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Q2 2020 MARKET REVIEW – 30 July 2020

Financial markets recovered sharply in the second quarter following measures taken by central banks to inject liquidity in the financial system and by governments to minimise the economic impact of the lockdown on businesses and households. Financial markets were initially buoyed by the hope of a quick economic recovery following the end of lockdowns in Europe and the US and by any sign of a vaccine or treatment breakthrough. As the spread of the virus accelerated across the world, financial markets continued to perform well despite a worsening situation. The continued market rally is surprising and can only be explained by the unprecedented measures taken by central banks and governments including ultra-low or negative interest rates, large scale purchases of government, bank and corporate debt and large fiscal stimulus.

Central banks have significantly expanded unconventional policies to respond to the crisis

The Covid-19 crisis came at a time when interest rates in major developed economies were close to zero and there was little scope for central banks to boost the economy through traditional monetary measures, i.e. reducing interest rates. In the US, where interest rates were just above 1.5% at the beginning of the crisis, the US Federal Reserve quickly made two emergency interest rate cuts in March effectively reducing interest rates to zero. In order to avoid a financial and economic crisis, central banks quickly injected additional liquidity in the financial system by buying or guaranteeing government, bank and corporate debt.

The Federal Reserve balance sheet was expanded from $4.2 trillion in early March to over $7 trillion in June. To put these figures in context, the size of the Federal Reserve balance sheet was below $1 trillion before the 2008 financial crisis. At the time, the Federal Reserve initially expanded its balance sheet to $2 trillion to avoid a systemic failure of the global financial system. Other major central banks have followed the same path. The European Central bank balance sheet was expanded from €4.7 trillion in early March to €6.3 trillion in June. It is estimated that major central bank reserves have more than tripled since the financial crisis.

These policies have significant implications for financial markets as they lead to low interest rates, low bond yields and help support high levels of public debt as governments can more easily finance debt in a low interest rate environment. Low interest rates also incentivise companies to increase their debt and help sustain uneconomical businesses. It is not clear what the impact of increased government and corporate debt will have on the economy in the long term as the debts will have to be repaid eventually. In the meantime, savers and investors have no option than to invest in riskier and more volatile assets such as equities, property and higher risk corporate debt (high yield and emerging market debt) to generate any income. This is leading to the current situation with equity markets rising despite a poor economic outlook. Low interest rates and the seemingly unstoppable market rally have also encouraged speculative investors to borrow funds or to use derivatives (option trading) to invest in the stock market. Some of the recent market rallies in the US technology sector, in biotech companies and in the Chinese stock market can be partly explained by speculative investors.

Governments may be compelled to extend fiscal stimulus for longer

Meanwhile in the ‘real’ economy, the virus continues to spread and major economies remain impacted by social distancing measures. Most countries have started to come out of strict lockdown and economic activity is recovering but there is a risk of a second wave and more targeted lockdowns in the winter. Governments in most developed markets have taken significant measures to protect households and businesses during the lockdowns by putting in place generous unemployment benefit programmes and by providing business support loans and other similar measures. Some of these programmes are due to come to an end in the summer with a risk of triggering a rise in permanent unemployment and business failures. Given that the virus is still not contained, governments are likely to have to extend the fiscal stimulus measures for longer in order to support household and business confidence and avoid a deep protracted recession. This will raise public debt further and will lead to difficult political choices. As we mentioned in our last quarterly review, it is not clear how governments intend to repay the unprecedented levels of debt incurred during this crisis. Increased taxation is a likely outcome.

The recently agreed €750 billion recovery fund is a significant milestone for the European Union

Following a French-German initiative, the European Union (EU) leaders have agreed a joint recovery fund to help support the countries' worst impacted by the Covid-19 epidemy. The 27 EU leaders have also agreed on a proposed EU budget for the next seven years. This is an important milestone as the budget discussions were anticipated to be difficult given the expected shortfall following the UK's departure. In the end, the 7-year budget was barely mentioned as the focus was on the €750 billion Covid-19 recovery fund. After difficult negotiations, the EU leaders agreed to a €750bn recovery fund made up of €390bn of grants and €360bn of loans. The €750bn will be financed by common EU debt issued by the European Commission. This is a significant step in the history of the European Union as up to now richer countries and in particular Germany were opposed to the issue of common debt and fiscal transfers to poorer countries. The fund will be used to help mostly Southern countries which have been most impacted by the virus.

This recovery fund will help to soften the economic impact of the crisis as well as significantly strengthen the European Union through increased solidarity. The decision sends a strong signal of the EU leaders' determination to strengthen the European project. The euro, as a currency should benefit as the fund will attract more capital to the Eurozone and the risk of break-up in the Eurozone has been significantly reduced as a result of this initiative.

In these volatile markets, we continue to follow a disciplined investment strategy and continue to be extremely cautious about the direction of stocks markets given the extreme disconnect between financial markets and the underlying economy.