Global Matters Weekly

5 October 2020

The Perfect Storm

– Alex Harvey, CFA

If readers cast their minds back to February this year, they will remember the horror that unfolded on the high seas with dozens of cruise ships being forced to stay at sea as the first wave of Coronavirus took hold. The poster child for the industry was the 'Diamond Princess', a Gem-class cruise ship with a capacity of nearly 2700 passengers and 1100 crew, which eventually anchored at Yokohama port in Japan where passengers had to remain on board and self-isolate for several weeks. The world watched on thinking perhaps this would be contained to Asian shores but of course this was wrong as we now know. Global equities would continue to make gains for almost three weeks after the cruise liner had docked before freefalling, only to reach a bottom just over a month after that. Far from plain sailing.

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These 'floating petri dishes', as they became known, also inadvertently shone a light on an asset class that we at Momentum have long favoured owning in our multi asset portfolios: convertible bonds. We have written about these before – most recently in April - but following strong performance they warrant further praise. These types of corporate bonds are more complex than their 'straight' bond equivalents, but it is worth spending a few moments to consider their attributes and what they bring to an investor's portfolio. In its simplest form a convertible bond is a corporate bond with an embedded call option that allows the bondholder to convert the debt into equity if certain conversion criteria are met. The effect of pairing a call option with a corporate bond is that if the underlying equity goes up, the bond behaves more like equity; if it goes down it behaves more like a corporate bond. This 'convexity' effect – which extends to a portfolio of convertibles - thus plays a useful and impartial role in self-allocating into and out of risk as equity markets rise and fall.

> The effect of pairing a call option with a corporate bond is that if the underlying equity goes up, the bond behaves more like equity; if it goes down it behaves more like a corporate bond

Convertible bondholders may earn a coupon, but it is usually lower than that which would be paid on the straight bond equivalent as the equity option acts as a sweetener. It is why convertible bonds can be attractive to issue for higher growth companies who may not generate enough cash to service traditional debt and who often prefer to recycle earnings into the business. By the same notion, convertible bonds can prove to be a lifeline to an imperilled business needing a capital injection. Step in Carnival Corporation, the global operator of 10 cruise line brands. When the business hit the proverbial reef earlier this year, they needed to raise cash quickly to help finance the ~$1bn a month needed to stay afloat, literally. $4bn of the $6.25bn raised came from a straight bond paying a whopping 11.5% coupon while $1.75bn was issued in 5.75% convertible bonds (and the rest from a watered-down equity raise). Issued at $100 the convertibles traded up to nearly $260 and now rest closer to $170. At the same time the 11.5% coupon bonds traded up from $99 to $112, while the equity has marched nearly 80% higher since the two bonds were issued in early April. With the convertible bond sharing in almost all the equity upside it has been the clear risk adjusted winner of the three.

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At a broader level, a portfolio of global convertibles has also performed remarkably well year to date. They suffered less than half the drawdown of global equities in March, yet have tracked almost one for one on the way back up as expectations of higher volatility (which serves to make the embedded option more valuable) and a flood of cheap issuance has supported the asset class. At Momentum we can use asset classes like convertibles to improve the journey for our clients, investing with several small but well-established teams in this somewhat niche and underrepresented asset class. We owned these types of bonds at the start of the year, added on several occasions after markets bottomed, and continue to favour the asset class today given the richness in some sectors and potential uncertainty that lies ahead. For convertible bonds these are not uncharted waters. While they are not risk free assets, they should provide ballast if and when the next storm whips up.

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The **Marketplace**

- A relatively strong week for global markets which returned 1.6%
- President Trump and the First Lady test positive for coronavirus
- Brent crude fell -6.3% ending the week at $39.3 a barrel
- Gold rose 2.1% to end the week at $1899.8 an ounce.

Market **Focus**

US

- The large-cap US equity benchmark broke a string of four weekly losses, returning +1.5% on the week. Most sectors within the benchmark recorded modest positive returns, with the exception of energy
- Talks on the new fiscal stimulus bill continued, with progress being made but an agreement is yet to be reached
- President Trump signed an executive order to expand domestic production of rare minerals vital to manufacturing, with the aim of reducing US dependence on China
- The US economy added 661k jobs in September, easing sharply from an upwardly revised 1.489 million in August, and below market expectations of 850 thousand
- Weekly jobless claims were more encouraging, with the number of Americans filing for unemployment reaching a post-pandemic low of 837 thousand
- The ISM manufacturing PMI fell to 55.4 in September from 56 in August and below market expectations of 56.4
- The Consumer Confidence index rose sharply to 101.8 in September from 86.3 in August

Europe

- Consumer confidence for Italy came in at 103.4 for September, beating market expectations of 100.8
- ECB President Lagarde announced that the ECB is ready to implement further monetary stimulus if recovery falters
- German inflation fell to -0.4% in September, below the -0.1% expected reading, while France's inflation was 0.0% against +0.2% expected
- The European Commission's economic sentiment indicator for the euro area rose to 91.1 in September from 87.5 in August and beating market expectations of 89.0
- The flash manufacturing PMI for the euro area rose to 53.7 in September from 51.7 in August
- The main continental European equity index returned +1.9% last week

UK

- EU Brexit negotiators have indicated that they are prepared to begin drafting a joint legal text of a trade agreement with the UK
- Consumer credit data showed that net borrowing was £0.3bn in August, against £1.45bn expected
- The EU has begun legal proceedings against the UK after it refused to remove sections of the Internal Market Bill. The UK has until the end of November to respond to the EU's concerns over the draft legislation
- UK equities rose +1.1% on the week

Asia/Rest of The World

- Japanese bourses halted trading for the full day on Thursday following a hardware breakdown at the Tokyo Stock Exchange
- China's official manufacturing PMI was 51.5 for September against 51.3 expected. The non-manufacturing PMI rose to 55.9, outperforming market forecasts of 54.7
- Global emerging markets rose +2.2% last week.

