

Review of Q1 2020 and further thoughts

16 April 2020

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In our current extraordinary circumstances, it is hard to believe that the term “COVID-19” was unknown to us at the beginning of the quarter. Risk assets may have started the year in relatively buoyant form, but the shadow of the coronavirus soon made its presence felt.

As the virus spread from China and further into Asia and Europe, so risk assets tumbled and at break-neck speed. Equity indices posted eye-watering daily price moves during February and into March. In bond markets, credit spreads blew out, with the spread on high yield bonds exceeding +1000bps at the worst moments. Sovereign bond yields plumbed record lows but even here, elevated volatility and poor liquidity disrupted normal market function. Gold, too, was unable to avoid investors’ dash-for-cash, failing to deliver on its renowned defensive characteristics at the point of greatest need.

Events in the oil industry served to compound the challenges for the global economic order. The price of crude began the quarter at over \$60 per barrel and ended at close to \$20 after Russia and Saudi Arabia failed to agree on limiting production, opening the way for massive over-supply at a time of severely diminished demand. Stories of oil tankers trapped at sea, unable to unload their cargoes, painted a vivid picture of the deteriorating state of the world economy.

By the quarter end, global authorities had poured oil onto stormy waters with announcements of interest rate cuts, asset purchase arrangements and direct government support for households and businesses. These developments, hurried and chaotic as they were, lent support to risk assets. A short-covering scramble added impetus to a rally in equities that tempered at least some of the pain of the previous weeks.

Nevertheless, unless you were invested in sovereign bonds, the Q1 “scores-on-the-doors” did not make for happy reading:

- The main equity markets typically fell in the order of 20% or more (local currency terms). A weaker sterling mitigated some of the declines from unhedged overseas holdings.
- There were extreme divergences at the underlying sector level, with the share prices of businesses at the forefront of the coronavirus impact, notably in the energy, travel and leisure and auto sectors, falling by 30-40% in the face of revenue interruptions. At the other end of the scale, sectors such as internet and software, household and food products, pharmaceuticals and utilities avoided the worst of the falls.
- Mid and small-cap equities underperformed large caps. Style-wise, value underperformed growth.
- News that the Federal Reserve was to buy corporate debt helped credit markets to recover from their lows. Nonetheless, negative returns were seen from most sectors except the highest quality, with high yield suffering the most.
- Government bond yields fell, reaching record lows in early March. The broad gilt market chalked up a positive return of over 6%.

Review of Q1 2020 and further thoughts (continued)

Further thoughts

As we move into the second quarter, markets are displaying schizophrenic behaviour as they straddle the opposing forces of devastating cuts to corporate revenues and unprecedented stimulus measures. With reference to the latter point, the week before Easter was the strongest for the S&P 500 index since 1974 and junk bonds had their best day on record after the Federal Reserve launched another salvo by announcing that it would purchase “eligible” high yield bonds (notably “fallen angels”), as well as high yield ETFs. Indeed, since 23rd March, risk assets have recouped around third to half of the value lost in the COVID-19 slide.

Naturally, investors are asking whether it is time to re-commit to risk assets. The bullish case rests upon the stimulus argument. In the words of JP Morgan, “...unhindered by moral hazard, the response of fiscal and monetary authorities is, and will continue to be, unprecedented, with the goal of essentially making everyone ‘whole’...”. In short, don’t fight the Fed. This may well be true (again) but following the point through to its conclusion would lead us to question the relevance of capital markets at all (particularly so if the central bank resorts to buying equities). Today, as a fixed income manager, why not just buy what the central banks are buying?

Those of less optimistic persuasion point to the increasing disconnect between the financial reality of a looming recession and asset price behaviour. As one commentator put it, “Over a billion workers have been affected. Many will be forced to take on crippling debt to get through the crisis. This will prove to be the biggest, most devastating demand shock in history”. The economic multiplier is working in reverse and at lightning speed. Markets may be working through the first order effects of the crisis, but the second and third order effects are impossible to judge - and often overlooked - with no clear sight of the scale or duration of the disruption ahead. While Wall Street is mesmerised by financial bazookas, Main Street is battling for survival.

As for fund managers, with no earnings outlook, the priority is to assess each company’s resilience. How strong is the balance sheet? What is the cash burn? Can they access capital? Can they support their supply chain? Will they emerge stronger? Put another way, the opportunity set is often framed in the following way:

- Companies that have the means and flexibility to survive and eventually thrive.
- Companies that face challenges, but where share prices have over-reacted.
- Companies that are beneficiaries of the crisis, eg, digital services, gaming, delivery.

It is impossible to gauge the damage to final demand in the medium term. Companies that weather the storm will attain a stronger competitive position, but economic distress remains a tough backdrop against which to foster profit growth. We can only guess at the extent to which risk appetite and behaviours will be altered. Will companies cancel that non-essential capex project? Probably, yes. Will individuals be more inclined to re-build their personal balance sheets? Almost certainly.

Most smart investors agree that this is not a time for grandiose statements or claims about the future. Although more experienced practitioners may be able to recall previous bear markets, each has its own character and this more than any other. Unless you happen to be a clever (or lucky) short-term trader, now is the time to ensure your portfolio has resilience and to buckle up for the ride; the rough and tumble is not over yet.

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Finally, here is a brief thought on fund behaviours from here. As fund managers prioritise corporate survivorship over earnings outlook, the growth versus value story may not be the dominant driver of relative performance outcomes in the foreseeable future. A UK equity portfolio might equally hold Tesco (a beneficiary of the times) and WH Smith (has shored up its finances through a capital raise, giving it the opportunity to improve its competitive position as others fail). These are treacherous waters but there is opportunity for active managers with vision and courage who are prepared to take a strategic view of a company's worth.

For more of our recent thoughts that have been published as this crisis has unfolded, please visit the [Adviser Guidance](#) section of our website ("[COVID-19 crisis – economies, markets and policy responses](#)"; "[COVID-19 crisis – back to basics](#)" and "[The anatomy of a bear market](#)").

We wish you and your families all the best during this difficult time.