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Wealth & Investment

Market Commentary

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Overview

Although we are only two months into the year, enough has already happened in markets to account for a full twelve months' worth of activity. Several equity indices hit new all-time highs in the third week of February, before concerns about the spread of a novel coronavirus triggered the sharpest weekly falls witnessed since the financial crisis. At the time of writing it is far from clear how the situation will evolve, but there is some optimism that a robust response from both medical and financial authorities will prevent a more serious outcome.

Almost forgotten now is that January started with a literal bang - the killing of Iranian military leader Qassem Soleimani by US forces and the ensuing retaliatory attack. Viewed in retrospect the whole incident seems almost trivial, especially when the minimal market impact is taken into account, but in real time there was a greater sense of alarm. The Middle East has long been viewed as a potential flashpoint, and the relationship between the US and Iran has declined markedly since President Trump backed out of the nuclear deal drawn up under the previous administration in 2015. The whole incident was de-escalated with welcome speed, but was a reminder of the sort of risk that can lie dormant for long periods before reminding us of its existence.

In mid-January reports of a novel coronavirus began to emanate from China. This turned out to be an altogether more serious threat. The story of COVID-19 has played out in two stages so far. Initially the focus was very much on China, and particularly on the province of Hubei. As a hub of the global manufacturing industry, Hubei provides a host of finished goods and components. There was immediate concern that the stringent measures taken to contain further spread of the virus would eventually impact global supply chains, leaving manufacturers in other parts of the world unable to run their own production lines. China's government announced a range of measures to protect businesses and the economy, which helped to restore some confidence. Relatively quickly, the daily increase in new cases began to decline, and, with investors already anticipating pre-emptive policy support in western economies, equities were bid up to new all-time highs. Once again it was stocks with a growth bias that led the way, notably in the technology sector, boosted by falling discount rates in the form of lower bond yields.

This burst of optimism turned out to be premature. As expert epidemiologists' views gained greater exposure, it became clear that COVID-19 was more contagious than normal seasonal viruses, and potentially able to spread at a faster rate. Furthermore, its mortality rate was also higher, making it an even more potent threat. The reality of the situation became clear over the weekend of the 22nd/23rd February, when the number of cases in Italy leapt from just three on Friday to one hundred and fifty-seven on Monday. As the week progressed the numbers rose even more dramatically and new cases were reported in an increasing number of other countries. Italy's government locked down twelve towns in the north of the country and cancelled events including the final days of the Venice Carnival. Photographs of once-busy but now empty streets circulated, drawing comparisons with cinematic interpretations of a zombie apocalypse. Suddenly the world was facing not just a supply chain threat, but also demand destruction, as more events were cancelled, business travel was discouraged, and consumers were either threatened with quarantine or just too nervous to head into crowded environments.

Against this background, equity markets faced a sharp downgrade to corporate earnings growth forecasts for the year ahead. In aggregate, at the global level, earnings per share had been forecast to rise about 7.5% in 2020, but strategists quickly reduced this number to zero. Equity indices took little time to discount this reduction, and also to reverse the previous misplaced optimism. There were double-digit falls for headline indices around the world. The MSCI All-Countries World Index fell 11.6% from its peak; the S&P 500 Index in the US fell 12.8%; here in the UK the FTSE 100 Index fell 11.8%. The VIX Index, measuring market volatility, rose above 40, a level not seen since China's disruptive currency devaluation in 2015.

The cavalry soon arrived in its usual guise, with central bankers around the world pledging to take all necessary steps to avert a crisis, and this sparked the beginnings of a recovery. Although not strictly within this reporting period, it should be noted that on the first trading day of March, the S&P 500 Index rose a remarkable 4.6% in anticipation of action by the Federal Reserve Bank (Fed). This duly arrived the following day in the form of an (emergency) intra-meeting interest rate cut of ½%, the first such move since the financial crisis.

