus, the likelihood of a vaccine is still many months away despite the headline grabbing ventures and initiatives from the pharmaceutical industry. To date only Remdesivir, from Gilead Sciences, has shown an ability to reduce the symptoms from 11 days to 8, which could be significant in saving lives. There has been some success at Utrecht university in Holland at blocking the Covid-19 virus with a monoclonal antibody which looks promising. However, accelerated clinical trials will still have to take place, and so the likelihood of a vaccine in the near future remains remote.

Certain countries that have had lower death rates (e.g. Singapore, Germany and the Nordic countries) have better funded and more efficient healthcare systems. Countries with weaker healthcare spread (less funded and efficient) across the population have had higher death rates.

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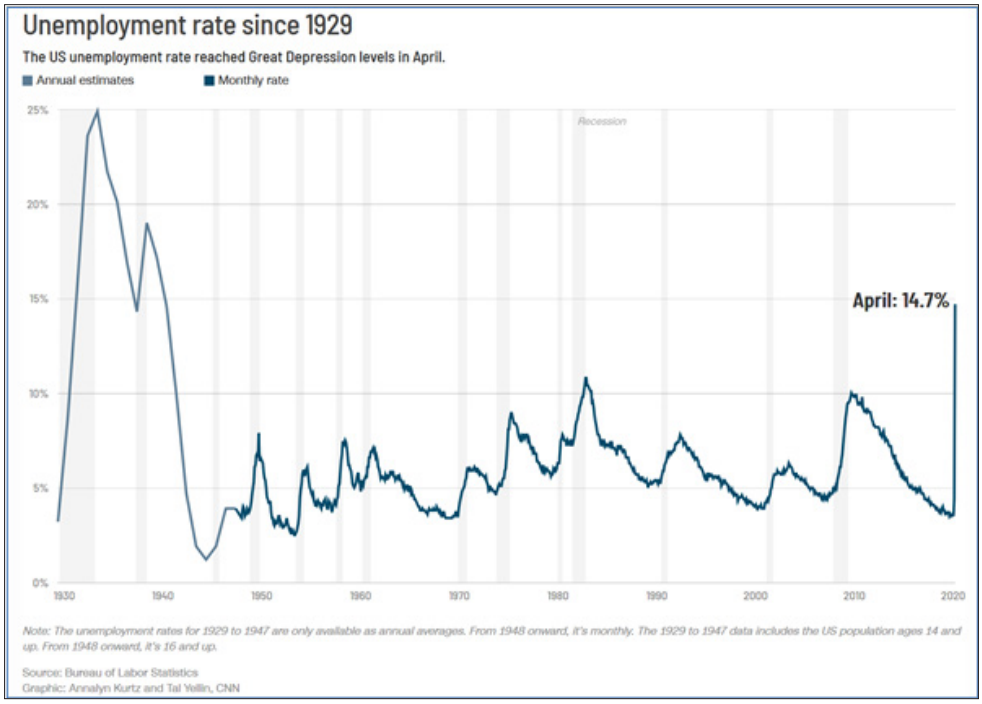
Impact on the Global Economy

Whilst the response to the virus in the developed world has been reasonably effective, the effect of having large parts of the workforce stay away from their place of employment has had a devastating effect on the economy. In this section we review the impact it has had on each major economy and region.

United States

There was a rapid response from the Federal Reserve (Fed) which cut interest rates twice in March for the first time since the global financial crisis and announced unlimited quantitative easing (buying bonds). The bonds being bought now include high yield bonds, and the Fed has intimated it may well buy shares as well. US interest rates now stand at 0-0.25%. The US Senate also passed a $2 trillion stimulus package (10% of GDP). The proposed package includes $250 billion worth of direct payments to households, $500 billion for loans to distressed companies and $350 billion for small business loans.

Unemployment insurance payments have also been boosted by circa $600 per week for the first 4 months. It is worth mentioning that US unemployment insurance payments only last between 12 and 28 weeks depending on which State you live in. What happens to the 33 million Americans currently out of work at the end of that period is uncertain, and the highest unemployment since the Great Depression is the greatest concern for the recovery, i.e. how quickly will they be rehired. The labour force is estimated to be 164m Americans, out of a total population of circa 330m. The recent announcement of 14.7% unemployment may well be understating total unemployment as a percentage of the labour force which is close to 20%.



(Source: Bureau of Labor Statistics)

The effect in the real economy, or Main Street as it is known, has been severe. All sectors saw significant declines in economic activity. Energy stocks were hit hard, with the addition of the oil price war weighing heavily. Financials and industrials also fell sharply. The information technology and healthcare sectors held up better, albeit with what would be considered steep falls in any other quarter. Amazon has rallied over the period but fell back in recent weeks due to the extra costs incurred in ensuring expanded deliveries wiped out profits in the most recent quarter.

The worst affected areas are the retail, leisure and travel industries. President Trump shut down the international flights in and out of the country, and airlines are having to stretch their borrowings to the limit despite a $58bn Federal bail-out which has loan packages and staff wage subsidies at its core.

Cinemas, restaurants, hotels and gyms have all been closed. The effect on the latter has seen Gold's Gyms (700 gyms worldwide) seek chapter 11 bankruptcy protection. Retail has been hit hard, with Neiman Marcus filing for chapter 11 bankruptcy protection. Companies with excessive borrowings (a.k.a. leverage) have the highest risks.

The US bailout package has given each individual with incomes under $75,000 a one-off payment of $1,200. Between salaries of $75,000 and $99,000 this tapers down to zero. In addition, there is $500 per child under the age of 17. This is known in economics as 'helicopter money', or direct payments to citizens to stimulate demand, avoiding expensive bureaucracies in the process.

These payments were the lion's share of the $2tn package of stimulus measures. In addition, there was $117bn for the hospital and medical sectors, $500bn of loans for businesses as well as the bail-out for airlines and cargo carriers already mentioned. The scale of the package is likely to cushion but not prevent the blow to the economy.

Regionally, New York's economy has been particularly badly hit, and other urban centres are bearing the brunt of the infections and economic slowdown. As with other countries, rural areas are faring better than urban areas due to lower population density.

Eurozone

Italy, Spain and France have been the worst affected countries by the Covid-19 virus in the Eurozone, although Britain remains the worst affected country in Europe (in terms of death rate). The Pandemic Emergency Purchase Programme (PEPP) stimulus package announced by the European Central Bank (ECB) of EUR750bn combines government and corporate bond purchases, which is a form of quantitative easing. Individual governments have put in place their own stimulus measures and the EU is moving closer to an EUR 1tn package that would see the EU budget deficit ceiling rise to 2% of GDP from its current 1.2% limit.

Eurozone economic growth was already anaemic at best, registering 0.1% growth in Q4 2019. The initial indications are that the Eurozone contracted 3.8% in Q1. Without doubt the pandemic will push Europe further into recession in Q2 as the lockdown more severely inhibits economic activity. Forward-looking indicators showed how economic activity has collapsed. The flash composite purchasing managers' index (PMI) for March fell to a record low of 31.4, compared to 51.6 in February. The PMI survey covers companies in both the services and manufacturing sectors, and an index reading below 50 indicates economic contraction.

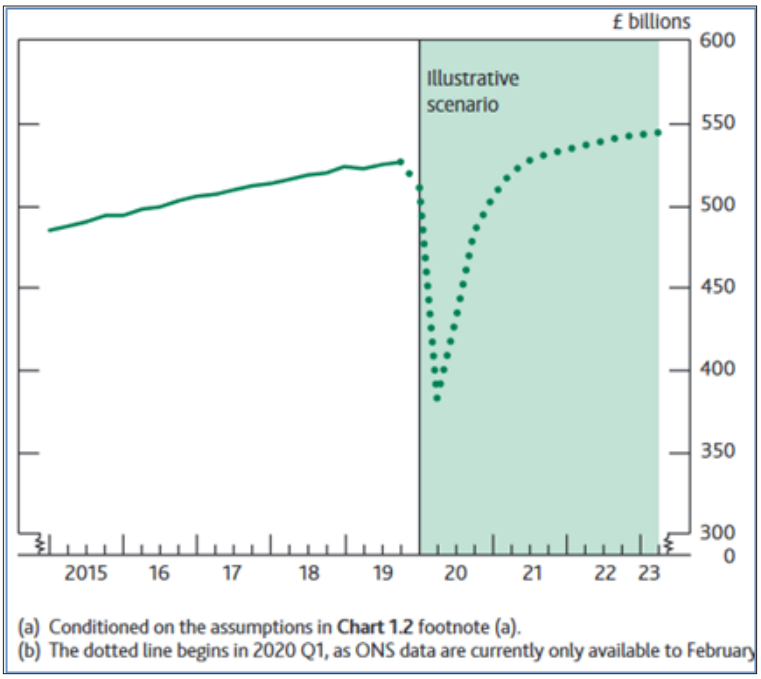
All sectors fell over the first quarter. Defensive areas of the market such as healthcare and utilities held up best. Financials and industrials were among the worst hit sectors. Regulators have pushed for banks across Europe to suspend dividends and share buybacks until at least the autumn. This would help increase their capacity to manage rising non-performing loans as borrowers struggle to make repayments.

