

Growth versus capital preservation

By: Richard M aparura, CFA, Portfolio Manager, Butterfield Bank (Cayman) Limited

Amongst all other variables, from slumps in commodity prices and wide sector shutdowns to unprecedented stimulus packages and corporate earnings surprises, uncertainty has remained the only constant in the global financial markets since the start of the pandemic. The phrase "safe haven" has resurfaced again as investors seek avenues to manage uncertainty.

Faced with a challenging environment, traditional (non-speculative) long only investors have to manoeuvre around uncertainty as they grapple with a disconnect between market prices and the economy. Markets have continued to rise despite the worst economic downturn since the Great Depression. Long only investors may have to choose between two extreme strategies; capital growth or capital preservation as they cannot utilise market strategies such as short selling or the use of derivatives for hedging purposes.

A capital growth strategy seeks to achieve long-term capital appreciation mainly from equity investments. Due to the significant exposure to equity investments, this strategy may experience periods of high volatility. On the other hand, a capital preservation strategy aims to achieve long-term capital protection in real terms whilst generating income from a significant exposure to fixed income securities.

Before settling on which strategy to pursue, it is worth observing the current market environment for guidance on the best possible strategy to follow. Bearing in mind that the right investment strategy is one which suits the market environment and the unique needs of each investor, a discussion of some of the major current market conditions would be invaluable.

The second wave

The pandemic continues to spread in the US and throughout the world, infecting more than 23.6 million globally and leaving over 810 thousand casualties as of August 2020. According to the International Monetary Fund, COVID-19 is a crisis like no other and as such there is higher-than-usual degree of uncertainty around the path to recovery.

In the US, the states of Florida and Texas decided to slow down their reopening compared to other states. Most countries have asserted the wearing of masks as cases are surging across the world. Australia restored the state of emergency in the region of Victoria while the UK government has kept restrictions in northern England in place. In Africa, cases recently surpassed the 1 million mark and new infections seem to be rising. The US, Brazil, India, Russia and South Africa are leading the pack with the highest confirmed cases. The rapid increase of cases continues to harm those industries that are heavily dependent on unrestricted mobility including travel, restaurants and tourism.

Stimulus packages

Synchronised fiscal and monetary easing globally has helped to offset some of the damage caused by the pandemic, but support will be required until the health crisis is resolved. Most federal governments across the world have continued to provide pandemic relief packages to their people, an intervention that is helping to keep unemployment from spiking further. The relief packages have put money directly in the hands of the public, which has fueled consumer spending to some extent.

The EU will lend €750 billion to member countries under different programmes in order to help those most affected by the pandemic. This deal has been a tailwind for European equities and the single currency which accelerated against the dollar. In the US, President Trump recently signed an executive order for \$400 unemployment insurance per week for qualifying persons through to the end of the year, along with payroll tax holidays, student loan reliefs, and eviction moratoriums. The Bank of Japan launched a 75 trillion yen (US\$690 billion) virus response package to help its economy. Small jurisdictions like the Cayman Islands and Bermuda have passed laws that allow their residents and citizens to withdraw portions from their pensions. These stimulus measures have increased liquidity in most investors' hands.

U S - C h i n a t e n s i o n s

U S - C h i n a relations have continued to deteriorate as the US closed a Chinese consulate in Houston, triggering retaliation from the Chinese government which ordered the closure of a US consulate in Chengdu. The closures are a prelude to the worsening relations between the two nations which have clashed over trade, technology, handling of the coronavirus epidemic and global influence. The tensions threaten to cloud prospects for trade between the world's two largest economies and might spur yet another trade war.

Moreover, the US accelerated the ban of some Chinese applications such as Tik Tok and WeChat over longstanding concerns that these applications might be forced to share US users' personal information with the Chinese government. A WeChat ban may force Apple to remove the application from its iOS App Store impacting iPhone demand in China. By one estimate, iPhone shipments to China could fall by as much as 25 to 30 percent. WeChat is more than just a messaging application; it is also one of China's two largest mobile payment applications, accounting for nearly 40 percent of the \$8.4 trillion in mobile payment transactions in the last quarter of 2019 alone. With no knowledge on how China would react to these bans, moves in this direction will inevitably be disruptive to the markets.

