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Review of the Week

3 August 2020

Control the message

Corporate results fared well during lockdowns, yet they are still well below pre-pandemic levels. Chief investment officer Julian Chillingworth examines why gold has hit record highs and why 'riskier' banks have done better than vanilla ones.

After a pretty considerable run for markets, the past couple of weeks have delivered hard figures on how public companies fared during the pandemic lockdown.

As you would expect, the profits of many retailers, eateries, manufacturers and energy companies have taken a beating. Yet perhaps not as much of a beating as people first thought they would. The ability to pivot toward takeaway and home delivery has helped some, and the relaxation of lockdowns has even helped the oil price float higher as more tanks get filled up.

There have also been more than a few earnings results that would be cheered in normal times, let alone during a pandemic. These have come mostly from technology companies, investment banks and consumer brand conglomerates. Overall, with just over half of the S&P 500 having reported, 85% of the companies have beaten earnings forecasts. And not only beaten them, they've smashed them. Average profits were more than 20% higher than expected. It's all relative though, earnings are on track to be roughly 35% lower than the same time last year.

Banks' profits have been hit particularly hard all around the world because they have slashed the value of all the mortgages and loans they have extended to households and businesses. They expect the pandemic and the lockdowns to upend more borrowers than they had accounted for, so they have included an expense that reduces the profit they report for the quarter. There's a better than even chance that many of them have overcooked this estimate, particularly among the banks that are better capitalised, i.e. the banks that have more than enough equity to soak up future losses. It makes more sense for a CEO to dump all the bad news on the market now while the world is sympathetic, and while all their competitors are doing it, than have to do a second revaluation of their loans further down the line. To be clear, the banks may have undercooked their estimates of future loan defaults (let's hope not), yet if all goes to plan for our gang of CEOs, in a couple of years' time they can report better than expected profits. Management is mostly the art of managing expectations.

There is one interesting deviation from these crushing losses among lenders: investment banks. These villains of the last crisis have shown that their internal trading businesses - the brokers that help people buy and sell stocks and bonds - made a phenomenal amount of money because of the large spike in price volatility and trading volumes. Those with strong bond sales desks did particularly well. They were helped further by a wave of companies that needed to issue bonds to bolster their bank accounts ahead of the worldwide lockdowns. In many cases, the profits from these areas more than offset the losses from the lending side. While the trading desks of investment banks helped cook up the global financial crisis, this time around those same desks provided helpful ballast to profits - something 'less-risky' vanilla banks didn't have. It just goes to show that nothing is inherently bad, it depends on the context and how it's used.

Gold rush

Looking ahead to the rest of the year, analysts have been getting steadily more optimistic about third-quarter earnings. That may end up misplaced, given the surge in American coronavirus cases has forced some states and counties to ramp up restrictions and shutter shops and bars. It's too early to say.

But it hasn't been too early for many people to load up on gold. The yellow metal has soared over the past few months. During the height of the March market sell-off, the price had slumped from almost $1,700 to less than $1,500. It recovered quickly and since then it has set off at a steady march toward $2,000. It is now within touching distance and at all-time highs.

Gold is a lot like the currencies it used to underpin in that it is extremely difficult to determine whether it will go up or down in the coming months or years. It is notoriously hard to value as well: how much should a lump of metal that is never going to be used and offers no cash flow be worth? Gold has important industrial uses, but about 95% of it is made into jewellery or melted into bars and stacked in vaults for investors and central banks. Speculation and investment demand tend to drive a lot of moves. A store of value since time immemorial, many people see gold as the ultimate currency. It has also become more attractive as interest rates and bond yields hit the floor (and in many cases went through it). That's because you're no longer missing out on interest payments by having your money in gold rather than the bank. And the greater the discussion of negative-interest-rate policy, expect gold to become even more appealing to investors.

Like other dollar-priced commodities, such as crude oil and copper, the gold price tends to move in the opposite direction to the greenback. The way to understand this is to remember that the commodity is valuable for itself. Take oil for instance: people want to use it to power their cars and boats, or to turn it into plastic. That value isn't lessened or increased because the dollar has risen or fallen. So if the dollar is worth less, and the value of oil hasn't changed, the amount of devalued dollars needed to equal that value is higher. It works the same in reverse, too. So fewer stronger dollars would be needed to match the unchanged value of oil, pushing the dollar oil price down.

And so it goes with gold: the price of gold has been given a boost by a dramatic fall in the value of the dollar. The dollar, measured against the world's largest currencies, dropped about 4% in July, its worst month since September 2010. The dollar is now 10% lower than its peak in March. More people have been wanting to buy gold, sure, but the falling dollar has given the metal's price a massive tailwind as well.

As for sterling, well, it has rocketed. Last week it flew 6% against the dollar, making it the best-performing major currency. Its best month in a decade has now recovered from its coronavirus plunge, trading near $1.32. Much of these gains are because of the weakening dollar, but the pound has also been buoyed by better-than-anticipated economic data and greater confidence that an EU-UK trade deal will be agreed by October. Two-thirds of businesses were fully operational in July, up from just half in June, according to a survey by the Confederation of British Industry (CBI). This could flatter the nation, however, given increased restrictions in the north of England that have since been implemented. The CBI survey shows that businesses are struggling most with a lack of customer demand, which will no doubt give the Bank of England something to ponder when it meets on Thursday.

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