Airline bailouts, like the US, have been a feature of the support given to industry, much to the chagrin of Europe's largest airline, Ryanair, which will soon make an official competition complaint to the European Commission.

UK

The Bank of England (BoE) said on the 7th May that the UK would endure a deep recession. Recently appointed BoE Governor, Andrew Bailey, predicted an overall 14% GDP decline in 2020, assuming the lockdown is mostly relaxed in June. GDP declined circa 3% in Q1, and is estimated to have fallen 25% in Q2, implying full year estimates may fluctuate over the coming months as the economy exits lockdown.

UK GDP Forecast



(Source: Bank of England, May 2020)

Oil and gas was the worst performing industry sector over the period, selling off on concerns about falling demand in the wake of the virus, as well as the failure of negotiations between OPEC (the Organisation of the Petroleum-Exporting Countries) and Russia to control the global supply of oil. An agreement was eventually reached, but there has been no meaningful recovery in UK oil stocks to date. The low oil price implies much of the North Sea is uneconomic for new exploration drilling at oil prices below $30.

The consumer services sector also performed very poorly as investors sought to calibrate the effect of a sharp fall in consumer demand as the UK and other governments introduced lockdown measures. Other affected areas have been travel, hotels and restaurants. Defensive sectors such as pharmaceutical and food retail weathered the storm best.

The stimulus package in the UK has included loans for most businesses, business rate relief, a £10,000 grant for the smallest businesses that occupy rented premises and a 3 month furlough scheme of income support for employees that are temporarily suspended from their positions.

Regional councils have so far been promised £3.2bn to relieve cash flow problems. The total cost to date is estimated at between £40bn and £50bn. Chancellor Sunak's budget also mandated higher infrastructure spending, notably on HS2, and an enhanced road building programme (albeit mostly pre-announced). The first phase of the HS2 construction contracts have been awarded.

Japan

The economic slowdown in Japan has been muted by comparison to other countries. Covid-19 cases have been low as can be seen by the graphs in the Covid-19 update article. Numbers of new cases per day are in the hundreds despite the 126.5m population, nearly double the population of the UK. The economy is currently predicted to contract between 5% and 6% in 2020.

The current shortage of workers for available positions, a chronic problem in Japan, has been diminished by the crisis and has seen jobs per applicant fall to a three year low of 1.39. Goldman Sachs believe that unemployment in Japan could rise to 4.2%, even higher than during the financial crisis.

The Bank of Japan (BoJ) has increased its bond purchases, although, given the scale of their existing monetary activities, it is now causing a shortage of available bonds to purchase.

One factor that is always worth mentioning when discussing the impact on corporate Japan is that many companies carry large quantities of cash on their balance sheets. This means the need to increase leverage to survive the crisis is hardly a problem for many companies.

Will this cash now be put to use investing in overseas opportunities via mergers and acquisitions, or will corporate Japan hold onto its cash as usual? Whatever they decide, much of corporate Japan is in a very strong position to weather the crisis.

Emerging Markets

Emerging market equities (EM) fell heavily in Q1, negatively impacted by the Covid-19 pandemic. The spread of the virus beyond China led to lockdowns globally and resulted in sharp falls in economic activity.

A global recession is now expected this year. Against this backdrop, a stronger US dollar was a further headwind for EM. The MSCI Emerging Markets Index underperformed the broader MSCI World Index.

Brazil was the weakest market in the index, with currency weakness amplifying negative returns. Most of the weakness was caused by the pandemic denial stance of President Jair Bolsonaro which has helped to cause a major outbreak in the country, aided by population density in the favelas or slums of the major cities. The Brazilian central bank cut its headline interest rate by a total of 75bps to 3.75%. It announced measures including reserve requirement reductions for banks and agreed a foreign exchange swap line with the Fed.

The government also took fiscal measures to help households and businesses. Colombia was another underperformer as it was additionally impacted by the fall in crude oil prices following the failure of talks to limit oil production.

Asian economies have also done better than most emerging markets on the back of the rapid recovery of the Chinese economy and cheaper oil imports, the latter reason being they are oil importers.

Outlook for Corporate Profits

Globally there are very few companies whose profits will not be affected by the pandemic's effects on revenue as a result of low demand. In this section we look at the issues facing business in general and the sectors least and most affected by the virus.

The major issue for companies is the chronic lack of revenue, despite government initiatives. With large fixed costs, most companies will dip into loss rapidly. Companies that send invoices out will find it difficult to gather the cash from customers. To ensure the cash is available to pay for those fixed costs, many companies have decided to increase their borrowings up to the maximum capacity, usually via increasing their overdraft, or revolving credit facility (RCF), with banks. They have also accessed government loan schemes, although the time taken to get these funds varies by country.

Banks in turn have relaxed many of their loan 'covenants', or tests based on total debt and profitability. Banks would be swamped and possibly become rapidly insolvent were they to insist on these lending criteria. Given the hopefully temporary nature of the crisis, they are right to defer covenant checks.

Sectors that are least affected by the virus are:

- Pharmaceutical
- Healthcare
- Software
- Computer Games
- Delivery
- Food retail
- Defence
- Utilities

These sectors have predictable revenue streams which minimise the effect if increased losses. Those with higher margins, such as pharmaceuticals and software, are best placed to survive the margin compression. Having said that, with 33million people unemployed in the US alone, even Microsoft will eventually face lower Office 365 subscription revenues.

Pharmaceutical and Healthcare companies are also suffering from lower revenues as medical professionals focus on the pandemic and routine surgery and treatments are deferred. Even supermarkets have had increased costs from hiring staff to ensure social distancing measures are in place which has offset the increase in revenues from customers.

Sectors most affected by the virus are:

- Restaurants
- Retail
- Hotels
- Travel
- Oil and Gas
- Banks
- Commercial property

Restaurants, hotels and most retails outlets have zero revenues at present, and it is here that most pain is being felt. Oil and Gas companies have been hit hard by the halving of the oil price from over $50 to the current level of circa $27 (West Texas Intermediate). Airlines, buses and trains will be affected by social distancing measures. Michael O'Leary, CEO of Ryanair, has said he would not accept any middle seat distancing measures. However airlines may have to implement these measures which would push up air fares.

Banks have already shown loan losses from the recession. JP Morgan revealed a $7bn jump in bad loan provisions in its Q1 results, causing earnings to fall 69%. It is likely that British banks will see few profits over the coming two years, although capital ratios are reasonably strong. Some loans being 'guaranteed' by government may go sour in the years to come.

Commercial property is also facing a difficult time. Home working that has become a reality for many employees may see companies continue it post the pandemic's end to reduce their ongoing costs. Retail rent collections from tenants has become problematic. Rent forgiveness has been a feature of the crisis. Any property companies with excessive leverage may collapse, such as shopping mall operator Intu, or may need refinancing such as Hammerson. Light industrial parks, often occupied by smaller companies, are also suffering.

As always, those companies with most leverage in any sector will be the first to suffer, whereas those companies holding cash will do better. In our analytical work we have focused on those companies with lower leverage, where consumers have to buy their products and where margins are not under historic pressure.

Dividend Changes

The Covid-19 virus has seen many UK and international companies temporarily reduce or abandon their dividends. Whilst we do not see these dividend cuts as permanent, the loss of income for investors means that it will be necessary for clients to dip into their capital to cover the lost income where it is not already covered.

However, the long term impact may be somewhat different for total returns.

- Many companies are still paying dividends in full. These tend to be companies with good balance sheets, defendable business models and low pay-out ratios (a pay-out ratio is the percentage of earnings per share paid out as a dividend e.g. a company that earns 3p a share and pays a 1p dividend has a 33% pay-out ratio).

