Capital Markets Update

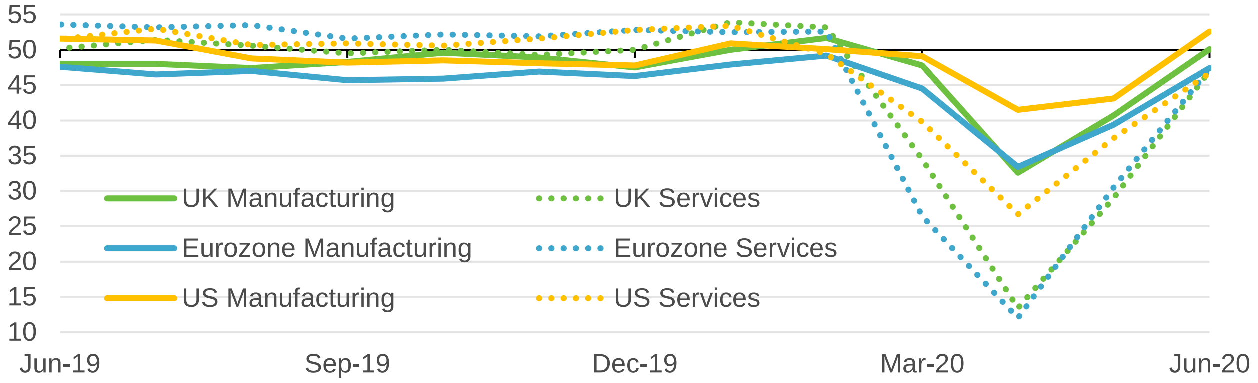
Summer 2020

It was a strong quarter for equity and credit markets as governments provided unprecedented levels of support, central banks implemented substantial monetary easing announced in the first quarter, and economies began to re-open.

However, the global Covid-19 pandemic worsened as it accelerated in the Americas and southern Asia. In northern Asia and Europe, new infections declined sharply; any resurgences have been local and, so far, quickly contained. Of the major developed economies, only the US has so far failed to contain the spread of the disease, resulting in a retightening of lockdown conditions in some states. Some lingering uncertainty about the economic recovery may be evident in a 10.6% rise in the dollar price of gold.

Although Europe, the UK and the US – broadly in that order – went into lockdown only during March, all recorded falls in GDP in the first quarter. The falls in second-quarter GDP are likely to be even greater. After plunging to unprecedented lows in April, Purchasing Managers' Index numbers for the US, Eurozone and UK rebounded in May and June (Chart 1). Although composite indices, which combine manufacturing and services data, remain below the neutral 50 level, most commentators suggested the sharp rise in the last two months provide a better guide to month-on-month growth in output. It seems likely that April marked the low point of the downturn.

Chart 1: Purchasing Managers' Indices for manufacturing and services

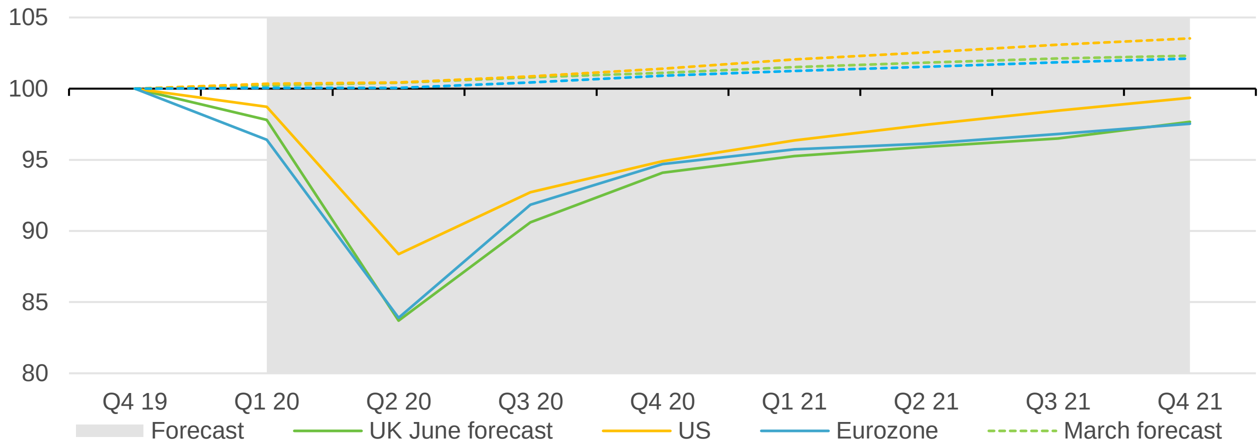


Source: Bloomberg

Given the extent of economic shutdowns, a rapid rise in near-term activity is almost certain as lockdowns ease. However, the absolute level of activity in most sectors still looks well below the level seen prior to the crisis and the longer-term recovery remains highly uncertain. Many restrictions will have to remain in place until effective treatment or a vaccine is available. Uncertainty over the recovery and job prospects will also likely weigh on demand for goods and services. Potential further waves of virus infection also suggest the balance of risks remains skewed to the downside.

