

Market commentary

April 2020

When China sneezes, the world

Overview

The coronavirus COVID-19 global pandemic ('The Great Virus Crisis') infected financial markets in the first quarter of 2020 as the global economy was subject to residential lockdowns, the curtailing of the movement of people and the furloughing of workers. According to the World Health Organisation (WHO), there were less than 3,000 confirmed deaths of Covid-19 globally by the 1st March 2020 when markets started to tumble and this figure had increased to just below 15,000 by the 23rd March, when markets bottomed. The official death toll is now above a quarter of a million and the effect on peoples' lives and the global economy has been profound as the full scale of the pandemic has been revealed.

The FTSE All-Share Index, which is a measure of the largest 640 companies listed in the UK, fell by a painful -35% from the start of the year to the mid-March bottom, taking the index back to levels last seen at the beginning of 2013. However, at the time of writing, it has staged a spirited rally to reduce its losses to -21%, year to date. The speed of the decline was chastening even for seasoned investors, as it played out within a brief 3 week period from the end of February to mid-March. In the US, the S&P 500 Index (a performance measure of the largest 500 companies) suffered the fastest drop in value of -30% or more in its entire history, achieving the milestone in just 22 trading days. The pain has been particularly brutal for the hotel and resorts sector but more markedly in the cruise line and airline sectors, which fell by 57% and 45% respectively. However, on a positive note, the recovery in the US market since March has been startling and the main index is now only down by -10% from the start of the year. Investment portfolios have undoubtedly been affected to varying degrees as only a portfolio of government bonds would have ridden the storm successfully but in general, valuations at the time of writing should have improved somewhat since the 5th April print that you have just received.

As is now customary since the Financial Crisis, the US Federal Reserve (the US Central Bank) intervened by providing a suite of policy measures designed to support financial markets and the US economy. They slashed interest rates to between 0 and 0.25% from 1.25%, an extreme cut by historical standards and took it back to December 2008 levels. They announced a programme (effectively 'Quantitative Easing 4' – QE4) to buy \$700 billion in US Treasury Bonds and mortgage-backed securities to support bond prices and assist in keeping the cost of borrowing low. Whilst these measures are somewhat opaque to the ordinary investor, it is the primary reason why bonds held in investment portfolios have staged a partial recovery from mid-March. Unprecedented in size and scope, the US government also launched the \$2 trillion 'Coronavirus Aid, Relief and Economic Security Act', also known as the 'CARES Act' to address the economic fallout of the pandemic.

The UK meanwhile, announced its lowest ever interest rate at 0.1% and its Covid-19 Corporate Financing Facility (CCFF), "to provide funding to non-financial businesses making a material contribution to the UK economy to support them in paying salaries, rents and suppliers, while experiencing the likely disruption to cash flows associated with Covid-19". To add to the dictionary of ever expanding financial acronyms, they also reignited the Asset Purchase Facility (APF) and the Term Funding Scheme with additional incentives for SME's (TFSME). The European Central Bank (ECB) launched its Pandemic Emergency Purchase Programme (PEPP) to the tune of €750 billion and China, Hong Kong and Japan all pumped billions into their respective economies. These measures represent a step towards the watchwords 'helicopter money', a term first defined by the economist Milton Friedman as governments and central banks increase their intervention in financial markets and the economy to stimulate economic growth. If you were wondering why markets were holding up relatively well during an economic crisis described as the deepest since the Great Depression, then the size and scope of the global financial stimulus supporting them goes a long way to explaining it.

UK equities

The FTSE All-Share Index produced a total return of -24% in the period under review (6th October 2019 to 5th April 2020). The latest figures from the World Health Organisation show that the pandemic is gradually coming under control but it is becoming clear that leaving lockdown will be a process not an event. Getting an accurate and timely picture of the damage that has been done to the UK economy is a challenge given the time taken to collect the data. It is no surprise that in March and April, both manufacturing and services went into freefall but it won't be until the autumn that we have a more accurate picture of the decline in the economy during the lockdown period.

One of the most visible aspects of the crisis to investment portfolios, aside from current valuations, will be the cuts to dividends. Whilst announcements by companies are still arriving daily, the majority of companies that have already reported are either stopping dividends, cutting their pay-outs, or deferring and reviewing at a later date. In a historical move and in the face of low oil prices, Royal Dutch Shell cut its dividend for the first time since 1932. It's a sensible strategy for all companies to follow, as fund management organisations counselled boards to conserve cash in order to protect their businesses. It is better to conserve cash and protect the value of the business today as dividends can always be picked up again at a sustainable rate, when the outlook becomes clearer. In very broad terms (and with obvious caveats implied), the dividend cuts across the top 350 companies in the UK approximate to 50% of their pre-Covid-19 levels.

