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Learning To Live With The Worry

I keep torturing myself with thoughts of what might have been happening had the world not been exposed to the SARS-CoV2 virus. Thus I imagine a parallel universe in which last Friday I was attending The Open golf championship at Royal St George's in Kent. No doubt some professional golfers are waking up this morning imagining the famous Claret Jug trophy lying beside them. Next year, hopefully.

In financial markets, in any normal year we would now be turning our full attention to the second quarter results season. This year we remain more than a little distracted by other events, but the earnings are still going to be a very important pointer. They might also serve to close the gap between strategists' "top down" aggregate market estimates for this year and still lagging analysts' "bottom up" forecasts.

Looking at UK Large Cap stocks, the Bloomberg consensus of analysts' estimates for the first half-year earnings (expressed as pounds of earnings for the FTSE 100 Index) is currently £122 versus £208 at the start of the year. That's a drop of 41% in expectations since the start of the year and 37% below the figure for 2019, although many strategists are expecting earnings to halve or worse. Even so, that should still mark the low point for reported earnings, as the consensus estimate for the full year has fallen to £276 from £415, a downgrade of a mere 33%. The pattern is estimated to be much the same for most developed markets.
The damage will probably be somewhat greater for the FTSE 350 and All-Share indices owing to their greater exposure to domestic companies with the UK economy having been hit harder than many others.

As we have pointed out in previous Weekly Digests, investors are already expecting this earnings season to be appalling in aggregate, and so the surprises are more likely to be in the details of sectors and individual companies. Investors will be keen to see how well, for example, the key banking sector is faring. Banks are a key intermediary for fiscal support to the economy as a channel for government-backed loans, and remain crucial to the smooth functioning of the economy. Although we haven't been great fans of banks from an investment perspective for a while, neither have we believed that they would be the source of another crisis to match the financial crisis of 2008, and that seems to be the case so far. The early results from the US Banks sector, always something of a bellwether for the season as a whole, revealed almost $30 billion of bad debt provisions, but set against strong trading profits and the capital buffers built up over the last decade they presented a minimal threat.

There are two more angles to consider. First is to see just how much damage has been done to companies caught in the teeth of the coronavirus

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storm, notably in service sectors relating to transport and hospitality. Will there be any clear guidance available? How long can they survive without some sort of normality returning? Will there be a need for (further) capital raising? What about issues in supply chains for manufacturing and distribution companies?
And, more optimistically, will some companies have fared better than expected? There are bound to be a few surprises in both directions.

Then there are the companies that have had a "good crisis" – either those whose business was resilient or those who have seen their growth profile accelerated by lockdowns and working from home. Have investors rewarded them too generously with high valuations? Have growth trends been extrapolated too aggressively? There was a warning shot from Netflix last week about future growth potential, and its shares fell 10% (admittedly they still sport fantastic long-term gains, and were, perhaps, vulnerable to some profit-taking by short-term traders). Remember that lockdowns were in their very early stages when companies last reported at the end of the first quarter. This will be the first time we have seen anything close to the full picture.

Obviously it's impossible to ignore the continuing effects of Covid on all matters financial and political. News from the United States over the weekend continues to suggest that case growth is not abating, and there are plenty of reports of hotspot outbreaks from countries around the world which have previously had more success in controlling the spread of the virus. And yet markets appear to remain relatively untroubled. Why should this be? First is the fact that we are dealing with something with which we are now a bit more familiar, even if our knowledge remains far from complete. It is often noted that the first hour and twenty minutes of the film Jaws are the scariest because until then the infamous shark is no more than a shadow in the water and a fin. At least now we've had a good look at what is trying to kill us. Second is the unwavering support of central banks. It is hard to overemphasise the supportive nature of their actions. Third is fiscal support from governments, more on which below.

And finally there is the belief in progress on the medical front. We are led to believe (courtesy of a Robert Peston scoop last week) that there will be news of meaningful progress in the development of a vaccine announced today by the team at Oxford University (a group that also benefitted from a very positive profile published by Bloomberg last week). The latest fund manager survey from Deutsche Bank (published this morning) shows that 75% of respondents believe that a vaccine will be widely available in six to eighteen months, and 12% within six months (which is more optimistic than June's survey). That suggests that any material acceleration of that timeline would be positive for risk assets. By the same token, any meaningful drift into 2022 would be negative. Indeed the longer and deeper the scarring effects on economies of restrictive measures, the more existential the threat to affected industries and companies becomes.

In this context I would also like to cite some research published by Bernstein at the end of last week. Their Healthcare team modelled the latest surge in cases in the US and concluded that although the reported number of infections is set to continue to rise through July and August, they should peak towards the end of August. This is based on the relationship between seroprevalence, modified behaviour and herd immunity. Seroprevalence is the amount of the population that has been infected and therefore (theoretically) imbued with some degree of immunity, thus creating a "dead end" for viral transmission. Modified behavior is the use of masks, etc., and greater personal hygiene as well as lockdowns. A combination of these factors reduces the R-nought (infection rate) of the virus from its natural range of 2.5-3.5 (the average number of new infections created by one spreader) to closer to 1. Crucially, it also means that much sought after herd immunity is achieved with a far lower overall population infection rate – possibly as low as 25% rather than the much quoted 60-70% figure. One always caveats such work with the comment that it is just one set of opinions based on theory, but it is at least a scientific approach rather than one based purely on emotion.

To end this week's piece, a quick follow-up on some recent topics, namely the US political situation and the potential for recovery in Europe. In the US, we are heading towards a possible "fiscal cliff" at the end of July when various measures of support for the economy are due to expire. If they did, that would be bad news. However, there are encouraging signs that a new stimulus package amounting to as much as $1.5 trillion will make its way through Congress in the nick of time. Even though some of the support levels for the unemployed will probably be reduced (possibly to encourage them to go looking for work again), the key thing is to continue to provide some sort of safety net. Be prepared, though, for emotive headlines, last-minute horse-trading and pre-election point-scoring on both sides.

Meanwhile on this side of the Atlantic, but the other side of the Channel, European leaders continue to thrash out the final terms of the proposed stimulus package. It does now look as though the percentage of grants will be reduced in favour of guaranteed loans. This is to satisfy the "Frugal Four" (the Netherlands, Austria, Sweden and Denmark) who do not want to (or be seen to) hand out free funds to their "profligate" southern neighbours. In the end it will be a matter of saving face on all sides, which tends to be the outcome of most such disagreements in the EU. Again, failure to sign off a deal would be taken badly.

All of the factors mentioned above create the environment for a possible market wobble in the short term, or at least increased levels of volatility. These should be manageable given the potential for timely resolution in all cases. Furthermore, investor positioning does not suggest the potential for the sort of market panic we experienced in March.

Last week’s Economic Highlights

FTSE 100 Weekly Winners

Company	Change
Fresnillo PLC	16.1%
Flutter Entertainment Plc	9.5%
Johnson Matthey Plc	9.1%
SSE plc	8.7%
Smith & Nephew plc	8.2%
BHP Group Plc	8.1%
AstraZeneca PLC	8.0%

FTSE 100 Weekly Losers

Company	Change
Burberry Group plc	-5.6%
British American Tobacco	-3.2%
Taylor Wimpey plc	-2.3%
SEGRO plc	-1.6%
British Land Company PLC	-1.5%
Associated British Foods plc	-1.5%
Melrose Industries PLC	-1.2%

FTSE 100 Index, Past 12 Months

Source:FactSet

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