Forecasts for global GDP growth in 2020 have fallen significantly since the end of the first quarter. June's survey by Consensus Economics showed an average fall of 4.7%, compared to a 2.1% expansion forecast in March. However, there has been some moderation in the pace of downgrades recently. The forecast level of GDP in 2021 has fallen across the world and is substantially below 2019 levels in the US, Eurozone, Japan and the UK, and even further below previous forecasts (Chart 2); only the secular momentum of the Chinese economy pushes the forecast two-year growth in global aggregate GDP marginally above zero.

Chart 2: Real GDP level – June versus March Consensus Forecasts



Source: Consensus Economics and Datastream

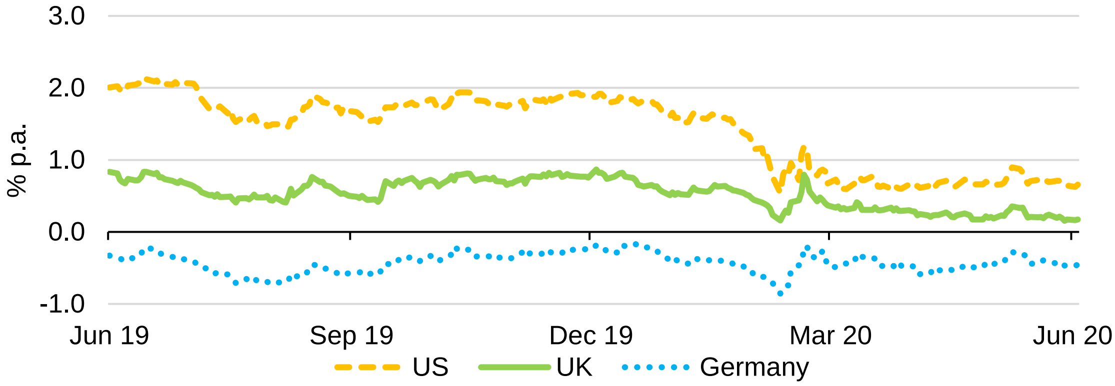
The huge government stimulus packages launched across the major economies will lead to a dramatic increase in bond issuance. However, the effect on financial markets will be considerably diluted by the asset purchase programmes of the major central banks. In many cases, including the US Federal Reserve, the European Central Bank and the Bank of Japan, the scale of the announced purchases surpasses the level of those delivered during the global financial crisis. The actions of central banks have prevented an excessive tightening of financial conditions and the risk of an economic and health crisis becoming a financial one has subsided.

UK CPI inflation fell from 1.5% in March to 0.6% in June. Lower energy prices made a big contribution to the fall but core inflation (excluding food and energy) has also fallen from 1.6% to 1.4. While there has been some renewed talk about the risk of deflation, most forecasters assume that a fall in inflation this year will be followed by a modest increase in 2021.

Government bonds

Near-term disinflationary pressures may help to explain the resilience of government bonds – US and German yields were little changed, and UK yields drifted lower – even as investors flocked back to equity and credit markets. Central bank policy did remain supportive – the European Central Bank announced a further €600bn of QE and the Bank of England raised its QE programme from £645bn to £745bn – but the major policy shifts had been announced by the end of March.

