Investment outlook

A monthly round-up of global markets and trends
May 2020

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Investment outlook

Looking for recovery after the coronavirus sell-off

After falling 34% from their peak this year, global equities (as measured by the MSCI All Country World Index) bottomed-out on 23 March. At the time of writing, they had since rallied 25%[1]. Investors returned on signs that the coronavirus outbreak may be peaking after a slowing in daily new cases in epicentres like Italy and New York. Equities were also lifted after the Fed (and other central banks) stepped-up their asset purchases (Quantitative Easing) and governments around the world unveiled record stimulus programs.

Crucially, governments and central banks are working together to ensure funding flows to the private sector during the lockdown. For example, the $2.3trn US Coronavirus, Aid, Relief, and Economic Security Act (the 'CARES' Act) stimulus package includes unprecedented US Treasury-Federal Reserve co-operation. Essentially, the US Treasury will allocate $454bn to the Fed who can multiply this capital by up to 10 times to provide credit worth around $4.5trn for firms, municipalities and funding support for the corporate bond market[2].

This 'state capitalism' of injecting money into the economy has ensured there is ample liquidity flowing through the financial system. Indeed, US broad M2 money supply (e.g. currency in circulation and bank deposits), a rough proxy of the stock of money in the financial system, is expanding by over 18% a year[1], the fastest pace since the Second World War. The hope is that this largesse also helps support other credit markets.

Despite the improving funding environment, the underlying picture for global growth looks gloomy. For instance, China, the first major economy to release output data, saw its real GDP contract 6.8% in the first quarter, the biggest decline seen in over 30 years of available data[1]. For the 2020 calendar year, the IMF's latest economic projections see a 3% decline in global GDP, its worst performance since the Great Depression[3] more than 90 years ago. GDP contractions have led analysts to revise down global Earnings Per Share to -12% for 2020 so far[1].

If equities are to sustain their recent rally over the longer term, there needs to be a fundamental improvement in growth. For that to happen governments need to ease back on lockdowns. This is starting to happen. In Germany, small shops and car dealerships (an important industry for the country) resumed business from 20 April, while schools for older children are due to reopen on 3 May. According to a Sunday Times report, the UK government may start a partial reopening of the economy from 11 May. And President Trump, with an eye to the upcoming election in November, is upping the pressure on state governors to loosen the lockdown.

A V-shaped economic recovery will only be possible if restrictions are lifted and soon. However, there is the ever-present risk that a second coronavirus wave stalls this re-opening.

Nevertheless, a more immediate risk is the impact of government lockdowns on labour markets, domestic demand growth and debt defaults. US initial jobless claims (an early read of the unemployment rate) have risen by a staggering 30 million cumulatively over the past 5 weeks[1]. Higher unemployment is already leading to lower domestic demand. For instance, retail sales fell by 8.7% in March, the biggest decline on record from data going back to the early 1990s[1]. Less demand is likely to lead to rising private sector debt default rates, which instils uncertainty in financial markets.

However, the Fed's explicit backstop of the US corporate credit market enabled investment grade rated companies to issue a record $264bn in bonds in March, breaking the prior record in January 2017 by over $80bn[4]. Given that major corporations continue to have access to capital markets, the risk of a credit event, such as the collapse of Lehman's during the Global Financial Crisis in 2008, has been somewhat reduced. Our base case is that policy support will drive equities higher over the next 12 months.

Risks to portfolio income streams

As the repercussions of the global lockdown response to COVID-19 becoming clearer, corporate boards are cutting dividends in response to commercial and regulatory pressure. Some industries, such as airlines, face an unprecedented period with almost no business until more normal life resumes. The impact on company earnings (and therefore dividends) is dependent on how long lockdowns continue and how long the recovery takes.

