



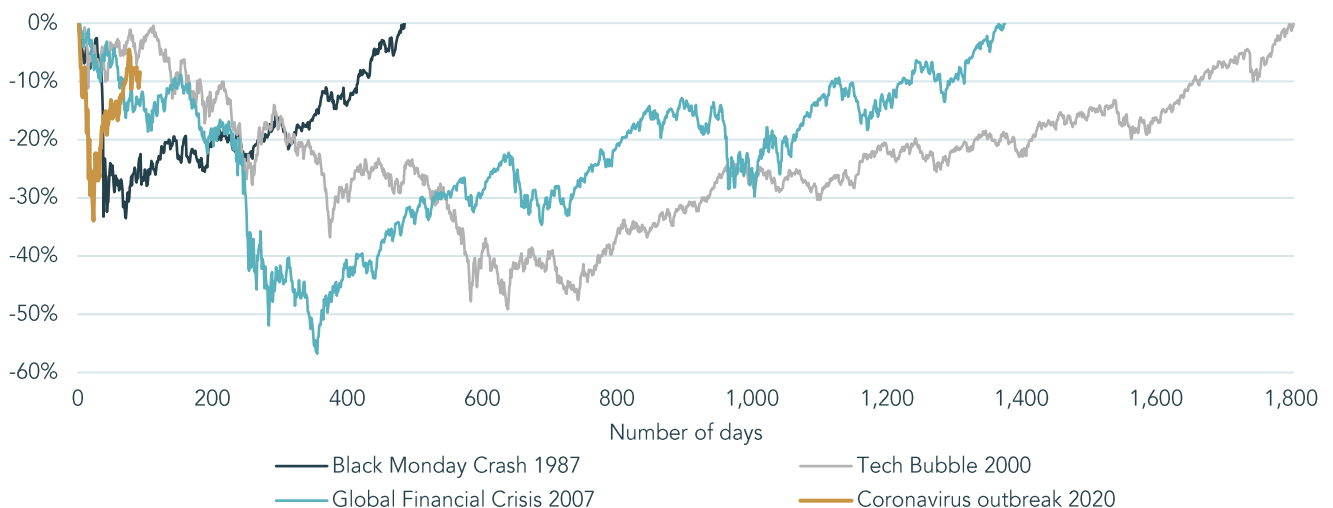
Investment Letter – Q2 2020

“Remember, no one decides who they’re going to vote for based on the vice president. I mean that literally.”
Joe Biden, Vice Presidential Candidate, 2008

When we wrote to you at the end of the first quarter, we had just navigated one of the most turbulent periods for markets ever, with global equities down 24% from their peak in February, having made record-breaking daily falls along the way. The past three months have delivered a remarkable recovery. The US equity market, as measured by the S&P 500 Index, has produced its fastest rebound on record and the strongest quarterly return since 1998. All this whilst c.200 of the Index’s 500 companies have withdrawn earnings guidance as they assess the impact of the pandemic on their operations. With considerable uncertainty far beyond the US corporate earnings picture, these are challenging times.

The recovery from Q1’s equity market collapse is the fastest in history by quite some margin. The chart below illustrates this point, with the US market having regained 95% of its losses in just 54 days, whereas it took nearly a year for the losses from the nearest comparable market collapse, the Black Monday Crash of 1987, to be recouped. Market recoveries following the Global Financial Crisis of 2007 and the bursting of the tech bubble in 2000 took considerably longer.

