First State Investments

FIRST STATE DIVERSIFIED GROWTH FUND

Multi Asset
April 2020

"Buy Another Day"

In our last semi-annual review published in November 2019, we discussed the impacts on global markets caused by escalating geopolitical tensions. Since then, the US and China have agreed upon a Phase One trade deal and the UK general election placed Boris Johnson in power, allowing the UK to officially leave the European Union and enter a transition period. Things were looking optimistic, until the COVID-19 virus outbreak emerged from China and began its world tour in January 2020, causing widespread panic and enormous suffering in its wake. While this pandemic is not yet over, we explore the main areas of concern as we try to make sense of what the world might look like once we are on the other side.

COVID-19 – the virus that sent the world grinding to a halt

Reports of a coronavirus outbreak in Wuhan, China began to emerge in January 2020; but it was not until the Lunar New Year holiday period that it became evident just how far this could spread. Worldwide cases have now surpassed 4 million, and the virus has earned the 'pandemic' title from the World Health Organisation. The residents of Wuhan have finally seen lockdown measures eased after two months, however; COVID-19 and the harsh economic repercussions of containment continues to wreak havoc elsewhere, most notably in the US, Europe and the UK. As social distancing measures have led to the shut-down of non-essential businesses, many sectors are facing a severe pause in activity and the expectation for future company earnings is bleak. Restrictions have turned many capital cities into ghost towns with the expiry of lockdown measures in some regions not yet known. While many may try to speculate when we might be back to normal, it will remain to be seen just what 'normal' will mean again.

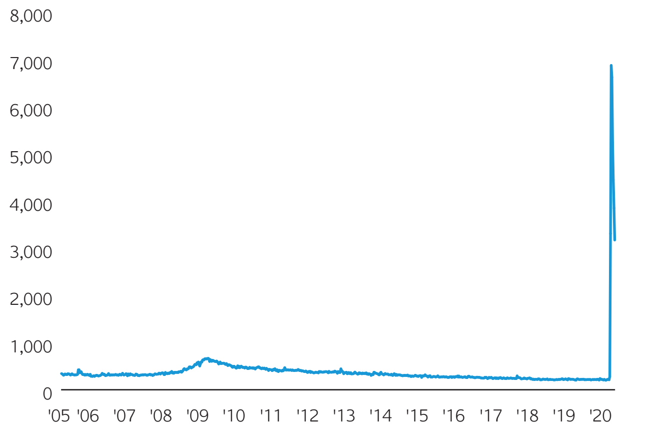
Global economies feel the pain

Cracks in the world's largest economy are now wide open. The decline in the global trade outlook had regained optimism and the American consumer remained resilient until the COVID-19 effects made its way to the US and began its aggressive spread. Unemployment has spiked like never before, with over 30 million Americans filing for unemployment in a six week period. This has more than wiped out the 22 million jobs created in the employment boom since 2010. Unsurprisingly, the University of Michigan's consumer sentiment index is sitting at 71.8 in April – the lowest level since December 2011. Manufacturing has also plunged, with the ISM Manufacturing PMI falling further into contractionary territory at 41.5 points (anything below 50 points is a contraction) – the lowest since the Global Financial Crisis (GFC) as orders, both foreign and domestic, have been either cancelled or postponed. As many services have come to a halt, the US IHS Markit Services PMI fell to 29 in April, the most since the index began. With both international and domestic travel heavily reduced or restricted, the stay at home orders are expected to drastically hurt the accommodation and food services sector. The US is not alone with a negative outlook. In the UK, expectations for Q1 GDP are dismal and consumer confidence fell from -9 to -34 in April, which is the biggest fall in more than 45 years. In Europe, conditions were already fragile with Q4 2019 growth printing at only 0.1%. Unsurprisingly, the region contracted by 3.8% for Q1 2020 as some of the largest European economies – Spain, Italy and France – were some of the hardest hit nations of COVID-19. In China, economic growth for Q1 2020 recorded a year-on-year contraction of 6.8% - the first GDP contraction since records began in 1992.

