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Q1 2020 MARKET REVIEW – 24 April 2020

Investors started the year with expectations of an improved economic environment following the negotiation of a 'phase one' trade agreement between the US and China. The coronavirus pandemic has triggered one of the fastest market sell-off as one country after another has implemented social distancing measures to reduce the spread of the virus and to allow health systems to cope. Today it is estimated that a third of the world population is in lockdown. The lockdown measures have led to a sharp fall in economic activity with most countries expected to enter a deep recession in 2020. In the US alone, 22 million people have filed for unemployment over the last 4 weeks. This figure compares to 2.6 million during the 2008/09 financial crisis. Governments have responded by taking unprecedented fiscal measures in order to avoid the short-term economic shock triggering a long-lasting economic depression.

Saudi Arabia and Russia oil price war

In addition to the coronavirus economic crisis, the world economy is also facing an oil price shock as Saudi Arabia and Russia initially failed to agree production cuts in light of lower oil demand. In order to put pressure on Russia to agree production cuts, Saudi Arabia took the decision on 8 March to increase oil production. This decision led to a sharp fall in the oil price. The oil price (Brent crude) collapsed from about $60 in early March to $23 a barrel at the end of March. Saudi Arabia's decision to increase oil production was also thought to be aimed at the highly indebted US shale oil sector which needs a higher oil price to be profitable. Many of the US shale oil companies will face issues re-financing their debt if the oil price remains too low. On 12 April, a US-backed deal led Saudi Arabia and Russia to agree to cut production by close to 10%. Despite the agreement, the oil price remains below $30 as the production cuts are not likely to be sufficient given the collapse in oil demand. Further production cuts are likely to be needed to support the oil price.

A full-blow financial crisis was averted by rapid central banks actions

In the middle of March, the expected economic impact of the lockdown measures and the oil price shock led to heavy selling across all financial markets. The sell-off is thought to have been aggravated by highly leveraged investors having to sell safer assets to meet margin calls (cash calls from financial institutions lending to investors). The scale of the sell-off led to a lack of liquidity even in the larger and safer US Treasury market (US government bonds) and raised the risk of a full blow financial crisis. The lack of liquidity led to market distortions with the price of safe assets such as US Treasuries and gold falling at a time when they are expected to be stable or rising. US Treasuries sold off and gold lost more than 11% in value between 9 and 19 March. US Treasuries and gold have since more than recovered their value. The US Federal Reserve and other central banks took rapid action to inject liquidity in financial markets in order to avoid a full blow financial and credit crisis. US interest rates were slashed to zero and the US Federal Reserve significantly expanded its bond buying programme and established a loan facility to help credit markets.

Unprecedented fiscal measures taken by governments globally

In addition to central banks' measures to inject liquidity in the financial system and to reduce interest rates, governments have taken unprecedented measures to provide financial help to companies and households during this time. The US government quickly approved a $2 trillion stimulus package to help businesses and individuals. The package includes direct payments to individuals, suspension of student loan payments for six months and more importantly an expansion of unemployment insurance which will give unemployed workers $600 a week for four months in addition to state benefits. The benefits are to be extended to self-employed and gig economy workers. As part of the package, a $500 billion lending programme has been approved to help companies impacted by the lockdown such as airlines. Other developed countries have put in place similar measures to boost their economy and avoid large scale unemployment and business failures which could lead to a prolonged economic recession. The objective is to enable companies and individuals to financially cope during the lockdown and be ready to resume their activity as undisrupted as possible once the lockdown is lifted.

Public deficits will swell to levels not seen historically outside war time. It is not clear what decisions governments will need to make in the coming years to pay for these current measures and reduce public debt. Given that austerity measures since the last financial crisis have left many households in already precarious situations and given the expected demand for higher public health spending in the coming years, it is difficult to see what cost cutting measures governments will be able to take to reduce their deficits. In theory, we should expect higher taxation and possibly higher inflation.

Stock markets have significantly rallied since the end of March as investors hope that the measures taken by Central banks and governments will allow the economy to recover quickly once lockdown measures are relaxed. We continue to be cautious given the scale of the economic disruption, the uncertainties around the containment of the virus and the long-term impact of the fiscal measures taken by governments worldwide.