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OMNIS MARKET UPDATE: BEYOND COVID-19

29th May 2020

Understandably, individuals, companies, governments and investors have, for several weeks, been focused almost entirely on the Covid-19 pandemic and its implications. Having seen the introduction of unprecedented social restrictions in an attempt to contain the virus' spread, large parts of the world have recently begun to take tentative steps towards easing these restrictions and building back towards more 'normal' social and economic conditions.

Each country's experience of the pandemic has been unique. The steps necessary to return to normality are therefore different for each nation. Similarly, the pace and success of the recovery will differ. While New Zealand, for example, appears well-placed to continue easing restrictions, evidence that infection rates in South Korea are increasing once more reminds us that the threat posed by the coronavirus has not yet passed. Nonetheless, where safe to do so, the relaxation of social distancing measures has been welcomed by all, including investors. International stock markets have, in recent weeks, continued their relatively serene progress from the lows of late March.

Lockdown in the UK has, for many people, been made more bearable by unseasonably beautiful weather. With the guidelines set to permit small, socially distanced gatherings in gardens from next week, the temptation is to dust down the barbecue and enjoy some hard-won rest and recuperation.

Alas – for investors at least – it seldom pays to take your eye of the ball entirely. As illustrated by South Korea, the threat of a second wave of infection remains real. And, as if that were not enough, there are myriad other issues that will undoubtedly influence financial markets over the coming months and years. As ever, whether this influence is positive or negative is not pre-determined: the impact on asset prices will depend on whether the outcomes are perceived to be better or worse than currently expected. This update aims to provide a brief introduction to some of the key issues that we expect to shape the investment environment during the coronavirus crisis and beyond.

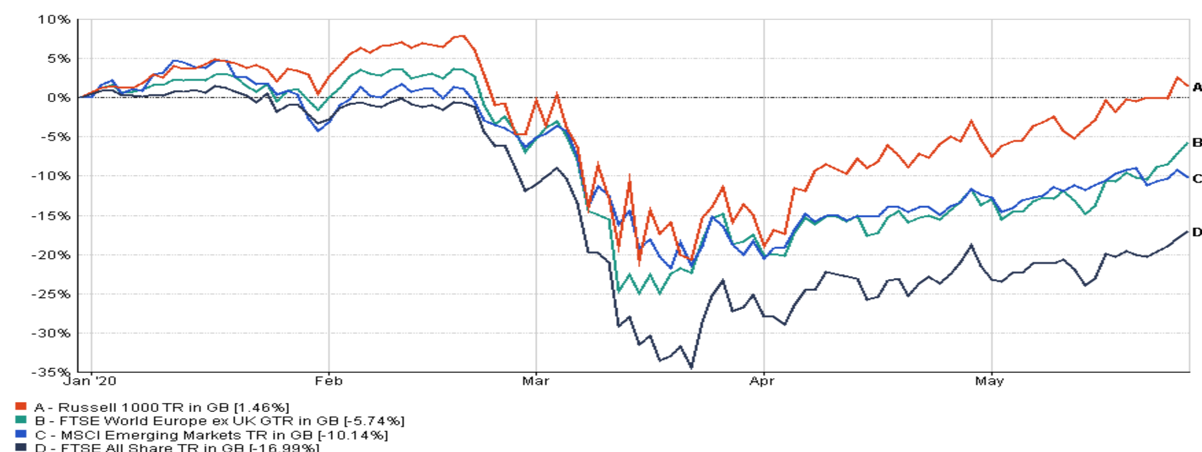
BREXIT

Both UK and European governments have, in recent weeks, been rightly focused on containing the coronavirus and mitigating its economic impact. However, this has necessarily detracted from negotiations over the UK's withdrawal from the EU. Lest we forget, the UK has until the end of June to request an extension to the negotiation period, without which the transition arrangements will cease on 31st December 2020.

The proximity of these deadlines, together with the prioritisation of the Covid-19 response and the government's refusal to countenance any delay to the process, raise the chances that the negotiations will fail. This, in turn, increases the chances that the UK's departure from its current trading arrangements will ultimately be 'hard'.

