MARKET COMMENTARY - MARCH 2020

QUILTER CHEVIOT

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Past performance is no guarantee of future returns.

Global stock markets reached new all-time highs in early February before suffering a sharp and broad based sell-off as it became clear that Covid-19 had not been contained within China and would likely reach most countries to varying degrees. The economic impact – mainly the result of public health countermeasures rather than sickness or death – is unknown in magnitude or duration as there are no precedents in the current globalised supply chain world. The virus is expected to peak within the next month or so, though this is a quickly evolving situation.

Market returns over February

A surge in selling volumes saw most major equity markets end the month with negative returns of between 8 and 9% in local currency terms. Despite heavy weightings in energy and resource stocks, the UK matched other markets with FTSE 100 losing 705 points to 6580, a level last seen in July 2016. Sterling depreciation of nearly 3% to $1.28 cushioned returns from international investments for UK-based investors. Emerging market and Asian equities outperformed over the month with negative returns of between 2-4%.

US and UK 10-year bond yields fell to new lows at 1% and 0.38% respectively, above negative yields in Japan and Germany. The prospect of a recession means reduced demand for oil (Brent $50) and other commodities. Uncertainty boosted gold to $1,584 and the Wall Street VIX 'fear gauge' spiked to 40 from the mid-teens recently.

The outlook for global growth

Global GDP estimates have been downgraded to 2.5% from 2.7% at the start of the year – potentially the weakest annual rate since the financial crisis – with the most impact on China, Hong Kong, emerging markets and commoditydependent economies. Current assumptions are that the advanced Western economies will be less affected by coronavirus with GDP growth trimmed to 1.4% from 1.5%.

Further downgrades to global growth are likely given the potential disruption to the global supply chain as Hubei province, of which Wuhan is the capital city, is a major producer and exporter of automotive, iron and steel, high-tech manufacturing, machinery and electrical equipment as well as textile products.

Asian countries are most vulnerable to growth downgrades and supply disruption but China ranks fourth in the world after Germany, Japan and the US for automotive goods inputs. Advanced economies dependent on consumer spending also face potential disruption from significant quarantine measures, so a growth recession (where global growth stays positive but below the rate of increase in population) cannot be ruled out.

A turning point for coronavirus' epicentre?

With China at the more advanced stages of the epidemic, it will be interesting to see how their recovery develops. New cases are reducing, recovery rates improving and numbers under medical supervision receding, with this all suggesting a turning point. Chinese officials have designated industrial production a priority and expected a near full return to work in state-owned enterprises by the end of February.

Private enterprises are seeing a slower recovery however. By the end of February, only 50% of the 120m migrant workers were back at work from the extended holiday period, coal consumption by power plants was down 40%, traffic levels in major cities were at 70% of normal levels, and property sales were 20% of normal. It will not be a 'V' shaped recovery. The Chinese business surveys for February painted a fairly grim picture with the private industrial manufacturing and non-manufacturing PMI plummeting to record lows, suggesting Q1 GDP could easily be down to 3.5% year-on-year from near 6% previously. Private consumption growth is estimated to fall to 1% vs. 5% in recent years. Extensive stimulus measures should see a rebound to back over 5% in H2 in the absence of a resurgence of infections.

The outlook across developed markets

The timing of COVID-19 was somewhat unfortunate. We had seen signs of a cyclical upturn in economic activity – especially in global manufacturing – as trade war pressures eased. Despite the dampening effect of Boeing's production suspension of the 737 Max and softer capex investment, the US economy has continued to grow steadily. Small businesses are still very upbeat. We are seeing solid hiring conditions, durable goods orders beating expectations, consumer confidence strong and personal incomes mildly above expectations.

