Market update

April 2020

It is now clear that the world economy is experiencing a sudden stop, which is without precedent in peace time. There are few economic parallels we can call on to give us a framework for how this may pan out as economies have never been closed down so abruptly before or populations locked down in this way. We must however look to the future as data begins to improve and governments look to formulate exit strategies.

The rally in markets in the last week has shown that investors have accepted this downturn and started to look across the valley at the world that will emerge on the other side. This will depend entirely on how fast the coronavirus lockdowns can be lifted. If, for example, the reverse to market consensus earnings estimates lasted only one year, and these earnings declined by up to 50% in 2020, using DCF models, a one year setback, even on this scale, would justify a market fall of not much greater than 5% as share prices clearly take in more than one year's corporate earnings. This of course is likely to be far too optimistic but illustrates the point that after the severe market setback, it is the prospect of corporate earnings in the years to come that will drive markets forward.

Major economies and regions have entered suppression/lockdown strategies at different times. After China, more limited suppression measures were adopted by other Asian countries such as Hong Kong, Singapore, and South Korea, followed by Europe and lastly the US. Whilst the New York lockdown has captured the media's attention, this is not typical of what is occurring across the United States. In more sparsely populated areas, restrictions on people remain limited. Around three-quarters of the population are in very light shelter-in-place regimes, whilst around one quarter have no restrictions at all. Looking at some economic forecasts, there are estimates that the annualised rate of decline in global GDP in Q1 2020 could approach minus 20%, triple that recorded in the worst quarter of the Great Recession in 2009. The latest US forecasts from Goldman Sachs show the trough of recession being reached in the second quarter of 2020, with GDP likely to be 11-12% below the pre-virus reading. This would involve a dramatic decline at an annualised rate of 34% in that quarter. The OECD has stated that the group of seven leading, high-income countries could see declines in GDP of 20-30% and estimates that every month large parts of economies stay closed, annualised growth will fall by around 2%. Academic reports show that costs are unequally shared, with those who can work remotely continuing with their roles and unskilled workers suffering more acutely with job losses.

Some have suggested that the emerging world could be a safe haven, but this rarely proves true at times of crisis. Many emerging and developing countries are being hit by falling commodity prices, especially oil, and by collapsing external demand. The level of outflows from emerging market assets, including bonds, are far in excess of those witnessed during the financial crisis, showing that an unprecedented capital flight has taken place. In the oil and commodity price

Market update cont.

April 2020

collapse of late 2015/early 2016, commodity-exporting, current account deficit countries had some of the worse performing stock markets in the world and they are currently having to manage the pandemic with highly inadequate health systems. Sierra Leone has 18 ventilators for a population of 7.5 million, and the Central African Republic has 3 ventilators for 5 million people. In India, it is estimated that the national lockdown has put 50 million jobs at risk in textiles, shoemaking, jewellery, and other consumer goods sectors. The lockdown was abrupt and poorly planned, leaving shipments stranded in trucks alongside highways or at ports and many overseas buyers are citing force majeure to cancel orders. Lockdowns are especially brutal in countries with limited or no welfare states, with many in emerging economies relying on subsistence earnings working within the informal economy.

As the worst ravages of the disease, in terms of death, start to ease in the developed world, the focus will then turn to exit strategies as the current level of economic damage will not be sustainable for long periods, and arguably risks causing significant damage to the health of large proportions of the global population. While lockdowns are justified in the short term, if kept up indefinitely, will cause huge personal suffering, and significant social and economic damage. Many governments have adopted a temporary universal basic income, but this is unlikely to be maintained permanently. Where governments can't afford the stabiliser effects of costly social protection measures, the negative effects will be even more profound. In Germany, there are calls for a risk-adapted strategy, a trade off minimising economic damage whilst avoiding large numbers of untimely deaths.

The market rally last week has been led by the United States as case numbers in major cities have shown signs of plateauing. Investors believe that GDP will start to rise gradually during the second half of this year, even if the pre-virus levels are not reached before the end of 2021. Even two wasted years in the US would not justify market falls of 25%+. The latest data from China shows a partial economic recovery (the Fulcrum data for China shows a rebound in month on month annualised growth to +4.6% in March compared with -2.0% in February) but there is concern that China's export orders are weakening and will remain weak as foreign markets decline sharply. Chinese industrial output growth is still very negative compared to a year earlier. To date, central expectations on economies are for a strong global recovery to commence in Q3, following the pattern of China and Hong Kong after the Sars crisis in 2003. Economists generally believe epidemics to be temporary events that do not cause long-term structural damage. The coronavirus, however, is clearly having a greater effect than Sars, Mers, Ebola or Swine flu. Partly because the global economy is more integrated, making the disease itself a global rather than a localised event, and due to the emerging world being the driver of global growth in the post-crisis period.

