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Market Commentary

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Overview

2020 continues to be a year that defies attempts to compare it to any periods in history, and certainly to any periods within the living memory of the investment community. A pandemic of an extent not experienced since 1918, before the birth even of the redoubtable Captain (now Colonel) Tom Moore (who is also now at liberty to drive a herd of sheep across London Bridge, should he so desire); lockdowns of populations across the world which resemble the imposition of martial law; empty streets of the sort depicted in post-zombie apocalypse movies; a collapse in economic activity that will make the downturn of the Great Financial Crisis (GFC) look relatively benign; an unparalleled monetary policy response combined with fiscal support previously only seen in war time; and record-breaking gyrations in financial markets, including the oil price trading below zero. And it's not as though anybody has the option of taking a holiday to recharge the mental batteries.

And yet, providing evidence of the discounting mechanism of financial markets, equities have enjoyed one of their best ever months in April. The S&P 500 Index in the United States had its best monthly performance since January 1987, only narrowly missing out in the final few hours on having its best showing since October 1974. Credit spreads, the extra yield over safe government debt demanded by investors to fund companies, have tightened sharply. Even so, it is clear that we have yet to experience the worst of either the economic data or company results. How can we square this particular circle?

Much of markets' movements can be ascribed to the nature of this particular downturn. Past recessions can be broadly categorised as either cyclical or structural. The former tend to involve central banks deliberately depressing the economy to reduce inflationary pressures; the latter, such as the Technology bust of 2001-03 and the GFC, involve the rapid and disruptive unwinding of financial excesses and imbalances. Both, by their nature, are drawn-out affairs. By general consent, the current recession can be described as "event driven", with the expectation that once the "event" ceases (in this case the spread of the coronavirus and all its consequences), life can return to normal fairly quickly. We will discuss that supposition in more detail later, but it's fair to say that, for now, investors are looking through the trough of activity towards a more recovered state as we progress through 2021.

The market has also moved pretty aggressively to differentiate between potential long-term winners and losers. Technology companies, especially those benefitting from increased use of online services, and companies deemed to have all-weather growth prospects supported by strong balance sheets, have led the rally, while many consumer service companies, especially those related to the travel and leisure industries, have been shunned.

How bad will things get? The International Monetary Fund's latest forecast for the global economy in 2020, by no means the most pessimistic, suggests a 3% contraction, and that compares with -1.7% in 2009. However, that annual number fails to capture either the probable magnitude of the decline in the second quarter or the peak-to-trough shortfall, both of which will be well into double digits for most economies. We had a glimpse of what is to come in the first quarter Gross Domestic Product prints. China, where it all started, saw its economy shrink by 6.8% compared to a year earlier, and has probably already seen the worst. Relative to the last quarter of 2019, the US (-1.2%) and Europe (-3.8%), saw less severe declines, but bear in mind that the restrictive measures were not in place until March. Meanwhile the UK reported a 0.1% month-on-month fall in activity in February, following a rise of just 0.1% in January, hardly suggestive of an economy that was firing on all cylinders even before the ravages of Covid-19.

A more timely measure of the extent of the current downturn is the Weekly Jobless Claims data in the US. This series now shows that more than thirty million people have filed for unemployment benefits in just six weeks, suggesting that the next reading for the unemployment rate could be as high as 20%, up from just 3.5% in February. The number in the UK will not be as dramatic owing to the furlough scheme put in place by the government. Much will then depend on how fast people are allowed, able and willing to return to work. Governments have had to admit that not all jobs and businesses can be saved by policy. Some big companies, notably those related to airline travel, are already preparing the ground for permanent redundancies. Many smaller companies will be suffering in silence.

And this is where investors are struggling with their projections. What shape will the recovery be? Initial hopes of a fast "V" have receded further, to be replaced by "U", "W" or even "L" depending on one's reading of the situation. The Nike "swoosh", depicting a sharp initial decline followed by a very shallow recovery, is also a candidate. Our central view is for something between a "U" and a "swoosh", suggesting a reasonably quick bounce in activity once pent-up demand is released followed a by a slower return to normal activity levels as social distancing continues to be a factor and animal spirits take a while to be restored.