- Some may pay lower dividends than normal due to the effect the economic situation is having on their profits. It is likely that these companies will restore dividends as soon as practicable. We would expect within 2-3 years they will be back at 2019 levels.

- Some companies have entered this economic environment with too much debt or their revenue has disappeared overnight (or both). These companies cannot pay dividends at the moment and need this cash flow to restore their balance sheets.

- Some companies have strong balance sheets and made good profits in 2019 that they would like to distribute but have been told by regulators to not do so, including the life assurance, general insurance and banking sectors. The value of the unpaid dividend remains on the balance sheets of these companies.

We understand the need for companies to rebuild their financial strength and on the whole view dividend cuts as sensible except in a few cases where companies could have paid and have chosen to not do so as a result of pressure from their regulators.

Companies that have cut their dividends to prioritise cash holdings that enable them to operate and trade effectively can often recover faster than those that have blindly pursued the maintenance of dividend targets set in a completely different environment.

At 4 Shires we moved quickly to identify those companies we thought might not pay their dividends and focused on companies with strong balance sheets where payment cuts would not make sense. We focus on companies with the following facets:

- Strong balance sheets, with lower debt levels relative to profits.

- Cash flow that is more than sufficient to pay dividends.
- Business models that are sustainable. In particular, we like companies where people have to use their services (e.g. food and healthcare companies).
- Good management.
- Companies that are not undergoing structural change in their industry (e.g. restaurants).

We responded to the situation by:

- Selling out of companies where profits may be affected significantly and for a long time to come.
- Avoiding companies with too many debts.
- Holding those companies where we expect profits to partially or fully recover in the next 12-18 months.
- Holding those companies where balance sheets and profits are sound, but where regulators have blocked dividends in the short term that could normally have been paid.
- Investing in, or holding, investment trusts with revenue reserves that can afford to pay dividends in difficult times (e.g. City of London investment trust).

A look at past crises shows that the overall impact on the intrinsic value of a business from a temporary dividend cut is generally small and, for long-term investors, it is important not to lose track of that fact amid the short-term market noise.

We understand everyone's circumstances are different and each individual's reliance on dividend income for their lifestyle varies.

Please do not hesitate to get in touch to discuss how we can assist. Our expertise is to provide bespoke portfolio management that meets both your and your family's needs.

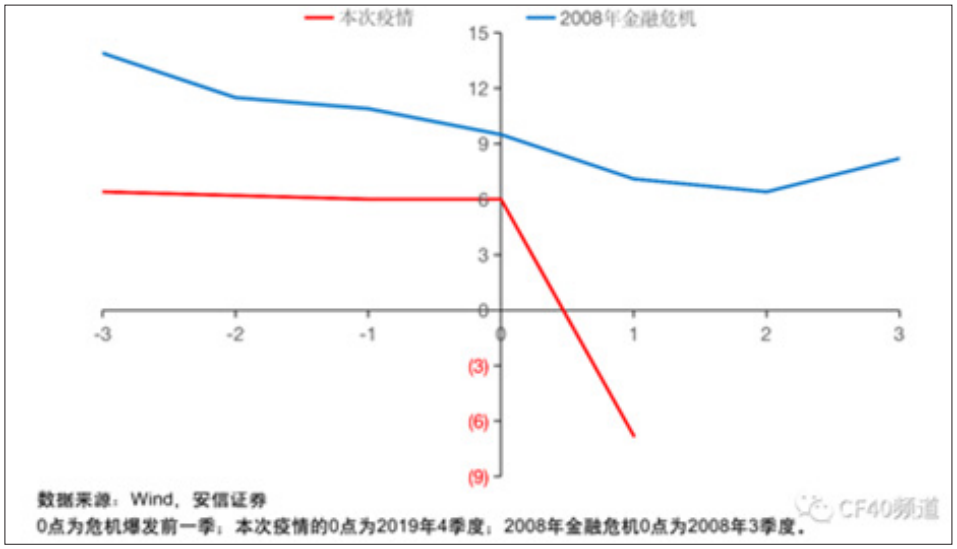
China – A Reason for Optimism?

China entered the epidemic and implemented controlling measures well ahead of the rest of the world. To gain insights for the economic situation in the Western world, we look at China's first quarter economic data and gauge the economic impact and its implications including future policy response in a post-epidemic era. This technical analysis informs our view of the likely route to economic recovery.

Courtesy of our friends in the investment community in China, this is a summary of an article by Dr. Gao Shanwen, academic member of the China Finance 40 Forum (CF40), a private think tank, and Chief Economist of Anxin Securities, a mid-sized investment bank in China. Here are his observations and analysis of China's economic data for the first quarter (4 Shires' comments are in brackets in italics):

1.'In the first quarter of 2020 during the Coronavirus outbreak, the total economic output and the overall price level produced a very strong contrast: the impact of the pandemic on output is two to four times of that during the Global Financial Crisis (GFC), but the impact on the overall prices is only about 20% of that during the GFC (both industrial and consumer prices).

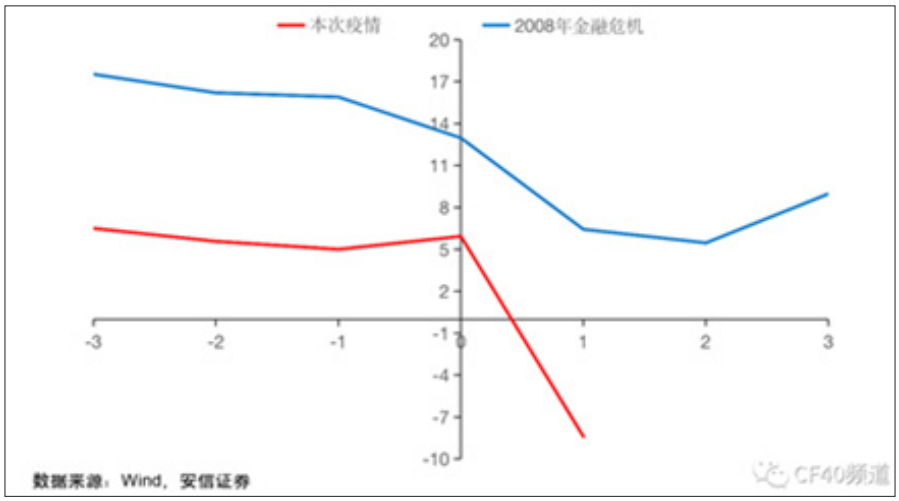
Impact of the GFC and Pandemic on Economic Growth



(Source: Wind, Anxin Securities)

0 is the previous quarter before the crisis, 0 for the COVID-19 epidemic is 4Q2019, 0 for GFC is 3Q2008
Blue line – 2008 GFC
Red line – COVID-19 epidemic

Impact of the GFC and Pandemic on Industrial Production

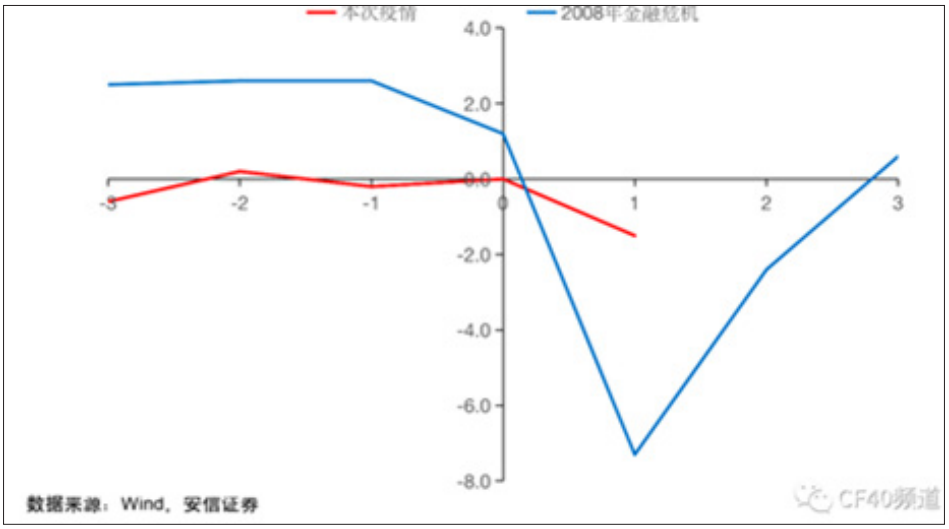


(Source: Wind, Anxin Securities)

0 is the previous quarter before the crisis, 0 for the COVID-19 epidemic is 4Q2019, 0 for GFC is 3Q2008
Blue line – 2008 GFC
Red line – COVID-19 epidemic

Based on the economic data for the first quarter of 2020, the impact on the economic growth rate by the epidemic was four times that brought by the financial tsunami and the decline of industrial output this time is twice as much as that during the GFC.