Market update cont.
April 2020

As previously mentioned, the American Enterprise Institute has provided a road map for ending lockdowns, suggesting a clear pattern of 14 consecutive days of declining case numbers, together with capacity in the health system, justifying a re-opening of an economy on a phased basis. However, there is always the risk of a flare-up in disease levels which will result in further lockdowns, or the reintroduction of restrictions, as has been the case in both Hong Kong and Singapore. As a result, recovery is likely to be stop-start at best this year, certainly until a vaccine is produced.

The US market may also have been encouraged by the supposed indicative success rate of the cocktail of hydroxychloroquine, the anti-malarial drug, mixed with the antibiotic azithromycin which, in Donald Trump's view, could be 'one of the biggest game changers in the history of medicine'. To date, the effect of these drugs is unproven, but the turnaround time in New York hospitals for patients contracting COVID-19 does seem to have been quicker than in Europe, with less patients needing to move on to ICU beds. The relative outperformance of the US over Europe can also be explained by the continued lack of a coordinated economic response in Europe.

Suppression measures have successfully reduced the reinfection rate from carriers to other people quite dramatically. The UK was slow to put measures in place and there are some estimates that the reinfection rate had been as high as 6.0x at one stage. This has now fallen back to around 1.8x. In other words, at the worst of the outbreak in the UK, 6 people were being infected by every carrier, and this has now dropped to 1.8. The previous number may seem high, but looking at the packed tube trains at the height of the crisis, it isn't entirely surprising. There are suggestions that the rate of reinfection in the US has dropped to 1.5x and is only around 0.5x in Australia today. Explanations for the lower infection rate in Australia include the lower density of population in cities, lower levels of smoking, a younger population, and the fact that it is summertime in the Southern Hemisphere. Australia has also quarantined anyone returning from abroad, including its own citizens. Estimates for transmission rates in Italy and Spain now suggest that these have been successfully suppressed to around 0.8x.

One area of the stock market that has suffered a severe hit, having previously proved defensive, is the property companies or Reits. There has been significant publicity of the non-payment of rents on retail space and there is also evidence to suggest that the same is occurring in offices. In Australia, some property companies have already reported significant downgrades to asset values on portfolios that are not wholly retail orientated. Clearly some big downgrades to NAV are likely to occur.

Summary

Markets have gone into the second quarter placated by the huge fiscal and monetary packages provided. There is evidence that the peak intensity of cases (in the developed world) is now occurring and the focus is on potential exit strategies. If economies can return to some level of normalisation by the end of the year, albeit with a caveat that travel and leisure sectors are likely to be impacted negatively for longer, markets will be able to continue to make progress. Year to date, the Chinese and US stock markets have been the best performers, and this seems justified by the economic policy response in both cases. China is now emerging from an authoritarian lockdown, which appears to have successfully stemmed the spread of the disease. In the States, the policies of the administration are to contain deaths and remain focused on avoiding long lasting economic carnage. Markets will now be highly sensitive to how the prospects for recovery pan out in practice and, until this becomes clear, may well settle into a trading range. Any positive news, either on vaccines or potential cures, even if only widely available many months ahead, will be viewed as positive news and today, markets rapidly discount future events at an unprecedented rate. This was seen with the most rapid decline into bear market territory in history, and after last night's gains, (which has left the S&P 500 23% off its intraday lows), was followed by one of the most rapid rebounds into bull market territory.

To date, the market has played out the recession copybook in classic fashion, with cyclicals and highly geared companies the hardest hit and in fact it is these companies that have rebounded the most over the past 10 days. After the initial rebound in these hardest hit stocks, market attention is likely to refocus on who will be the long-term winners in the post coronavirus world. Whilst in a typical recession, earnings can decline up to 50%, stock markets generally take 12-15 months to move from peak to bottom, rather than the four weeks which have just occurred. Studies of previous downturns show that markets typically recover in 2-3x the period it took them to fall. In other words, a 12-month bear market takes 2-3 years to regain all the lost ground under this formula, but with the level of uncertainty persisting, it would be unrealistic to expect a full recovery in only three months. However, even if the economic recovery is sluggish, being more U-shaped than V-shaped, one lesson from the GFC is that stock market recoveries can be very different.

Despite the fact that it took a decade for the global economy to return to more normalised levels of economic growth, in contrast, the stock market rebound was V-shaped. Today, with the influence of quantitative trading and risk parity funds, markets are likely to anticipate and take on board positive or negative future news flow at a much faster rate than has occurred in the past. Positive news on vaccines, drug treatments, or successful containment of the disease, once lockdown measures are relaxed, could well result in a V shape stock market recovery, even if the economic rebound is more muted.

Where we are

We have advisers throughout the UK, based in eight regional offices.

Need to speak to us?

T: 0370 1432 100
E: contactus@wrensterling.com
W: wrensterling.com

Glasgow	**T:** 0141 341 5240
Halifax	**T:** 0333 0438900
Nottingham	**T:** 0115 908 2500
Warwick	**T:** 0333 043 9001
Grantham	**T:** 01476 560 662
London	**T:** 0370 1432 100
Weybridge	**T:** 01932 481069
Belfast	**T:** 0370 1432 100

WREN STERLING