W e a k e r d o l l a r , i n f l a t i o n a n d l o w e r b o n d y i e l d s

Against the backdrop of monetary easing, the dollar has weakened and overseas inflation is expected to rise a little, although in general the virus impact will be disinflationary in the short term. Bond yields in many parts of the world have stayed close to zero. Germany, France and Switzerland are amongst major economies which currently have negative bond yields. The dollar has recently lost its ground against almost all the G10 currencies especially the Euro and the British pound which have rallied over 5% each from their June levels. The weakening of the dollar has created some opportunities in emerging markets whilst low yields have stained the attractiveness of nominal bonds.

P r e c i o u s m e t a l s

As fear rises and investors seek to elude risk, more money seems to flow into gold and silver. These precious metals have retained their shining glory and have become true safe havens during these times of high uncertainty. The heightened uncertainty has been the main driver of this precious metals rally, with gold near an all-time high and silver at a seven-year high. Looking ahead, experts believe that as the global epidemic improves, some market funds will shift from currency-based gold and silver to more industrial-based commodities such as copper, zinc, and iron ore, which may lead to some price fluctuations in gold and silver.

U S Elections

The political event of the year in the US will be the 3 November presidential election. This election can have a major impact on policy, laws and foreign relations. According to research by US Bank analysts, "since 1932, an incumbent US president has never failed to win re-election unless a recession has occurred during their time in office".

The impact that any president can have on the economy and the market depends on the ability to enact legislation. To be able to pass robust policies, control of both the House of Representatives and the Senate is required. Republicans currently have the majority control of the Senate whilst the Democrats control the House of Representatives; such a divided Congress adds more uncertainty on policy changes. In terms of the markets, historically, the S&P 500 volatility has typically been higher in election years than in non-election years, as markets frequently reprice the probability of the future administration's policies. The uncertainty of an election can also imply higher risk in certain stock prices, especially those impacted significantly by electoral outcomes.

With the US officially in a recession this year, one which was ignited by a raging global pandemic, history will have to be rewritten if the incumbent president is to win. The Democratic presidential candidate, former Vice President Joe Biden's pick of Senator Kamala Harris as his running vice-president has already changed the narrative of history. Senator Harris becomes the first woman of colour to be nominated for national office by a major political party. This election result will not be an easy one to predict, heightening uncertainty.

Conclusion

Having considered some of the key factors currently driving uncertainty and increased volatility in the market, it is evident that a one size fits all solution may not be the most prudent approach. Instead, a blended approach of the two divergent strategies maybe more plausible. The blended approach takes us back to the traditional 60:40 strategy. Also known as the balanced strategy, this is a hybrid of equities (60%) and fixed income (40%). The strategy seeks to achieve long-term capital growth from equity investment, whilst reducing volatility with an actively managed exposure to bonds and cash.

When implementing this strategy, investors should consider key principles: (i) selecting assets that will outperform inflation over time and (ii) diversifying those assets based on how they are correlated with changing future macro and micro economic scenarios. In applying these two principles to the balanced strategy, two key shifts have the potential to provide positive impact to the overall performance: reducing portfolio exposure to inflation by shifting part of the portfolio from nominal bonds into inflation-sensitive assets like Treasury Inflation-Protected Security (TIPS), and diversifying assets by reducing the portfolio's exposure to the major monetary and credit systems of the world, with the US dollar, the Euro and the Chinese Yuan topping the list.

Sources: Forbes.com ; CNBC News and USBank.com

Disclaimer: The views expressed are the opinions of the writer and whilst believed reliable may differ from the views of Butterfield Bank (Cayman) Limited. The Bank accepts no liability for errors or actions taken on the basis of this information.