Cave's Quarterly

Cave&Sons

Stockbroking & Investments Since 1906

Edition 17, Q1 2020 Round Up

Corona Crash

We are living in extraordinary times. It has long been said that 'when America sneezes, the world catches a cold.' As we moved into the new decade after a long bull run and an extended period of low volatility, the city of Wuhan coughed, and the world caught a new coronavirus.

It took some time for global stockmarkets to react to the Covid-19 outbreak. In fact, through January and in the early weeks of February, equity markets shrugged off virus concerns and appeared remarkably sanguine as Chinese authorities implemented drastic actions to contain the spread across their mainland. Fast forward a few weeks to the end of March, and the US tops the list for the highest number of confirmed cases globally and Southern Europe has become the new epicentre of the pandemic, with the number of fatalities recorded by Italy and Spain now surpassing that of China.

Sadly, the human impact continues to rise, and the virus has now claimed the lives of tens of thousands of people. From an investment point of view, the fear of the unknown has taken a considerable toll on both financial markets and investor confidence. As governments around the world implement stringent quarantine rules and 'lockdown' strategies, the reality of a severe slowdown in global economic activity has triggered an indiscriminate and rapid sell-off across asset classes, and we are seeing elevated levels of volatility not witnessed since the global financial crisis.

In contrast to 2008, governments and central banks have acted decisively to shore up the global economy through unparalleled monetary and fiscal stimulus programmes. The biggest move so far has come from the US where Donald Trump's government signed off a $2 trillion stimulus package which included direct cheque payments to households, bailouts for distressed industries, loans and grants for small business, tax credits and increases to unemployment benefits. Closer to home, the new chancellor of the Exchequer, Rishi Sunak, said he'd do "whatever it takes" to prop up businesses and jobs before delivering a series of aid packages throughout March worth over £65 billion.

Equities

With much of the population adjusting to a new daily regime of remote working, home schooling and hunting the supermarket shelves in search of the last packet of linguine, the value of our UK stockmarket moved sharply lower; London's blue-chip FTSE100 index and the more consumer exposed FTSE250 suffered a peak drawdown* of 36% and 44% respectively in the first quarter of the year. The outlook for our largest market sectors, oil and banks, has turned negative with oil majors suffering from historically low prices and banks grappling with the effects of a marked decline in business activity, an even lower interest rate environment, and the suspension of mortgage and loan payments from huge swathes of customers.

Whilst the sell-off in equities has been widespread, companies operating in the retail, hospitality, travel and leisure sectors of the global economy have been hit hardest, with the long-term prospects for many businesses called into question following a complete shutdown in day-to-day operations. The financial impact of lockdown restrictions has started to feed through to macroeconomic data, with PMI (Purchasing Managers Index) readings across the Eurozone confirming stark declines in manufacturing and service activity. Elsewhere, the US labour department revealed 3 million Americans filed for unemployment benefits in the week ending 21st March – by far the largest single-week rise and a reflection of the extreme cost-cutting measures already being taken by companies across the Atlantic.

Global stocks registered their worst quarter since the 2008 financial crisis; US markets suffered their quickest fall into a bear market on record, as the S&P500 index plummeted 35% from all-time highs set just 16 days earlier. Now at the centre of the crisis, European shares, as measured by the Euro Stoxx 50 index, logged a peak drawdown of 38%. In Asia Pacific markets, the Nikkei (Japan) and Hang Seng (Hong Kong) indexes fared only marginally better, with drawdowns of 31% and 25% respectively.

* - Drawdown is defined as the peak-to-trough decline of an investment during a specific period.

Commercial Property

Commercial property was not immune to the wider market panic as concerns over asset valuations and dividend cuts were brought to the fore. Several asset managers running open-ended vehicles were forced to suspend trading, citing ‘material uncertainty’ over underlying asset prices amidst the virus lockdown.

With tenants of all types asking landlords for help and rent-free periods, investors were forced to reassess the likelihood of temporary dividend suspensions as well as some longer-term cuts. Another key issue for investors was the level of debt that some REITs* hold, with any dramatic fall in portfolio values having the potential to breach Loan-to-Value covenants with lenders. Listed REITs have seen significant price falls in recent weeks, with average share price ratings relative to NAV (Net Asset Value) for the commercial property sector moving from a 0.6% premium at the start of 2020 to a 24% discount by the end of March.

*REIT – Real Estate Investment Trust

Alternatives

The rapid spread of Covid-19 reset expectations for global growth and led to the sharpest contraction in oil demand since the 2008 global financial crisis. With virus containment measures also disrupting supply, the price of Brent crude p/b (per barrel) softened from $71 in late January to almost $50 by early March. At an OPEC+ (Organisation of the Petroleum Exporting Countries) meeting on 6th March, the stage was set for the major oil producers to make further commitments to hold back on supply. Instead, Russia sparked a global price war after refusing proposals put forward by Saudi Arabia, and both sides now appear intent on producing as much as possible to deliberately undermine market supply. This perfect storm of oversupply and falling demand has left oil markets reeling, with the price of Brent crude p/b having traded as low as $22.32.

Gold has long been regarded as a market hedge and a safe-haven asset that finds support as sentiment towards riskier investments turns sour. In this context, the price of the precious metal has been behaving strangely of late, having traded as high as $1702 and as low as $1451 in March alone. In line with government bonds, the spike in volatility for the asset has been attributed to investors selling “anything with a bid” in a desperate attempt to generate cash.