Past performance is not indicative of future returns.

Source: Bloomberg. Returns in local currency unless otherwise stated.

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Asset Class/Region	Currency	Currency returns			
		Week ending 2 Oct. 2020	Month to date	YTD 2020	12 months
Developed Market Equities					
United States	USD	1.5%	-0.4%	4.7%	17.5%
United Kingdom	GBP	1.1%	0.7%	-21.0%	-15.9%
Continental Europe	EUR	1.9%	0.4%	-7.6%	1.3%
Japan	JPY	-0.7%	-1.0%	-4.4%	3.3%
Asia Pacific (ex Japan)	USD	1.8%	0.0%	2.8%	14.6%
Australia	AUD	-2.9%	-0.4%	-11.2%	-9.9%
Global	USD	1.6%	-0.2%	1.5%	13.2%
Emerging markets equities					
Emerging Europe	USD	0.2%	-1.4%	-29.5%	-18.7%
Emerging Asia	USD	2.6%	0.0%	8.0%	22.6%
Emerging Latin America	USD	-1.8%	-0.6%	-36.4%	-27.8%
BRICs	USD	2.0%	-0.2%	1.9%	16.6%
China	USD	2.6%	-0.5%	15.9%	33.5%
MENA countries	USD	0.5%	0.0%	-8.0%	-3.1%
South Africa	USD	7.4%	2.3%	-19.6%	-7.9%
India	USD	4.0%	2.0%	-8.0%	-1.5%
Global emerging markets	USD	2.2%	0.0%	-1.2%	11.9%
Bonds					
US Treasuries	USD	-0.4%	-0.1%	9.2%	7.7%
US Treasuries (inflation protected)	USD	0.1%	-0.1%	9.7%	10.0%
US Corporate (investment grade)	USD	0.1%	0.0%	6.7%	7.6%
US High Yield	USD	0.9%	0.2%	0.7%	3.9%
UK Gilts	GBP	-1.1%	-0.6%	7.8%	3.2%
UK Corporate (investment grade)	GBP	-0.4%	-0.3%	4.6%	4.4%
Euro Government Bonds	EUR	0.2%	0.2%	4.0%	1.3%
Euro Corporate (investment grade)	EUR	0.2%	0.2%	1.0%	0.5%
Euro High Yield	EUR	0.6%	0.3%	-2.5%	-0.6%
Japanese Government	JPY	0.0%	0.0%	-0.9%	-1.7%
Australian Government	AUD	0.1%	0.0%	5.0%	2.3%
Global Government Bonds	USD	0.3%	0.0%	7.2%	6.4%
Global Bonds	USD	0.4%	0.0%	6.4%	6.5%
Global Convertible Bonds	USD	1.5%	0.4%	12.2%	19.2%
Emerging Market Bonds	USD	0.3%	-0.1%	1.3%	4.9%

Source: Bloomberg. Past performance is not indicative of future returns

Asset Class/Region	Currency	Currency returns			
		Week ending 2 Oct. 2020	Month to date	YTD 2020	12 months
Property					
US Property Securities	USD	6.1%	4.5%	-14.2%	-14.1%
Australian Property Securities	AUD	0.4%	1.7%	-16.3%	-19.1%
Asia Property Securities	USD	1.4%	0.4%	-17.6%	-13.0%
Global Property Securities	USD	4.1%	2.4%	-15.5%	-12.0%
Currencies					
Euro	USD	0.9%	0.0%	4.4%	6.9%
UK Pound Sterling	USD	1.8%	0.2%	-2.5%	5.1%
Japanese Yen	USD	0.2%	0.1%	3.1%	1.6%
Australian Dollar	USD	2.0%	-0.2%	1.9%	6.9%
South African Rand	USD	3.7%	1.0%	-15.4%	-7.6%
Swiss Franc	USD	1.0%	0.1%	5.0%	8.3%
Chinese Yuan	USD	0.5%	0.0%	2.5%	5.3%
Commodities & Alternatives					
Commodities	USD	-2.5%	-2.9%	-21.7%	-15.7%
Agricultural Commodities	USD	1.0%	-0.7%	-1.0%	5.7%
Oil	USD	-6.3%	-4.1%	-40.5%	-31.9%
Gold	USD	2.1%	0.1%	24.8%	26.5%
Hedge funds	USD	0.6%	0.1%	1.7%	4.5%

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Momentum Global Investment Management (Company Registration No. 3733094) has its registered office at
The Rex Building, 62 Queen Street, EC4R 1EB

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