What exactly is the NAA review?

The first step in our investment process is to determine the economic outlook, both globally and for individual countries. Twice a year, we formally review existing assumptions and determine the likely long-term values for inflation, risk free rates, long-term bond yields, and earnings growth. Using current valuations as a starting point, these determinations enable us to calculate expected returns for various asset types globally. In turn, this helps inform the most appropriate mix of investments (NAA) to deliver on our portfolio objectives.

Figure 1: US job claims surge to unprecedented levels
US Weekly Jobless Claims (in '000s)



Source: FactSet 24 April 2020

Equity markets plunge after reaching all-time highs

During the last NAA review, we were still riding the longest US equity market bull run in history, reflecting on the fact that it had well and truly cheated death after more than bouncing back from the December 2018 stumble. The question on many minds however remained: how long would this go on for? What would bring it to its knees? On 19 February 2020, the S&P 500 closed at its new all-time high of 3,386.15 points.

In the background however, COVID-19 was beginning to unnerve the global economy and in a somewhat belated response, US equities finally lost their balance, with the S&P 500 contracting by 8.6% for the month of February and by 19.6% for the first quarter of 2020 – a stark contrast from the 31% expansion over 2019! US equities of course were not alone, with the MSCI World and FTSE 100 indices contracting by 20.0% and 23.8% in local currency terms respectively, for Q1 2020.

Figure 2: Raging bull meets ferocious bear
Equities - Indexed at $10,000

Source: Bloomberg, 31 March 2005 to 01 April 2020

While we cannot predict with perfect precision what lies ahead for equities, we can reflect on previous downturns for ideas. For example, the highest close of the mid-2000s bull market was 1,565 points in October 2007. It was not until April 2013 that the index managed to push above this milestone level. It is interesting to note that after previous US stock market crashes - excluding the Great Depression – the average recovery time was 25 months, with the 2008 crash taking 49 months (see Figure 3). As ever, past performance is no indication of the future....but it is all we have for now!

Figure 3: What goes down, must come up

Period	Decline of the S&P 500	Time to Recovery (months)
Sept 1929 - June 1932	-85%	266
Feb 1937 - Apr 1942	-57%	48
May 1946 - Feb 1948	-25%	27
Aug 1956 - Oct 1957	-22%	11
Dec 1961 - June 1962	-28%	14
Feb 1966 - Oct 1966	-22%	7
Nov 1968 - May 1970	-36%	21
Jan 1973 - Oct 1974	-48%	69
Nov 1980 - Aug 1982	-27%	3
Aug 1987 - Dec 1987	-32%	19
July 1990 - Oct 1990	-20%	4
Mar 2000 - Oct 2002	-49%	56
Oct 2007 - Mar 2009	-57%	49
Feb 2020 - Apr 2020	-34%	ongoing
Average	**-39%**	**46**
Average ex Great Depression	**-35%**	**27**

Source: Bloomberg and Goldman Sachs

Here come the bailouts

As business activity levels stoop and unemployment gains frightening upward momentum, the world has seen a rapid increase in fiscal stimulus as governments try to stave off prolonged economic deterioration. The fiscal stimulus support will be of great help for businesses and the economy, but these initiatives may come with an expiration date....one that may not align with the length of this downturn! In the US, a fiscal stimulus package was unveiled of USD $2 trillion. This is accompanied by USD $50 billion in aid as well as tax payment deferrals. Similar measures have been unveiled across the world, with European governments agreeing to spend more than USD $2 trillion on national industries – a package that rivals the reconstruction programs post WWII. This unprecedented government spending is expected to see a sharp spike in the issuance of global government debt. There are considerations surrounding this. Accruing such large debts in itself could have implications for future spending, if governments instead decide to direct their budgets to paying back these debts. Other considerations typically surround a sudden increase in fiscal spending, including the possible increase of inflation. Under normal circumstances, the vast spending packages could be expected to add inflationary pressure. Given the potential offsetting impacts of rising unemployment and shocks to both supply and demand, however, it is unlikely that inflation will materialise broadly within the wider economy, in our view.

