Market performance update (to 1 May 2020)

Overview

Our Capital Markets Update sets out our view of economic and market developments in Q1, in particular the dramatic effect of the spread of coronavirus on financial markets since the last week of February. This note concentrates on subsequent developments and is updated weekly.

Economic background

The first official estimates of first-quarter GDP in the US and Eurozone showed falls of 1.2% and 3.8%, respectively, from the final quarter of 2019 (The US headline number of -4.8% is annualised). These reflect a limited impact from the pandemic – lockdowns began around the middle of March in Europe and in the last week of March in the US – and so second-quarter numbers are likely to be much worse.

An early sign of the full impact of lockdown came with Purchasing Managers Index (PMI) numbers for April. The PMI numbers are based on surveys of senior executives at private sector companies and serve as indicators for economic health. These plunged to unprecedented levels in April, well below already-low readings for March, and further than had been expected. More generally, Economic Surprise Indicators, which compare actual data releases with forecasts, remain at levels that indicate forecasts across many economies have not yet fully adjusted to the downturn in activity.

Oil rallied since the headline grabbing moment a week previous when the May futures contract for West Texas Intermediate crude (the US benchmark) traded at negative prices shortly before it expired. There is still some lingering evidence of the storage problems which drove prices below zero. Brent crude, the global benchmark, is now trading around $26 a barrel, around $4 higher than it was at the end of March. WTI has recovered only to end-March levels of around $20 a barrel.

Lower oil prices contributed to a fall in headline inflation in April, but core inflation (excluding food and energy) also edged lower in the US, Eurozone and UK. Forecasters assume, on average, that inflation will fall in 2020 – the effects of the collapse in demand are assumed to outweigh the effects of reduced supply of goods and services. In practice, it will be difficult to interpret inflation numbers in the short term, because the pattern of actual consumer expenditure will be very different from that assumed in the basket of goods and services that underlie inflation indices.

Foreign exchange markets have been relatively quiet since the end of March. Sterling has recouped a little of its first-quarter weakness against the US dollar and is little changed against the Japanese yen. In trade-weighted terms it has risen 0.7% since the end of March.

Market update

The table below highlights some of the market movements since the beginning of the year:

UK	QTD	Q1 20	YTD	GLOBAL	QTD	Q1 20	YTD
EQUITIES	2.6	-25.1	-23.2	**EQUITIES**	8.0	-20.0	-13.6
BONDS				North America	9.8	-19.6	-11.7
Conventional gilts	2.5	6.3	9.0	Europe ex UK	6.3	-20.9	-15.9
Index-linked gilts	4.3	1.6	6.0	Japan	2.1	-17.2	-15.5
Inv Grade Credit	4.5	-3.4	0.9	Dev. Asia ex Japan	5.8	-20.6	-16.1
PROPERTY*	n/a	-1.4	-1.4	Emerging Markets	8.4	-20.2	-13.5
STERLING				**GOVERNMENT BONDS**	0.9	3.2	4.1
v US dollar	1.2	-6.4	-5.3	**HEDGE FUNDS***	n/a	-9.0	-9.0
v Euro	0.8	-4.2	-3.5	**COMMODITIES**	-0.5	-25.6	-26.0
v Japanese yen	0.2	-7.0	-6.9	**OIL (BRENT)**	17.2	-65.9	-60.1

Percentage returns in local currency ($ for Commodities and Hedge Funds). *All returns to 01/05/2020, apart from property and hedge funds (31/03/2020).

Equity markets

Global equity indices have risen 8% this quarter, building on the rally that began in the last week of March, but have sustained little of any advance since the middle of April. Volatility has declined steadily but remains high by the standards of the last decade.

Last week, the FTSE All World rose 0.9%. On a regional basis, the best performances last week came from Asian and European markets. This is most easily explained by the fact that they were shut when the US market fell sharply on Friday. The UK market performed broadly in line with global averages, even though its income attractions took a hit when the biggest individual dividend payer, Shell, cut its dividend by two-thirds.

Despite Shell's dividend cut, global energy stocks performed relatively well last week. Financial stocks led the global sector rankings last week but remain towards the bottom of the table for this quarter, along with typically defensive areas such as healthcare, telecoms and utilities. Energy and basic materials are among the best performers this quarter, but energy is still, by a long way, the poorest performing sector this year. Technology and consumer stocks have also done relatively well this quarter and are also near the top of the year-to-date rankings.

Bond markets

After falling substantially in the first quarter, yields in the major developed global government bond markets have drifted marginally lower in the second. The growing pessimism about the post-pandemic global economic recovery has helped to keep some downward pressure on yields, but there has been little activity from central banks to compare with the policy shifts of March. The US Federal Reserve made no changes at its meeting last week. The European Central Bank tweaked some of its lending programmes, but markets had hoped for more: German bond yields fell a little over the week. The Bank of England's Monetary Policy Committee meets this week and there is some speculation that they may expand the latest Quantitative Easing programme.

Policy support in developed economies, alongside muted domestic inflation pressures, has allowed some emerging market central banks to cut rates and embark on asset purchases of their own. As a result, yields on local currency debt continued to move lower, falling 0.24% p.a. last week. Hard currency emerging market debt (debt issued in US dollar) spreads fell 0.26% p.a. last week, moving them below their end-March level. However, spreads are 3.17% p.a. wider than year-end levels, as dollar strength and falling oil prices have raised concerns over the ability of emerging market economies to service external debt.

Credit spreads narrowed last week in both investment-grade and speculative-grade (rated BB+ or lower) markets. In the case of the latter this unwound the weakness of the previous week.

Our View

Recent positive market moves have slightly 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 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.

We advocate holding more cash than usual, with a view to reinvesting with greater certainty at some point in future. Just as importantly, in a period when market activity could be depressed for some time, there is a need for caution in meeting 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.