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technical news

For professionals working with international clients

Reset for the recovery

Fears about the economic impact of coronavirus-induced lock-downs sparked a record-breaking sell-off in March. But global financial markets have since staged an equally record-breaking recovery, driven by monetary and fiscal stimulus, and re-opening economies.

Now is the time for investors to reset for the recovery. In a world more indebted, less global, and more digital, the key focuses for investors will be: a) finding income, b) managing volatility, and c) finding winners and avoiding losers.

Equity markets entered 'bear market' territory at their fastest pace ever, followed by the most rapid recovery on record. Markets dropped 34% between 19 February and 23 March on fears about the effect of coronavirus-induced lockdowns on the global economy. But extraordinary monetary and fiscal support, the lifting of lockdowns, and therapeutic drug developments have left global markets only 10% below their record highs.

Government bond yields fell sharply in response to lower interest rates and investor demand for safe havens, and remain far below prior levels. Yields won't change materially from here, posing a challenge for investors looking to earn income and manage portfolio volatility.

After years of record-low equity market volatility, the VIX index jumped to a record high at the peak of the crisis in March. It has since fallen, but remains at elevated levels. Higher volatility will continue, and it will be a challenge for investors at a time when traditional portfolio hedges have such low yields.

Although equity markets overall are now close to prior highs, the crisis has driven significant divergence between markets and sectors. That trend of winners and losers will continue as the recovery evolves.

To stimulate the recovery, central banks have cut interest rates to, or below, zero, and embarked on unprecedented quantitative easing programs. The challenge of finding income is made even more pressing because central banks may be willing to allow for a period of moderately higher inflation (for example 2% to 5%) in order to manage debt burdens. In short, it means cash and the safest bonds are likely to deliver negative real returns for the foreseeable future.

Markets dropped

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between 19 February and 23 March on fears about the effect of coronavirus-induced lockdowns on the global economy.

To protect purchasing power, investors will need to question if they are holding more cash and safe bonds than is necessary. They should set aside two to five years' worth of net expenses in cash and high-quality bonds, in addition to reserving some safe borrowing capacity to provide for cash flow needs in the event of a worst-case bear market event.

This provides a 'buffer' to allow the remainder of the portfolio to be invested for growth over the medium- and long-term.

Investors will also need to seek income from dividends and higher-yielding credits. But if investors need to accept taking more risk in order to earn income, the value of diversification and careful portfolio management is heightened. Any individual credit issuer could be at greater risk in a post-COVID-19 world and the crisis has already seen traditionally high-dividend-yield companies cutting payouts. Investors could choose to delegate decision-making on these topics to a professional manager.

In the context of a well-diversified portfolio, attractive alternative sources of yield include private markets, select real estate, senior loans, and bank capital, or, in the sustainability space, green bonds.

Volatility hit a record peak in March and remains far above pre-crisis lows. Investors will need to think carefully about how to manage such volatility. A key long-term cost of elevated volatility is that it can trigger indecision and leave investors stuck in 'safe' but low-yielding assets for extended periods. But volatility can also present opportunities provided investors act with discipline.

A disciplined approach to portfolio rebalancing can allow investors to benefit during periods of volatility by aiming to 'buy low and sell high' in a systematic way. Rebalancing at the end of the first quarter in 2020, when stocks sold off and bonds rallied, would have enabled investors to participate more strongly in the recent stock market

rebound, for example. It's worth noting that rebalancing at the height of a crisis can be psychologically challenging, so delegating or automating decision making on rebalancing can be an effective way of maintaining discipline.

Periods of volatility can also be good opportunities for investors to build up long-term positions. However, it can be unnerving to invest during volatile times because investors fear 'regret' if they buy and the market subsequently falls. One way of overcoming this is to commit to a phasing-in strategy based on time or price, for example using dollar cost averaging.

The coronavirus crisis has created winners and losers. Some sectors, such as e-commerce and fintech have benefited. Others, such as travel and leisure, have experienced acute pain. This trend of relative winners and losers will continue as the recovery evolves.

Stocks and bonds exposed to the sustainable investing trend have outperformed year-to-date, and they remain well positioned to be winners in a post-COVID world. By replacing traditional asset classes with sustainable asset classes, investors can improve the quality of their portfolios while also exposing themselves to enduring longer-term themes. Companies that can play a role in the low carbon energy transition such as renewable energy, agricultural yield, water, and clean air and carbon reduction should be well supported by evolving regulation, government stimulus, and increased funding from sustainability-minded investors in the years to come.

Has the Dollar had its day?

Soaring debt levels and the failure of America to manage the Covid-19 crisis is undermining trust in the world's reserve currency. The ICE US dollar index,

which compares the value of the Dollar against a basket of other currencies, has advanced by just over 1% this year. The currency is considered a safe-haven asset, so its value surged during the market meltdown in March, only to retreat as the stock rally gathered pace.

