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Quarterly Markets Review Q1 2020

A look back at markets in Q1 2020 when the spread of coronavirus across the world saw stock markets fall sharply.



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- The spread of Covid-19 profoundly affected global markets in the first quarter. Equities suffered steep declines and government bond yields fell (prices rose) as investors favoured their perceived safety.
- Shares fell across developed markets as coronavirus spread and countries went into lockdown to try to contain the outbreak. Governments and central banks announced measures to support businesses and households and reduce borrowing costs.
- Emerging market (EM) equities also tumbled, slightly underperforming developed markets as a strong US dollar proved to be an additional headwind.
- Government bonds saw yields fall (meaning prices rose) as investors sought out assets perceived to be lower risk. Corporate bonds underperformed government bonds.

- In commodities, oil prices plunged as the spread of coronavirus weakened the outlook for demand, at the same time as there was a breakdown of an agreement between oil producers to constrain supply.

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US

US equities declined significantly over the quarter as the coronavirus outbreak spread. Confirmed US cases of Covid-19 rose from 150 to over 100,000 between 4 March and 27 March, and the economic impact grew clearer. Jobless claims rocketed by over three million in the last week of March and economic indicators suggest more pain will follow.

The Federal Reserve (Fed) cut interest rates twice in March for the first time since the global financial crisis and announced unlimited quantitative easing (buying bonds). US interest rates now stand at 0-0.25%. The US Senate also passed a \$2 trillion stimulus package. The proposed package includes \$250 billion worth of direct payments to households, \$500 billion for loans to distressed companies and \$350 billion for small business loans.

All sectors saw significant declines. Energy stocks were hit hard, with the addition of the oil price war weighing heavily. Financials and industrials also fell sharply. The information technology and healthcare sectors held up better, albeit with what would be considered steep falls in any other quarter.

Eurozone

Eurozone equities experienced a sharp fall in Q1 due to the spread of coronavirus. Italy and Spain became some of the most severely affected countries. Nations across Europe took steps to restrict the movement of people and shut down parts of the economy in an effort to slow the spread of the virus. Growth in Europe was already fragile - the eurozone economy grew by just 0.1% in Q4 2019, with Germany registering zero growth. A sharp economic downturn is expected.

Forward-looking indicators showed how economic activity has collapsed. The flash Markit composite purchasing managers' index (PMI) for March fell to a record low of 31.4, compared to 51.6 in February. The PMI survey covers companies in both the services and manufacturing sectors, and an index reading below 50 indicates economic contraction.

All sectors fell over the quarter. Defensive areas of the market such as healthcare and utilities held up best. Financials and industrials were among the worst hit sectors. Regulators have pushed for banks across Europe to suspend dividends and share buybacks until at least the autumn. This would help

increase their capacity to manage rising non-performing loans as borrowers struggle to make repayments.

The European Central Bank announced the Pandemic Emergency Purchase Programme (PEPP) – a €750 billion scheme. The PEPP will fund the purchase of government and corporate bonds until the end of the Covid-19 crisis. Governments across Europe also announced spending packages to help businesses and households bridge the gap between the loss of income during this period of disruption and the expenditures required to survive.

UK

UK equities tumbled as efforts to deal with the coronavirus pandemic hit economic activity indiscriminately and simultaneously. Prior to these events, domestic politics and Brexit had dominated the narrative around UK assets and the economy for much of the quarter. At the height of the market sell-off, all assets (including government bonds) fell amid fears around the stability of the financial system.

Against this backdrop, sterling hit multi-decade lows versus the US dollar as investors sought safety in cash, particularly US dollars. In line with other central banks, the Bank of England materially reduced interest rates, cutting by 65 basis points to 0.10%. This response was co-ordinated with the UK government, which unveiled an unprecedented series of fiscal support measures, in line with initiatives by many other developed nations.

Oil and gas was the worst performing industry groups over the period, selling off on concerns about falling demand in the wake of the virus, as well as the failure of negotiations between OPEC (the Organisation of the Petroleum-Exporting Countries) and Russia to control the global supply of oil. The consumer services sector also performed very poorly as investors sought to calibrate the effect of a sharp fall in consumer demand as the UK and other governments introduced lockdown measures.

Japan

After a relatively stable start to the year, the Japanese market fell steeply in late February and early March before recovering some ground to end the quarter with a total return of -17.5%. Even allowing for the exceptional environment, the yen was extraordinarily volatile through this period but, if anything, has probably remained slightly weaker than one might otherwise expect.

Market dynamics were fairly chaotic, especially during the mid-March rebound, with some days marked by a strong recovery of those stocks and sectors seen as most heavily oversold, while other days seem to represent a more genuine willingness by investors to take on risk in larger cap cyclical sectors. Smaller companies have been significantly weaker than the main indices across the quarter, despite some relative recovery in the second half of March. Style influences were also prevalent, as value stocks

underperformed across the quarter, with particular weakness in the first half of March. Value stocks are those that tend to trade at a lower price relative to their fundamentals, such as dividends, earnings and sales.

The initial estimate of Q4 GDP growth released on 17 February was much weaker than consensus expectations. Even allowing for the consumption tax increase and the major typhoon, which hit Japan in October, this was a poor data point.

In terms of the actual virus spread, Japan has so far been on a very different trajectory to most other developed nations with a slower spread and lower mortality rate. This has resulted in a slightly less stringent response from the authorities so far. From late March, however, there have been more forceful requests from both central and local governments to curtail social activities and it is possible that more severe restrictions on movements will be imposed on Tokyo in the near future.

