Market performance update (to 8 May 2020)

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 weekly update shares subsequent developments

Overview

Economic surprise indices still suggest that current data releases are, on average, falling short of expectations, but on Friday the key US labour report for April was better than forecasts. Nevertheless, unemployment rose to almost 15% and may be significantly understated. In the UK, where government support has reduced unemployment, the Bank of England's quarterly Monetary Policy Report suggested unemployment would rise to 9% in the second quarter and that GDP would fall by 25%.

Financial markets focused less on current numbers than on the moves to ease economic lockdown in Europe and the US. Equity markets and oil prices rallied, and speculative-grade credit outperformed investment-grade credit and government debt.

Economic background

The Bank of England suggested UK GDP might fall by a further 25% in the second quarter from its first-quarter level and by 14% in 2020 as a whole relative to 2019. April's survey by Consensus Economics showed an average forecast of -2.1% for the global economy in 2020, but anecdotal evidence suggests these forecasts have fallen significantly in recent weeks.

It seems that economic forecasters are also becoming less positive about the scale and speed of post-lockdown recovery. In China, where seemingly substantial progress has been made in controlling new infections, social distancing measures are being relaxed only gradually and consumer spending remains depressed. It seems increasingly likely that lockdowns will be eased very gradually in Europe, even though infection rates have declined dramatically in many countries. The situation appears less clear-cut in the US, where considerable tension remains between the Federal and some State governments and the evidence of a decline in new infections is less conclusive.

The behaviour of oil prices suggests financial markets have been taking a more positive view of the potential for economies to reopen. In April, Brent crude had fallen below $20 a barrel for the first time in 18 years, but a recovery in the last two weeks has taken it back to $30, $7 above its end-March level but still less than half of its end-2019 level.

Foreign exchange markets were again quiet last week, as they have been since the end of March. Sterling slipped slightly but remains a little higher than it was at the end of March against the US dollar and the euro. In trade-weighted terms it has slipped back to end-March levels and fallen 3.8% so far this year.

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	5.3	-25.1	-21.2	**EQUITIES**	10.7	-20.0	-11.4
BONDS				North America	14.0	-19.6	-8.4
Conventional gilts	3.1	6.3	9.6	Europe ex UK	6.7	-20.9	-15.5
Index-linked gilts	7.1	1.6	8.8	Japan	4.1	-17.2	-13.9
Inv Grade Credit	4.6	-3.4	1.1	Dev. Asia ex Japan	6.3	-20.6	-15.6
PROPERTY*	n/a	-1.4	-1.4	Emerging Markets	8.0	-20.2	-13.8
STERLING				**GOVERNMENT BONDS**	0.6	3.2	3.8
v US dollar	0.4	-6.4	-6.0	**HEDGE FUNDS***	n/a	-9.0	-9.0
v Euro	1.4	-4.2	-3.0	**COMMODITIES**	3.7	-25.6	-22.9
v Japanese yen	-1.0	-7.0	-7.9	**OIL (BRENT)**	31.1	-65.9	-55.3

Percentage returns in local currency ($ for Commodities and Hedge Funds). *All returns to 08/05/2020, apart from property and hedge funds (31/03/2020).

Equity markets

Equity markets rose last week as investors again seemed to take heart from the tentative steps towards easing of lockdowns. Global equity indices have now returned 11% this quarter and 26% since the low point of 23 March. Volatility has declined steadily but remains high by the standards of the last decade.

Energy stocks performed strongly last week as the oil price recovered. But the technology sector performed even better as investors continue to back the stocks that have been relatively unaffected by lockdown. These two sectors lead the performance rankings for this quarter, followed by basic materials and consumer stocks. Technology and consumer stocks have also been amongst the best performers since the end of December, with energy and financials faring worst.

A high exposure to technology helps to explain why the US led the regional rankings last week and leads for both the quarter and year to date. The bounce in energy boosted the UK last week, but it lags behind global averages for the quarter and year to date. However, the subdued returns from European and Asian markets last week reflects in part the fact that they were closed when the US fell sharply on the previous Friday.

Bond markets

Yields in most markets edged higher last week as risk markets rallied and are now back at end-March levels in the US, but are still a little lower in the UK and Germany. Changes by the US Federal Reserve described later were aimed at credit markets. There had been some speculation that the BoE would expand quantitative easing at its Monetary Policy Meeting last week, but it left policy unchanged.

Local currency emerging market debt had another good week, with index yield index falling by 0.2% p.a. to 4.8% p.a.. The yield is now at its lowest level of the year, 1.5% p.a. below the peak in March. Credit spreads on hard currency (US dollar denominated) emerging market debt also fell last week, slipping back under 6% p.a., well below its March peak of 7.3% p.a. However, the spread is 3.0% p.a. higher since 31 December, reflecting lingering concerns about the effect of US dollar strength and falling oil prices on the ability of emerging market economies to service debt.

It was a mixed week for global corporate credit markets. Spreads in speculative-grade markets (BB+ credit rating and below) narrowed (euro markets, catching up after being closed on a weak Friday the previous week, were an exception) and are now 1.4% p.a. lower than they were at the end of March. Investment-grade spreads were marginally higher but have still fallen 0.7% p.a. so far this quarter.

Our View

Recent positive market moves have slightly reduced the apparent cheapness of global equity and credit markets but the outlook for corporate earnings and defaults remains very uncertain at this stage, with sentiment likely to remain fragile through the first half of 2020. Even if lockdowns begin to be relaxed as some economies pass the peak of infections, the sudden stop to global activity is now expected to generate the most severe recession in living memory and the restart is unlikely to occur quickly. Furthermore, unprecedented fiscal and monetary policies may provide short-term liquidity and ease market stresses, but they may be unable to halt rising unemployment or prevent insolvencies in the deep downturn entered.

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