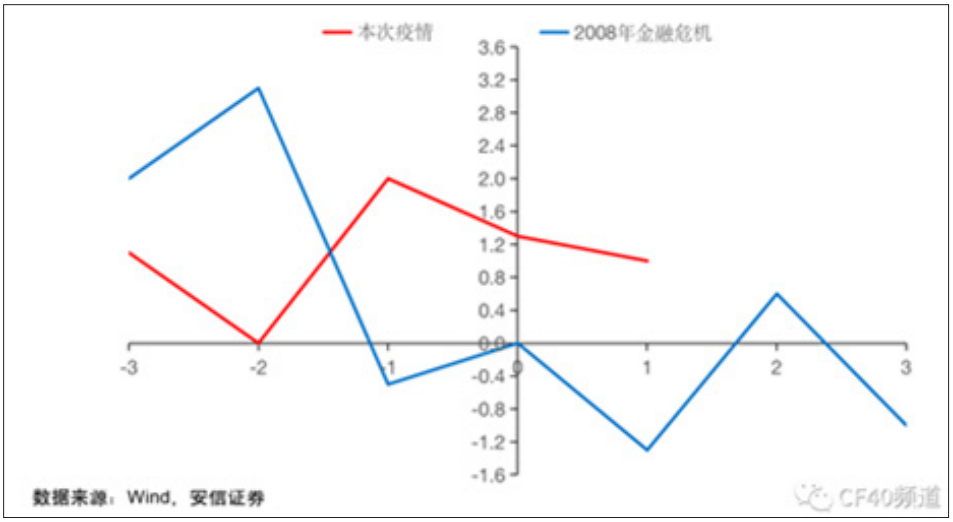
Impact of the GFC & the Pandemic on Produce Prices (PPI)



(Source: Wind, Anxin Securities)

0 is the previous quarter before the crisis, 0 for the COVID pandemic is 4Q2019, 0 for GFC is 3Q2008
Blue line – 2008 GFC
Red line – COVID-19 epidemic

Impact of the GFC & the Pandemic on consumer prices (CPI)



(Source: Wind, Anxin Securities)

0 is the previous quarter before the crisis, 0 for the COVID pandemic is 4Q2019, 0 for GFC is 3Q2008
Blue line – 2008 GFC
Red line – COVID-19 epidemic

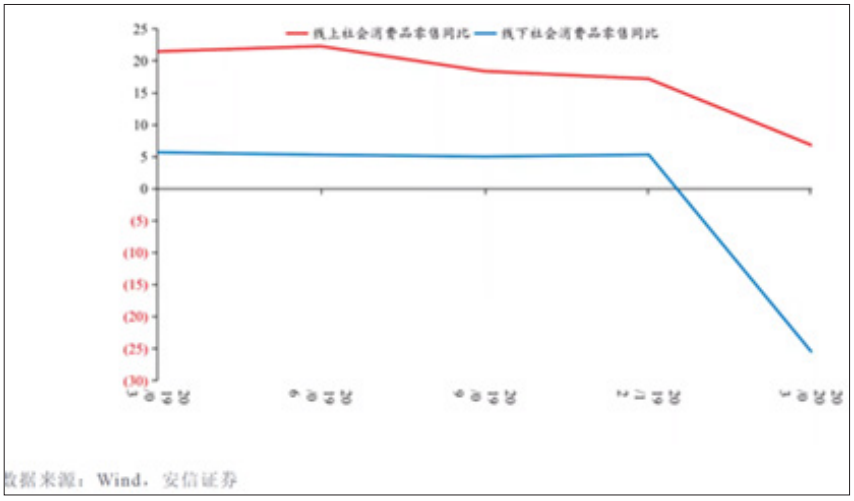
Although it is still too early to say where prices may end up, this is an encouraging development, as lower price falls ought to do less damage t the economy. This is because the Covid-19 virus outbreak is disturbing demand, but it is also causing a very substantial disruption to total supply *(as we identified in our last 4 Shires Quarterly Report, February 2020)*

On the one hand the outbreak has led to a significant reduction in consumption and investment activities, but on the other hand, production and services activities have also experienced a significant decline as a result of the Government's lockdown measures. Since demand and supply have fallen sharply at the same time and the gap between the two is not so large, prices have only shown very modest declines. However, the sharp decline in production and service activities are reflected in the output data, which is used to calculate the GDP figure, and that is why we are seeing very shocking headline economic figures around the world.

The policy implication of this observation is that, until the blockade on total supply is fully lifted, the one-way stimulus to demand may not have a desired effect but could easily lead to inflation. Thus, policies need to take into account the changes in demand and supply, as well as the size of the gap between the two and their dynamic evolution, in order to avoid over-reliance on aggregate demand management (i.e. Keynesian stimulus).

2. During the pandemic, not only did offline consumption activities experience a very sharp decline, but online consumption (such as clothing, daily necessities, etc.) also fell significantly. This shows the complexity of consumer behaviour in the wake of the lockdown shock.

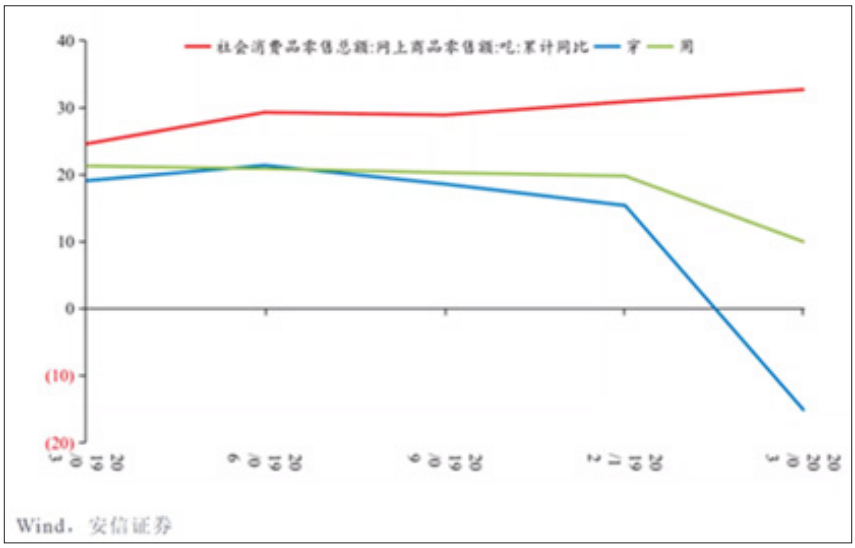
Impact of Pandemic on Online and Offline Consumption



(Source: Wind, Anxin Securities)

Red line – online total retail sales (year on year growth rate)
Blue line – offline total retail sales (year on year growth rate)

Impact of the Pandemic on Online Sales of Food, Daily Necessities, Clothing



(Source: Wind, Anxin Securities)

Red line – online sales of food (year-on-year growth rate)
Green line – online sales of daily necessities (year-on-year growth rate)
Blue line – online sales of clothing (year-on-year growth rate)

The question to ask is: If people reduce offline consumption such as eating out, traveling and buying goods to control risk, why have online sales experienced a significant decline as well? Obviously, this cannot be explained by infection risk and lockdown measures.

We believe that under the impact of the Covid-19 virus outbreak, people's behavioural decisions are carried out and evolved over three levels:

- The first is panic. In the face of this event where the spread of the disease and the health implication are unknown, it is natural that people would become panic and rush to be in a safe environment. Hence people would not only restrict their travel but also focus on online shopping for basic needs.

- The second is adaptation. If the risk of the infection is expected to persist for a long period of time, people will assess the risk of infection under different types of behaviour, the availability and effectiveness of safeguards and the benefits of renewing activities. People will gradually restore those activities which can maximise the benefits and minimise the risk of being infected. Thereby consumer behaviour will dynamically evolve and adapt to the new living environment.

- The third level is expectation adjustment, which is to assess the impact of the outbreak on the individuals' long-term income outlook and short-term cash flow and adjust the expenditure plan accordingly.

