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MARKET UPDATE: WHY HAVE STOCKMARKETS RISEN WHEN THE NEWS SEEMS SO DIRE?

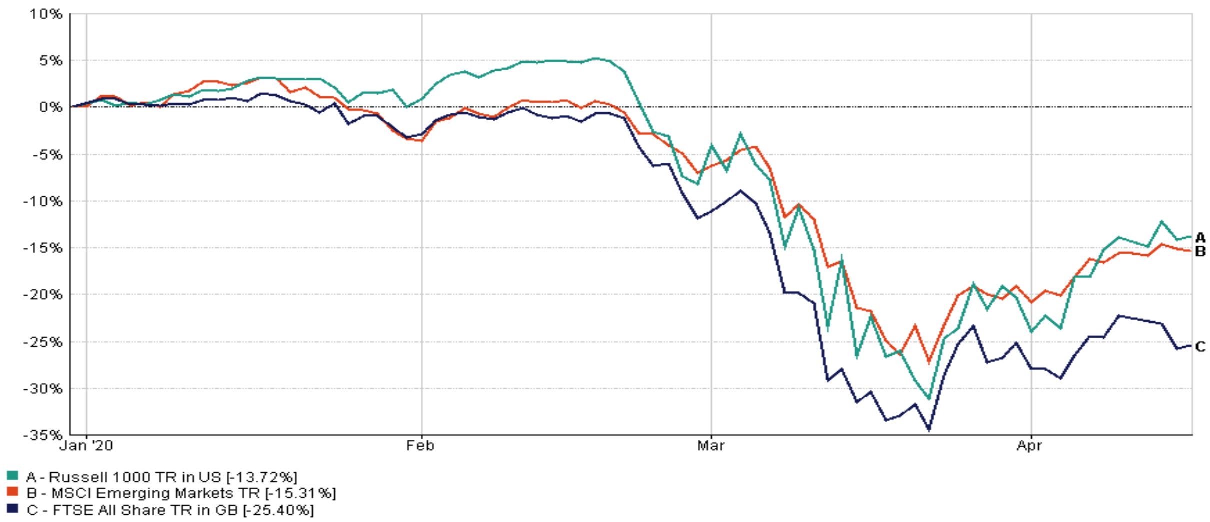
17th April 2020

As confirmed by the UK government's decision to extend the lockdown for a further three weeks, the coronavirus crisis is far from over. The virus continues to claim lives all around the globe, and measures designed to limit its spread continue to exert a powerful downward force on economic activity. Nonetheless, global stock markets are significantly higher than they were just three weeks ago. Investors may be justified in asking whether this makes sense, and whether markets can possibly hold onto their recent gains.

Though some have dissented, the majority of governments around the world have decided to prioritise containment of the virus above all other considerations. Closing non-essential workplaces and forcing citizens to stay at home has had a clear and significant impact on economic activity. In the US, some 22m people have filed for unemployment benefits in the past four weeks while the Chinese economy contracted 6.8% in the first three months of the year, the first decline in more than 40 years. As signalled by the International Monetary Fund (IMF), many economies – including the US, Europe and the UK – may well suffer even sharper declines in economic activity.

Investors may be surprised to see that, against this bleak background, equity markets have nonetheless been making gains in recent weeks. The US stock market is some 25% higher in just three weeks, while the UK is up 14% and emerging markets have gained 16%. However, context is everything: as material as these gains have been, they have only partially reversed the losses accumulated earlier in March (see Figure 1 below).

Figure 1: Stock market returns, year-to-date



Source: Financial Express Analytics, 31st December 2019 to 16th April 2020, total returns in local currencies.

Still, the question remains: why have stock markets have risen in the face of dire economic news? The answer lies in the forward-looking nature of financial markets. Equities (stocks and shares) entitle the owner to a share of the company's profits. To assess the value of this share, investors look not just at this year's profits, but at the company's potential profits over a number of years to come. Signs that the crisis will prove temporary – for example, a return to more normal levels of economic activity in China and initial efforts to soften lockdown measures in parts of Europe – have reduced fears over the longer-term outlook for company profits, and stock markets have risen as a result.

In the Omnis Investment Team, we believe the outlook from here will be largely shaped by developments in four key areas. Firstly, as argued by Ben Bernanke, former Chair of the US Federal Reserve, in a recent update call in which we participated (presented by PIMCO, the California-based fixed income specialists) the crisis will only truly end with the development of an effective vaccine. This may take 18 months or more. In the meantime, we are watching closely to see whether the extraordinary support from the world's governments and central banks is effective in preventing the lockdown inflicting permanent damage on the global economy. Third, the likelihood of success is closely tied to the duration over which these measures are required. We are therefore giving a great deal of thought to how and when various sectors of the economy will be brought back to work. Finally, we are also paying close attention to how markets absorb the huge amounts of debt that have been created by the policy response.

Recent weeks have seen some positive developments on all four counts. While an effective vaccine likely remains some way off, unprecedented international research efforts are being directed towards tracing, curing and preventing infection. Most importantly, new infection rates in Europe and the US have begun to slow, in line with the pattern established in Asia. On the economic front, many governments have responded quickly to initial glitches, and financial aid is now starting to reach the places it is needed. Meanwhile, economic activity in China is slowly resuming. As countries such as Austria and Denmark pioneer the relaxation of lockdown measures in Europe, bit by bit, the global economy can gradually click back into gear. Finally, central banks have made it clear that they will go to any lengths necessary to support the record levels of debt that have necessarily been issued to combat the crisis.

The rise and fall of stock markets is, to some extent, a dance between ever-changing expectations and current stock prices. Markets have risen as some of the most pessimistic scenarios have become less likely. However, markets would surely fall once more if recent optimism proves misplaced. Given the uncertainties presented by the pandemic, it would appear sensible to brace for further bouts of turbulence as the outlook evolves over the coming weeks and months. For now, however, signs that human and economic costs of the virus are being managed are clearly welcome.

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