Capital markets update

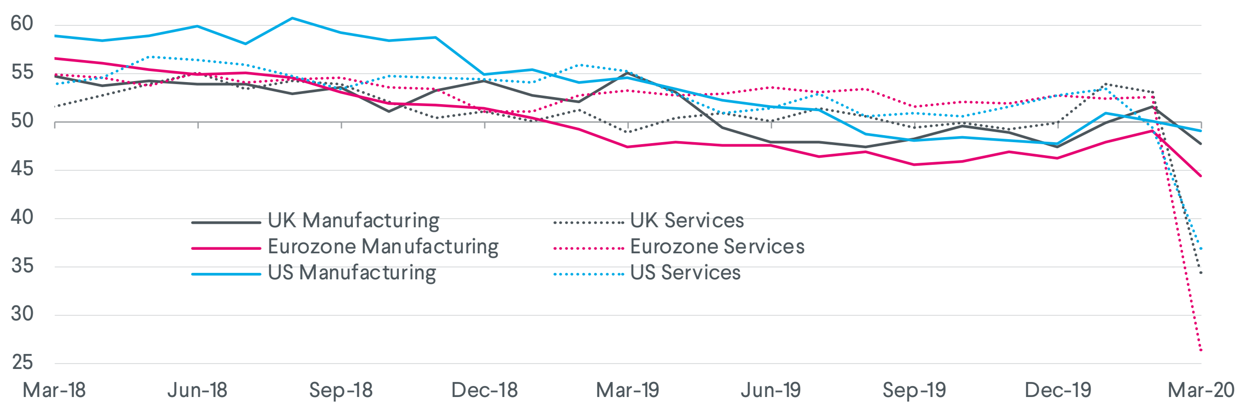
The start of 2020 was reminiscent of much of 2019. Bond yields drifted lower, consistent with the slowdown in global growth, manufacturing, and trade in 2019 and persistently low inflation. Despite the effect on corporate earnings – lacklustre growth and falling forecasts – and already-high valuations, global equity markets pushed even higher.

But no markets could ignore the likely economic effect of the outbreak and global spread of COVID-19, and on 20 February markets turned. The impact on supply and demand from containment measures adopted across much of the world will inevitably impact the rate of global economic growth in 2020 and beyond. Latest consensus forecasts suggest the global economy will shrink 2.1% in 2020, with the major advanced economies expected to contract more than during the Global Financial Crisis. The near-term environment will be extremely challenging, given the necessary halt in economic activity. Services Purchase Managers' Indices (PMIs) fell to record lows in the US, Eurozone, Japan and UK in March (Chart 1). Manufacturing PMIs fell less, but likely do not reflect the full extent of the contraction and may have been supported by a technicality of increased supplier delivery times, which in more normal circumstances suggest increased demand.

Forecasts point to a recovery once social distancing measures are relaxed, and monetary and fiscal stimulus combine with resumption in discretionary spending and production. The challenge of course is when this will be, and how quickly demand and supply will ramp up.

The experience of China may provide a leading example for the outlook. February data revealed industrial production fell by 13.5% year-on-year, retail sales by 20.5% and fixed asset investment by 24.5%. Indeed, Chinese GDP was confirmed to have fallen 6.8% year-on-year in the first quarter. But, having plunged to a record low in February, the Chinese manufacturing PMI unexpectedly bounced back in March to a level consistent with expansion. A word of caution: this may just reflect more than half of the surveyed businesses having resumed production. A collapse in demand in the major advanced economies has the potential to hinder recovery in China and elsewhere, as of course would a second wave of the virus.

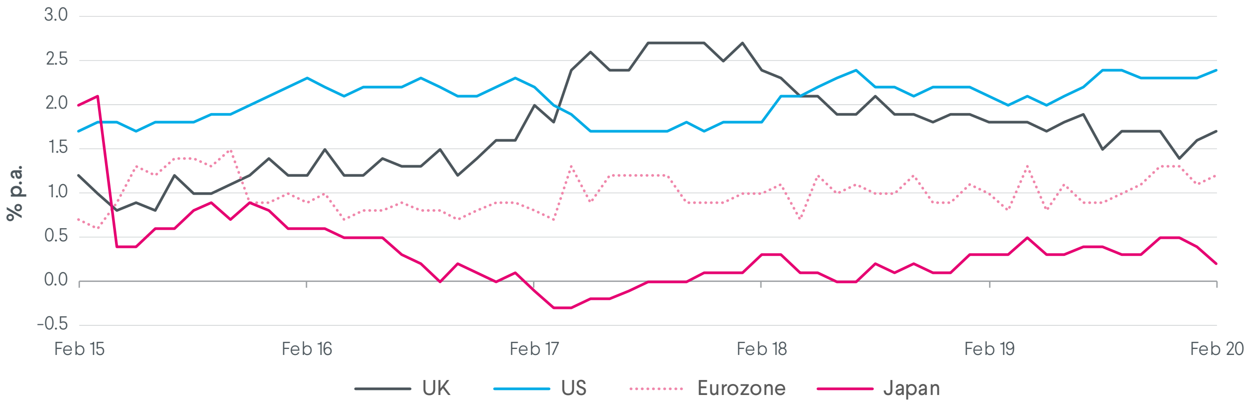
Chart 1: Manufacturing and services purchasing managers' indices (PMIs)