Our considered opinion remains that there is limited benefit in trying to execute a short-term trade in which we sell out of riskier assets with the intention of buying them back when they are cheaper. The extreme volatility has provided some justification for this stance. Even though the virus has spread more widely, we continue to believe that it will prove to be containable. A widespread information campaign certainly means that citizens are better educated in prevention strategies. There has also been a welcome degree of global cooperation amongst the medical and scientific communities in trying to create a vaccine, a process enhanced by the progress of technology in areas such as gene sequencing. However, we would caution against the expectation of anything being made widely available soon.

Other Factors

Normally we address "Key Influences" in this section, but COVID-19 has, with some justification, hogged the first part. Central banks continue to play a key role in determining the outcomes for investors. Even before the virus outbreak they appeared committed to maintaining loose monetary policy settings this year, but now they are being even more aggressive. Preventing recession and the ensuing threat of deflation appears to be the prime objective. With inflation remaining low by recent historical standards, there is even growing talk of letting inflation "run hot" for a while to balance the previous undershoot of the preferred 2% target. Both the Fed and the European Central Bank (ECB) are expected to air further thoughts on the subject in 2020. The decision by Sweden's central bank to raise interest rates back to zero does, though, give pause for thought, suggesting that we are close to the limits of traditional monetary policy without creating damaging side-effects elsewhere in the system.

Politicians will also remain influential. In the UK, much will hang on the post-Brexit transition period and the negotiations with the EU covering our future trade relationship. The initial post-election euphoria has been tempered by the Prime Minister's insistence that he will not countenance any extension of the transition period, which is due to end on December 31st 2020. That perpetuates the risk of a "no deal" Brexit, or at least one that fails to provide an acceptable arrangement for many sectors of the economy. That risk has been recognised in renewed weakness for sterling. The US presidential election will be the major set piece of 2020. First, though, it will be instructive to see how far to the left the Democratic Party is willing to swing in its choice of candidate. A Bernie Sanders ticket would be poorly received by investors, although the odds have shifted in favour of the more moderate Joe Biden following "Super Tuesday". President Trump will run effectively unopposed for the Republicans.

Markets – UK

Equity markets breathed a huge sigh of relief following the Conservative Party's election victory in December. Not only was the threat of an extremely left wing Labour government averted, but there was also the promise that the Brexit logjam would finally be broken. Small and mid-cap companies found special favour thanks to the promise of increased investment in the economy by the government. Some of the gains were already under pressure owing to the renewed risk of a "no deal" Brexit before the coronavirus made its presence felt. A high weighting to Energy stocks has been detrimental to the UK's relative performance owing to downward pressure on the oil price. While perhaps not displaying great growth prospects, the FTSE All-Share Index continues to sport one of the highest prospective dividend yields (4.9%) amongst major markets, and this income looks especially attractive relative to a 10-year government bond yield of 0.4%.

US

There is much talk of the US equity market being "in a bubble" and overdue a sharp fall, and recent events appear to substantiate such claims. However, we would note that US companies have, in aggregate, grown their earnings much faster than peers in other regions. Investors are also willing to pay higher valuation multiples for the better growth prospects and extremely high free cash flow generation of the market leaders. While an economic setback is now more probable than it was at the start of the year, in only 4% of all periods since 1945 have investors suffered a capital loss of 10% or more when the US economy was expanding. The odds continue to favour remaining invested, especially given that policy, both from the central bank and the White House, will remain supportive.

Europe

Europe is a frustratingly general tag for a diverse group of economies that have a wide range of individual strengths and weaknesses. Germany, as the largest member, tends to set the tone, and it experienced a year to forget in 2019, narrowly avoiding falling into a technical recession. However, that cannot disguise a recession in its manufacturing sector. The slowdown in world trade hit its exports, while the secular shift away from higher carbon-emitting vehicles caught its automotive industry unprepared. Although year-on-year weakness appeared to be bottoming out, COVID-19 will provide new challenges. Europe's perennial problem child, Italy, has perhaps been unlucky to be the EU's epicentre of the outbreak. Given the fact that it is hardly to blame (unlike for many of its other problems), it is assumed that policy will be relaxed sufficiently in all quarters to prevent a major threat to the integrity of its banking system and, subsequently, the euro.