The highest profile impact for Japan has been the postponement of the Tokyo Olympics for one year to July 2021. Although this is not particularly significant in economic terms, with maybe 0.2% of GDP shifted from this year to next, there could be political implications as the Games are now planned just before the end of Mr Abe's term as Prime Minister in October 2021.

Asia (ex Japan)

Asia ex Japan equities declined sharply in the first quarter, as Covid-19 became a pandemic and the prospect of a global recession loomed. US dollar strength was a drag on returns. The MSCI Asia ex Japan Index decreased in value but outperformed the MSCI World Index.

ASEAN (Association of Southeast Asian Nations) markets were notably weak and all underperformed the MSCI Asia ex Japan Index. India also finished behind the index as the number of Covid-19 cases began to increase, and the government announced a national lockdown for at least three weeks. South Korea also lagged behind. Although the country's response to the crisis appeared to be progressing, the weaker outlook for global trade and growth weighed on the market.

China and Hong Kong were the only markets to outperform the index. China, seen as ahead of the curve as it was the first country to record cases of Covid-19, took measures to lock down the city of Wuhan. Its measures to contain the spread were deemed a success as the number of active cases of Covid-19 in mainland China appeared to peak in February, and subsequently fell sharply. Meanwhile, the spread of the virus appeared to be relatively contained in Hong Kong.

Emerging markets

Emerging market (EM) equities fell heavily in Q1, negatively impacted by the Covid-19 pandemic. The spread of the virus beyond China led to lockdowns globally and resulted in sharp falls in economic

activity. A global recession is now expected this year. Against this backdrop, a stronger US dollar was a further headwind for EM. The MSCI Emerging Markets Index decreased in value and underperformed the MSCI World Index.

Brazil was the weakest market in the index, with currency weakness amplifying negative returns. The central bank cut its headline interest rate by a total of 75bps to 3.75%. It announced measures including reserve requirement reductions for banks and agreed a foreign exchange swap line with the Fed. The government also took fiscal measures to help households and businesses. Colombia was another underperformer as it was additionally impacted by the fall in crude oil prices following the failure of talks to limit oil production. Greece, South Africa and Pakistan all underperformed.

By contrast, China recorded a negative return but outperformed the MSCI Emerging Markets Index as the number of Covid-19 cases declined, and economic activity began to resume. The initial response to the virus outbreak led the authorities to effectively quarantine the city of Wuhan, and the wider province of Hubei. These measures only began to be eased at the end of the quarter. A mixture of interest rate cuts and fiscal (tax and spending) measures were also announced during the quarter.

Global bonds

Government bond yields declined over the quarter, meaning bond prices rose, as higher risk assets such as shares saw heavy declines amid rising fears over the Covid-19 pandemic. Investors favoured the perceived safety of government bonds due to the growing likelihood of a deep global recession. The moves largely occurred in late-February and March as numerous countries went into lockdown in response to the pandemic, seriously depressing economic activity. This resulted in severe declines and extreme daily swings in assets prices on a scale comparable to the crises of 2008 and 2011.

Markets saw extreme declines and volatility in March. US stock market trading was temporarily suspended on a number of occasions due to the size of daily moves and, for several days, companies were unable to issue bonds. Government bond yields and prices were volatile, first reaching extreme lows on heightened fear, but then rising, as panicked investors sold liquid assets indiscriminately in order to raise cash.

As the crisis unfolded, governments and central banks announced unprecedented support programmes for businesses, households and the financial system, helping to stabilise markets later in the month.

The US 10-year yield dropped from 1.92% to 0.63% over the quarter, while the two-year yield dropped from 1.57% to 0.23%. The German 10-year yield fell from -0.19% to -0.49%, France's from 0.12% to 0%. The Italian 10-year yield rose from 1.41% to 1.57%. Spain's increased from 0.47% to 0.71%. The UK 10-year yield fell from 0.82% to 0.32%.

Corporate bonds, and emerging market debt and currencies declined significantly, mainly in March, and underperformed government bonds, with moves exacerbated by a sharp tightening in liquidity. For several days, companies were unable to issue bonds although this improved later in the month. US investment grade bonds ultimately saw a record month of issuance in March, as the Federal Reserve announced it would buy corporate bonds. Investment grade bonds are the highest quality bonds, as determined by a credit ratings agency, while high yield bonds are more speculative, with a credit rating below investment grade.

High yield credit was hit hard given the heightened risk aversion. The sell-off was sharper in more vulnerable sectors related to travel and retailing, as well as in energy as the oil price plummeted.

In emerging markets, local currency bonds saw the heaviest falls. Currencies more sensitive to growth and oil prices, and also those with more liquidity, saw double-digit declines, in some cases of around 20%.

The overall MSCI World Index lost -21.1% in Q1. Convertible bonds, as measured by the Thomson Reuters Global Focus Index, effectively protected investors from losses and finished the quarter with a loss of -8.6% in US dollar terms. In any equity market sell-off (and especially in a vicious sell-off with the speed and extent witnessed in March) the valuation of convertibles comes under pressure. Convertibles have become cheaper in all regions but the traditionally rather efficient US market has seen a sharp 4% drop in valuations.

Commodities

The S&P GSCI Spot Index experienced a major fall over the quarter. US dollar strength weighed negatively, so too the energy component. Crude oil prices fell heavily as talks between OPEC and other oil producers including Russia failed to agree on extensions to production cuts. This impact was exacerbated by a weaker demand outlook for oil stemming from the impact of Covid-19.

Industrial metals also fell, led by copper, as the demand outlook deteriorated. The agriculture component posted a negative return with cotton and sugar prices falling heavily. Conversely, precious metals generated a small gain, aided by an increase in gold prices.

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