Chart 3: 10-year government bond yields



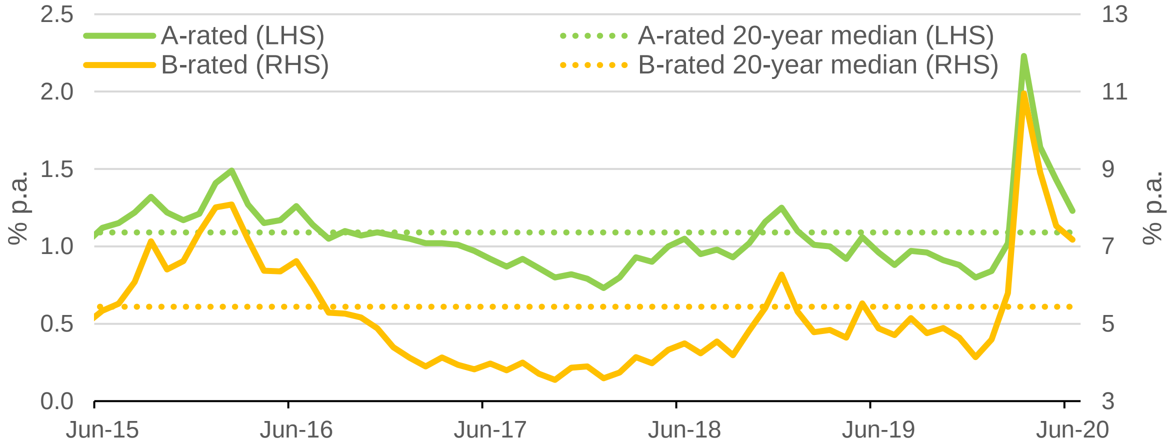
Source: Bloomberg

Notwithstanding the fall in current inflation, 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., as high as it has been for three months and only 0.1% p.a. lower than end-2019 levels. The ongoing consultation on the use of RPI as an inflation measure remains an upside risk for real yields.

Credit

In April, the Fed significantly expanded the size and scope of the corporate credit purchase programmes it had announced in March to include, for the first time, some areas of speculative-grade debt. Reflecting the expansion of central bank support and broader improvement in sentiment, global credit spreads have fallen sharply since the peak of market stress in March – investment-grade spreads are now nearing long-term median levels, while speculative-grade spreads remain above long-term medians (Chart 4).

Chart 4: Global investment- and speculative-grade corporate bond yield spreads



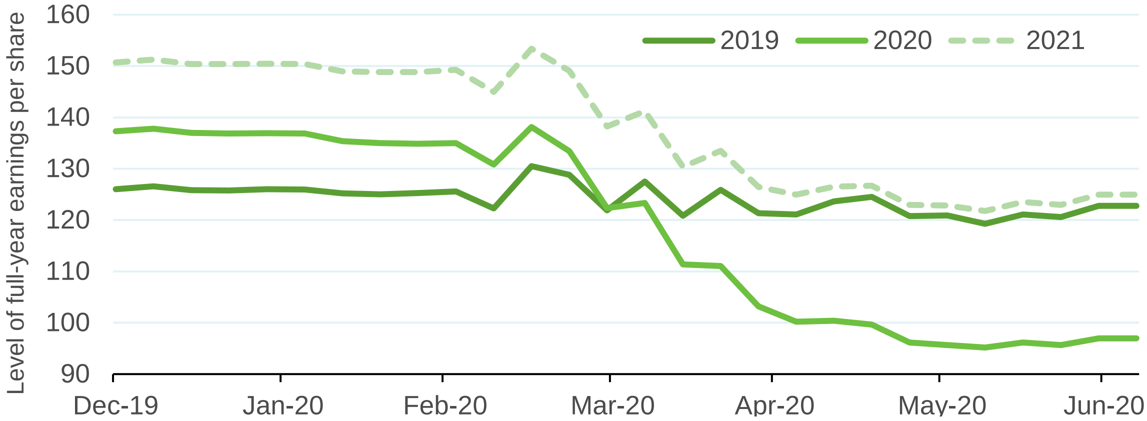
Source: ICE Index Platform

Given the improvement in financial conditions, investors are less pessimistic about the scale of defaults than they were in March, albeit not as optimistic as they were at the start of the year. In stark contrast to the experience of the global financial crisis, and in part a result of central bank support, markets have remained open. Issuance is running at record levels in corporate credit markets, particularly US investment-grade, where year-to-date issuance is already higher than for any previous year's total.

Equities

Equity markets had risen 35% above their 23 March nadir by the end of the second quarter and volatility had fallen substantially, though it remains well above levels at the start of the year. After a poor first quarter, cyclical sectors have fared better in the second: basic materials, industrials and consumer services, have outperformed the market; oil & gas has been broadly in line. But financials have fallen further behind. Technology is again at the head of the global performance rankings and, after a relatively resilient first quarter, defensive sectors, such as utilities, telecoms and healthcare, have lagged.