The renewable energy sector de-rated aggressively through March, with many funds moving to sizeable discounts relative to historic NAV. Whilst the sector has some sensitivity to the economic backdrop through power prices, cashflows and dividends should remain reasonably strong through a downturn, especially when compared with other areas of the market. Some shares appear over-sold as a result and when conditions normalise, defensive assets with contracted revenues such as wind and solar farms could rebound strongly.

Fixed Interest

In times of extreme market stress, it is not uncommon for fixed income assets to perform well as panicked investors ditch equities in favour of perceived safe-haven assets like government bonds. In the recent turmoil however, equities and bonds (including those issued by governments) have been subject to wild price swings and there have been few places for investors to hide. This was not a conventional ‘risk-off’ reaction from the market and anecdotal evidence would suggest these chaotic flows were, initially, as a result of forced selling from investors who had to sell their most liquid assets in a dash for cash and, subsequently, expectations of further stimulus packages from central banks.

Fears of widespread bankruptcies in the event of a global recession have made investors particularly nervous of holding corporate debt. Credit spreads have blown out (prices have fallen) as a result and lower quality ‘investment grade’ issuers have underperformed their higher rated counterparts, indicating a flight to quality has taken place as the risk of defaults and ‘fallen angels’** has increased.

After a few days of eye-watering volatility, global government bonds stabilised into the final week of March and yields moved lower (prices rose) to reflect the risk-off sentiment amongst investors. At the end of the first quarter, the yield on the UK 10-Year Gilt and the US 10-Year Treasury Note stood at 0.35% and 0.69% correspondingly.

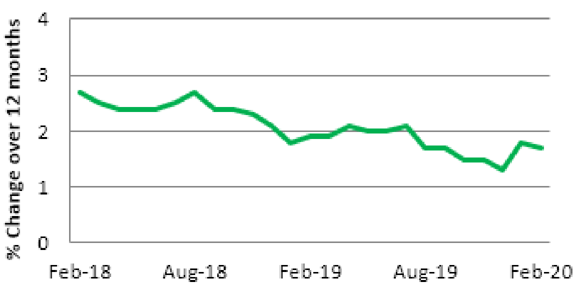
** - A fallen angel is a bond that was rated investment-grade but has since been downgraded to junk status due to the declining financial position of its issuer.

Outlook

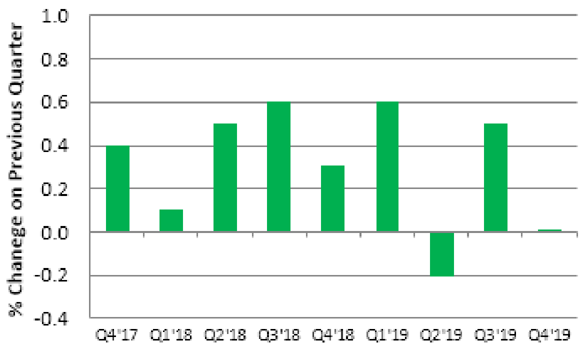
It is too early to assess the ultimate impact of Covid-19 on economic activity or corporate earnings. This will remain the case until such time as the virus has been confidently contained and risk assets are likely to remain volatile in the coming weeks and months. In line with previous shocks, we are mindful that there could be a very sharp recovery at some point and financial markets tend to move well ahead of improving fundamentals. We remain invested for the long term and will continue to construct our portfolios with high levels of diversification, recognising the importance of mitigating capital volatility in times of stress as well as seeking gains when conditions start to improve.

A year in numbers

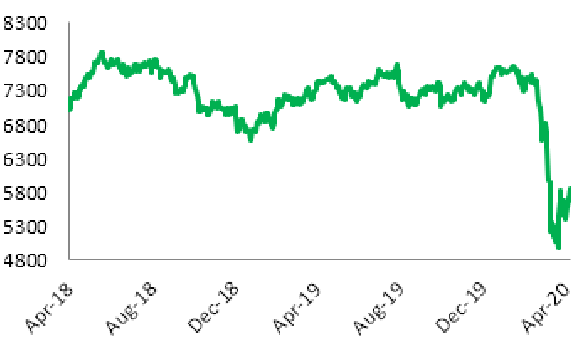
UK Consumer Prices Index (CPI)



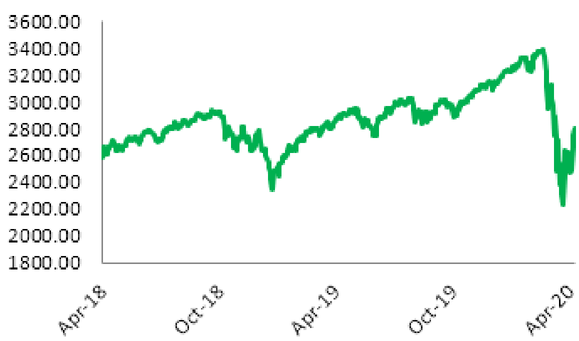
UK Gross Domestic Product



FTSE 100 Index



S&P 500 Index



Cave&Sons

Stockbroking & Investments Since 1906

Head Office Lockgates House, Rushmills, Northampton NN4 7YB
Tel: 01604 621 421 **Fax:** 01604 234 335
Email: info@caves.co.uk **Website:** www.caves.co.uk