The one thing that would make everyone much more positive would be an early breakthrough in the quest for a vaccine and the ability to administer it to a large segment of the population quickly. However, most current expert opinion suggests that nothing will be available in even small doses until at least the end of the year. Markets have already shown themselves to be highly sensitive to news from the pharmaceutical industry, with first good, then bad, then good news again on Gilead's Remdesivir, a potential treatment, provoking sharp mood swings. A vaccine would be game-changer.

The main antidote to the economic malaise has been the exceptional monetary and fiscal response. Maybe we can count ourselves lucky that the experience of the GFC provided a handily available playbook for this crisis, which the authorities followed without hesitation. It took only four weeks for the US Federal Reserve Bank, which tends to be the leader in such matters, to provide more liquidity to the financial system than it did in the whole of the financial crisis. Central Bank asset purchases are back in favour, this time even with a modicum of "junk" bonds on the shopping list. Whatever one's feeling about the moral hazard involved in supporting businesses that might have taken on excessive risk, the clear message is that liquidity will not be allowed to dry up as it did on 2008.

On the fiscal side, it's as though the most profligate socialist governments were in power across the developed world, with everything from furlough schemes and rates holidays to cash handouts on the agenda. It would not be inaccurate to describe this as "money printing", with much of the associated government debt issuance being bought by the central banks. Indeed, it bears many of the characteristics of "Modern Monetary Theory", a policy increasingly espoused by left-leaning politicians. Again, whatever one's political stripe, it is exactly the right policy to be pursuing in the current circumstances. The alternative "Darwinian" solution for the private sector would not bear contemplation. It is imperative to allow companies and individuals a fighting chance to participate in the eventual recovery.

What happens to all the new government debt afterwards remains a matter for discussion. It will be very difficult for any country to pay it down quickly, and a return to austerity seems most improbable, especially now that the value of public services has been demonstrated so dramatically. One theory is that the debt can be inflated away by allowing economies to grow faster than the debt pile while keeping interest rates low and depressing bond yields through central bank asset purchases – a policy known as "yield curve control" that the Bank of Japan has been implementing for several years. This is certainly an option, but one that requires investors in government debt

to retain the belief that they will be paid back at some point in the future. Once that trust is lost, financial crises and currency devaluations such as we have recently seen in Argentina and Lebanon are all too possible.

Markets – UK

Last month we suggested that the overall dividend payments from UK-listed companies might fall around 40% in 2020. Now we think it could be more than 50%. While some businesses, such as banks, could clearly afford to pay a dividend currently, regulators have leaned on them to preserve capital. Others, though, having seen their revenues and profits demolished, are hanging on to every last penny just to survive. The Energy sector has been the source of close to a fifth of the market's dividend payments, but has been badly affected by the price of oil, which, as represented by the West Texas Intermediate benchmark, fell briefly into negative territory. This was the immediate result of investors offloading expiring futures contracts to avoid having to take delivery of physical barrels of oil. But the underlying cause was the huge, lockdown-related reduction in demand in an era of burgeoning supply, leading to a surfeit that is outstripping storage capacity. Consequently, Royal Dutch Shell cut its dividend for the first time since World War II.

US

The rally in Technology companies has left the US market looking somewhat top-heavy. The combined market capitalisation of the top 5 names is $5.16 trillion, and their last reported combined net income was $159 billion (Microsoft and Amazon alone are more valuable than the FTSE 100 Index!). Meanwhile the combined market value of the bottom 350 names is $5.18trn, and their last reported combined net income was $307bn. Admittedly those top 5 stocks have combined net cash of $270bn, versus the bottom 350 combined net debt of $307bn, but many are questioning the continued outperformance of such a select group. Our belief is that the market leaders are robust businesses, with plenty of growth runway ahead, and the situation is not akin to that at the top of the Tech bubble in 2000, when such an imbalance was last seen. Even so we do not exclude the possibility of a rally in favour of smaller and more cyclically exposed companies as the Covid-19 fog clears.

Europe

Europe appears to be over the worst in terms of the virus itself, with many countries gradually relaxing lockdown policies, but now has to deal with the consequences of that lockdown in the form of high unemployment and increased debt levels. Europe's fatal flaw, is the lack of fiscal unity. This remained apparent in the most recent meeting of the European Council, with a core group of Northern European countries remaining opposed to what they would consider to be a "bailout" for the South (plus France). Only the European Central Bank once again stands between the euro zone and oblivion, it seems, and its President, Christine Lagarde, is now firmly "on message" after a shaky start. Until the region finds more common ground between its members, it is hard to see it recovering as quickly or as sustainably as elsewhere.