Tobacco and Technology Hardware were the only sectors out of 39 that made positive gains in the period under review although Food and Drug Retailers (supermarkets and pharmacies) performed creditably through the crisis as consumers stockpiled necessities. The UK sectors that suffered the largest falls as the pandemic took hold were Oil and Equipment Services, Travel and Leisure (which includes airlines, cruise liners and hotels), Banks and General Retailers but given this is not a typical financial crisis, there are very few areas of the economy that remain unscathed. Carnival Plc, which is the largest cruise liner in the world with over 100 ships in operation paused its entire global operations in May until the end of August. The share price has fallen by 73% this year. The airline industry has also been hit hard with Heathrow Airport declaring a 97% fall in traffic in April to just 200,000 passengers, typically numbers seen in just one day. IAG Plc who own British Airways announced 12,000 redundancies and Virgin Atlantic slashed 3,000 jobs as it pulled its operations from Gatwick Airport in a bid to 'reshape and resize' its business. IAG shares have shed 74% of value this year.

We will clearly be living in a different world post Covid-19 and the adaptation of business models to the new normal will provide interesting analysis. With bricks and mortar shops and restaurants closing their doors, online businesses have stepped in to the void. Ocado Group is a leading pure online grocer and holds around 15% of the UK online grocery market. Whilst the shares have performed well in recent years, they have risen exceptionally well during the crisis to satisfy demand for doorstep delivery. Likewise, Just Eat Takeaway.Com operates an online food delivery marketplace partnering customers with local restaurants, which has been ideal for the conditions we have confronted. It remains to be seen if their current share prices are justified and sustainable as the lockdown is released.

International equities

The S&P 500 Index, used as a broad measure of the total investment return achieved by the largest 500 publicly quoted companies in the US, fell by -14.5% in the full period under review. The effect of the pandemic has been global in nature with similar effects on corporations, irrespective of country borders. The worst performing businesses in the US have been in the Travel and Leisure sectors, Oil Producers, Hotels and General Retailers.

Further analysis reveals that the performance of some of the large, mega-cap technology stocks, namely Facebook, Amazon, Apple, Microsoft and Google have netted returns of +10% since December 2019, whilst a portfolio of the remaining 495 stocks would have returned -13% in the same period. These five stocks now represent over 20% of the entire value of the top 500 stocks, which is an imbalance unlikely to persist in the long-run.

The latest US employment figures revealed a shocking loss of over 20.5 million jobs in April with unemployment at 14.7% of the working population. The final numbers will be much worse but 90% of the lay-offs were temporary workers and these were broadly speaking low-skilled and low paid workers, highlighted by a surprising but significant rise in the average wage in the economy for April. With evidence that states are starting to re-open, businesses will be flexible in their re-hiring of staff. Unfortunately for some workers, the pandemic will have undoubtedly caused some permanent economic scarring and the level of longer term structural unemployment may prove to be persistent. Firms that furloughed workers can restructure their work force with some employees working from home but will also look to save costs and improve productivity where they can. It's too early to draw any firm conclusions on the shape of the economy in the future but a return to pre-Covid-19 conditions in the short-term seems implausible. When polled, a third of Americans say that they would still be uncomfortable visiting a mall even if lockdown restrictions were removed, and in Sweden and Denmark, consumers have cut their spending on travel and entertainment by 80%, even though both countries had contrasting lockdown rules.

Whilst the US government likes to talk about the struggle against Covid-19 as a war, in one respect they are right. Public borrowing by advanced economies is about to soar to 1945 levels. Whilst factories, shops and offices shut, tax revenues are collapsing and governments are writing millions of cheques to help households and firms survive. Across the world, the International Monetary Fund (IMF) says government debt will rise by \$6 trillion to \$66 trillion. The colossal debts will burden societies for decades to come but the good news is that financial markets are suggesting that interest rates will have to stay very low for decades to accommodate. America spends less than 1.8% of its budget on debt interest and modestly higher inflation levels will help to reduce debt levels in real terms over time. Governments will have to prepare for the grim business of balancing budgets later in the decade but the politics of deficit reduction will be toxic. Calls for higher spending on medical services will come from an ageing population and spending on public services will continue to increase. Reckless borrowing by corporations and homeowners will need to be curtailed. After the financial crisis of 2007-09, European governments opted for budget cuts and austerity but the political backlash resulted in the rise of populist politics. Making budgets add-up looks like it will be the defining challenge of our post-covid time.