Source: Bloomberg

The immediate impact of collapsing demand globally and steep oil price declines are disinflationary. The slump in global demand for oil was compounded by a price war between OPEC (led by Saudi Arabia) and Russia. Even a subsequent agreement to cut supply, equating to around 10% of pre-outbreak global production, failed to provide much support, with oil prices still close to 60% below end-2019 levels. Global headline inflation is forecast to fall in 2020, with some economies in the Eurozone and Japan expected to enter deflation. Any inflationary effects owing to reduced labour supply, via widespread quarantine and sickness, and disruption to highly integrated global supply chains, for now, remain largely absent.

Chart 2: Core CPI inflation



Source: Datastream

Low realised (Chart 2) and forecast inflation reduced the risk of further action by central banks and governments at the start of the year. The US Federal Reserve (the Fed) and the Bank of England (BoE) cut rates to record low levels and the European Central Bank and Bank of Japan have joined the Fed and the BoE in announcing large expansions of their quantitative easing programs. The Fed's now unlimited purchases will, for the first time, include corporate debt.

Central bank actions are aimed at ensuring ample liquidity in the financial system and preventing financial conditions from tightening, but a simultaneous supply and demand-shock requires dual policy responses. Companies and households face a cash crunch as business interruption increases the risk of bankruptcy and unemployment. Aware of this, governments are making available unprecedented levels of fiscal support in the hope that near-term support may enable a return to business as usual when, what should be temporary, disruption is over. However, there are challenges as to the pace and breadth of the delivery of support.

Currency markets have been typical of a period of increased risk. The haven appeal of the dollar and yen was apparent particularly at the peak of market stress in mid-March and, in line with their less defensive reputation, emerging market currencies fell. Sterling also fell, following a period of strength that continued into the start of the year.

The depth and length of the global slowdown is unknowable at this stage. There are three key unknowns, which in time will provide more clarity for the direction and pace of recovery in markets:

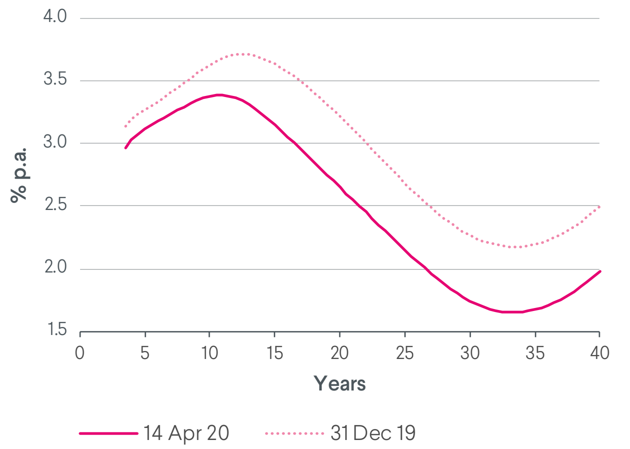
- Uncertainty over how long containment measures to restrict the spread remain in place. This is key, with markets looking at how well and how quickly the likes of China and Italy emerge from their lockdowns.
- The scale of monetary and fiscal policy responses has been enormous, but it remains to be seen how effective they are in limiting bankruptcies, unemployment and financial stress, particularly in the corporate and sovereign debt markets. Inevitably every day will bring news of companies that will not survive.
- Beyond that, there may be lasting effects on the health of businesses and individual wealth that affect the pace of recovery, individual spending patterns and government policy.

Government bonds

Despite starting from what were considered low yields, government bonds have delivered further positive returns as yields fell to new record lows. Downgrades to both growth and inflation forecasts lend technical support to nominal gilt markets in the short-term, at least. Yields are still well below our long-term notion of fair value but given the scale of current uncertainty, not only might the rise in yields be even slower than we might have previously envisaged, yields could still fall further.