WeI do not believe that people can completely reject risky activities, just as people know that planes have a very small probability of an accident, a life-threatening risk, but there is still a general risk of air travel because people believe that air travel brings significantly more benefits than the risks.

From this extreme case, we would like to explain that, although many offline activities are risky under the conditions of the outbreak, people will gradually develop different control methods for different activities, independently assess risks and benefits. In this context, many offline activities will be gradually resumed.

Not only will consumers make such an assessment, but the government will also assess what measures can better restore the economy, and at the same time lead to a relatively small risk of re-emergence of the pandemic, so as to continue to trial and error and optimization *(diagnostic testing becoming more widespread will aid this return of confidence).*

Entrepreneurs will also follow similar patterns of behaviour to consider investment arrangements.

3. Looking at the prices of household services and maintenance (CPI) in the first quarter , the decline was the same as that during the GFC. In another words, similar to the GFC, the decline in prices of home services and maintenance was five times larger than the overall price drop. This phenomenon suggests that the low-end labour market (which can also be extended to some sectors and SMEs) has been more impacted by the outbreak. More generally, some industries, enterprises especially SMEs and low-income people have been more significantly affected and need to be helped by transfer of payments and other means.

In general, people will, as we come out of the panic, begin to assess the impact of the Covid-19 virus outbreak on individual long-term income and short-term cash flow, and adjust their spending plans. If long-term income is expected to fall, it will be necessary to reduce spending, delay the consumption of many consumer durables. For example, instead of buying a large house, they will now only buy a smaller one. In general, those with higher incomes, certain financial assets, savings and relatively good credit qualifications, tend to maintain their short-term consumption behaviour as long as the long-term income stream is unaffected. This is because they can obtain credit or use financial assets and savings to support short-term expenditures.

However, those low-income earners, although their long-term income expectations may not change (which is a big one), have experienced a sharp drop in short-term incomes. They don't have enough financial assets as a buffer, and some may even have financial liabilities such as children's college debt or instalments. They will have difficulty in accessing low-cost credit. For this group, the pandemic will cause greater social suffering in the short term and for the overall economy as they are forced to reduce consumption under liquidity constraints. They will also cause the secondary economy to contract which in turn will affect the overall economic recovery.

Can we give this group some degree of income support to stimulate demand?

Let's start with the following questions:

First of all, is this the most effective tool to stimulate demand? We don't think so. If the government gives money to low-income groups, they may spend 90% of that to create a stimulus to demand, but the propensity to consume is unlikely to be greater than 1 *(In China savings rates are much higher than in the West, circa 35-40% vs. between 5-10% respectively)*.

However, if the government invests the money in infrastructure and banks provide additional matching loans, this will result in an expansion in demand that is likely to be greater than the initial spending.

Second, where does the money come from?

There is no doubt that it is up to the government to issue debt. Government debt issuance will ultimately be borne by future taxpayers, absorbed in the worst-case scenario by inflation. This is fundamentally involved in the transfer of income between the crowds, and even between generations.'

4 Shires comment: Whilst it is early to say for certain the nature of this economic correction might take, the point about consumers changing their pattern of consumption over time is relevant. The article is calling for Chinese government stimulation of demand, favouring infrastructure expenditure over direct grants to the citizen to avoid inflation. However, if lower income citizens in China spent 90% of any grant, this would make a substantial difference to the normally high savings rate. So far the government has favoured raising money from bond issuance and injecting money via the banking system to companies. GDP fell 6.4% in Q1 in China, but there are signs of recovery.

China's economy has recovered relatively swiftly and has reported a trade surplus in March with exports falling by 6.6% and imports down by 0.9% from the same period last year. This is against economists' expectation of minus 14% in exports and minus 9.5% in imports.

Most industrial production has now returned to normal and even in Japan production is now 80% of its normal level.

12 Month Trajectory

The question we would all like to know is when and how we will exit the lockdown and how will it affect the economy. China's example shows that recovery can occur quite rapidly despite a rapid drop in GDP in the first quarter. In addition, governments are unable to continue the stimulus at levels required to protect the economy for longer than six months.

Governments have bought time so that healthcare systems can cope with the pandemic and measures can be put into place to ensure that the damage from a resurgence of the virus can be quickly dealt with.

Economy

The current likelihood is that primary schools and employees (under 65's) will return to work first, probably in early to mid June. The restart to the economy will include social distancing measures, increased diagnosis and limits to social interaction (e.g. restaurants, bars and places with high people density). On the last point, a recent secondary outbreak of Covid-19 in South Korea has been linked to discos.

What is not clear is how many staff will be rehired, or not made redundant if subject to a furlough. Another question is how quickly transactions will return to the economy. Given that unemployment was abnormally low prior to the crisis, it makes sense to expect that unemployment will be higher than it was before the pandemic. Economic activity will take a considerable amount of time to return to 2019 levels, probably in the order of 1-3 years.

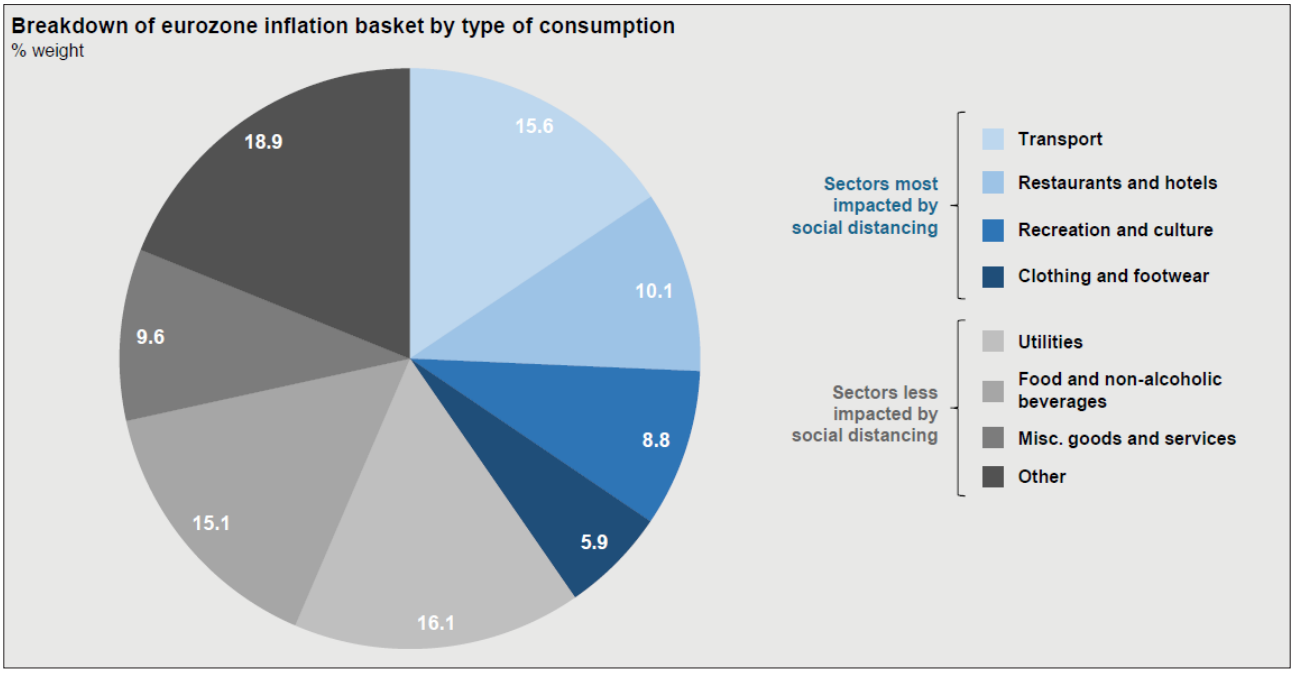
As to asset levels, so far these have changed little, but there will need to be some transactions to establish the actual price level post the pandemic. It is likely that commercial property will face a downturn due to lower payment levels by tenants and increased levels of home working reducing demand for offices. Retail property will remain the worst asset sub-class. Leisure assets will also take a time to recover as people will remain unwilling to return to areas of high people density until a clear cure or confidence in a system returns.

People are likely to drive more than take public transportation, increasing pressure on airlines, train and bus companies. Some return to public ownership is possible rather than payments to transport franchise holders.

In the leisure sector, restaurants, always difficult businesses prior to the pandemic, will shrink in number and the move to takeaway delivery will increase. Older citizens will use restaurants less and this will cause great pain in the sector as they are the main consumers of such services.

