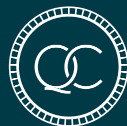

MARKET COMMENTARY - JULY 2020

QUILTER CHEVIOT

Quilter Cheviot provides bespoke investment management for private clients, trusts, charities and pension funds. To provide a truly personal service, we assign to each client an investment manager whose role is to design and implement an investment strategy tailored to the needs of the client. A local presence and easy accessibility to investment managers is a key element to the personal attention we give our clients. Quilter Cheviot has a network of regional offices located in major cities in the UK, Ireland and Jersey.

Past performance is no guarantee of future returns.

The global economy may be in the deepest recession for decades but – with signs that the worst could be over despite sporadic resurgences in Covid-19 infection rates – financial markets have been swift to discount both a recovery and a return to normality.

Global equities rose another 3% in June taking returns for the second quarter to an eye-watering 20%. It was a catch-up month for Asia and emerging markets with gains of 7%-8% bringing them into line with other global markets. The US recorded a more modest 2% gain, making 20% for the quarter and 40% since the 23 March low.

High octane US technology stocks have been the standout winner with second quarter gains of 30% and just under 50% from the low. UK equities continued to lag – which is more a reflection of the index's industrial profile than the economy itself – gaining 1.5% in June and 10% over the three months to the end of June.

Although year-to-date global equity returns are more or less all square, the UK is down 18% and has not been helped by sizeable dividend cuts. Bonds had a quieter month with negative yields widespread in Europe and Japan. UK gilt yields are negative out to six year maturities and the yield on 10 year bonds closed at 0.18%. Conventional and index-linked have had positive returns over both the second quarter and year-to-date. Oil has had a rollercoaster ride but, with production discipline and the prospect of an economic upturn, Brent ended at $41 per barrel having briefly touched $16 in April. Gold closed at $1,775 and has proved a useful risk hedge.

Recovery v-shaped for now

The rate of change after such a sharp and deep economic setback means the rebound appears "V"-shaped at this stage. Although high frequency mobility data confirms that we are all on the move again and retail sales have spiked up,

there has been a significant fall in economic output, not least because some sales have been permanently lost. Caution is still warranted on the sustainability of the recovery.

Many economies, including the UK, have benefited from furlough schemes; unemployment is likely to increase once these come to an end. Current estimates suggest that, after a 3.5% downturn this year, global GDP growth will be 5.5% in 2021 before settling to a normal 3% thereafter. Advanced economies will not recover as quickly and, after a 5% downturn this year, GDP growth is likely to be 4.8% in 2021. The US is expected to fare better than average – albeit with increased uncertainty on tax if the Democrats win the Presidential election – while Japan and the UK will be significantly worse. India and Latin America are likely to drag emerging market growth into mildly negative territory this year before a strong cyclical upturn in 2021.

China provides some insight on the shape of rebound. From a low point in February, industrial production and construction continue to recover much as expected while until recently consumer spending and corporate capital expenditure lagged. With services accounting for around 60% of economic activity and 50% of urban employment, the sharp upturn in the latest survey covering private businesses is encouraging and suggests the recovery is now broadening out. However, companies are still shedding jobs and clusters of new Covid-19 infections – including in Beijing – are being met with localised lockdowns that are likely to be problematic for restaurants, entertainment and tourism. These trends are also starting to appear in other Asian economies.

The rebound in US activity had exceeded expectations – at least before the latest Covid-19 resurgence. Economic data is likely to remain volatile and there appears to be some confusion between the rate of change and absolute levels. For example, job hiring was a major upside surprise last month but only about one-third of those lost jobs have been regained, with the unemployment rate standing at 11%. In Europe, Germany was least affected by the pandemic and is expected to be the first to return to normality while Italy and Spain only bottomed out in the second quarter. Spain is particularly dependent on tourism and, despite its furlough scheme, the impact on employment may not be apparent for some time.

UK GDP could fall nearly 10% this year reflecting the economy's dependence on services and consumer spending. Recovery can be expected as lockdown eases although job uncertainty will continue until furlough schemes are unwound. The likelihood of a no – or a very limited – Brexit deal means additional uncertainty in 2021. Falling demand is usually disinflationary so the Bank of England, like other central banks, will want to maintain ultra-accommodative monetary policies. This suggests that very low interest rates and a flat yield curve will continue for some time.

FTSE ALL SHARE

Source: Refinitiv Datastream 02/07/2020

FTSE BRIT GOVT ALL STOCK

Source: Refinitiv Datastream 02/07/2020

FTSE ALL WORLD £ - TOT Return IND

Source: Refinitiv Datastream 02/07/2020

Outlook for markets

While retail investors have been substantial net sellers of equities year-to-date, institutions appear more sanguine ahead of second quarter corporate results. Aside from the clear winners in the digital/technology space, many companies will be relieved to survive relatively intact. Many of the worst affected cyclical ones have already provided updates and these have largely been absorbed without drama. While balance sheets are stronger than at the time of the global financial crisis, not everyone will escape unscathed as demonstrated by the one-third fall in dividends from a diversified UK equity portfolio.

The lack of political appetite for another blanket lockdown, evidence of economic recovery and the sheer weight of policy stimulus suggest there is support for equities for the time being despite valuations looking full by historical standards. Although aggressive $6trn quantitative easing asset purchase measures by central banks will not be used directly to buy equities, this is a sizeable sum in relation to the $70trn value of quoted global equities.

With bond yields close to zero, the search for assets offering positive returns is greater than ever. However, it is difficult to ignore the fundamentals and – if global GDP estimates are accurate – "top down" corporate earnings could fall 50% this year before rebounding 40% in 2021. As this would be 30% lower than in 2019, there is a large "disconnect" with the current "bottom-up" consensus that assumes earnings will recover by the end of 2021.

No one knows what the "new normal" looks like but we expect structural changes to continue and possibly accelerate. This includes a shift towards international investment where many of these opportunities can be found. Our themes associated with e-commerce, software services, emerging market consumers and digital leisure should benefit and we are also maintaining our exposure to reliable defensive companies such as those in the healthcare sector.

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Investors should remember that the value of investments, and the income from them, can go down as well as up and that past performance is no guarantee of future returns. You may not recover what you invest.

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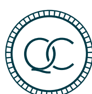

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