A crash could well be looming though. The fundamental issue is that Americans do not save enough, forcing the economy to import foreign capital: America has run a current-account deficit every year since 1982. That arrangement depends on the trust and confidence of foreign savers, many of them Chinese. Mismanagement of the coronavirus pandemic, combined with wrenching social turmoil, is not a good look for a global leader. Growing debt is another threat to the dollar's credibility. The Federal budget deficit looks set to hit a peacetime record of 17.9% of GDP in 2020.

Although the greenback's fundamentals may be weakening, its role as a global safe haven is not over yet.

China's clampdown begins

China has drawn international condemnation for passing a sweeping national security law for Hong Kong. In an unprecedented show of China's control over the city's legal system, the new law was enacted without even being discussed by the Hong Kong legislature. Although nominally designed to protect national security, experts agree that the law, which came into effect this week, will increase Beijing's grip on the territory. Hong Kong is supposed to have a high level of autonomy under the deal that marked the territory's handover from Britain to China in 1997.

China announced its intentions to impose the law on Hong Kong back

in May, but the details show that it is worse and more overarching in scope than many had anticipated. Not only does it allow for 'life sentences or long jail terms' for vaguely defined and wide-sweeping national security crimes, but the new powers given to mainland Chinese state officials to operate in the city also radically restructures the relationship between Beijing and Hong Kong. In particular, it destroys the 'legal firewall' that has existed between the city's independent judiciary and the mainland's party-controlled courts.

The new rules seem to be having an effect already, with several groups that supported Hong Kong independence immediately deciding to dissolve rather than risk being forcibly broken up. However, large numbers of people remain ready to risk the new law's harsh consequences by continuing to defy the Communist Party's attempts to bring the territory to heel. The day after the details of the new law were published, there were renewed public protests, resulting in arrests and the use of water cannons and pepper spray.

Opposition to the law remains strong, but protestors know that there is little they can do on their own to stop the law. Their only hope lies in mobilising foreign opinion to put pressure on China. They may be successful given that international unease about the new security law is part of a broader anxiety about China's growing assertiveness in a range of fields. After all, if Hong Kong is threatened, can it be long before Beijing tries to bring Taiwan under its direct control?

The depressing scenes in Hong Kong are a reminder that the more powerful China becomes, the less it will respect its treaty commitments. As a result, the democratic world needs to start acting to counter the Chinese threat to the rules-based order.

Chinese officials argue that they are doing nothing wrong: national-security laws are common around the world, even in democracies. But this one allows China's Communist Party to rip up its promise of one country, two systems and send its secret agents into Hong Kong to impose order as it pleases. Most national-security cases, supposedly, will be tried in Hong Kong's own courts. But the judges will be government-appointed. They will be allowed to dispense with juries and try cases in secret. Most worrying is that 'complex' or 'serious' crimes may be tried on the mainland. The past year of unrest in Hong Kong was sparked by fears of just such a possibility—that a now-shelved extradition law might let dissidents be whisked away to face the mainland's brutal justice. That is what the new law allows. Officials do not rule out that those convicted by mainland courts could be executed.

The first arrest under the new law, on July 1st, was of a man who was merely carrying a banner calling for an independent Hong Kong. The bill could be invoked to arrest someone who uses 'unlawful means' to undermine China's communist system. Could that include taking part in a banned rally commemorating the Tiananmen Square protests of 1989?

Britain was right to say on July 1st that it would make it easier for about 3m holders of "British national overseas" passports in Hong Kong to settle in Britain and eventually qualify for citizenship. Those born in the territory before 1997, as well as their dependents, will gain the right to live and work in Britain for five years, after which they can apply for citizenship. The government indicates that those who take up the offer will not need a job before arriving, and will not be subject to a salary threshold. It is the most generous opening of British borders to foreign workers since new EU citizens were welcomed in 2004.

Could Brexit Britain look to Switzerland?

The UK needs a trade deal with the US. It needs, finally, to make peace with Michel Barnier, and come to an agreement with the EU. It needs to secure access to markets around the world so that it can still export globally. As the deadline for ending our transitional deal with the EU draws closer and closer, there are lots of different deals that Britain needs to negotiate in a hurry. But one is perhaps easier than any of the others and potentially more valuable: a UK partnership with Switzerland to create a global powerhouse in financial services.

With just 8.5 million people, Switzerland is far from the largest country in the world, but its incredible prosperity makes it more important than you might imagine. It ranks 99th in the world in terms of population, but 20th by total GDP. More significantly, just like the UK, it is a powerful force in banking and money management. As a recent report highlighted, Britain and Switzerland between them dominate global exports of financial services. UK financial exports are \$82bn and Swiss exports are \$23bn. Combined, that dwarfs the US at \$68bn, Germany at \$16bn and France at just \$1.5bn. The US, of course, has a massive finance industry, but it mostly services its domestic market, while the rest of Europe hardly competes at all. But London, Edinburgh, Zurich and Geneva are all outward-looking, global financial hubs, focused on working with companies and investors around the world.

