

# Market Commentary

June 2020

## Overview

As the UK enters its third full calendar month of lockdown, many could be forgiven for thinking that things really aren't too bad. Government income support schemes combined with forbearance on certain loan payments have, for many, cushioned the blow of not being able to work; stock markets have rallied strongly from their lows, with some indices and many individual stocks hitting new all-time highs; and (at least for those of us living in the South East) the weather has even complied to lift animal spirits with an almost endless stream of blue skies. And yet the numbers of coronavirus-related infections and fatalities keep rising; the economic news remains dreadful; several big High Street names might not be there when we do actually return to the High Street; and geopolitical tensions, put aside for a while, are back in the headlines. In this commentary we will assess how investors have been balancing positive and negative factors, and what paths markets could realistically take next. Bear in mind, though, that whereas we can tell the story of what has happened with reasonable confidence in its accuracy, the forward-looking part will be, more than usual, an exercise in weighing the balance of probabilities of various potential outcomes.

We have opined on more than one occasion in past commentaries that, reduced to the simplest level, the direction of financial markets is predicated on the interaction between liquidity and economic growth. If they are both rising, financial assets tend to rise strongly; if they are both falling, then the bottom can fall out of markets. Indeed, as we saw again in March, such is the structure of markets today that the falls tend to happen a lot faster than the rises. When the two forces are opposing each other, markets tend to struggle for direction, but the evidence over the years suggests that liquidity ends up having the greater influence in the short term. Thus, if we cast our minds back to March, investors were faced with the prospect of a lockdown-driven air pocket in economic activity at the same time as market liquidity evaporated as both investors and companies couldn't get their hands on cash fast enough. That's about as bad as it gets.

Financial markets being forward-looking in their nature, the trough in equity market indices was reached well before the trough in economic activity. While we can identify precisely the market lows on charts, calling the bottom of the economy is rather more difficult, especially as countries are moving at different speeds through the downturn, and not all sectors of the economy are affected equally. However, at a global level, and indeed specifically in the UK, a broad consensus has

formed that April marked the nadir. We can see this in all sorts of timely indicators, from purchasing manager surveys to retail sales and credit card transactions, although final calculations for Gross Domestic Product (GDP) will not be released for some time yet. These days we also have access to real-time "big data", such as traffic movements and levels of urban pollution, and all point in the same direction. And so it is worth bearing in mind that future headlines generated by dire economic data will very much be referencing the scene in the rear-view mirror.

In terms of liquidity, that is being provided by central banks and governments in hitherto unseen quantities. Central bank asset purchases are running at a rate of more than \$5 trillion per annum. To put that into some context, the maximum rate achieved in the aftermath of the financial crisis of 2008 was a little over \$2 trillion. Interest rates have also been slashed, with speculation rising that both the US Federal Reserve and the Bank of England will have to utilise negative rates within the next twelve months, effectively requiring depositors to pay for the privilege of having cash in the bank. This policy would theoretically be designed to encourage more borrowing as well as to reduce pressure on indebted companies and individuals (not to mention governments), but evidence of success from where it has been tried so far is mixed at best. There is no historical precedent to guide either central bankers or investors through this monetary experiment. Even so, investors welcomed the injection of funds, and prompt central bank action was a crucial factor in reversing the across-the-board sell-off of financial assets that reached a climax on March 23rd.

Complementing the central banks' actions, governments have also been quick to provide support in equally copious amounts. The sums in the UK are comparable only to the sort of spending seen historically during wars. Some of this has come in the form of cash handouts, rather more in the form of loans distributed through the banking system. The intention is to create a financial "bridge" to the other side of the recession, although there is already concern that many of these loans will never be repaid. Even so, it is generally agreed that it is better to try to support households and businesses for the longer term than to allow mass bankruptcies. Bond investors concur, and the yields on government bonds remain very close to all-time lows.