UK implied inflation has fallen as real yields fell less than their nominal counterparts (Chart 3). While this fall coincides with the impending consultation on the reform of RPI, to which index-linked gilts are referenced, it is in line with the pattern in other markets where there is no comparable technical risk. The impact has been only modest returns from index-linked gilts over the quarter.

Chart 3: Forward gilt-implied inflation

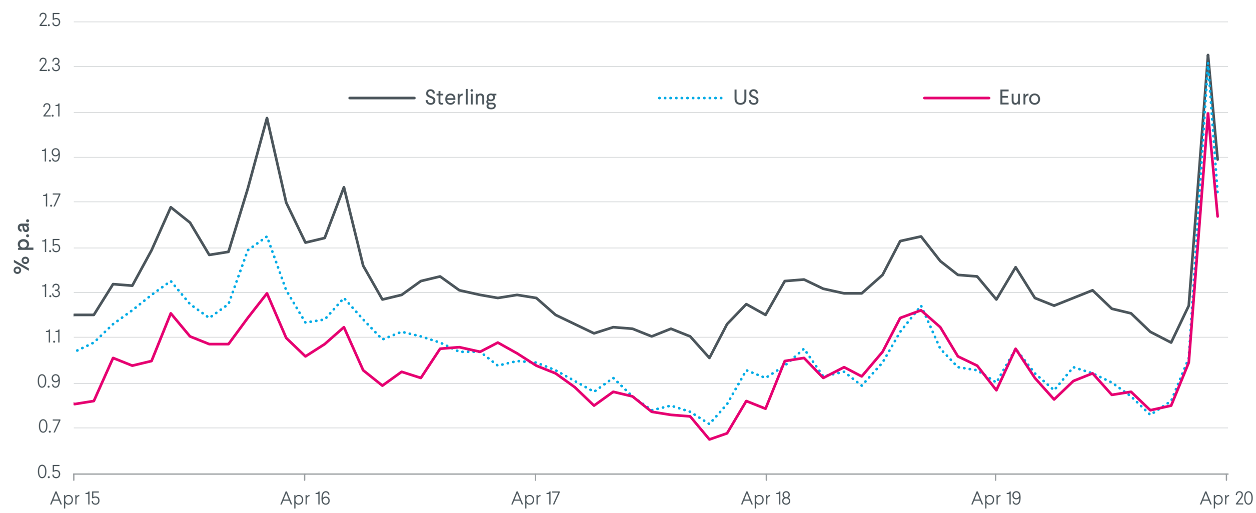


Source: Bank of England

Credit

Though sterling investment-grade credit spreads rose substantially above long-term median levels (Chart 4), falling government bond yields have cushioned the absolute fall in price terms. US investment-grade credit spreads widened more than in sterling or Euro credit markets, perhaps reflecting larger exposure to the energy sector in US indices, with the usual spread premium available in sterling markets versus US comparators disappearing as a result.

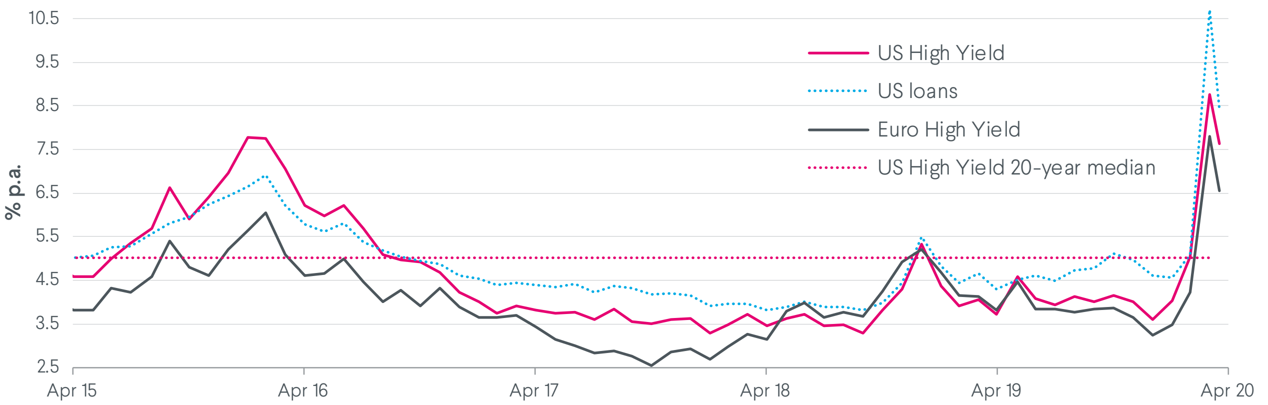
Chart 4: Investment-grade A-rated corporate credit yield spreads to 15 April 2020



Source: ICE Index Platform

Price falls in speculative-grade markets have been more substantial, moving credit spreads to levels which have historically represented an attractive entry point (Chart 5).