In the UK, the government revealed a GBP £12 billion emergency fiscal package, as well as tax cuts and guaranteeing loans. Additionally, unlimited 12-month interest free loans are available for businesses. The government has endeavoured to keep employees with their employer by paying 80% of their salary, as many businesses will struggle to pay these themselves as the pandemic severely reduces business activity. The latest report from the Office of National Statistics indicated unemployment in February was 4.0% however, this was before the implementation of social distancing measures. In the UK, many speculate the virus cases may almost be at its peak, however, thousands of new cases are still emerging each day.

Figure 4: Fiscal Stimulus as a percentage of GDP as at early April

Country	Fiscal Stimulus % of GDP
United States	6.9%
Australia	10.6%
United Kingdom	6.9%
Germany	4.4%
Japan	10.0%
Singapore	7.0%
China	2.5%
Canada	5.2%

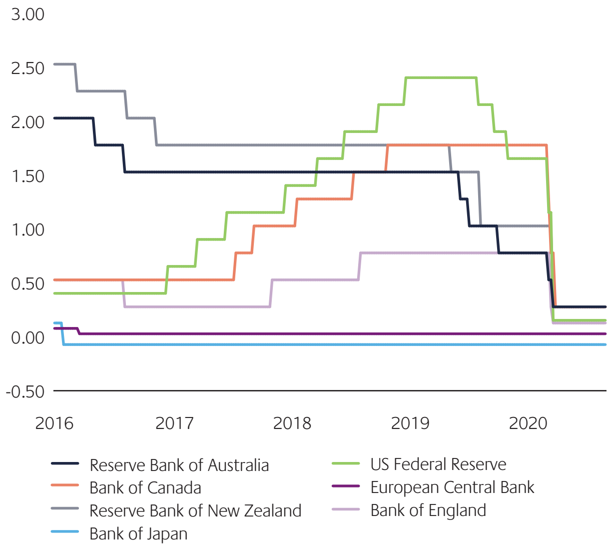
Source: International Monetary Fund (IMF) as at 8 April 2020.

Central banks to the rescue (again)

In a synchronised fashion, central banks around the world responded to the COVID-19 outbreak with extraordinary measures in the form of capital injections and interest rate cuts. Many countries were sitting on relatively low (or negative in some instances) interest rates but in the time of need, more cuts were unveiled. Monetary policy rate changes were made to boost the cash of businesses and the household sector. While this is problematic for anyone relying on interest income, it does lower borrowing costs for businesses as well as the Government at a time when fiscal spending is rampant. The US Federal Reserve has been steadily reducing rates in the second half of 2019 before lowering rates twice in the month of March from 0 to 0.25%. The Bank of England slashed borrowing costs to 0.10% after it had remained at 0.75% since August 2018. In addition to lowering interest rates, other various initiatives have been implemented such as repurchase operations, quantitative easing (QE) programs, asset purchase programs, and funding facilities to name a few. The European Central Bank (ECB) has also utilised some of its flexibility by focussing its government bond purchases in countries most impacted by the virus such as Italy and Spain.

