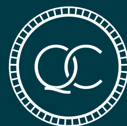

MARKET COMMENTARY - AUGUST 2020

QUILTER CHEVIOT

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Past performance is no guarantee of future returns.

Financial markets have been encouraged by continuing evidence of a 'V'-shaped recovery albeit recognising that it will take some time until former output levels are restored. Central bank monetary policy, combined with record fiscal stimulus measures, has outweighed Covid-19 infections and likelihood of a second wave in some countries.

Global equities gained another 5% in July, now up 40% from the late-March low to within a whisker of the start of the year level. Wall Street continues to be the star performer, especially technology stocks which are nearly 20% higher than the start of the year.

July was another challenging month for UK investors as the FTSE 100 fell 272 points to 5897 – still over 20% lower than the start of the year – and dollar weakness/ sterling strength reduced returns from international markets. Europe and Japan were also down over the month while Asia and emerging markets performed well as the Chinese recovery continued apace.

As China's economy has picked up, so too has demand for commodities which, together with production discipline, supported a recovery in Brent crude to $44 per barrel. Central bank policy continues to suppress yields with negative rates in UK gilts out to eight years and the 10-year yielding a paltry 0.11%. Gold was not just an event risk hedge but a star performer, ending the month at $1,974 per ounce – some 30% higher year-to-date – boosted by negative real interest rates.

Negative GDP numbers pass markets by

Economic activity collapsed in the second quarter due to public health measures taken in response to Covid-19. While China rebounded slightly more than anticipated, most industrialised countries contracted at least 30% over

the quarter and 10% year-on-year, worse than expectations especially in services consumption and inventories.

The market reaction was negligible, however, as the focus has moved swiftly onto the recovery where business surveys and other data for July suggest economic activity has returned to growth. If anything, US consumption has surprised on the upside in the short term – especially on larger ticket items including cars and new mortgage applications – but is likely to slow in the coming months as the $2trn fiscal support tapers.

Another round of stimulus measures in the US is likely including a partial extension of enhanced unemployment benefits but while rehiring was strong in May and June – with around 7.5 million jobs created helping unemployment to fall to 11% – business surveys suggest the rate will slow. The scale of stimulus suggests some pick-up in inflation might be possible as reduced inventories/furloughed workforces fail to keep up with demand, but elevated unemployment levels will exert a disinflationary force for some time to come. The Federal Reserve has recognised the challenges on increasing infections, guiding towards extended accommodation and the necessity for fiscal measures.

The lifting of lockdown measures and opening of borders means Europe has also seen some upside surprises in economic data. A meaningful fiscal response was agreed by the EU-27 somewhat belatedly, funded by the issuance of €750bn of joint debt in the form of grants and loans rather than joint issuance and primarily targeting public investments with a green/digital theme.

A second wave containing more traditional stimulus measures such as tax cuts and spending can be expected to follow the broader European stimulus. Germany was relatively unaffected by Covid-19 infections but still suffered from lockdown activity impairment and disrupted supply chains in the early part of the recovery. Fiscal response has been quite proactive for a change, but strong finances mean the budget deficit remains within sight of the Maastricht limit. France is also recovering strongly while activity levels remain low in Spain – not helped by tourism turmoil – as well as Italy, where a budget deficit of 11% and unsustainable debt levels present longer-term challenges.

UK conditions more challenging than many

UK GDP contracted at its fastest rate on record over the three months to April, falling 26% in just over two months. While global GDP is estimated to be down 4% in 2020 and 5% in the industrialised world, the UK will likely be down 10% reflecting the high dependency on domestic consumption. For now, there is plenty of evidence that recovery is underway but the threat of higher unemployment, revolving localised lockdowns and 'hard' Brexit means GDP growth will likely lag competitors for some time.

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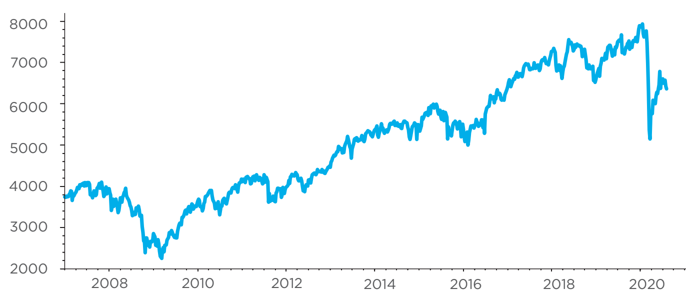

Source: Refinitiv Datastream 06/08/2020

FTSE BRIT GOVT ALL STOCK

Source: Refinitiv Datastream 06/08/2020

FTSE ALL WORLD £ - TOT Return IND

Source: Refinitiv Datastream 06/08/2020

Like other central banks, the Bank of England remains supportive but has ruled out negative interest rates for the time being, cognisant of the potential harm to UK banks. UK public borrowing is already at unprecedented peacetime levels but the prospect of rising unemployment, an underwhelming recovery, a permanent loss of output and disinflationary pressures suggests more fiscal easing and further quantitative easing are likely this autumn. With an extended period of negative real interest rates, the financial system is becoming addicted to quantitative easing which will no doubt end in tears at some point.

Winners to continue winning

Equity markets have performed exceptionally well given the challenging economic backdrop and a period of consolidation is to be expected. Second quarter corporate results saw US earnings 33% lower year-on-year but thankfully produced few major negative surprises – albeit with considerably lower expectations than at the start of the year. The strongest performers have been a relatively small number of large companies including healthcare and utilities, but the standout performers have been those associated with the secular growth in the 'digital and cloud world'.

Unlike previous cycles many digital and cloud names have better established business models and strong earnings growth to support current valuations so there is not an obvious 'bubble' to burst. If anything, Covid-19 will accelerate digitisation leaving behind a number of historically solid names which may look optically cheap but are likely value traps. Volatility has reduced from peak levels but remains elevated and of course there is plenty for markets to worry about over the quieter summer period including US/China trade and the run-up to the US Presidential Election, as well as the uncertain path of the virus.

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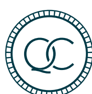

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