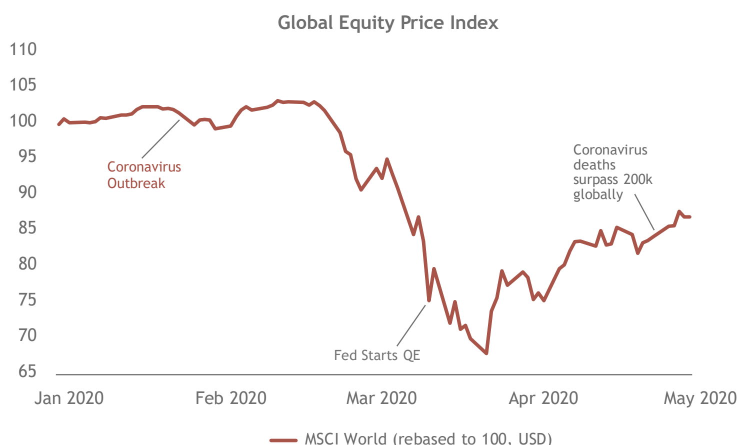
UK payouts look particularly precarious, with dividend cover low relative to other major markets and idiosyncratic sector risks; regulators have told UK banks to cancel their 2020 dividends to retain capital, for example.

Cuts to dividends serve as a reminder of the benefits of diversification in a multi-asset portfolio. Income investors need to look beyond UK financials, and towards overseas markets. While government bonds look expensive on an historic basis, the security of their coupon (and principal) repayment is reliable. It is difficult to generalise across differing mandates, but we would expect income to be reduced by around 20% on a typical multi-asset portfolio. Please get in touch with your investment manager if you would like to discuss this further.

[1] Refinitiv Datastream, 30 April 2020
[2] JPMorgan, 3 April 2020
[3] IMF, 20 April 2020
[4] Morgan Stanley, 30 April 2020

Equities

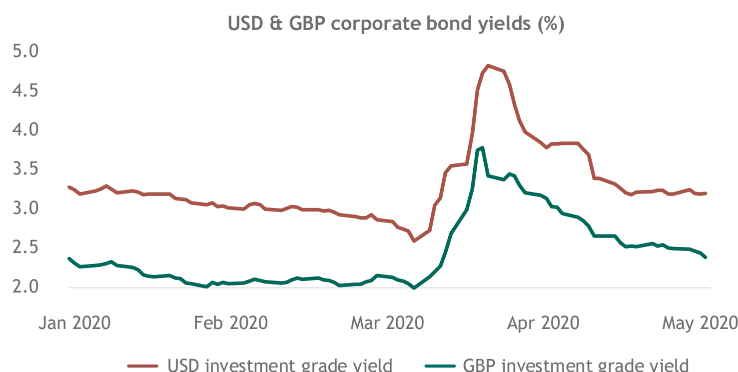
Since the market low on the 23 March, the MSCI All-Countries World index has staged a sharp rally of 25% to the end of April. April was the best month for the global index since October 1990 when it recovered 9% as fears over oil supply problems abated following the success of US-led forces in the Gulf War campaign. Recent optimism is based on very different assumptions – in particular, that we have seen a peak in the rate of coronavirus infections around the world, and that the unprecedented levels of government stimulus will be enough to offset the demand destruction caused by the lockdowns.



Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 30 April 2020

Fixed income

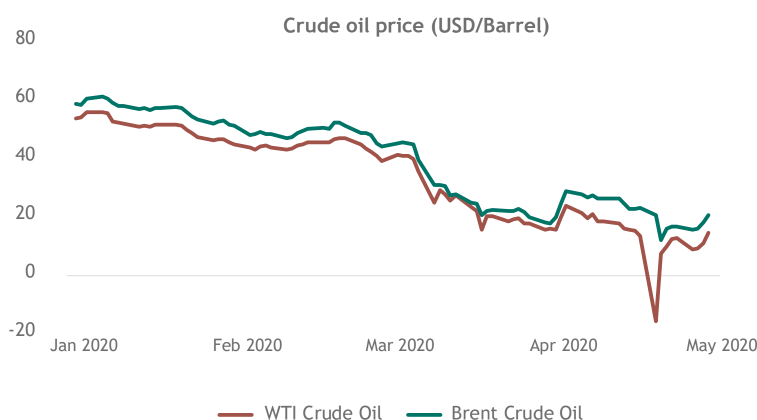
Bond yields (which move inversely to prices) moved higher as the crisis escalated. The yields on the highest quality (investment grade) bonds issued by companies went as high as 4.8% in the US and 3.7% in the UK (where interest rates are generally lower). Since then yields have fallen as markets have recovered, particularly helped in the US by the news that the Federal Reserve would, for the first time, be prepared to buy corporate bonds as part of its support package for markets. This intervention means that companies reliant on the corporate bond market for financing are less likely to face higher interest costs.



Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 30 April 2020

FX and commodities

April has been a remarkable month for oil prices. At the start of the month there was optimism that Saudi Arabia and Russia would agree to make a cut to their output levels, and prices rallied. This agreement was delivered in their meeting of the 9 April, but this also marked a high for oil prices. Markets were disappointed by the scale of the cuts which were around 10mn barrels/day or about 10% of (pre-COVID-19) global demand. In the face of such levels of destruction on the demand side from grounded planes, idle industry and locked-down populations, there was widespread fear that they had not gone far enough. The oil price tumbled. On the 20 April, the West Texas benchmark price briefly went negative, which was mainly a technical development in the futures market. However, it does not detract from the conclusion that markets see little chance of demand increasing for 'black gold' in the short term.



Source: Refinitiv Datastream/Smith & Williamson Investment Management LLP, data as at 30 April 2020

Market highlights

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	8.9	-7.9	-1.2	55.0
FTSE 100	3.9	-18.1	-17.1	3.7
FTSE 250	9.2	-21.8	-14.7	7.8
S&P 500	10.9	-5.2	4.3	88.5
MSCI Europe ex UK	4.6	-12.2	-7.2	26.9
MSCI Japan	3.6	-6.9	0.7	38.1
MSCI Pacific ex Japan	9.8	-14.0	-13.2	22.0
MSCI Emerging Markets	7.3	-8.5	-8.7	23.5
Bonds				
iBoxx GBP Gilts	3.1	6.2	16.1	34.6
iBoxx USD Treasuries	-1.1	11.7	19.0	48.4
iBoxx GBP Corporate	6.3	-2.5	6.1	26.6
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	12.9	-56.2	-65.0	-60.5
Gold ($/ounce)	5.8	7.4	32.9	44.4
GBP/USD	1.7	-4.3	-3.2	-17.9
GBP/EUR	1.9	-3.2	-1.0	-16.0
EUR/USD	-0.2	-1.2	-2.3	-2.3
USD/JPY	-0.9	-1.3	-4.0	-10.6

Glossary of terms

Bonds – The relationship between price and yield. Yield is the return you get on a bond. When the price of a bond changes prior to maturity due to supply and demand pressures, so does its yield. When the price of a bond goes up due to demand, the yield goes down to compensate. This is so the bond's fixed rate of return (coupon) remains relatively constant – and vice versa. A bond's price and its yield are inversely related. A key factor which influences a bond is the prevailing interest rate. When interest rates rise, the prices of bonds fall, thereby raising yields. This is because the older bonds are sold in order to buy new higher yielding bonds.

Equities – A stock or any other security representing an ownership interest.

Fed – Federal Reserve Bank.

FX – Foreign Exchange.

GDP – Gross Domestic Product.

IMF – International Monetary Fund

Monetary policy – Actions of a central bank or other agencies that determine the size and rate of growth of the money supply which will affect interest rates.

V Shaped Recovery – Real GDP growth trajectory,

Key macro data	Latest	2020 Consensus forecast	Spot rates	30-Apr	Yields (%)	30-Apr
UK GDP (YoY%)	1.10	-5.00	GBP/USD	1.24	FTSE 100	5.22
UK CPI Inflation (YoY%)	1.50	1.00	GBP/EUR	1.15	FTSE 250	3.89
Bank of England Base	0.10	0.10	EUR/USD	1.10	10 Year Gilt	0.19

All values and charts as at 30 April 2020. Total returns in sterling.
Returns are shown on a total return (TR) basis i.e. including dividends reinvested (unless otherwise stated).
Net return (NR) is total return including dividends reinvested after the deduction of withholding tax.
Source: Thomson Reuters Datastream and Bloomberg

Important information

Please remember the value of investments and the income from them can fall as well as rise and investors may not receive back the original amount invested. Past performance is not a guide to future performance.

Sources

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