Investment Commentary

April 2020

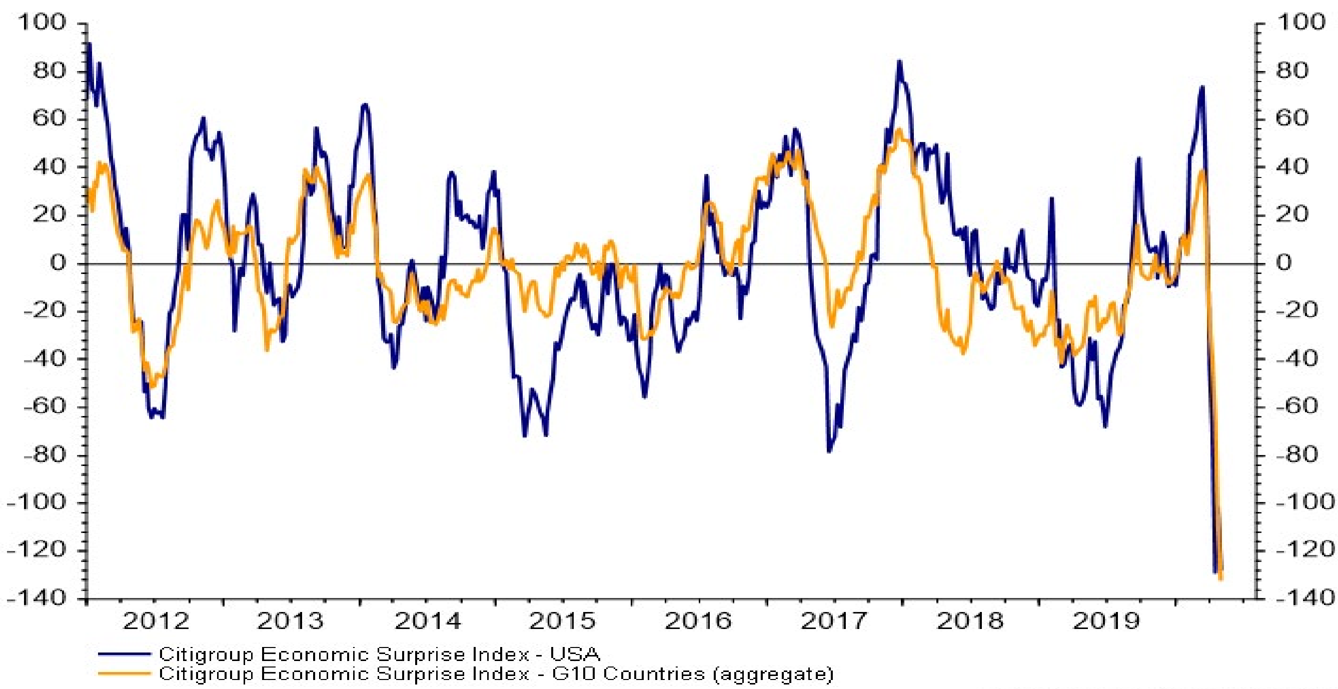
Recent economic developments

■ The hit to economic activity from the ongoing response to the covid-19 outbreak has become more apparent in economic reports over the past month. It has resulted in a raft of data showing unprecedented rates of decline across a broad range of measures of economic activity including consumer spending, factory production and housing starts. This is illustrated by the Citigroup Economic Surprise Index which tracks the deviation of economic data from market consensus forecasts (Chart 1). In the chart, positive [negative] readings of the index indicate that economic reports have on balance been stronger [weaker] than consensus forecasts.

■ Perhaps the most staggering impact has been seen in labour markets across the developed economies. For instance, within a few weeks of the lock-down taking effect in the US, the economy had shed more jobs than were created over the entire period since the end of the global financial crisis. Indeed, private businesses in the US laid off over 20 million workers in April alone. That marked the biggest decline in employment on record.

■ In response to sharp contractions in their domestic economies, most governments and central banks have announced measures to mitigate the fallout from the spikes in the numbers of the unemployed and support the functioning of financial markets. In the US, Congress has passed a bill to spend US$2 trillion to help businesses and workers. Also, the US Federal Reserve (Fed) has cut interest rates to zero and initiated another round of quantitative easing. In the UK, the government has unveiled a £350 billion package of financial measures and the Bank of England has cut interest rates to the lowest level on record. Stimulus measures are also being implemented in Japan, the Eurozone and elsewhere across the developed markets while China is leading a similarly robust response across the major developing economies.