Large volume public events (festivals, theatres, music venues, cinemas, gyms) will face lower demand for some time to come. Online equivalents will grow in sophistication.

The level of inflation will probably remain subdued in the short to medium term (1-3 years) as the economy operates below capacity. In addition, some of the drivers of inflation, mostly leisure and clothing, will see reduced demand and pricing power:



(Source: JP Morgan)

Companies

Levels of debt will strangle companies that entered the downturn with too much debt. The rules of investing will change, and lower leverage will over time become the norm once the current debt spike has been cleared. Post the GFC there was a deleveraging for a short period of time, but this then reversed. Government's initial stimulus will stop in by year end 2020, although follow up stimulus may be required into 2021.

Conclusion

The economy will start to recover in the second half of 2020, albeit slowly. Leisure activities will take a considerable amount of time to return to pre-crisis levels of participation. We review in the outlook section what we expect the 12 month trajectory may have on financial stock markets.

Portfolio Activity and Investments

We have been focused on the issue of leverage and dividend income in portfolio construction. For example, we could see that Royal Dutch Shell was paying an unsustainable dividend and exited the position where possible (CGT allowing). We also sold out of City of London Investment Group following an excellent total return.

D S Smith

We replaced Shell with D S Smith, a paper and cardboard packaging group benefiting from the move to more sustainable packaging by supermarkets and other companies. We have followed the company for years but when the shares fell in the first quarter we used it as an opportunity to buy a large position. The company is a beneficiary of lower energy prices.

D S Smith has had a proven track record of earnings growth since Miles Roberts became CEO (prior to that he was finance director of McBride). He has made several acquisitions, including Spanish company Europac, that have helped grow the scale and profitability of the company.

The stock trades on 11.6x April 2021 earnings with a prospective 4.6% yield more than twice covered by earnings. The company has omitted its 2019 interim dividend, but we currently believe it will probably pay its final dividend given the strong operational results of the company.

Strix

Strix is an Isle of Man based business that makes heat sensors for the world's kettles. The sensors turn the kettle off when the water has boiled. The company has 38% of the world market for these sensors. In recent years the business has made progress in diversifying into new business areas, including baby care products, Acqua Optima water filters (no.2 brank in the UK) and hot water on demand. These new product areas are likely to bear profitable fruit over the coming years.

The company has recently invested in a more efficient new factory in Guangdong province in China which opened this year. The factory is already operating efficiently and in-line with the company's projections.

The stock trades on 13.2x historic earnings and has a 4% yield twice covered by earnings. We are expecting circa 8-10% earnings growth in 2021 which looks good value for a company with strong market share and a good pipeline of new product areas that ought to help to diversify earnings in the future.

Markets & Investment Outlook

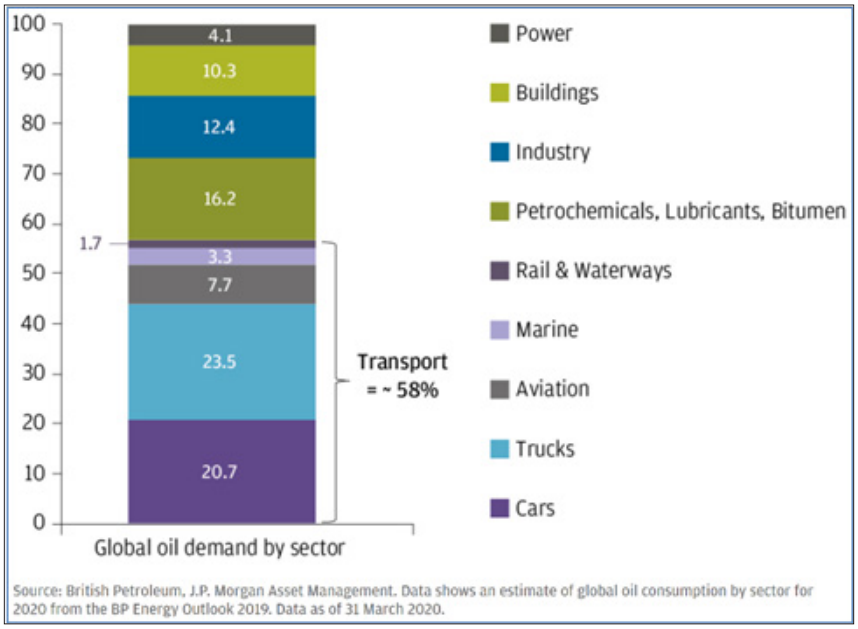
The stock market gyrations have seen a strong recover in share prices, albeit to a level below that of the beginning of 2020. Government stimulus levels are sufficient to prevent economic collapse, but the longer term recovery in Q3 2020 and beyond are reliant on consumer expenditure returning rapidly.

In this section we look at what is happening to the oil and commodities markets. In the outlook section we look back at previous market falls to give insight into what might happen to financial markets as we exit the crisis.

Oil

The tumultuous events of the past few months in the oil market reflect both short term political power plays and the effects of the virus on consumption. The longer term changes are because the world will become less dependent on hydrocarbons.

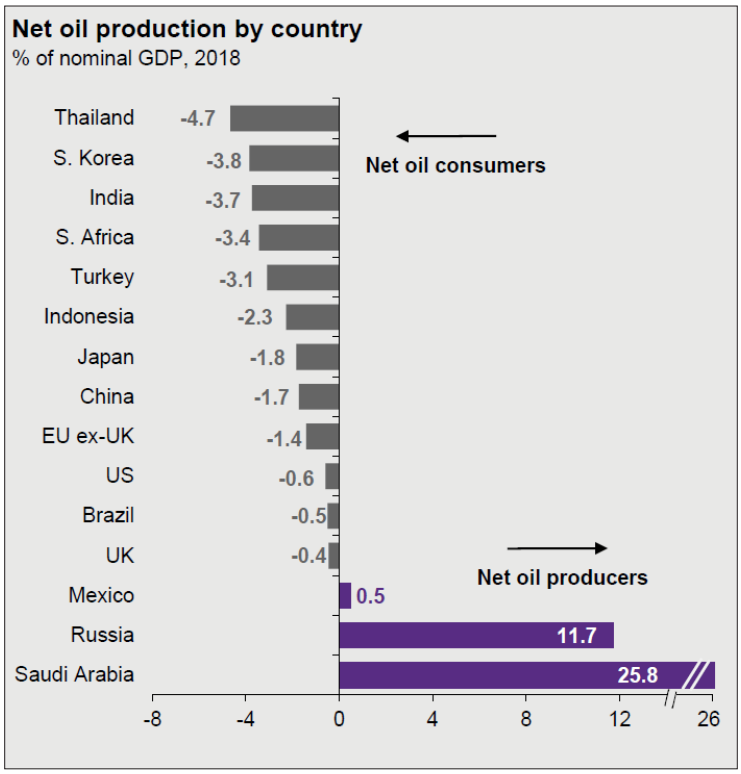
Global Oil Consumption by Sector



(Source: BP/JP Morgan)

The graph above shows that almost 58% of global oil demand is derived from fuel for transportation. The impact on demand, and thus the oil market, is significantly worse this time than in normal recessions because of the widespread implementation of travel restrictions, which has reduced global air traffic by 30%. Quarantine measures have also caused a significant drop in road traffic, by roughly 40%, leading to a large drop in demand for petrol and diesel.

The recent drop in the oil price into negative territory on April was a direct result of the glut in the oil market caused by the lack of transportation usage. The Saudi Arabians opportunistically increased production to try to force OPEC & Russia to agree production cuts. Lockdowns and stay-at-homes have reduced oil demand so much that at one point (at the expiry of the futures contract) producers were paying traders to take their oil away. The world's storage facilities are bursting at the seams and can take no more oil. This will probably keep oil prices in check for some time to come as the reduction in supply does not yet match the drop in demand.



(Source: Bloomberg, EIA, J.P. Morgan Asset Management. Data as at 31/3/20)

The graph above shows those countries that will benefit from lower oil prices as the economies recover. Negative oil production is another way of saying oil consumption as a percentage of GDP. The higher the percentage that oil consumption is of an economy the bigger the benefit from low oil prices as the economy recovers. In the case of the UK the effect will get better as we produce less.