Chart 5: High yield bond and US loan yield spreads to 15 April 2020



Source: ICE Index Platform

We note that, a vertiginous rise in spreads in speculative-grade markets has been accompanied by a sharp deterioration in the outlook for earnings and defaults – Moody's expected default frequency (based on market values, liabilities and asset volatility) has recently indicated a potential high yield default rate as high as 10%. We are inclined to wait to see how the fundamental picture evolves. Constrained liquidity would make any significant investment in these markets challenging for the moment in any case.

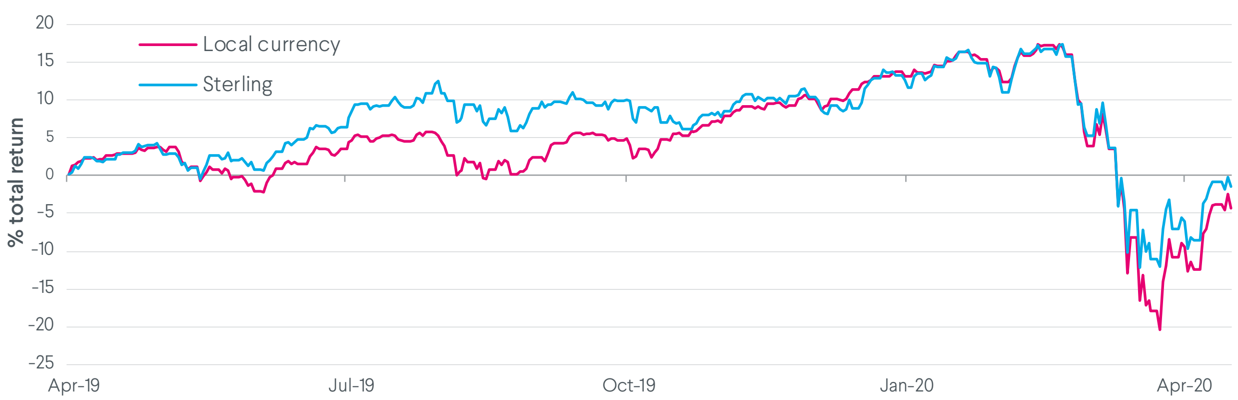
However, for both investment and speculative-grade debt, spreads have fallen substantially over April. This primarily reflects the expansion of the corporate credit purchase programmes of the US Federal Reserve (Fed). The Fed also took the unprecedented step of extending purchases to include non-investment-grade debt, both new issuance from companies recently downgraded from investment-grade (so-called "fallen angels") and the purchase of ETFs investing predominantly in high-yield debt in the secondary market.

Equities

Global equities moved higher at the start of 2020, even as expectations of last year's earnings growth continued to be revised down, before falling precipitously in March (Chart 6). Potentially boosted by signs that the daily number of new cases may be reaching a peak in some economies and consensus fall in earnings may be limited, global equities have risen over 20% above their March lows, although still 19% below February peaks.

Recent moves remove some of the apparent cheapness that emerged in March. However the large degree of uncertainty over the duration of shutdown across major economies means earnings visibility is non-existent, despite the impact of policy support measures, and current consensus estimates for 2020 of -7.8% may still be too optimistic.

Chart 6: Global equity returns to 15 April 2020



Source: Datastream

In the absence of viable exit strategies or earnings data, we treat current equity valuations with some caution, cognisant they may or may not yet fully compensate investors for the significant fundamental risks that equity markets face. Newsflow from the current US earnings season may at least provide some more information around potential impact, but cannot address the risk associated with an extended duration to the downturn.

Despite falls, the US remains at a premium to other regions, but the defensive characteristics of the market may mean it remains in favour in the short-term. The large technology exposure in the US market is also supportive - demand appears more insulated from the pandemic and demand for technological solutions has increased amid social distancing.