That is not to say that everything is rosy, by any means. One of the key tasks in the months ahead will be to assess the pace and extent of the recovery. Even though there is a sense of

relief, and even euphoria, around the gradual relaxation of lockdown measures, it is clear that the world will not be able to return to anything approaching "business as usual" as long as social distancing is still required. This will have implications for both the demand and supply sides of the economy. Large gatherings (for example sporting events and concerts) appear to be off the agenda for a while yet, while the travel, retail and entertainment sectors will have their physical recoveries curtailed by reduced capacity. Offices and factories will similarly face restrictions on the number of staff allowed on-site at any one time, which, especially in manufacturing industries, will tend to reduce productivity. Many office-based service industries (ours included) are coping well enough with remote working, but one wonders whether at some point the lack of personal contact will have a negative effect on creativity.

Ultimately, the escape from our newly restricted lifestyles depends on the progress of the coronavirus, and here we have to admit (as should all lay people) that we have no greater insights than the next person. That is not to say that we do not consume an ever-increasing amount of information on the subject with a view to being as well-informed as possible, but even so it is clear that, as is often the case, even the "experts" fail to agree. The good news is that as more data is analysed on the outbreak so far, it can inform us of what appear to be the greatest risks to health and how to take the best precautions. This at least, combined with restrictive government policies, suggests some ability to contain the virus, although with persistent economic costs. The ultimate goal is the development of a vaccine, and investors have reacted strongly to any news, good or bad, on the subject. Balanced against the fact that there are over a hundred in development and more than a dozen already in trials, the more unnerving truth is that no vaccine has yet been successfully developed to combat any of the existing coronaviruses. Moreover, the practicalities of producing, distributing and then administering billions of doses are far from straightforward. Until more clarity is achieved on this front, we will be reluctant to add more risk to portfolios.

## Markets – UK

UK Equities have been a distinct laggard this year, especially when the weakness of the pound is taken into account. The wider UK market is down 17.7%, while the world index is just 1.6% lower in sterling terms. Much of this is the result of heavy index exposure to the Oil & Gas and Banking sectors, both of which have fallen around 40%. Although the Pharmaceutical and Grocery sectors are in the

black, they were not big enough to make up the shortfall. The UK market also remains depressingly bereft of large technology stocks, which is one area that has been very strong this year. Much can be learnt about the shape of the economy and investors' reaction to it from the big winning and losing shares in the FTSE 100. Ocado, now a company that specialises in providing logistics and distribution solutions, is by far and away the best performer (+71%), followed by Polymetal (a gold producer, +36%) and Scottish Mortgage Trust (+26%). The latter, contrary to its name, does not invest in mortgages north of Hadrian's Wall, rather in companies worldwide that its managers identify as long-term winners, especially in new technologies. The bottom of the pile is littered with travel companies, notably Carnival (cruises, -71%) and IAG (parent of British Airways and Iberia, -63%).

## US

The US stock market continues to be the stand-out performer amongst global markets, mainly thanks to the strength of its mega-cap constituents. Technology industry giants such as Microsoft, Apple, Facebook, Amazon and Netflix have prospered in the work/play at home environment. Microsoft and Apple alone have a larger combined market capitalisation than the whole of the UK stock market. However, this is leading many to question just how much further the US market can go without the participation of more cyclical companies. There are signs that this is beginning to happen as confidence in the recovery grows. It is possible that the rally can then continue through the summer, although there is then a major uncertainty ahead in the form of the presidential election in November.

## Europe

Virus-related news in Europe continues to improve, with the worst-affected countries slowly exiting lockdowns. This has encouraged investors to buy more cyclical companies, an area to which the European bourses are more exposed. Smaller companies' shares have also rallied. Some of the credit for this can be given to the European Union, which, under the leadership of France and Germany, has constructed a stimulus package potentially worth some €750bn. While it would seem premature to begin talking of fiscal union, it is certainly a step in that direction. However, there remains a core of reluctant participants, known as the "Frugal Four" (Austria, Denmark, Sweden and the Netherlands), who might yet force the offering to be diluted. Meanwhile, the European Central Bank continues to utilise all its weaponry (even in the face of objections from Germany's Constitutional Court) to support the economy.

