Markets in a Minute

16 June 2020

Shares down, but not out, on second wave worries

It has been conspicuous by its absence, but the pull back in equity markets that so many people had been expecting arrived last week. The sell-off hit the UK, Europe and US the hardest, with the worst one-day falls since mid-March occurring on Thursday.

By the end of the week, however, markets had recovered the worst of their losses.

Yesterday, while Asian markets suffered continued selling, the UK and Europe pared steep losses in early trading to finish less than 1% down. Indeed, the FTSE250, and all US indices, closed in positive territory.

Today, global markets have rebounded enthusiastically on the back of the US Fed's plan to buy corporate bonds, and expanded stimulus from the Bank of Japan. Asian markets have seen big gains and equity indices in the UK and Europe are all up by more than 2% in early trading.

As a result, whilst there is still some ground to make up, the broad-based rally that looked like it was running out of steam last week appears to have regained momentum, although there can be no complacency about a second wave.

Last week's falls*

- FTSE100: -5.84%
- Dow Jones: -5.54%
- S&P500: -4.75%
- Dax: -6.99%
- Nikkei: -2.44%
- Hang Seng: -1.89%
- Shanghai Composite: -0.37%

* *Data to close 12 June 2020*

Second wave stress

We have always felt the risks of a second wave are high as that seems to be the message from the researchers. At the same time, an acceleration now is coming sooner than most people would have expected it and appears to be down to poor management of the situation.

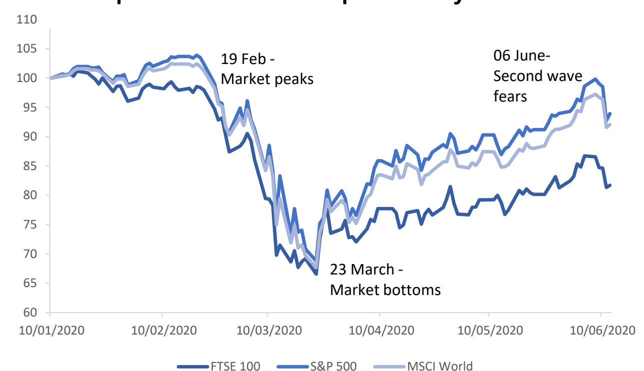
Case numbers are on the rise in 21 US states which is partly reflected in the testing numbers while analysts point to hospitalisations, which are a more accurate indicator.

- In Texas, the number of people hospitalised has risen by 45% over the past week, by 49% in Utah, 17% in Arizona, 37% in Arkansas, 19% in South Carolina, and 14% in North Carolina.
- There are some signs of infections increasing in European economies which have begun reopening their economies. What will concern the market is the prospect that lockdowns won't be lifted as soon as expected. Some may even be re-imposed – most notably, Austin Texas is said to be close to re-imposing its shelter in place order.
- Today, China imposed travel restrictions on residents in Beijing as the city attempts to contain a fresh outbreak.

The next week or so will also be worth watching closely for signs that the recent protests might have catalysed an increase in infections, and to monitor developments in China where scientists have said the virus may have mutated into a more contagious strain.

All this aside, there were a number of other reasons why we were cautious on the near-term prospects for the market and resisted a larger equity upgrade at our last asset allocation meeting.

Markets pull back after sharp recovery



Source: Thomson Reuters Datastream

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Market headwinds

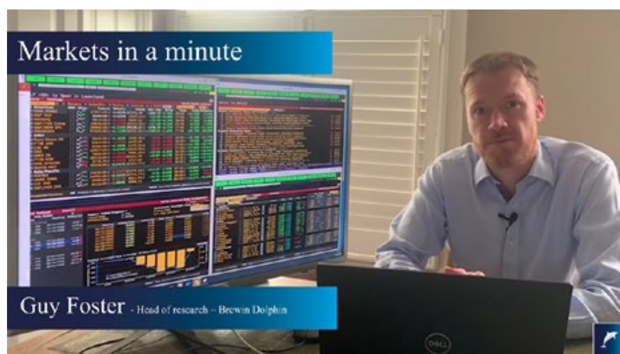
Most obviously markets were quite overbought over the short term. This was most evident in the put to call ratio which had moved from extreme bearish to extreme bullish positioning. However, perhaps the most telling cause for concern is in valuations where the FY3 PE ratio is close to a two-decade high.

We also had some gloomy economic forecasts, most importantly from the US Federal Reserve, which pointed to a slower recovery with high unemployment and interest rates that would stay lower for longer. This final point is usually a positive for equity markets, which brings us on to our reasons for optimism.

Reasons to be cheerful

The prospect of further lengthening lockdowns would no doubt fill a lot of us with dread, but there are a lot of positive features in this rally which underpin our upbeat view on equities on a twelve-month basis:

- Discount rates are very low and the Fed seems determined to keep them there. This means that policymakers have been very willing to support the economy through fiscal as well as monetary means – this is in stark contrast to the austere recovery of 2010 onwards.
- The US economy, which the NBER announced was in recession last week, is almost certainly at its nadir right now and will improve from this point onwards, even if the pace of that recovery is threatened by the lock down uncertainty. It is entirely possible that, after the longest period of economic expansion, we will see the sharpest and shortest economic recession.
- The usual suspects were weak as the market sold off. Credit widened, oil fell, value stocks underperformed growth stocks, index-linked bonds underperformed conventional bonds. The protection came from gilts (the longer-dated the better) and the US dollar.
- Despite the stronger US dollar, emerging markets, seem to have fared better than we might have feared during grim Thursday. We increased our allocation to emerging markets recently, partly motivated by the positive reaction that the region tends to have to surplus liquidity and economic recovery.
- We also now expect some weakening in the US dollar as a result of the new outlook for interest rates. It makes sense that the US dollar should lose ground as its steeply rising trajectory of interest rates changes to a flat outlook. The US dollar hugely outperformed the euro, and sterling, as US real interest rates became positive. We think there is some pent-up weakness as a reflection of the new, lower-rate outlook.
- Non-essential shops in the UK opened yesterday, bringing queues to many high streets, while numerous vaccines and therapeutics are showing promise in early trials.
- There are encouraging reports about willingness to compromise on both sides in order to reach a Brexit deal, as polls indicate Boris Johnson is under pressure from voters to avoid a no-deal departure.
- In addition to the Federal Reserve buying corporate bonds from today, President Trump is reportedly considering a new $1trn infrastructure spending package.



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