Chart 1: Economic reports have undershot even downwardly revised forecasts across the G10 economies



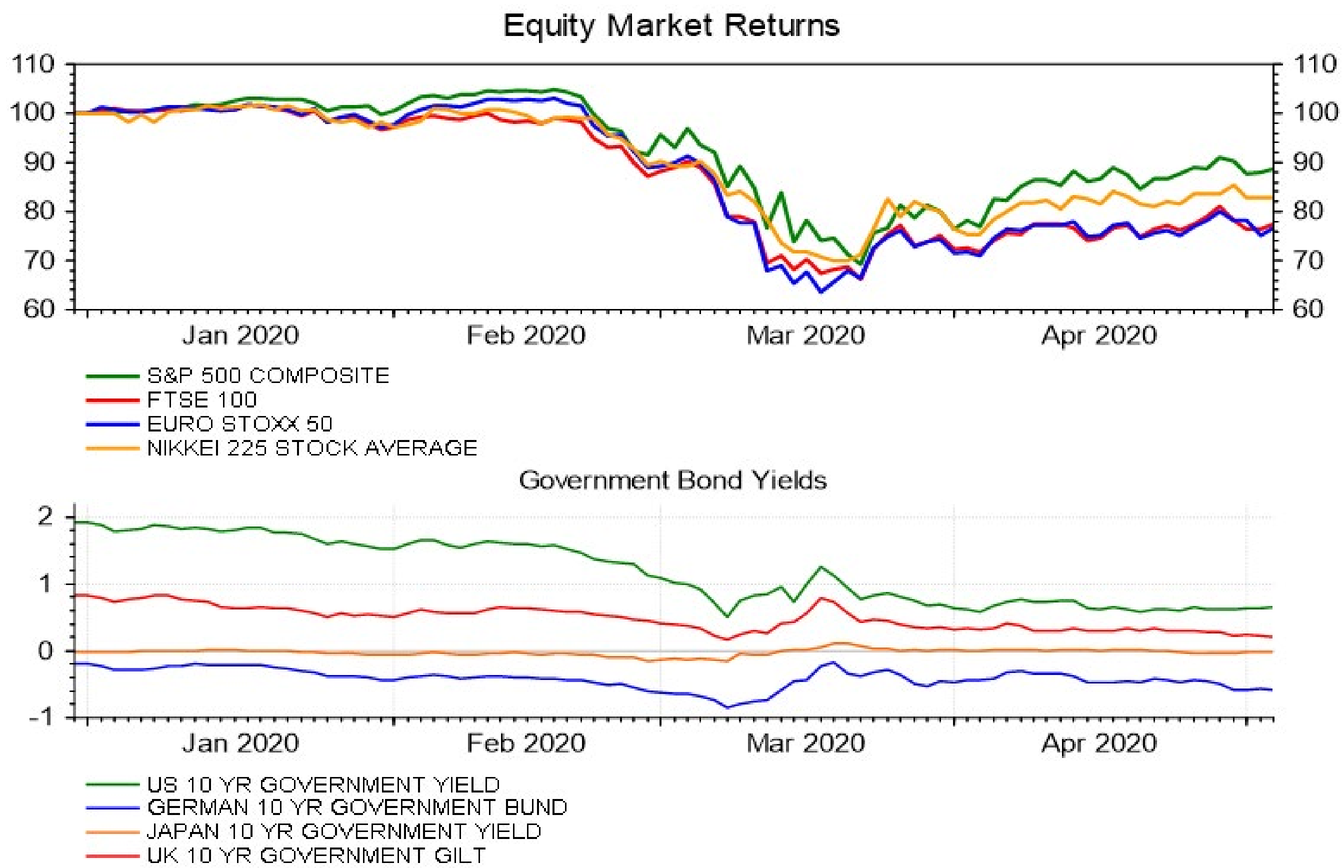
Source: Refinitiv Datastream

Financial markets & investment strategy

■ A sharp decline in the prices of risk assets in March was followed by a powerful rally in April. Over the course of the month, the rally which began in late March gathered strength and culminated in double-digit gains for the S&P 500 index and several other stock market indices. The gain in equity prices were fuelled by massive liquidity injection from various central banks, led by the Fed. Likewise, the Fed's decision to add both investment grade corporate bonds and 'junk' bonds to the list of assets that it can purchase boosted investors' appetite for those assets (perhaps in an attempt to front run the Fed's actual purchases) and triggered sharp rallies in corporate bond prices between late March and mid-April.

■ It is easy to read too much into the ongoing rally in risk assets. For instance, it is arguable that being discounting mechanisms, equity markets are simply looking beyond what many expect to be a short-lived hit to economic growth and corporate earnings. However, if it were that straight forward, then arguably the message would be consistent across all assets classes. But persistently low government bond yields appear to be telling a different story to the optimism that is being reflected in equity markets. On balance of evidence, the most compelling explanation is that broad equity markets are simply being buoyed by a torrent of

Chart 2: Stock markets delivered strong gains in April while safe-haven government bond yields stabilised



Source: Refinitiv Datastream

liquidity rather than any rational process of price discovery.

- The resulting rally has left various valuations metrics looking more stretched than before the outbreak began. The ongoing global recession is widely expected to be deeper than any experienced in the post-war period and, at this point, because the eventual duration of the outbreak remains unknown, it also remains unclear exactly how severe and prolonged the recession will be. Consequently equities remain vulnerable to bouts of volatility spikes.

- In terms of investment strategy, the balance of risks means that it remains sensible to be cautious in asset allocation decisions. Consequently, we continue to position client portfolios close to benchmark levels across the major asset classes while taking opportunities for tactical trading as prices move within established trading ranges.

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