In Europe, the FTSE Europe (excluding UK) Index dropped by -18.5% but has staged a reasonable recovery from the low point reached in March. Early estimates suggest the euro area economy will contract by -10% but high unemployment, corporate bankruptcies and behavioural changes will be very damaging. In Italy and Spain, tourism represents around 12% of their respective economies according to the World Travel and Tourism Council and it's hard to see a quick return to these levels any time soon. Financial support will inevitably be forthcoming for member countries through the proposed 'EU Recovery Fund'. Ursula von der Layen, the President of the European Commission said about the proposals, "we are not talking about billion, we are talking about trillion". Negotiations will be made all the more difficult by Italy's high debt to GDP ratio of 156% for 2020, which is well above the average for an advanced economy, particularly as they are experiencing a deterioration of their credit worthiness.

Fixed interest securities

The ten-year UK Gilt yield is a paltry 0.3%, which is the estimated annualised return an investor should expect to receive over ten years and remains below the rate of inflation. The equivalent U.S. 10-year Treasury bond yield is 0.7%. The US and UK government bonds are low risk but offer poor nominal investment returns over ten years. The main risk to investing in these assets is inflation, eroding the real value of capital over time. Government bonds in Brazil are yielding 7.2% and India bonds are yielding 6.2% but these come with significant foreign exchange and political risk.

As the lockdown measures were enacted, traders and hedge funds started selling their high yielding corporate bonds in fear of shuttered companies defaulting on their obligations. With few buyers in the market, prices quickly became distorted and the high yield bond sector subsequently sank by -23%. Aware of a potentially disorderly liquidation, the US Federal Reserve effectively became 'the buyer of last resort' and stepped in to stabilise prices. These calming measures were successful and prices staged a recovery with the high yielding bond sector down about -9% down on the year, retracing just over half of the initial sell-off. This scenario played out to a greater or lesser degree across many of the different bond sectors and creating very volatile pricing discrepancies in investment portfolios.

To professional investors, plunging bond prices are ordinarily an indicator of genuine stress and whilst the bonds may appear cheap, it is normally indicative of underlying solvency problems but this is the 'new normal' environment in which we now operate. The authorities cannot afford to let the bond market become chaotic because the economy is so fragile, so bond prices are essentially backstopped. This inhibits true price discovery as highly indebted and unstable companies are essentially 'let off the hook' by the authorities inhibiting the analysts role to determine which companies are the most viable.

Commercial property

The impact on the commercial property market could best be viewed by monitoring the market prices of Real Estate Investment Trusts (REITs). Whilst the market correction was initially breath-taking, the response at sector level was rational. The best performing sectors whose profits were expected to be impacted the least, namely healthcare, industrial, logistics and supermarkets held up well. The weakest positions were all other forms of retail, hotels, leisure and student accommodation. The student property sector came under pressure as it became clear that students would not return until the new educational year in October at the earliest. There is emerging evidence that commercial landlords and tenants are negotiating pragmatic solutions to the lockdown with mutual agreements for rent deferrals, holiday periods and other bespoke solutions. It will be some time before we see clarity on sustainable rent levels.

Alternative asset classes

We witnessed historical events in the oil market as WTI crude oil was trading at minus \$30 a barrel in the futures market. Oil demand plummeted as we entered lockdown but the wells carried on pumping at roughly the same levels. Eventually, storage facilities were full and it became cheaper to pay dealers to take oil off their hands than it did to store it. Financial traders faced with the legally binding obligation of taking delivery of millions of barrels of oil to their offices in the City had to dump their contracts at any price (paying to cancel effectively) causing temporary chaos in the financial futures market.

The gold price rose 9.8% in the review period, reminding investors of its role as a safe haven asset. Likewise, gold miners have performed well as one would expect.

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Indices performance statistics are for the period 6th October 2019 to 5th April 2020, total return with income reinvested. Returns are stated in local currency terms unless explicitly stated otherwise.

Source of statistics: PIMFA, Financial Express, Alpha Terminal, Bank of England, Office for National Statistics, Investment Property Databank, CFA Institute (UK), Financial Times, World Health Organisation.

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