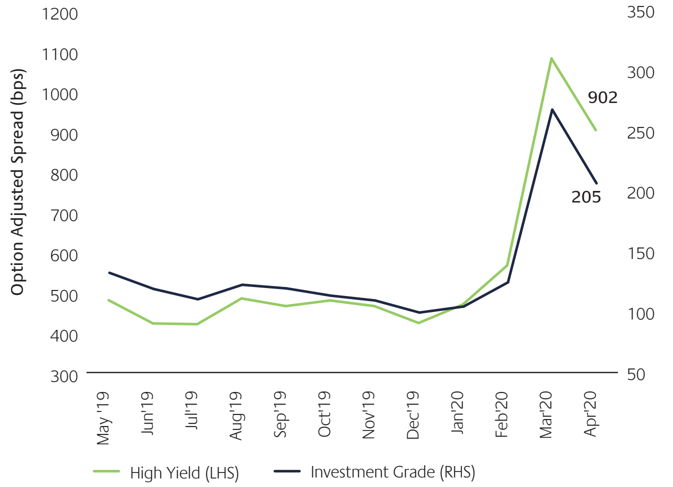
The traditional relationship between risk and defensive assets broke down as the second half of March saw an unparalleled sell off for equities, bonds and commodities. While defensive assets such as government bonds would traditionally expect to benefit from such market uncertainty, the COVID-19 outbreak proved that even bonds could not sufficiently provide comfort as investors instead rushed towards cold hard cash. Consequently, liquidity in the financial system dried up, pushing central banks to intervene and inject capital by means such as repurchase operations and term funding facilities. The corporate bond market saw spreads widen to levels last seen in the GFC – both in the investment grade and high yield market. Some support was found however when the US Federal Reserve announced the inclusion of corporate securities as part of its enormous asset purchase program, pushing spreads tighter.

Figure 5: Global Policy Rates



Source: Bloomberg 30 April 2020

Figure 6: Credit spreads 12 months to date



Source: Barclays 30 April 2020

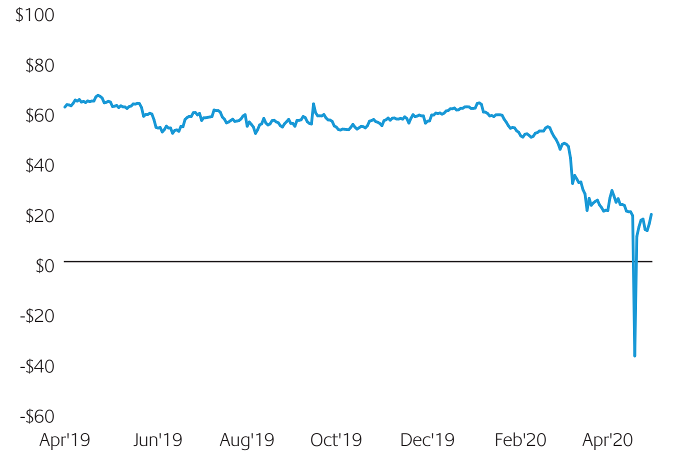
Currency volatility as investors retreat to safe havens

Just as both risk and defensive assets experienced tumultuous moves, foreign exchange markets joined them for the ride as investors grasped for safe haven assets. The US dollar, perceived to be a safe haven currency, was volatile throughout March, remaining steady against the Euro and Japanese Yen, but rising against most other major currencies as COVID-19 related uncertainty surged. The US dollar moved within a sizeable 100 basis point range over March but found support during April as panic slightly reduced. Since this crisis has unfolded, emerging market currencies have fallen to record lows. In mid-March, the British Pound fell towards a 35-year low against the US dollar as market risk aversion spiked.

Commodities: Oil suffers unthinkable supply AND demand shock

At first, oil prices faced pressure as Russia, Saudi Arabia and the OPEC+[1] members refused to agree on production cuts. Instead, the market was flooded with oversupply, driving prices downward. While OPEC+ and G20 production cuts commenced on 1 May 2020, it looks like nobody wants oil anyway. Demand itself has nosedived as COVID-19 led to a grounding of flights across the world, in addition to the severe slowdown in economic activity. Then the West Texas Intermediate (WTI) crude oil futures contract for May 2020 – a benchmark for oil prices in the US – dipped into negative territory and closed the day at –USD $37 as holders scrambled to sell their contracts before they were in the predicament of having barrels of oil and nowhere to store them. While the outlook for WTI futures may improve slightly, a resounding recovery will require patience. Turmoil in the oil market also encouraged the selloff of high yield bonds, which have a large sector allocation to energy.

