Fusion DFM
Rebalancing Update and Market Comments
28 April 2020

Performance Overview

Since the last update on the 15th of March, global markets fell even further down before starting to rebound in the last week of March. At their lowest points, equity indices were down between -30% and -40% from the start of the selloff, with both corporate bonds and commodities also in disarray. During April, markets essentially recovered at least half of what was lost during the previous quarter, on the back of the unprecedented monetary support from all Central Banks and the flattening of COVID-19 curves across Europe and the US, as well as first signs of economic revival in China and wider Asia. What pushed markets up was the "wave of money" coming to support economies on a scale never ever seen before.

Fusion portfolios, both Optima and Active Ranges, strongly outperformed their respective benchmarks – for all risk profiles the outperformance from the beginning of the year is around +5%. This is the result of defensive positioning, which we advocated at the previous re-balance in our January 2020 Re-balance update. When we said that "There is a considerable chance that we are at the end of one of the longest bull markets and at a setup stage of a large market event" nobody, including Fusion investment team, could foresee what was coming. However, through our defensive stance, both asset allocation and asset selection contributed positively to the out-performance. Our decision to under-weight GBP and over-weight USD exposure contributed to the significantly reduced drawdown levels.

Year-on-year performance remains positive for defensive (circa +1.4%) and balanced (circa 0.4%) portfolios and is slightly negative (-2.3%) for equity-like, most risky, generation programs.

Market Commentary

While stocks and other risky assets rebounded strongly, the underlying economic picture is not so rosy.

Confidence level has unsurprisingly collapsed across the economy, falling to its second lowest level in the last 35 years. The services sector has seen the biggest slump, with sentiment declining to its lowest level on record. Fears of a rise in unemployment have jumped to an eight-year high, without any significant rise in households' savings, which could create a negative feedback loop for the economy. The first-quarter US GDP shrank by an annualised -4.8%. Dropping demand and the oil trading war saw the price of oil collapsing – front-end futures at some point were trading at – (minus!!!) $37. While this was a technical effect specific to that particular futures contract, it really tells us that there is no free capacity to store excess oil and there is limited hope of quick revival of the demand for energy.

Stocks at the current price levels are not cheap if the economic state of affairs is taken into account. The S&P 500's almost 30% rally from the March lows has sent its 12-month forward P/E ratio to about 19.4. That is nearly the highest level since March 2002. It is abnormal for stocks to be this expensive against the backdrop of a particularly ugly earnings season. As of April 21st, about a fifth of the S&P 500 and as of April 23rd a quarter of the Stoxx 600 companies have pulled their 2020 forecasts.

The best-case scenario for the euro area this year is an 8% contraction in GDP, according to Bloomberg Economics. A second wave of infections prompting tighter controls could result in a 10% decline. There is also the possibility of governments failing to act strongly enough in a timely manner, scarring the economy for longer and risking turning a public health crisis into a sovereign debt crisis. According to Bloomberg, in their base case, they assume that the outbreak comes under control in Q2, massive stimulus replaces a substantial share of the lost income, and the removal of lockdown controls allows activity to resume at a rapid pace at the start of the second half of the year. That still leaves the most advanced economies facing the biggest economic decline since the Great Depression.

Downside risks are significant. Without a vaccine, relaxing lockdowns may trigger a fresh wave of infections. It is also possible that the stimulus will miss the mark. If that happens, a deep downturn in Q2 will leave deep scars, with high unemployment, bankrupt businesses and financial turmoil resulting in a painfully slow recovery.

Re-Balancing Portfolios

Looking forward, we continue to combine strategic allocations through models with tactical adjustments, based on our current cautious view on global markets.

During the last re-balance we maintained essentially the same asset allocation weights, with the only difference of re-allocating half of the UK investment grade corporate bond exposure into US investment grade bonds. This was done partially to increase geographical diversification and partially to benefit from the FED program of bonds buying in the US. In the UK bond space around 4% was re-allocated from longer-term bonds to shorter-term Gilts to reduce the duration risk and partially lock gains from decreased to nearly zero government interest rates.

On the asset selection side there are minor changes, primarily on the equity front. In the Optima range a US Low Volatility equity fund has been swapped for a low-cost equity index tracker. This is done partially to reduce portfolio costs and partially to reflect our view that volatility had peaked and in both positive and negative scenarios the economic stimulus will firstly lift easily tradable, large-capitalisation equity indices.

In the Active range, the Global Low Volatility fund has been swapped for the PIMCO fund which tracks Research Affiliates (RAFI) Dynamic Multi Factor US Equity index. The index follows a smart beta index strategy that is designed to provide investors with the benefits of a dynamically-weighted exposure to multiple equity style factors in a low cost and transparent manner. This index provides exposure to such equity factors as value, quality, low volatility and size, which had been proven to be robust from both an academic and empirical perspective. Though the value factor has lagged the market in the recent years, the current relatively low price levels for many value companies in comparison to growth stocks have made them uniquely attractive going forward.

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