Chart 5: MSCI World forecast earnings growth



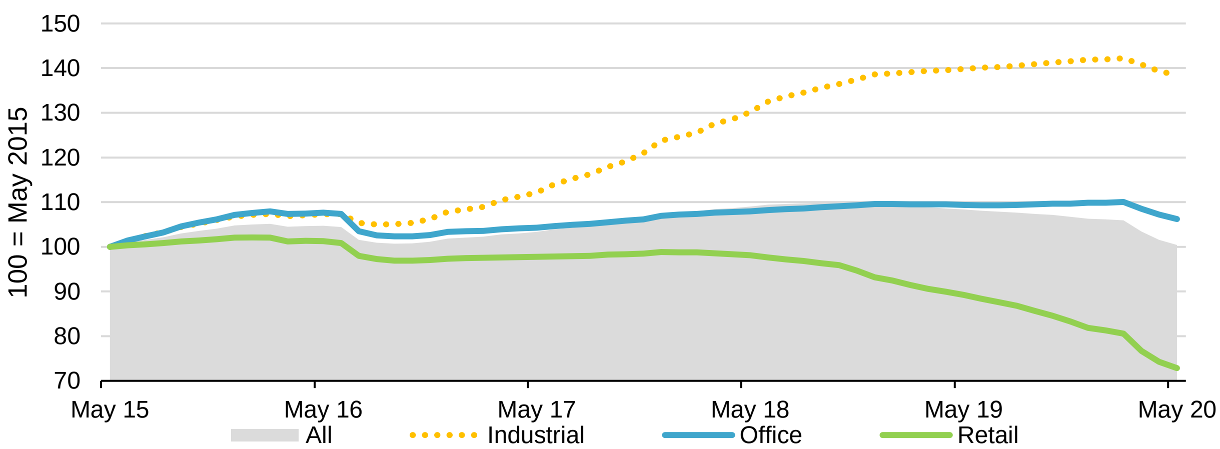
Source: IBES, Datastream. Note: 2019 forecast line continues to change after year-end as final accounts are prepared and published.

Global earnings forecasts for 2020 have been cut significantly since the end of March; earnings on the MSCI World index are expected to be 21% lower than in 2019. But the pace of downgrades has eased and forecasts for 2021 earnings are also showing signs of stabilising at a level just above earnings in 2019 (Chart 5). While a prolonged period of extraordinarily low government bond yields implies a higher present value of a future stream of earnings, these forecasts seem optimistic and current equity valuations may imply an even faster rebound in earnings.

Property

The pandemic has added pressure to an already fragile UK commercial property market and its impact is increasingly evident in the MSCI UK Monthly Property Index – capital values in May were 7.4% lower over one year (Chart 6) and rents are now falling month-on-month in all sectors. Anecdotal evidence suggests rent collection has been deteriorating – according to one estimate, receipts at the June quarter collection day in England & Wales were only 18% of amounts due, compared to 25% in March. We would, however, expect rent collection figures for the main institutional funds to be markedly better than this given higher office and industrial allocations, although rent collections across all sectors are likely to be lower than in March.

Chart 6: UK property capital values



Source: MSCI UK Monthly Property Index

In current circumstances, index data may still be a poor indicator of market levels, but there are signs of a tentative return to normality. There has been an uptick in transaction activity, although it is likely to remain low while physical distancing guidelines are in place. Surveyors have also started to lift the material uncertainty clauses that qualified valuations, starting in the safest parts of the market, such as supermarkets, medical facilities and properties with long-dated leases to government tenants. However, most core balanced funds remain gated and likely will be until the clauses on office and retail properties are lifted.

Conclusion

Sentiment has improved dramatically in the second quarter as investors look through dismal expectations for Q2 data and focus on a near-term rebound that has outpaced the worst fears in recent weeks. Nevertheless, the outlook for corporate earnings and defaults remains uncertain and the potential for further waves of infection remains a risk.

Recent market moves have reduced the apparent cheapness of global equity and credit markets and they may be vulnerable to disappointment in respect of the scale and speed of the post-lockdown recovery. This leads us to retain a degree of caution and advocate holding more cash than usual. For those reluctant to hold cash, non-directional strategies and strategies with a genuine absolute return focus, may offer an attractive alternative to outright equity exposure in growth portfolios. In developed markets, we continue to prefer investment-grade over speculative-grade credit, although private debt markets may offer opportunities to originate new deals with better terms in certain areas. Emerging market debt, particularly hard currency debt, potentially still offers some attractive relative value.

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