Figure 7: West Texas Intermediate (WTI) Crude Oil futures



Source: Bloomberg 30 April 2020

[1] Organization of the Petroleum Exporting Countries

Key points driving our thinking

The setting of the economic climate involves deciding on where we think the global economy is moving, and then for each country we determine the likely long-term values for inflation, risk free rates, long-term bond yields and earnings growth. By taking current valuations as a starting point, this allows us to determine expected returns for global assets from this point forward.

- Overall, there have been sizeable changes to the NAA compared to prior reviews as our economic climate assumptions evolve in response to the ongoing COVID-19 crisis.
- We believe these risks will play out more negatively in the period ahead. Financial markets have experienced great distress and we are not out of the woods yet.
- Therefore, we have lowered our inflation assumptions across all markets, along with lower cash rates and long-term yields to reflect the significant action taken by central banks. These emergency settings are expected to remain in place until the lockdown measures and social distancing rules are relaxed.
- Earnings growth will plunge over the coming quarter, with a return to more normalised earnings unlikely to be seen until 2021. In addition to lowering our expected earnings, we have increased the volatility from forward earnings to reflect the divergence in approach that corporations are taking towards providing forward guidance.
- Portfolio positioning has focused on the balance between equities and bonds. With lower equity allocations and therefore increased exposure to bonds, there are opportunities to increase the diversification within fixed income. Exposure to global bonds and domestic bonds has been increased. Within credit, we have spread the allocation across investment grade and high yield. We remain cautious on European equities and commodities.
- While market conditions might appear risky and raise concern, this can also lead to opportunities. The risks the economic climate can present are always dealt with diligently and in line with the Fund's investment philosophy.
- The Fund continues to strive for consistent returns above inflation while aiming to minimise drawdowns and preserve investor capital.
- As a highly experienced team with over two decades' experience, the Multi-Asset Solutions team will continue to implement the Fund's established and methodical NAA investment process and then adjust positioning through the Dynamic Asset Allocation (DAA) process as opportunities arise.

Neutral Asset Allocation as at April 2020:

DGF Neutral Asset Allocation	Nov-19		Apr-20	Change
Liquid securities	5.0%	-	5.0%	0.0%
Short-dated gilts	35.0%	▼	33.0%	-2.0%
Long-dated gilts	0.0%	-	0.0%	0.0%
Global government Bonds	0.0%	-	0.0%	0.0%
Global government Bonds 1-3	0.0%	▲	22.0%	22.0%
Global government Bonds 3-7	0.0%	-	0.0%	0.0%
Global Corporate Bonds	0.0%	▲	5.0%	5.0%
High yield	10.0%	▼	5.0%	-5.0%
EM local currency bonds	0.0%	-	0.0%	0.0%
EM hard currency bonds	0.0%	-	0.0%	0.0%
UK Equities	10.0%	▼	6.0%	-4.0%
European Equities (h)	0.0%	-	0.0%	0.0%
World (ex-UK) Equities	40.0%	▼	24.0%	-16.0%
Commodities	0.0%	-	0.0%	0.0%
	100.0%		**100.0%**	**0.0%**