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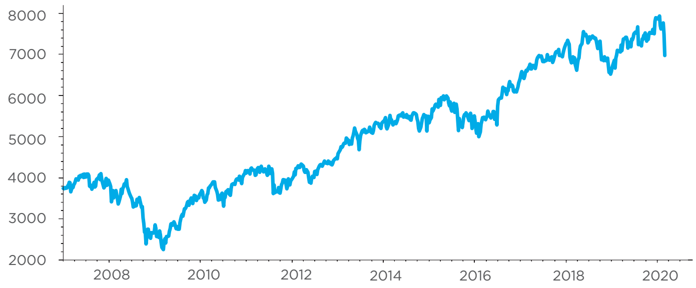

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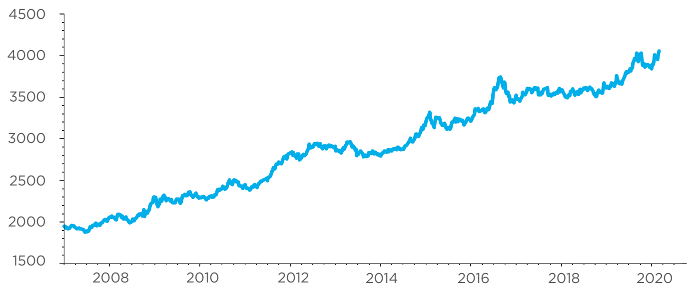

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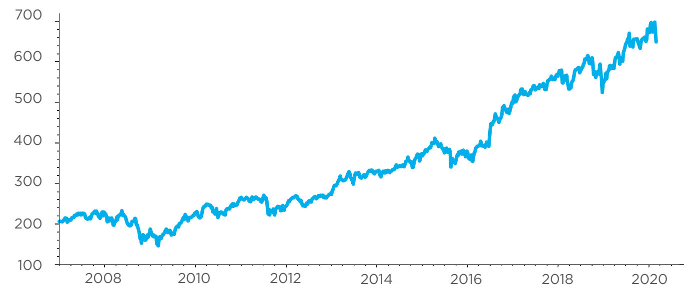

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However, the unexpected decline in a key US services business survey – into contraction territory in February with participants citing coronavirus dampening travel and trade – highlighted the developed world will not be immune to the global slowdown. The US Federal Reserve noted the virus poses an evolving risk, prompting a 0.5% cut in interest rates at the beginning of March.

The trade sensitive economies of Japan and Germany will be more impacted by coronavirus more than most. While Japanese growth will rebound from its depressed level in the fourth quarter of 2019, retail sales are not recovering as fast as expected following the rise in the consumption tax. Corporate earnings are highly correlated with weakening exports. While there is some talk of further fiscal and monetary measures, these are unlikely to have material impact.

The EU is also on track to continue its weak growth trajectory, especially the German auto sector. The changing political landscape in Germany may result in fiscal measures in due course, meanwhile the ECB is hoping steady consumption will prevent a recession.

While fourth quarter economic growth stalled in the UK, the most recent manufacturing numbers (as well as services surveys, housing market data, retail sales and consumer confidence figures) have shown a mild uptick since the election. The storm-battered economy should gradually pick up as pent-up demand is released, though tough EU negotiations ahead likely prevent a robust recovery. Meanwhile, the forthcoming budget will likely loosen the fiscal purse strings further.

Coronavirus overshadows corporate results

So will Covid-19 be the catalyst to end this long-running cycle? While we do expect the economic news flow to deteriorate before it improves, the underlying growth conditions remain positive and most of the financial indicators we use aren't flagging an end to the cycle. The sharp fall in the oil price will boost growth and additional targeted fiscal measures are likely. Central banks already have the taps wide open and while easier monetary policy probably isn't the most effective measure for the current crisis, there will be political pressure to do something, especially in the US where there is a presidential election to win.

Naturally, corporate results season has been overshadowed by recent developments. Fourth quarter results mildly beat expectations and many companies were guiding towards a small cyclical upturn as the impact of the trade war faded and Chinese growth improved. Investors began to discount an upturn in corporate earnings through the New Year, pushing up share prices and extending valuations.

This action clearly left markets vulnerable to an unexpected shock. The companies most obviously impacted are in the travel and leisure, luxury goods, energy and mining sectors. Other companies are also beginning to assess the direct as well as supply chain impact, guiding lower on 2020 prospects.

For some, sales will have been lost permanently – hotel chains and restaurants for example – but for others, such as luxury goods, consumption may only be postponed. Revised guidance from corporate management will trickle through to analyst earnings estimates in the coming months. Investor surveys suggest low single digit growth but markets could be in for another flat year overall. Investors may not be prepared to look through the disruption until new infections have subsided so further volatility can be expected.

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