Emerging Markets

EM falls into three distinct categories currently. China is in a league of its own. Despite being the source of the virus, it has apparently coped admirably with the effects, possibly owing to it being a command economy. Despite a sharp fall in first quarter GDP, the IMF believes that China will be one of the few economies to grow this year, even if only marginally. Local equity indices are also in positive territory year-to-date. The rest of Asia is a mixed bag, but will suffer from decreased demand for exports from the rest of the world. High levels of debt while the dollar remains strong are also a burden. Latin America is at the other end of the scale. It is still in the exponential growth phase for new cases as well as being subject to widespread government mismanagement. There is potentially interesting long term value developing here, but there is no hurry to go looking for it.

Fixed Income

Government bonds, having played their role as safe havens with great success during the first quarter (notwithstanding a brief aberration during the most violent liquidation phase), have settled into a more subdued trading pattern. Further capital gains are limited by the proximity of the zero bound for interest rates and yields. Of course, many sovereign bond yields are already below zero, but they performed less well during the downturn. Central banks such as the US Federal Reserve and the Bank of England appear reluctant to push rates into negative territory. But losses will probably be minimal too, as all central banks strive to hold down the cost of borrowing for governments which now carry even larger debt burdens. Whether or not one should explicitly call this "debt monetisation" or the grander "Modern Monetary Theory" is almost irrelevant in the short to medium term. At least it provides a path through the current crisis, which is the key factor.

We continue to search for higher levels of income, cognisant of the fact that this will require assuming more risk. The best risk/reward ratio is currently to be found in the Investment Grade credit sector, lending money to higher quality companies with stronger balance sheets. Returns will be driven by a combination of higher yields and spread compression that delivers initial capital gains. The sector is also backstopped by central bank asset purchase programmes. However, one should never make the mistake of confusing liquidity with solvency, hence a need still to set a reasonably high quality threshold.

UK Gilts have delivered a total return of 6.02% over the last three months and 14.97% over the last year. Index-Linked Gilts returned 2.13% and 8.02% over the same respective periods. Emerging Market sovereign bonds produced a total return of minus 7.41% in sterling over the three months to end April (+0.19% over 12m). Global High Yield bonds delivered minus 6.78% (-2.13% over 12m).

Conclusion and Outlook

The world feels like a less scary place that it did just a month ago, but no doubt substantially less certain than it did at the start of the year. The art of investing, now more than ever, is to find the right balance between short-term economic stress and long-term value in financial assets. Whereas towards the end of March the market was offering a higher and relatively attractive risk premium, the situation now looks less clear cut: risk assets have rallied, while expectations for growth, profitability and dividends have yet to find a firm floor.

We are all now, to a great degree, in the hands of the scientific community, with policy being guided by experts in the fields of virology and epidemiology. We also await developments in the realms of testing and vaccines. The development of a Covid-19 vaccine remains a primary target for governments and the pharmaceutical industry, and with the two joining forces it is possible that we will see positive results sooner than anticipated. However, as a motto attributed to the film director James Cameron goes: "Hope is not a strategy." We would prefer to see more concrete evidence before assuming more risk again in the absence of more obvious value. He carried on: "Luck is not a factor". One can have good outcomes by chance or by taking unquantified risks, but that strategy tends to come a cropper in the end. Neither did the developers of the Efficient Market Hypothesis list "Luck" as a factor in investing.

Cameron ended his rallying call (which he had printed on t-shirts for people working on one of his film sets) with: "Fear is not an option". We agree. When markets are at their most volatile is when they can offer the best opportunities for those who stick to a strict investing discipline and who are not forced to capitulate owing to the structure and nature of their funds. The longer one's investment horizon, the more one can take advantage of short-term dislocations. There may well be more of those ahead, and we await them with anticipation rather than dread, confident at the same time that our current investments will remain relatively resilient to the current turmoil while offering good longer term returns.

John Wyn-Evans
Head of Investment Strategy

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