Coronavirus Commentary

16th June 2020

Market Update

- Global debt issuance is moving forward in leaps and bounds as demand for debt remains high.

- New Zealand was recently declared free of Covid-19 but has reported two new infections, imported from the UK, which are believed to be isolated.

- Global cases continue to rise, although deaths appear to have peaked, causing some confusion over whether the global pandemic has peaked or not.

- Markets welcome the re-opening of Western economies but remain nervous of further outbreaks or a second wave. Some US States have reported a resurgence of infections, leading to renewed anxiety.

- Several vaccines have reportedly moved to human trials with growing optimism that a successful vaccine may be available before the end of 2020.

- The UK economy contracted by a record breaking 20.4% during April, reflecting a full month of economic lock-down. This marks the highest fall since records began in 1997, but it is likely to have recovered partly during May as economic restrictions were eased.

- Stock markets have remained volatile but generally buoyant during June, pushed on by stimulus and hopes of a ‘V’ or ‘U’ shaped recovery, despite concerns expressed by the Federal Reserve and the OECD (Organisation for Economic Co-operation and Development).

- Brexit has begun to re-emerge as the December 31st deadline looms. The British Government are adamant that no extension will be requested and the UK will exit the transition period without a deal if necessary. Both UK and EU leaders have recently talked positively about the prospects of reaching an agreement.

Commentary

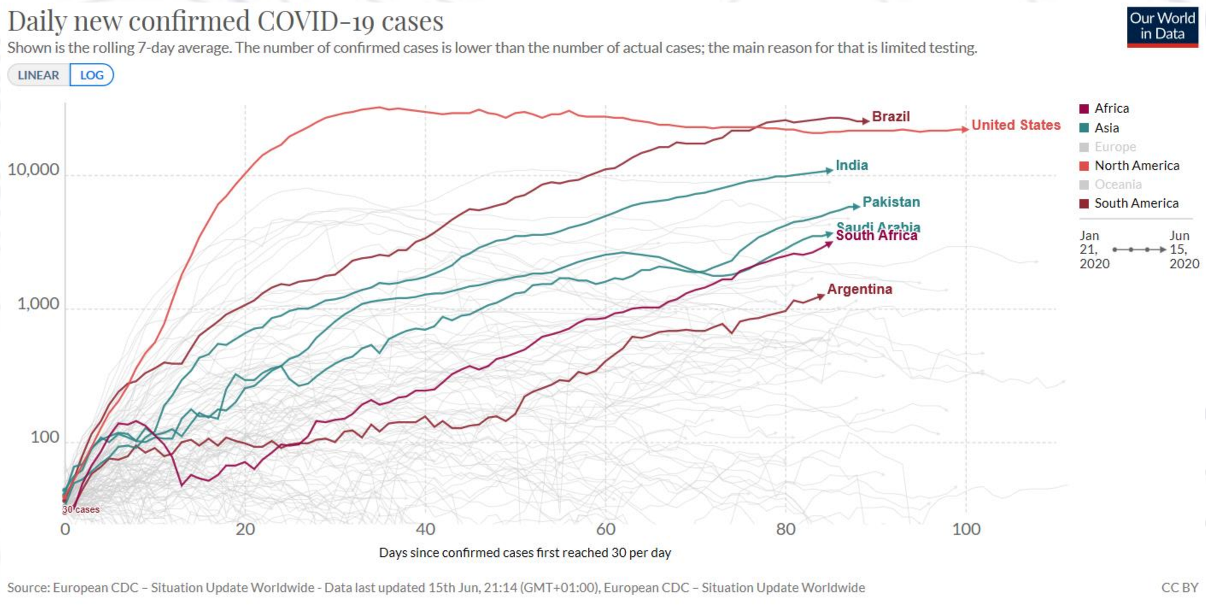
Historically, banks have been unkindly, but sometimes accurately, characterised as willing to lend you money you do not need. The same cannot be said for bond markets, which are presently willing to lend money which is desperately needed by governments and corporates to finance Covid-19 costs at record low rates.

