LGT vestra

Weekly COVID-19 update

24th April 2020

CIO commentary

It can sound insensitive to talk of death in numbers however, inevitably, statistics are relied on to ascertain the spread of COVID-19. Daily statistics are just numbers and fail to reflect the personal tragedy that surrounds each death. As the infection data is dependent on the numbers tested, we look to the death rate as a more reliable indicator of the spread of the virus. This suggests that the social distancing measures are proving effective, with some countries beginning to gradually ease the restrictions.

In the UK, the lockdown restrictions have been renewed for another three weeks but pressure is building for some to be lifted. Investment markets continue to be a balancing act between the economic damage and the measures to support the economy. This week, slowing demand caused dramatic moves in the oil market.

Medical update

Progress on treatment and vaccines has seen mixed news. It was reported that an Oxford based lab has developed a vaccine, which they are starting to test. If effective, it seems unlikely that it will be available until next year at the earliest.

As it stands, new treatments seem to be a more efficient solution. President Trump has championed Chloroquine as a treatment, however the jury remains out on this as the World Health Organisation advises that there is no definitive evidence to support its effectiveness. Remdesivir, a new drug developed as a treatment for Ebola, has also been undergoing tests. A report from China appears to indicate that this drug had little effect, however the reliability of this report has been brought into question due to incomplete testing.

Therefore, we will continue to rely on social distancing to control the spread of the disease for now. Testing and tracking appears to be the best hope for a faster release of the lockdown restrictions, but it looks as if some constraints could continue into 2021.

Economic update

The latest earnings season has seen a partial reflection of the shutdown of the economy. Many companies have cancelled dividends and share buy-back programmes, as well as cancelling forward guidance on earnings. Property funds have suspended trading, the reason for this is not because they do not have cash to pay redemptions, it is as a result of being unable to value their portfolio. Economic data has been understandably dire; the Eurozone Composite Purchasing Managers Index has fallen from 51.6 in February to just 13.5 two months later. Estimates of the damage to Gross Domestic Product vary enormously. We are in a recession with many economies shut down around the world; the depth of the recession is less for markets than what shape economies will be in when they get back to normal. Government and central bank action has been targeted with seeing businesses through the crisis so that economies can flourish long term.

Monetary and fiscal update

The US senate and Congress have passed a further $484 billion aid package that will be signed by the President today, and work on the next package is already underway. While political division delayed fiscal action initially, the take up has been rapid and the fund flows continue. In the UK, action was faster and the take up of the employment support has been good, however the loan schemes have been much less successful with only an 80% guarantee. Banks have been slow to gather credit information and have sought security against the loans. To address this, the Government is acting to ease these restrictions.

The European heads of government met yesterday and appeared to agree a package of economic support, but the details have yet to be finalised. The debate appears to be over whether to make payments as loans or as grants. It is also unclear at this stage how this will be funded. Meanwhile, many countries are increasing debt issuance and the European Central Bank may increase its bond buying. While the economic damage globally is huge, the measures to support the economies are equally so.

Market update

After a positive move last week, markets appeared to take stock of the weak economic and corporate news this week. The biggest headline came from the oil market, with West Texas Intermediate oil price going negative. The oil price is weighed down by excess supply over demand.

The fall in oil price has caused a flood of interest in trackers on the oil price from retail investors. We caution most strongly against being tempted to follow this. The quoted oil price that moved negative was a futures contract for delivery in May. As this drew towards the final day of trading on the 21st April, it was clear that storage for delivery was close to full. The rate for hiring a super tanker for storage is said to have gone up tenfold since February. Trackers on the oil price usually follow the shortest month and were selling the May contract to buy June. With no storage availability, no one wanted to take delivery and the May contract price collapsed. This dragged down the contracts for later delivery, but they remained at much higher prices than the May contract. Some Exchange Traded Funds that offered leveraged exposure to the oil price have been forced to close. The United States Oil Fund (USO), the biggest oil-tracking fund, has changed its methodology to hold some futures with longer maturities. With longer dated futures already pricing in a higher oil price, funds like this are unlikely to match a rising oil price.

This stresses the need to understand what you are buying and the dangers of derivative based trackers in particular. Those looking to take advantage of a higher oil price, please note that we do not recommend this trade yet and believe that investors may be better served by taking exposure to equities in the oil sector.

Summary

Equity markets continue to be a balancing act between declining economic activity and actions taken to support businesses long term. In the short term, statistics will continue to be poor and remain uncertain. The dispersion within sectors will remain high and markets volatile. On the positive side, the strict social distancing measures appear to be working and a gradual release of restriction seems likely. Albeit not as fast as President Trump would like.

For now, for those looking to add risk, we suggest adding selective exposure to corporate bonds. Central banks are buying corporate bonds and moves to cut share buy-backs and dividends are being made to support balance sheets. In the longer term, we are likely to see interest rates remain low for a prolonged period of time, which will support equity markets as earnings recover when we emerge from the COVID-19 restrictions.