Japan

Japan's rulers have a frustrating habit of undermining incipient recoveries. First the government increased VAT by 2% in October, which will constrain consumer demand despite some other fiscal concessions. Then it lowered the threshold at which foreign investors must seek permission to invest in Japanese companies from 10% to 1%. This potentially restrains the sort of activist investors who have succeeded in influencing corporate governance for the better in Japan, even if the rule is mainly intended to hinder China's technological and economic progress. The potential loss of the 2020 summer Olympic Games would be an even more unwelcome blow. Although there is potential value within Japan's stock market, we are struggling to see it being unlocked in a timely fashion.

Emerging Markets

The slowdown in global trade was a major factor in the lacklustre relative performance of EM equities over the last year, and now they are being hit by the coronavirus. Latin America, owing to its reliance on commodities, has borne the brunt of the pain. One extremely counterintuitive outcome, though, has been the strong relative performance of China's stock market, with the CSI 300 Index a mere 6% from its January peak at the end of February (and just 2.1% on March 4th). There is some suspicion that a "National Team" of buyers has been employed to support the market, but there is also some optimism that stimulus measures will provide a strong boost to activity once normality returns to the streets.

Fixed Income

We have maintained two key views on government bonds for some time now. One is that they fail to provide the sort of risk-free income that investors might need to finance future obligations. That is a distinctly negative attribute. On the other hand, though, they continue to provide the potential for short-term capital gain when investors seek safe havens. This is why we will never (in current circumstances, at least) eliminate them completely from balanced portfolios. Recent falls in yields to record lows have only made the problem of generating income even harder, and it is notable that government bonds starting with lower yields have underperformed, suggesting a potential floor to negative yields.

Investors willing to assume the volatility risk associated with extreme duration might have made a capital gain of 32% in the first two months of the year had they owned Austria's sovereign bond that matures in 2117. By the same token they could have lost 20% had they bought Argentina's bond that matures in the same year (and seen their capital halve since last summer).

The biggest threat to the government bond market remains inflation, and despite the odd scare there remains little sign of it breaking higher thanks to the strong disinflationary forces of technology and demographics. But we remain on high alert for any shifts in the trend.

UK Gilts have delivered a total return of 3.44% over the last three months and 11.88% over the last year. Index-Linked Gilts returned 4.07% and 12.42% over the same respective periods. Emerging Market sovereign bonds produced a total return of 1.93% in sterling over the three months to end February (4.94% over 12m). Global High Yield bonds delivered minus 0.26% (0.74% over 12m).

Conclusion and Outlook

The first two months of the 2020s have provided a sharp reminder that investors can be surprised by the turn of events. Even though a pandemic is one of the "icebergs" which our Global Investment Strategy Group has on its list of risk factors, it is by its nature an impossible phenomenon to predict. We believe that as long as no additional exacerbating risk factors emerge and also that governments and central banks provide appropriate and proportionate responses, there is little to be gained from trying to take short-term tactical trading decisions. We remain invested with a longer term horizon. It is a very rare human operator who can be sufficiently perceptive and also objective to be able to time both sides of the trade to perfection. Furthermore, our preference for companies with strong balance sheets and the ability to compound high returns over long periods confers a degree of resilience on portfolios.

However, it is almost inevitable that babies will be thrown out with bath water, and so we continue to scour our universe of stocks for mis-priced opportunities. Our investment process has proved to be robust and responsive, and the increased use of alternative assets in portfolios has provided a further layer of resilience. While we are far from complacent about the outlook, our central view is that a degree of normality will return to economies and markets by the summer, allowing investors to make positive portfolio returns, although we must caution that the heady returns of 2019 are not likely to be repeated for some time.

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