The Financial Times reported that US companies have issued nearly as much debt this year than during the whole of 2019 in order to build the cash required to navigate Covid-19 risks. Companies have even moved beyond raising cash that is required imminently to opportunistically locking in long-term cheap finance by taking advantage of current high liquidity. The Federal Reserve has also been boosting demand in the corporate bond market by making direct purchases. Amazon, for example, issued three-year bonds with a coupon of 0.4%, whilst Boeing, plagued with Covid-19 and previous 737 Max grounding issues raised $25 billion, including a 10-year bond with a 5.15% yield, reportedly three times over-subscribed.

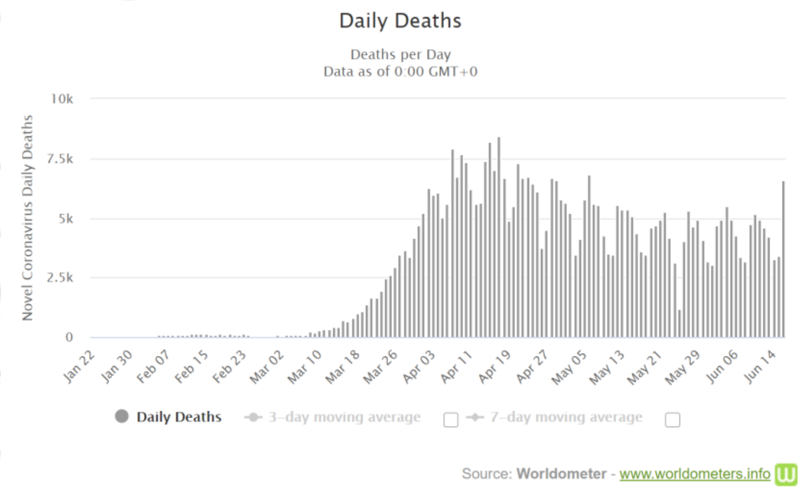
As more debt has been issued, market commentators have been looking for signs that demand will be overwhelmed, but this has not occurred to date. Global stock markets have an approximate valuation of $89.5 trillion compared to $253 trillion for global debt markets, meaning debt markets are approximately three times the size of equity markets. The size of the market and minimal yields illustrate the staggering amount of money seeking low risk assets at present and how a change in sentiment could push demand into the much smaller global equity market.

The availability of low-cost debt is a major advantage for businesses tackling Covid-19 risks, but lenders seem to be taking most of the risk for little return. The availability of low-cost debt is an important backstop for the global economy during these times of uncertainty, but we continue to be concerned for the long-term prospects of assets yielding less than central bank inflation targets.

Whilst Covid-19 infections are believed to have peaked in Europe and the US, global infections continue to rise. The graph below shows how the daily infections peaked for the United States but continue to steadily rise in Brazil, India, Pakistan and other economies.

