Weekly Digest

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We're All Epidemiologists Now

To the uninitiated (and even to seasoned professionals) financial markets can appear perverse. It is now about a month since the coronavirus outbreak became official, and equity markets, far from being undermined, are in many cases higher than they were before the city of Wuhan was locked down on January 23rd. China's broad CSI 300 share index may still be 3% below its mid-January peak, but a China Small Companies fund that I follow is up 15.5% so far this year, despite the fact that many of the businesses in which it invests must be close to standstill.

And it's not just China that seems to be defying the odds. This morning I have received a note from a prominent investment bank strategist highlighting the breakout to new all-time highs by the Euro Stoxx 600 equity index, which comes hot on the heels of very poor growth data for the fourth quarter of 2019 across Europe. Meanwhile in the United States, the S&P 500 Index closed at an all-time high on Friday despite the high-profile downgrading of Kraft Heinz's credit rating to "junk" status and the fact that Bernie Sanders, the Democratic Party presidential candidate least preferred by the financial industry, currently leads the opinion polls and the betting. Here in the UK, Sajid Javid will have been disappointed to see Gilts, equities and the pound move on from his departure from 11, Downing Street with barely a backwards glance.

As I explained last week, but which bears repeating given the extraordinary circumstances that we find ourselves facing, the key driver of the market's reaction has been the anticipation of announced and expected policy responses. For example, China this morning cut its one-year funding rate for commercial banks by 0.1% and is promising various other supportive measures. Futures markets are now pricing in a 0% probability that either the US Federal Reserve, the European Central Bank or the Bank of England will raise interest rates within the next twelve months – indeed further cuts are being priced in before the year is out. There is also the potential for further fiscal stimulus, notably in the UK, where it would appear that an unwillingness to open the spending taps was (at least to some degree) part of the reason for the now ex-Chancellor's demise.

I have observed in the past that, most of the time, the performance of risk assets will be defined by the balance between growth and liquidity. When growth is under pressure and liquidity is being withdrawn, reach for your hard hat. We last observed this confluence of factors in the fourth quarter of 2018, leading to a dramatic widening of credit spreads and a drop of around 20% for equity markets. I dread to think how bad things might have become had COVID-19 appeared during that period. Risk assets really started to get their skates on in the last three months of 2019 when growth expectations started to stabilise, forward looking survey data started to turn up and central bank liquidity provision remained generous.

So where are we now? It seems inevitable that growth forecasts for 2020 are going to be reduced, although it is as yet far from clear by just how much. A lot will depend on the persistence of COVID-19, and especially on whether or not it gets a foothold in other countries. The experience so far is encouraging, but far from conclusive. It feels as though investors are playing a high-stakes game of chicken with the virus. As we saw last week when the Chinese authorities changed their methodology for logging cases, leading to a huge spike in the numbers, there is still the capacity for nasty surprises. But against that we have seen interest rate cuts in a number of Asian countries and heard soothing words from central bankers in the West. My approach to this suggests that equities should be "muddling through" this period rather than vaulting higher, but the key point is that investors would still appear to be best served by remaining fully invested than by trying to cash in and buy back the dip.

A collection of brains far greater than my own reached the same conclusion last week. Our Global Investment Strategy Group convened an extraordinary meeting to evaluate the risk, and unanimously decided to retain our full equity weighting. That's not to say there will no bumps ahead. I remain concerned that when investors are faced with the reality of the shortfall in current year earnings there will be some challenging periods. We are also likely to face a sharp reversal in some of the "soft" economic data, notably the Purchasing Manager surveys which were so helpful to sentiment towards the end of last year. But any setbacks should remain relatively contained thanks to policy support.

Turning back to domestic issues, the exit of a Chancellor of the Exchequer, especially one who never got to present a budget, merits a comment. The consensus explanation is that Mr Javid was unwilling to embrace the spending plans demanded by Number 10, and was replaced by someone who might be, shall we say, more compliant. We don't want to get sucked into a debate about governance at this point, and so will concentrate on the implications for the economy and markets. The pound continues to be the best indicator of sentiment on such matters, and it rallied smartly on the news, rising about a cent against the dollar and the euro. This resulted from higher expectations of increased fiscal stimulus in the forthcoming budget, which should provide a boost to a still sluggish domestic economy.

This has put a bid back under small and mid-cap equities, which are much more exposed to the domestic economy than the FTSE 100. They have had a nice rally since the autumn, initially buoyed by good value – a view supported by an increasing amount of corporate activity – and then the result of the election. The Prime Minister's refusal to countenance an extension of the Brexit transition period has undermined some of that confidence, but the soon-to-be announced (although potentially delayed) policies will provide renewed support.

Last week's Economic Highlights

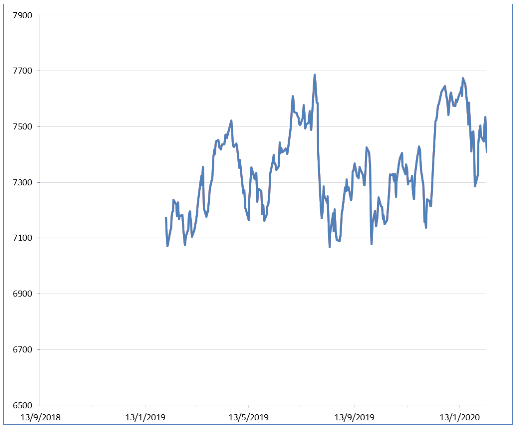
FTSE 100 Weekly Winners

NMC Health	10.7%
Barratt Developments	8.9%
John Wood Group	7.3%
Taylor Wimpey	6.5%
Persimmon	6.1%
Land Securities Group	5.8%
Next	5.4%

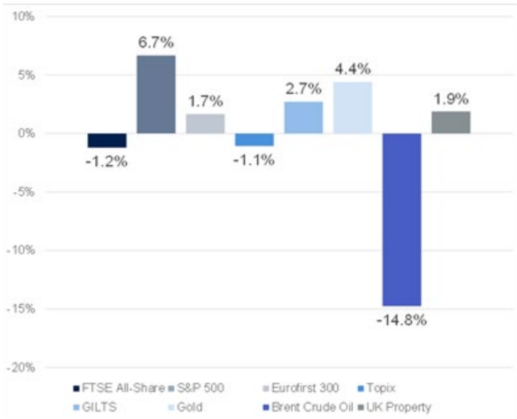
FTSE 100 Weekly Losers

Centrica	-16.3%
GVC Holdings	-5.9%
Ocado Group	-5.1%
AstraZeneca	-5.0%
Royal Bank of Scotland	-4.4%
Royal Dutch Shell	-3.6%
Evraz	-3.0%

FTSE 100 Index, Past 12 Months



Year to Date Market Performance



Source: FactSet

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