S&P 500 Index: major drawdowns and recoveries



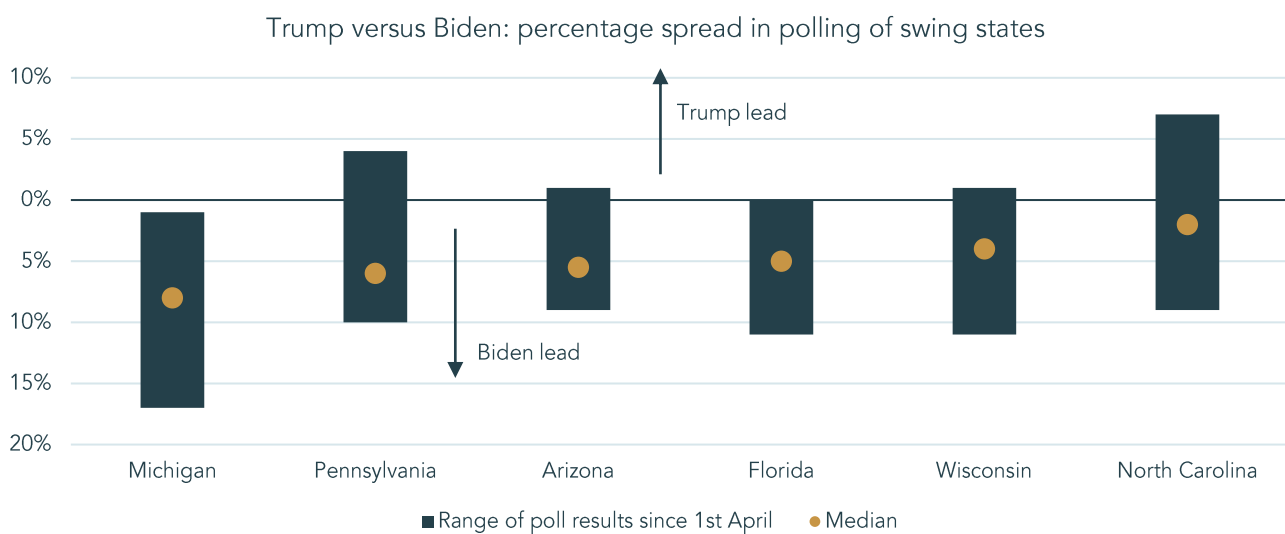
Source: Bloomberg LLP, 2020

The natural conclusion might be to say that the market’s collapse in February and March of this year was excessive, and its subsequent rally reflected more benign economic conditions than were prevalent in the other years on the chart. In reality, markets have been buoyed by immense central bank and government support, with an eye-watering \$9 trillion of fiscal stimulus announced around the world since the start of the crisis, which is at least twice as large as the stimulus delivered in the Global Financial Crisis. Parts of the equity market have also been driven higher by the unusually persistent support of retail investors, seemingly unphased by the slew of alarming corporate and economic data we have seen over the past quarter. For example, we saw shares in recently bankrupt Hertz rise 900% from their lows before collapsing again, as financial reality set in for these retail investors.

The market’s performance in the second quarter is also surprising considering that we are in a US Presidential Election year with the latest polling data pointing towards a Democrat win. This is perceived as less beneficial for equity markets than a Republican win, as the Democrats have campaigned on economic policies such as the rolling back of tax reliefs introduced by President Trump and a more interventionist approach to regulation. Polling in 2016 proved to be an unhelpful harbinger, so any predictive data should be treated with some caution. Nonetheless, a quick look at the state-by-state breakdown of the 2016 result provides some interesting context.



In 2016, the states of Pennsylvania, Michigan, Wisconsin and Florida flipped from Democrat to Republican, but President Trump won each by just one percentage point or less. Florida has long been a pivotal front in the battle for the White House, with 27 electoral votes up for grabs and a narrowly divided electorate. Michigan, Wisconsin and Pennsylvania account for a combined 46 electoral votes which, had they been in Hillary Clinton's favour, would have been enough for her to clinch victory in 2016 with 274 total electoral votes (270 are required to win). As it happens, the last election was effectively determined by 107,000 registered Democrat voters in those three states who decided to vote Republican. This explains why the data coming out of these states in the last 3 months makes for particularly interesting reading. The last quarter's polling data is collated in the chart below, showing a reasonable lead for Democrat Joe Biden in each of these states.



Source: J.P.Morgan & RealClearPolitics.com, 2020

Given their electoral importance, it is unsurprising that the Covid-19 pandemic in these states has, sadly, become highly politicised. Florida, Michigan and Pennsylvania have the 1st, 4th and 5th highest death tolls within the USA respectively. Although this is partially a function of their demographic composition, the resulting anger appears likely to pose a challenge for President Trump. Other key competitive states in the 2020 campaign include Arizona and North Carolina (featured above). Both have traditionally voted Republican, but rapid urbanisation and shifting demographics have created opportunities for Democrats to steal vote share.

A lot can change between now and November 3rd. History does favour the incumbent and President Trump has proven himself capable of doing whatever it takes to secure victory, making us wary of the possible actions he may take in the run up to the election. With the economy in a vulnerable position due to the pandemic and a wave of unfavourable polling data, President Trump's international relations could quickly become even more volatile. A re-escalation of trade wars to win votes would be a particular concern should the White House increase pressure on China and Europe. Shocks to international trade would be especially damaging in the current economic climate.

Looking beyond election day, whilst markets may be able to take Biden's presidency in their stride, with sub-sectors such as healthcare likely to respond positively, they would be unlikely to take kindly to the potential appointment of Elizabeth Warren as Treasury Secretary (or even Vice President). Markets were unsettled by moments of momentum in Warren's campaign for the Democrat nomination last year. With her legal background and strong stance on corruption, several think-tanks are touting her as an obvious candidate for the Treasury post, in which she could meaningfully shape the administration's economic and financial policy. Her influence would be exacerbated if the Democrats also take control of the Senate. If equity markets sense that Biden will choose Warren, we may see elevated volatility in the run up to election day, although if Biden's past words are anything to go by, it literally won't matter who he chooses.



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Regardless of the election outcome, we continue to view the US dollar as structurally expensive and expect to see many components of our portfolio benefit from its devaluation. In this environment, we see a particularly compelling case for owning Emerging Market Bonds in local currency, with attractive relative yields offered by well-financed issuers, alongside a prospective tailwind from the appreciation of emerging market currencies against the US dollar. A stronger local currency brings about profitability benefits for emerging market issuers, as the cost of imports eases.

Elsewhere in the portfolio, we expect to see Asia Pacific and Emerging Market Equities outperform their US counterparts in a weakening dollar environment, with our tactical allocations reflecting this view. In addition, we anticipate further support for both Emerging Market and European Equities from inflows into each asset class, with both regions currently extremely under-owned by institutional asset managers. We also expect Japanese Equities to benefit from their more attractive valuations, which are a significant determinant of future investment returns. Indeed, being cash-rich and conservatively leveraged, Japan's corporates have performed especially well in this year of economic crisis and we believe global investors will continue to reward the country's well-run corporations with further upward revaluations in coming years.

We are mindful that the recovery we have seen in financial markets is ignoring the damage done to the real economy by the pandemic. Unemployment is going to increase as government support schemes, such as furloughing in the UK, are withdrawn and we will see many more companies having to raise money to repair their balance sheets. However, there have been unprecedented levels of stimulus which continue to dictate the pace of markets, alongside inevitable pockets of positive data and corporate success stories. Whilst we expect the landscape to be uncertain in the short term, we aim to take advantage of opportunities in parts of the equity market which have been out of favour and will remain nimble in the implementation of our investment strategy.

Fred Hervey
Chief Investment Officer