## Emerging Markets

China continues to provide the template for recovery from virus-related lockdowns, and although overall activity looks relatively encouraging, at around 95% of pre-virus levels according to some studies, it still falls short of what it was. Furthermore, there is a definite divergence between the sort of activity that can be accelerated by the government and more discretionary behaviour. Thus manufacturing and local government spending on new infrastructure projects are buoyant (as evidenced by higher coal consumption and carbon emissions), whereas travel and retail sales are less so. China's exports are also under some pressure owing to weak growth elsewhere in the world, and the latest escalation of tensions between it and the US are also unhelpful, not to mention the imposition of new security laws on Hong Kong. Even so, China always holds the interests of its own economy closest to its heart, and still has plenty of fiscal and monetary ammunition to deploy if needed.

## Fixed Income

Government bonds have been relatively quiet recently compared to other areas of financial markets, having successfully fulfilled their role as "insurance assets" during the first quarter. Very low yields continue to deter income-seeking investors from buying, with the bulk of demand currently coming from central banks and entities needing to fulfil regulatory requirements. Yes, there are those predicting a slump into a deflationary depression who believe that yields can go substantially below zero, but they remain in the minority.

The next big discussion for holders of bonds (and indeed all investors) will be whether or not the combination of ultra-loose monetary policy and aggressive fiscal stimulus will reignite inflation. The risk of rising inflation is heightened by the backlash against globalisation (which has been a powerful disinflationary source for several decades), the potential shortening of supply chains post-Covid, and higher costs for companies in the form of increased wages and taxes (which they then seek to recoup through higher prices). One can also add in lost productivity as the result of anti-virus measures. There is more than a suspicion that governments would welcome a modicum of inflation to reduce the real burden of newly accumulated debts. We are of the opinion that inflation is a greater long-term risk now than it was just a few months ago, but that the immediate outlook is more deflationary. It is, for now, more a case of looking for hedges and insurance policies against the risk of inflation than betting on it returning.

In the Credit markets, investment grade companies' debt continues to offer a decent risk/reward trade-off for income seekers, especially with central bank support behind it.

UK Gilts have delivered a total return of 4.49% over the last three months and 12.29% over the last year. Index-Linked Gilts returned 5.17% and 8.49% over the same respective periods. Emerging Market sovereign bonds produced a total return of minus 2.29% in sterling over the three months to end May (+3.45% over 12m). Global High Yield bonds delivered minus 2.02% (+0.84% over 12m).

## Conclusion and Outlook

Markets reflect a growing confidence that the worst effects of Covid-19 are behind us, but we remain far from complacent. There are few economists, if any, who expect levels of economic activity around the world to return to their previous peak until sometime in 2022, and even that assumes a relatively swift return to some kind of normality. Given the continuing uncertainties about the progress of the virus, making large bets on equity markets returning to and then surpassing all-time highs is a bit of a stretch. Even so, consumption will not evaporate completely, and even in times of stress there are winners, as we have seen in this particular crisis. Thus we "stick to our knitting" in identifying companies and themes that will be profitable in the long term. We are also able to add a little more spice by investing in companies where we believe that the market is not correctly valuing their survival and/or recovery prospects. Needless to say, we endeavour still to build in a good margin of safety with these "special situations" in an effort to avoid investors' worst risk – the permanent loss of capital.

Another current challenge is to generate income at a time when the dividend distribution of UK-listed companies is forecast to fall by around a half from 2019 levels. The sensible approach will be not to reach for too risky payouts which expose portfolios to capital risk. If there is any silver lining to the situation, it is that dividends can be rebased to more sustainable levels from which they can grow at a faster pace. This tends to lead to better total returns for investors in the long run. In the meantime, we urge you not to rely on historic dividend yield data such as is published in the newspapers, and instead consult your investment manager or financial planner to ensure that your needs and aspirations remain achievable.

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