Here is the important point. Both Switzerland and the UK are now outside the EU. And both countries either have been, or will be, excluded from its single market in financial services. It remains to be seen what kind of deal

can be agreed with the UK, but the EU has made it very clear it doesn't want the City to keep the passporting rights that allow its firms to sell right across Europe, so it looks as if we will be excluded. Likewise, last year the EU locked Switzerland out of the single market in financial services in a failed attempt to whip the Swiss into line with its own rules. As it turned out, it didn't make a great deal of difference. Instead of trading Nestlé's shares in Frankfurt, you had to trade them in Zurich instead, but the Swiss market continued to outperform most of the rest of Europe as it usually does.

UK/Swiss \$105bn

US	\$68bn
Germany	\$16bn
France	\$1.5bn

There is a natural deal to be done. The UK already has a series of bilateral agreements in place that will preserve access to each other's markets after our transitional deal with the EU comes to an end. But it will need to go a lot further than that. The two countries are natural allies and partners. A UK-Swiss tie-up has the potential to create the world's most important financial hub.

Between them, the UK and Switzerland could create their own single market in finance. It would set its own rules and standards by agreement between the central banks and regulators in both countries. British firms should be allowed to operate completely freely in Switzerland, and vice-versa. Both markets should be thrown completely open to investors and companies from around the world. The legal systems, reputation and stability of both countries means those standards would immediately be accepted globally.

It is a big prize, with huge rewards for both countries. A UK-Swiss partnership

wouldn't necessarily be the biggest financial centre in the world. Wall Street would still be larger and Shanghai will in time move into first place as China's economy becomes the biggest in the world. But it would be the biggest international centre and one few investors could ignore. It would be a magnet for just about every company in Europe that wanted to tap the global capital markets and the gateway for American and Chinese businesses that wanted to raise money from the rest of the world. And it would be 50 or 100 times more important than Frankfurt or Paris, which would put all the heated debate about securing a trade deal with the EU by the end of this year in perspective.

UK House Prices falling

For the first time in eight years, one of the country's biggest house price indices has recorded a fall in house prices over the year – albeit just 0.1% compared to June 2019. The annual figure came after monthly falls of 1.4% during in June month, and by 1.7% in May. That leaves the average house in the UK now priced at £216,403.

It's no wonder that prices fell. There are a lot fewer transactions happening, for a start. Even though sales picked up in May compared to April, they were still down by about 50% on the year. Mortgage approvals were hit even harder – down by 86% year-on-year in May.

And of course, we're in the midst of a massive pandemic, unemployment has surged, and we've no idea what will happen next. Usually, we would be heading for epic falls. But this would require at least one of these two things: tighter credit conditions, or a sharp rise in longer-term unemployment. Both of these factors would create forced sellers, and both would reduce the number of potential buyers out there.

Lenders are wary of falling house prices, and rising unemployment. If you're concerned that house prices will fall, you want to lend to someone with a big deposit, so that they're the ones who take the hit first. So, if you're a first-time buyer, or someone who needs a specialist loan (for example, if you're self-employed) coronavirus has made it harder to buy.

But at the same time, rates on loans for those with big deposits or who are re-mortgaging are going ever lower. You can now get a ten-year mortgage for less than 2%, for the first time ever. So, if you already own a property, there's no prospect of a 'payment shock' any time soon.

In other words, if you want to sell, you might struggle to do so at the price you want. But no one is going to be forced to sell by rising interest payments.

Unemployment is trickier – it's probably the biggest question mark of all. It depends on lots of things including how quickly the economy bounces back, and also on how long it takes those who are made redundant to regain

their feet. The government has already spent huge sums on propping up the economy, meaning it's unlikely to allow a full-on house price crash take hold with politically toxic headlines about repossessions and the like (not to mention the impact on the banks).

A 2008-style crash is very unlikely. One wildcard is the rental market. If you're renting, particularly if you're in a big city, then now is the time to go shopping for a new place. With holiday bookings drying up, a lot of AirBnB landlords have apparently had to join the long-term lettings market, boosting supply.

As a result, various surveys suggest that rents have fallen in London. So, if your tenancy is up for renewal, there's no harm in having a look and either moving or using it as leverage in any rent negotiations.

There is unlikely to be a return of 'buy to let' landlords in any real number since the fundamentals rarely make sense. As for would-be buyers, it's possible that we might see a batch of rental properties hitting the sales market and driving up supply, although it's worth remembering that a lot of that has already happened in the wake of the buy-to-let tax changes.

So, if you're trying to buy a place to live in and you're able to do so, it's worth being punchy in terms of offers. Just bear in mind that the person on the other side of the table is more likely to be influenced by personal circumstances, rather than headlines about Covid-19.

Contact us

If you require further information about our services and how we can assist your clients, then please call us or send us an email about how and when we can contact you.

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