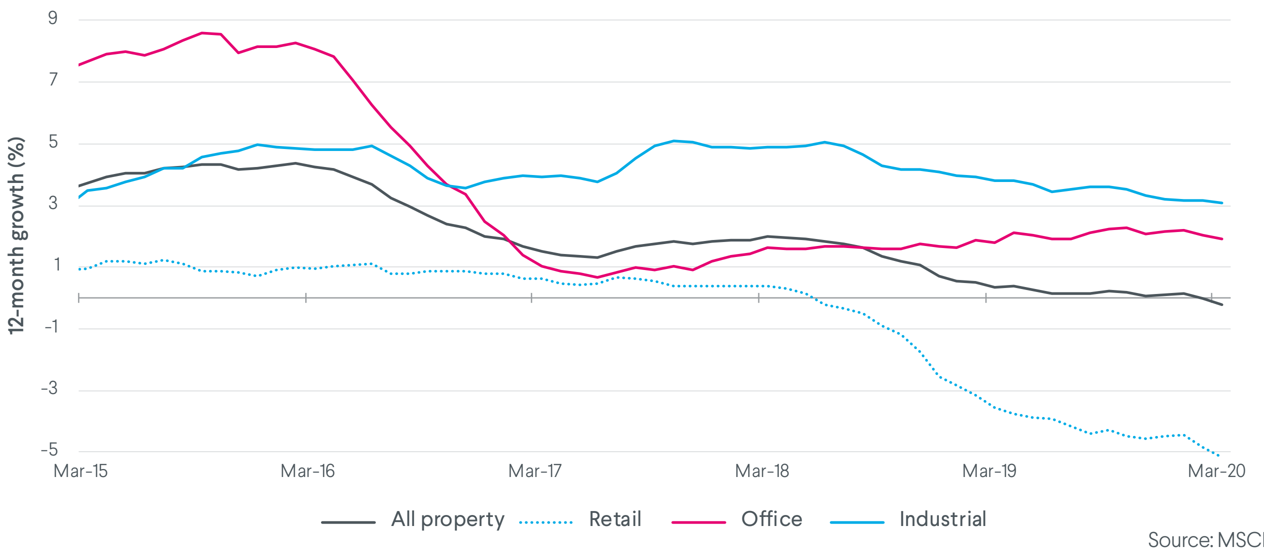
Property

Capital values fell during the first quarter of the year, with the post election bounce eliminated by the impact of COVID-19 on property markets. The current economic disruption is not fully reflected in property market data, but rental growth, which had already turned marginally negative prior to the outbreak, has fallen further (Chart 7) and is likely to remain on a downward trajectory for some time. Rents are likely to be most severely impacted in the retail sector and some alternative sectors, such as leisure and hotels.

Rent deferrals or tenants switching to monthly rent payments is now common, with rising vacancies inevitable as many businesses struggle.

With the property market effectively closed for the immediate future, a lack of post-outbreak transaction activity has led valuers to insert material uncertainty clauses into end-March valuations. The vast majority of property funds have gated redemptions due to the lack of a reliable market price. Secondary market activity in fund units has plummeted, although there is an increasing prevalence of discounts to the latest net asset value in indicative prices.

Chart 7: UK property rental growth



Source: MSCI

Conclusion

The rapid spread of the coronavirus will inevitably have a material impact on the rate of global economic growth in 2020 and beyond. It is important to note that, while growth is expected to take a severe hit in the near term, global growth and corporate profits will eventually enter a recovery. However, the timing and shape of any rebound is uncertain and depends on both the containment of the virus and the effectiveness of policy responses in preventing the widespread and material disruption to businesses and consumers causing permanent rather than temporary damage.

Recent positive market moves have reduced the apparent cheapness of global equity and credit markets, but the outlook for corporate earnings and defaults remains very uncertain at this stage, with sentiment likely to remain fragile through the first half of 2020. Even if lockdowns begin to be relaxed more widely as some economies pass the peak of infections, the sudden stop to global activity is now expected to generate the most severe recession in living memory and the restart is unlikely to occur quickly.

Furthermore, unprecedented fiscal and monetary policies may provide short-term liquidity and ease market stresses, but they may be unable to halt rising unemployment or prevent insolvencies in the deep downturn entered.

While the consensus being implied by the recent rise in markets may suggest something less than a severe downturn, the range of potential outcomes remains wide. Given the risks associated with this uncertainty, we advocate a degree of caution and holding more cash than usual, with a view to reinvesting with greater certainty at some point in future. There will also be investment opportunities to capture enhanced returns in some areas. Just as importantly, in a period when market activity could be depressed for some time, there is a need to ensure you can meet liquidity requirements associated with outgo as well as the collateral management associated with settlement of interest rate and currency hedging strategies and other derivative positions.

Chris Arcari

Investment Research Consultant
chris.arcari@hymans.co.uk
0141 566 7986

London | Birmingham | Glasgow | Edinburgh T 020 7082 6000 | www.hymans.co.uk | www.clubvita.co.uk