Equities

In light of the recent volatility in financial markets, the portfolio's allocation to equities has severely reduced since our last review. The neutral allocation to equities has fallen from 50% to 30%. We are increasingly cautious of the continued knock-on effects from the COVID-19 outbreak and while equity markets may be trying to look through into a more optimistic future, we think this may be premature. Instead, we anticipate the severe reduction in business activity flowing through to earnings falling drastically. Since our last review, developed world equities reached new heights before falling off a cliff's edge with the MSCI World Index contracting by -9.47% over the period 30 November 2019 to 30 April 2020 in local currency terms. Optimism was on the rise as the year began with China trade negotiations making good headway and the UK successfully withdrawing from the European Union. Japan's TOPIX delivered the best relative returns for the first quarter, even though it did shrink by 17.5%. Economic data releases so far have been negative, with more depressing news expected to come. World equities and UK equities now account for 24% and 6% respectively in the NAA and due to the extent with which the virus has impacted continental Europe both from a health perspective and the extreme lockdown measures required, we have decided to maintain our structural allocation to the region at nil. We can still take selective exposures to this region over the coming months through our DAA between now and the next review of our economic climate assumptions.

Credit

The high yield credit allocation has been halved to 5%, however this has been redirected to investment grade credit and will be spread across the US and Europe. Credit markets recently weathered great turbulence as spreads widened to levels last seen in the GFC. While liquidity had almost disappeared as the COVID-19 crisis surprised markets, support from central banks to improve liquidity has provided optimism – notably corporate bond purchase programs announced by the US Federal Reserve and the European Central Bank. These programs have indicated that they will not only be purchasing government bonds and investment grade credit, but that this will be extended to lower quality, high yield bonds which will be a first for both banks. While equity prices may still face pressure, the cross-market selling has subdued for now with bonds becoming more firm as the market becomes liquid due to central bank support.

Government Bonds

The allocation to short-dated global government has been increased, while exposure short-dated UK gilts has been reduced. Although even government bonds were not immune to the unprecedented sell off alongside riskier assets like equities, the traditional relationship between the two asset classes has improved. Much of this forced selling occurred as investors rushed to increase their cash levels. While liquidity was temporarily scarce, central bank initiatives to inject capital back into the economy have eased anxieties. As yields have begun to rise and we continue to take a defensive stance with our portfolio, our allocation to short-dated global government bonds has largely increased from 0% to 22%. UK gilt exposure has only decreased by 2%, down to 33%.

How do we determine the right mix of NAA (beta) and DAA (alpha)?

Based on our assumptions for the economic climate, and our expected returns, we can determine the likelihood of meeting the portfolio's investment objective over the investment horizon. It is becoming increasingly likely that relying solely on the NAA in a constrained long-only, unlevered environment will not be sufficient to meet the return objectives. This is where we use our DAA process to take into account shorter-term market dynamics to deliver additional returns and abate portfolio risks, such as tail events. By adding an uncorrelated return source (alpha) we can improve the portfolio's likelihood of meeting the investment objective.

The combination of NAA and DAA requires the consideration of the current allocations; as the extent to which active management may be used is managed through the portfolio's risk budget to avoid unwanted additional risks. We consider both the tracking error (as well as other risk metrics) and the expected return, in assessing the portfolio's ability to meet its investment objective. The ability to add scalable alpha to portfolios provides flexibility to deliver on the investment objective; even in a lower return environment.

In this lower return environment, by allowing the blending of alpha and beta strategies to be more dynamic within the framework described above, we still have the potential to deliver on our client's investment objectives.

In the current low return environment it is critical to have the flexibility to blend beta and alpha to increase the likelihood of delivering a real return of 4% pa above inflation over rolling five year periods before fees and taxes. We believe our investment process and philosophy provides our clients with the highest possibility of obtaining a real return, with the current outlook making our DAA paramount.

Why First State Investments?

Our investment strategy blends the qualitative views and experience of the team with the discipline and rigor of quantitative analysis resulting in a flexible approach to design and implementation of investment portfolios.

Investment decisions are taken with respect to the overall portfolio objective, unconstrained by conventional benchmarks or fixed asset allocation. Our flexibility to blend alpha and beta strategies is a key differentiator and essential to deliver on the investment objective over time.

Risk management is integral to our investment process. We continually seek to balance the trade-off between upside potential (meeting our investment objectives) and downside risk (capital loss), which we believe can generate consistent results.

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