Market performance commentary (to 29 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 blog concentrates on subsequent developments and is updated weekly. Last week's highlights included:

- Building on an earlier proposal by France and Germany, the European Commission has proposed a €750bn EU Recovery Fund to support areas hardest hit by the pandemic.
- Tensions in Eurozone bond markets eased further. In Spain and Italy, yield spreads over German bonds are now a little lower than they were at the end of the first quarter.
- Global equity indices rose to their best levels since early March. Credit spreads are as tight as they have been since the middle of March.

Economic background

Forecasts for global GDP growth in 2020 as a whole have fallen significantly since the end of the first quarter. May's survey by Consensus Economics showed an average fall of 4.1%, compared to 2.1% in April's survey. Forecasters have also become less positive about the scale and speed of post-lockdown recovery. The forecast level of GDP in 2021 has fallen across the world. However, there does seem to be a growing perception that May has marked the bottom of the global economic downturn.

The European Commission, building on an earlier proposal by France and Germany, has proposed an EU recovery fund of €750bn to support areas hardest hit by the pandemic, which will generally be in southern Europe. This would be a potential fiscal stimulus equivalent to 5.4% of EU GDP and represents the type of collective action that Germany in particular has resisted until now. The intention is that the fund distribute up to €500bn in grants and €250bn in loans; it would be financed by EU borrowing and repaid out of future EU budgets.

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	8.5	-25.1	-18.8	**EQUITIES**	15.1	-20.0	-7.9
BONDS				North America	18.6	-19.6	-4.7
Conventional gilts	3.0	6.3	9.5	Europe ex UK	11.2	-20.9	-12.0
Index-linked gilts	9.8	1.6	11.6	Japan	11.7	-17.2	-7.5
Inv Grade Credit	5.6	-3.4	2.1	Dev. Asia ex Japan	8.9	-20.6	-13.6
PROPERTY*	-1.3	-1.4	-2.7	Emerging Markets	9.9	-20.2	-12.3
STERLING				**GOVERNMENT BONDS**	0.8	3.2	4.1
v US dollar	-0.3	-6.4	-6.7	**HEDGE FUNDS***	2.4	-9.0	-6.8
v Euro	-1.6	-4.2	-5.8	**COMMODITIES**	8.4	-25.6	-19.3
v Japanese yen	-0.5	-7.0	-7.5	**OIL (BRENT)**	56.7	-65.9	-46.6

Percentage returns in local currency ($ for Commodities and Hedge Funds). *All returns to 29/05/2020, apart from property and hedge funds (30/04/2020).

Equity markets

Global equity indices rose another 3% last week, taking them back to their best levels since early March. After a month of trading sideways, equity markets regained momentum in the second half of last month as lockdowns start to ease and the perception grows that the global economy has passed the low point of the downturn. Global indices are now

15% up from the end of March and just under 8% down so far this year. Of the major regions, only the US has outperformed global averages since the end of March. The US is also the best performer so far this year, but a strong performance from Japan last week has nudged it ahead of global averages. The UK, a laggard last week, is at the bottom of the regional rankings for both the quarter and year to date

Last week saw some modest rotation in global sector performance. Utilities and financials, two of the worst-performing sectors this quarter, were the best-performing last week. Oil & gas and technology were the poorest performers last week, but remain at the top of the rankings for the quarter. So far this year, technology is well ahead of the pack, followed by consumer sectors; financials and, a long way behind, oil & gas bring up the rear.

Bond markets

10-year yields in the major government bond markets were hardly changed last week. Indeed, US and German yields are hardly changed since the end of March. In contrast, the gilt market has been supported by hopes of further monetary easing. Although the Bank of England made no changes last month, there is again speculation that the QE programme will be expanded at this week's Monetary Policy Committee meeting. The recent relative performance of conventional and index-linked gilts suggests little concern about deflation: 10-year gilt implied inflation drifted up to 3.2% p.a. last week, as high as it has been for three months and only 0.1% p.a. lower than it was at the end of last year.

The European Commission's recovery fund proposals provided a further easing of tensions in peripheral eurozone government bond markets. 10-year yield spreads over German government bonds are as low as they have been since the middle of March, but still higher than they were at the end of 2019 – by 0.4% p.a. in Spain and 0.3% p.a. in Italy.

Credit markets again took their cue from equity markets last week. Spreads on global corporate investment-grade (IG) indices fell by 0.1% p.a.; equivalent speculative-grade (SG) spreads fell by 0.4% p.a. So far this quarter, spreads have narrowed 1.0% p.a. (IG) and 2.3% p.a. (SG); so far this year spreads are 0.8% p.a. (IG) and 3.1% p.a. (SG) higher.

Other markets

After the May futures contract for US oil (WTI) expired in chaotic fashion in April at prices below $0 the expiry of the June futures contract occured without disruption and it is now trading at a far-from-exceptional discount of under $3 to the global Brent Crude index.

For the second week in a row, sterling strengthened against the US dollar and Japanese yen, but fell against the euro, which was again in favour as the recovery fund proposals were advanced by the European Commission. Once again, sterling was more or less unchanged in trade-weighted terms, leaving it 1.4% lower this quarter and 5.2% below its end-2019 level.

Our View

It seems likely that the sudden stop to global activity is expected to generate the most severe recession in living memory. However, lockdowns are beginning to be relaxed and attention is now turning to the complexity associated with lifting restrictions whilst managing the threat of a second wave of infections. Though enormous fiscal and monetary policy support has been deployed, it remains to be seen how effective this will be in supporting a strong recovery in economic activity.

Market sentiment has improved dramatically in the second quarter as investors look through dismal expectations for Q2 data to hopes of an economic recovery in the second half of the year. 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 and markets may be vulnerable to disappointment with regards the scale and speed of the post-lockdown recovery.

We continue to advocate holding more cash than usual, with a view to reinvesting with greater certainty at some point in the 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.