In the short term it is likely that oil demand will recover reasonably quickly as people prefer taking their cars to work over taking public transport. Medium term demand is likely to recover slowly because of changes to consumer behaviour as they work more from home and switch to hybrid, electric or fuel cell cars. Marginal oil production, such as shale, is likely to fall off from historic highs.

The oil price will probably remain relatively low due to the above problems of supply and demand. Oil supply discipline within OPEC is going to be problematic, and if Arabian producers can't balance their budgets, the potential for unrest in these countries could increase as generous government subsidies are withdrawn.

Commodities

Given the infrastructure needs in the world, we believe commodity demand should recover reasonably quickly over the coming 12 months. The S&P GSCI Spot Index experienced a major fall over the first quarter and this has continued into Q2. The US dollar strength weighed negatively, pushing down prices. Industrial metals fell, led by copper, as the demand outlook deteriorated. The agriculture component posted a negative return with cotton and sugar prices falling heavily. Conversely, precious metals generated a small gain, aided by an increase in gold prices.

Gold may continue its rally if governments in the developed world continue to print money to stimulate their economies, as unchecked printing will lead to a loss of confidence in 'fiat' currencies and potential devaluations.

Bonds

The risk aversion normally seen during bear markets has seen investors head for the safety of government bonds. The table below shows the change in yields since the beginning of the year for major bond markets. The US and UK bonds have rallied significantly on the back of considerable intervention by the Fed and the BoE respectively in the form of bond buying and the restart of quantitative easing. A buyer of German bunds today is locking in 0.52% losses every year until maturity before any purchase costs, which does not look attractive. Interestingly Italy's BTP market has seen yields rise since the start of the year as part of a risk off trade.

	Bond yields YTD		11/05/2020	
		Yield (%)		
	Bond	01/01/2020	11/05/2020	Change in bps
US	US 2 year	1.57	0.15	1.42
	US 10 year	1.93	0.69	1.24
Europe	German 10 year	-0.19	-0.52	0.33
	French 10 year	0.12	-0.03	0.15
	Italian 10 year	1.41	1.79	-0.38
	UK 10 year bond	0.82	0.26	0.56
Asia	Japan 10 year	-0.02	0.01	-0.03
	Australia	1.35	0.95	0.4

(Source: 4 Shires, Table data as at 11/5/20)

Corporate bonds fared less well over the first quarter but improved in April. Most companies fully utilised their credit facilities in anticipation of any cash flow issues that they might face. Some companies were forced to issue debt at high yields, for example Carnival Cruises raised nearly $6bn of debt, including $4bn at an 11.5% interest rate.

Preference Shares and Income

One of the anomalies of this crisis is the pressure that regulators have put on financial companies to not distribute dividends. However this does not apply to preference shares. Preference shares pay 'dividends', but are in fact fixed interest securities.

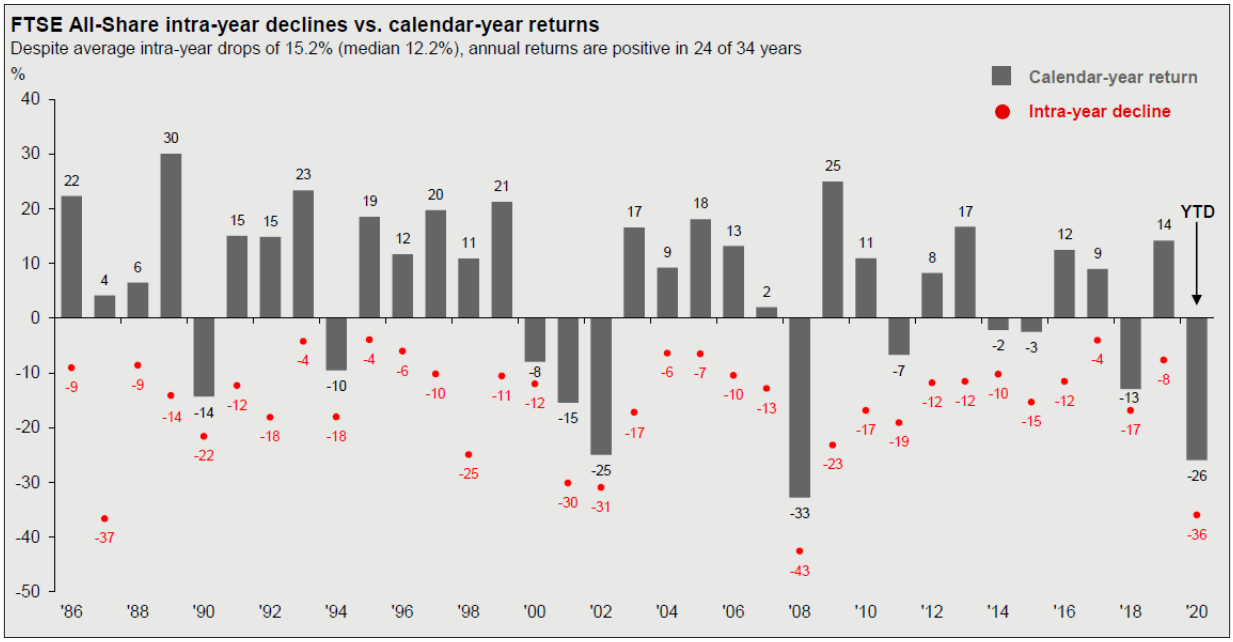
When it was announced that UK-listed Asian focused banks couldn't pay dividends, we contacted Standard Chartered to see what the situation was with their preference shares. The FCA has said they will not interfere in the debt activities of companies, and preference shares are considered debt instruments by the FCA. With yields north of 6%, preference shares offer good value for clients seeking to maintain, but not grow, their income.

If interest rates were to move higher then the prices would fall back, but any increases in market interest rates (government bond yields) look likely to be muted for the coming year.

Investment Outlook

Stock market corrections are an irregular and unpredictable part of investing but have happened in the past and will no doubt occur again. We have had a long and relatively uninterrupted gain in global equity markets from March 2009 until March 2020 making this the second longest bull market in history.

The recent fall in markets came very rapidly over 5 weeks in comparison to the GFC, when markets fell steadily over an 18 month period. The graph below shows intra year market declines and annual market returns:

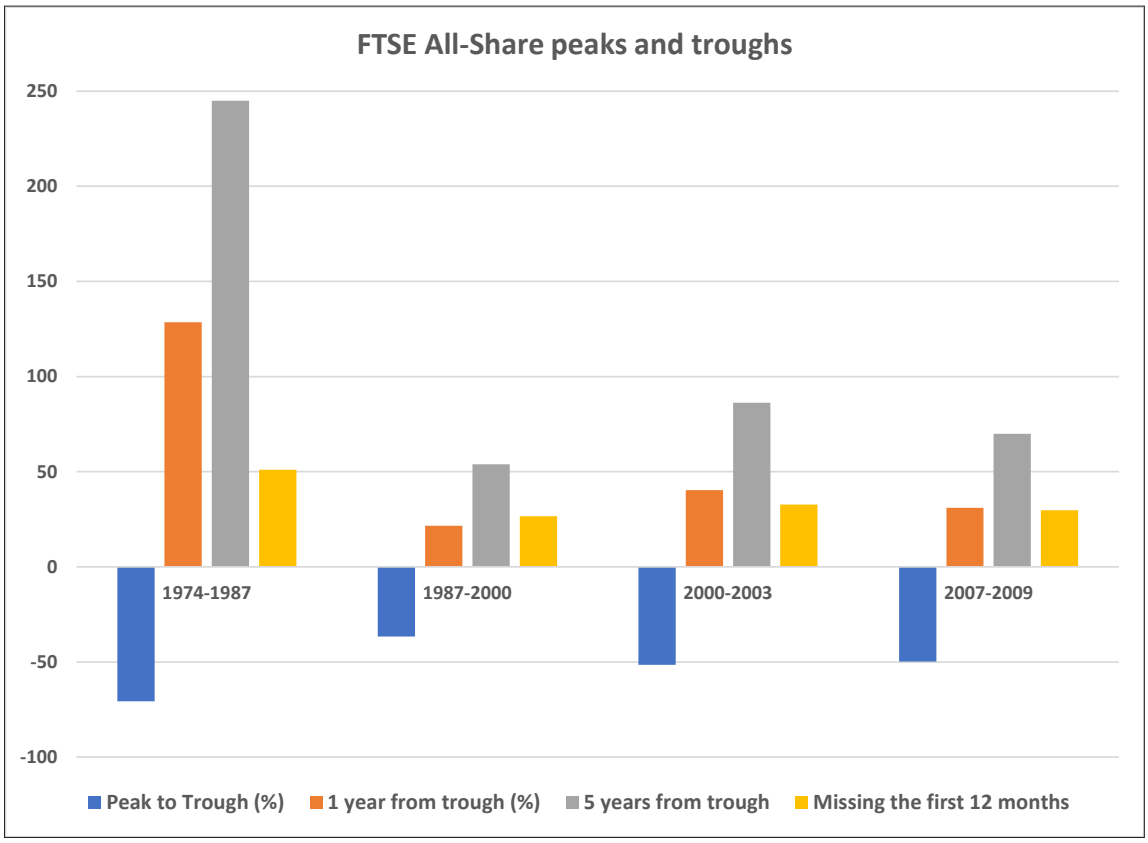


(Source: JP Morgan, data as at 31/4/20)

It shows that when markets fall sharply and by a large percentage, the returns over the coming years are higher for those investors who stayed the course and remained invested. It also shows that in the years when large intra-year (during the year) returns are significantly negative, calendar returns are somewhat better, implying a subsequent rally.

