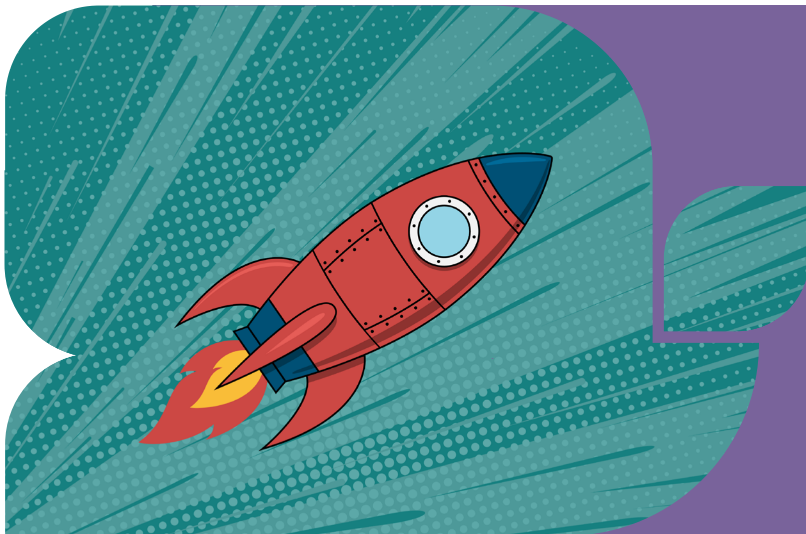

Rathbones
Look forward

Review of the Week

8 June 2020

Ka-boom

Stock markets are soaring higher as the developed world starts to relax lockdowns. Yet the virus is spreading rapidly in the emerging world, notes chief investment officer Julian Chillingworth, and there's still a chance of a second wave in the West.

Optimism for a quick global recovery ran hot during May, but last week markets went ballistic.

All major stock markets posted strong gains, yet European stocks went stratospheric with an almost 10% jump in euro terms. Money gushed into corporate bond markets too, as investors decided the risk of widespread defaults had receded. These high spirits were driven by better-than-expected economic data on both sides of the Atlantic, the announcement of greater stimulus by the EU and Germany, and a continued fall in the prevalence of COVID-19 in the West. The European Central Bank boosted and extended its quantitative easing programme (creating money to buy bonds in the open market). The stimulus was bolstered by €600 billion (£534bn) to €1.35 trillion and the purchases will now continue for at least a year. Germany announced €130bn of tax cuts and extra spending to bring the country out of its current funk with, in the words of the German Finance Minister, a "ka-boom".

Over in the US, the ISM survey of services companies (roughly 70% of American GDP) has rocketed back. And the headline nonfarm payrolls jobs report surprised economists, with the US adding 2.5 million jobs in May - a decrease of 7.5 million jobs had been forecast. When combined with resilient household income during the pandemic and the mass of savings building up on main street, the outlook for the US economy looks reasonable.

Yet the US unemployment rate remains north of 13%. Getting all those people back into work swiftly will be no mean feat, particularly when some industries could be shuttered or constrained for many months to come. The augmented unemployment benefits are due to cease in July and it seems unlikely that Congress will co-operate with the President's attempts to add yet more stimulus. Time is ticking for the US economy to right itself completely and get its people back to work safely.

Meanwhile, the risk of a second wave of the coronavirus in the US has not gone away - particularly as its infection rate isn't falling from its peak as quickly as in other developed nations.

Globally, the number of new COVID-19 cases had been running flat between 80,000 and 100,000 a day since April. Like everything with this pandemic, there's a tale of two worlds here. As the developed world has brought the virus to heel and started drastically reduced its spread, the pandemic has started to explode in emerging nations. In fact, over the past couple of weeks the number of new global cases has been creeping upward as the virus rushes ever faster through the populous regions of the Americas and the Indian subcontinent. COVID-19 is still spreading rapidly in our world, and that carries risks for everyone.

So are investors getting ahead of themselves? Market values suggest that a strong bounce in economic growth is locked in for the second half of the year. We're not so sure that this is a certainty. No vaccine is expected to be ready until halfway through next year at the earliest, so social distancing seems likely to be in force globally for a very long while. And any flare-ups in infections will precipitate a return to stricter lockdowns. So far, thankfully, the relaxation of rules in the US and Europe hasn't led to any spikes. Yet as we say regularly, this is a long, winding road and it won't be perfectly paved. At the moment, market values imply it's akin to the autobahn.

Squaring the curves

Here in the UK, the number of new COVID cases is running at 11,000 a week. While much reduced from the peak, the virus is very much still out there.

The Government is having to balance the risk of bankrupting swathes of the nation by keeping the lockdown too strict for too long with the risk of sparking a second wave of the virus that would lead to more deaths and, in turn, another lockdown that could shatter the nation's finances and economic wellbeing. This tug of war between the scientists and business leaders is no new phenomenon. Recently, however, it appears that Prime Minister Boris Johnson has been leaning more towards

his Chancellor and business leaders and started relaxing restrictions wherever he can. So we have the "Save the Summer" plan to potentially allow cafes, restaurants and bars to open up their outdoor spaces on 22 June. If done sensibly, this plan could help many businesses get by. However, there is still a chance that it's too early for such moves: In both Northwest and Southeast England, new cases figures have started increasing again in recent weeks.

Overall, however, the UK's COVID curve has been flattened. And, as with other developed economies, that flattening has led to a 'steepening' in a different curve. Government bond yield curves are the difference in yields offered for bonds of different maturities, from those that will be repaid in a month or three to those that still have 10 to 30 years to run. These curves can tell you a lot about how investors think the world will look in the future - and they have changed dramatically in the past month.

These government bond yield curves have 'steepened', meaning that the yields of bonds with maturities farther in the future have increased significantly compared with the yields for bonds that have shorter lives. As the infection rate in advanced economies has dropped, allowing lockdowns to be eased, investors have become more confident about the prospect of an economic revival. Barring a second spike in infections, this recovery in economic activity could bring with it greater inflationary pressure and better returns for riskier investments like corporate bonds and company shares.

While the potential for short-term inflation is higher than it has been for some time, there are still many forces in the world - ageing demographics, greater use of technology and increased debt - that tend to reduce inflation. The jury is still out on whether inflation or deflation will prevail, and for how long.

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