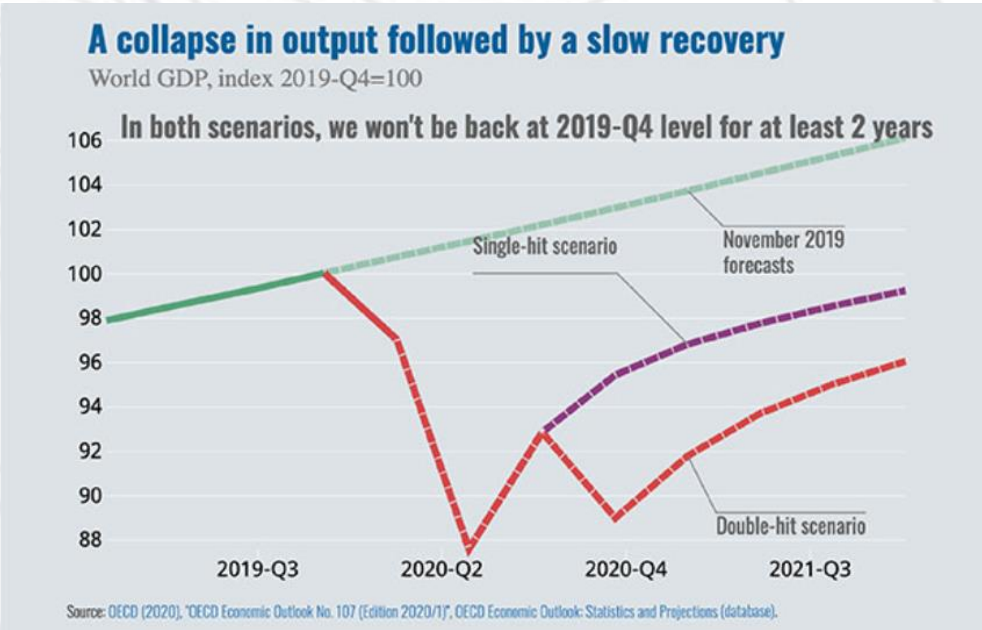


Whether the global economy is past the Covid-19 peak is a point of debate. Global deaths appear to have peaked, as shown on the graph below, despite infections continuing to rise. Optimists suggest this is due to higher testing levels picking up more infections, where previously many were unrecorded. Other explanations suggest that the virus is becoming less virulent and treatments are more effective, whilst the worst case is that deaths will begin to rise as they lag the infection rate.



Reports from the UK suggest a break-through in Covid-19 treatment as a widely available steroid, dexamethasone, assists in the recovery of around 75% of infected patients. It has also been reported that a number of vaccines have moved to human trials with a range of positive commentary resulting. It is accepted that finding a successful vaccine is hit and miss. However, a high number of simultaneous trials significantly increases the chances of success.

The OECD has released a graphic showing the predicted impact of Covid-19 on global GDP based on a single hit and a double-hit scenario. This does not provide any real surprises as a single hit results in a 'V' or 'U' recovery whilst a double hit leads to a 'W' recovery. The best case is a recovery to pre-pandemic global GDP by Q4 2021.



This underlines current market sensitivity to further outbreaks as the difference between the two scenarios is stark. Simply, the recovery will be much quicker and stronger if a second wave is avoided and, understandably, stock markets are currently very sensitive to data suggesting a break in either direction.

We believe the evidence points to a single hit scenario, although we accept that we are dealing with variables which are not completely understood. The experience of China, North Korea and others to successfully manage Covid-19, falling death rates, improving treatments and the prospect for vaccines all suggest that further infections should not lead to secondary economic shutdowns.

The BBC reported this week that senior EU figures had suggested the prospect of the UK and EU agreeing a trade deal was “very good” and could be achieved in July. Boris Johnson also felt that a deal in July was possible and both sides should “get on and do it”. These reports suggest the mood is turning more positive and markets would welcome the end of Brexit uncertainty that has been hanging over UK equities and Sterling since the referendum on 23rd June 2016.

We believe that the relative risk of Brexit has reduced as other global risks have risen steeply in relation to Covid-19. It is in the interests of both sides to reach a compromise arrangement, although European negotiations have a habit of being tense and concluding at the eleventh hour.

As noted in previous updates, the US equity market has outperformed other developed markets significantly over the past decade, partly due to higher earnings growth but also due to increasing valuation multiples. The US has been in a hurry to re-open and may have moved too quickly as some states, such as Florida, have reported increasing Covid-19 infections once more. This may force a more gradual approach and could lead the US economy to ultimately lag in the global recovery, with Asia already pulling ahead and Europe also emerging from lockdown.

In conclusion, we remain optimistic for equity valuations to continue to recover and we are nervous about the low yields offered by longer dated debt. Asia and European markets are attractively valued and may recover more quickly from Covid-19 due to the success of their lockdowns. In this case, US equities could disappoint as they are already priced to perfection. A surprise breakthrough in Brexit negotiations is possible and would boost UK asset prices, particularly UK mid-caps.

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