It is also important to stay invested and not to go into cash and miss out on those periods when the market recovers quickest.

Stock market historian David Stevenson collated information from peak to trough for several periods (1974-1987, 1987-2000, 2000-2003 and 2007 to 2009) and then looked at subsequent investment returns over 1 and 5 years:



(Source: David Stevenson/4 Shires)

This clearly shows the benefit of staying invested in the market. For example, if you had missed out of the 12 months after the market trough in 1974, five years later you would have missed out on over 190% of gains. If you had again missed out on the first 12 month of the rally post the market tough in 2003 you would have missed out on 53.5% of gains.

With regards to the investment outlook over the coming 1-2 years, there are currently positive and negative indicators as to investment performance (There may well be other factors on both sides of the debate and this is a non-exclusive list):

Positive Indicators

- Government stimulus measures have given considerable support
- Disease hardly affects those of working age
- Isolation measures have limited significant harm to the economy
- Diagnostic testing will give better data to prevent recurrent outbreaks
- Mortality is within reasonable bounds as a percentage of population
- Consumers have been protected
- Work on a vaccine is progressing
- Interest costs are low so corporate interest payments will be manageable
- Stock markets remain open for refinancing balance sheets

Negative Indicators

- Build up in debt in companies will restrict earnings and dividend growth
- High unemployment will be a drag on economies, particularly in the US
- Higher unemployment will cause lower economic demand
- Little or no revenue is very damaging for companies
- Leisure, travel, transportation and other sectors will suffer considerably
- It will take several years for profits to recover to 2019 levels
- Further stimulus measures are likely to grow government debt and taxes
- Vaccines may not work and further outbreaks are likely

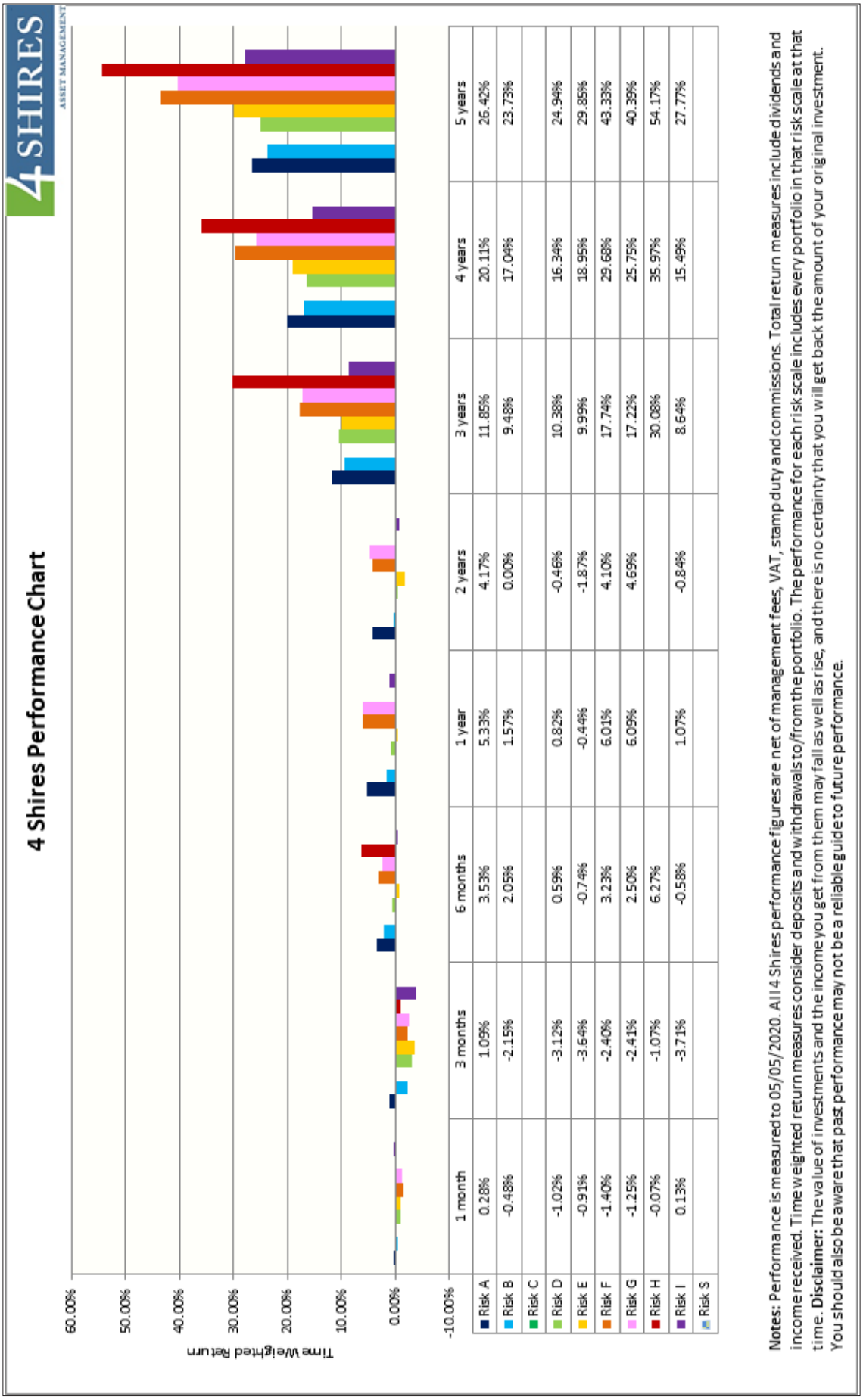
We are concerned about the level of unemployment in the US, and question whether unemployment in other countries will return to the very low levels prior to the crisis. We expect further volatility in equity markets, particularly given the low readings in the VIX (volatility index) which currently implies a benign outlook.

However, the return to work in China and Japan has been rapid and is encouraging for the rest of the developed world. Further stimulus is likely, including direct purchases of shares by central banks (the Fed is already mandated to do this).

As always, stay invested to avoid missing out on rallies.

JLS
11.05.2020

4 Shires Investment Performance



	1 month	3 months	6 months	1 year	2 years	3 years	4 years	5 years
Risk A	0.28%	1.09%	3.53%	5.33%	4.17%	11.85%	20.11%	26.42%
Risk B	-0.48%	-2.15%	2.05%	1.57%	0.00%	9.48%	17.04%	23.73%
Risk C								
Risk D	-1.02%	-3.12%	0.59%	0.82%	-0.46%	10.38%	16.34%	24.94%
Risk E	-0.91%	-3.64%	-0.74%	-0.44%	-1.87%	9.99%	18.95%	29.85%
Risk F	-1.40%	-2.40%	3.23%	6.01%	4.10%	17.74%	29.68%	43.33%
Risk G	-1.25%	-2.41%	2.50%	6.09%	4.69%	17.22%	25.75%	40.39%
Risk H	-0.07%	-1.07%	6.27%			30.08%	35.97%	54.17%
Risk I	0.13%	-3.71%	-0.58%	1.07%	-0.84%	8.64%	15.49%	27.77%
Risk S								

Notes: Performance is measured to 05/05/2020. 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. **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.

(Source: 4 Shires, Graph to 5th May 2020

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.

Any security mentioned in this commentary is for information purposes only and is not a recommendation to buy. 4 Shires, its clients and its staff may own some of the investments that we mention in this report.

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