Financial markets – which have long viewed a hard Brexit as negative for UK assets – have certainly been alive to this possibility. Though the FTSE All Share index of UK stocks has made firm gains in recent weeks, it has lagged other international indices. The pound has also weakened over this period, exacerbating the underperformance for sterling-based investors (see Figure 1).

Figure 1: Global stock market index returns in sterling terms, year to date



Source: Financial Express Analytics, 31st December 2019 to 29th May 2020

Under the tutelage of special advisor Dominic Cummings, the negotiating approach of the Johnson government appears to be one of brinksmanship. Without commenting on its political implications, from an investor's perspective this approach widens the range of possible outcomes, adding to the uncertainty that has unsettled the UK's financial markets throughout the Brexit process.

As the 30th June extension deadline approaches, we will be watching closely for signs of the government's intent.

US PRESIDENTIAL ELECTIONS

The US heads to the polls in November. At this stage in a presidential election year, the main party candidates would normally be deep into the campaign trail, wearing out the shoe leather and setting out their strategies to win over key swing states. Needless to say, lockdown measures have largely called a halt to normal proceedings.

This year's election is arguably unlike any other. At this stage it is even unclear how votes will even be cast, with Donald Trump campaigning furiously against an extension of postal voting rights. The outcome is exceptionally hard to predict. The president's approval ratings have slumped as the coronavirus crisis has escalated, and a recession in election year has historically pointed to defeat for the incumbent. Against this, Joe Biden is widely viewed as a relatively weak Democratic candidate and, come November, the US economy may well be recovering from the recession.

While the outcome of the election remains uncertain, we can have a little more insight into the near-term implications for policy. Firstly, both Democrats (in control of the House of Representatives) and Republicans (in control of the Senate) will be determined to cast themselves as saviours of the US economy. This may well lead to additional government spending, though the negotiations are likely to be characterised by unseemly efforts to ensure the 'right' party receives the credit. Meanwhile, Donald Trump will likely continue to stoke tensions with China in pursuit of his 'America first' agenda.

TRADE WARS

Economically, the reignition of hostility between the US and China comes at an awkward time, to say the least. Throughout 2019, financial markets made clear that the consensus views trade wars as damaging to the global economy. Given the severity of the recession prompted by measures to contain the coronavirus, wilfully inflicting further damage on the economy seems akin to rubbing salt into a very deep wound.

China's recent decision to impose new security laws on Hong Kong have increased the stakes. The US has responded by declaring Hong Kong no longer autonomous and threatened the removal of its special trading status. Ross Teverson, manager of the Omnis Global Emerging Market Equity Opportunities fund, summarises the implications as follows:

"These tensions come at a time when the Hong Kong economy is going through a second year of recession, and a wholesale revoking of Hong Kong's special trading permissions would be very negative for the domestic Hong Kong economy, particularly the property market. In making any major changes to Hong Kong's status, the US would be penalising a Hong Kong population that is largely pro-US and would be damaging US interests in Hong Kong (including the disruption of numerous US companies with their Asian headquarters there). It would also risk accelerating Hong Kong's integration into China, so it is hard to see the logic in the US doing so.

Our base case is that the rhetoric will be more aggressive than any actual action the US takes. A more likely scenario would appear to be headline generating measures targeting specific individuals or companies. Having said this, we cannot ignore the risk that something more disruptive happens, given the number of China hawks in the Trump administration and the upcoming election."

The Hong Kong stock market initially responded with its sharpest one-day fall in five years on Friday last week (22nd May). Though the benchmark Hang Seng index subsequently ended this week broadly unchanged, we remain alert to the implications for Hong Kong, and for the Asia Pacific region as a whole.

GLOBAL SUPPLY CHAINS

Whereas the impetus for 'de-globalisation' had previously been viewed as largely political, the Covid-19 pandemic has introduced an economic rationale for shortening global supply chains. International business models, with components delivered 'just in time' from a variety of international locations, are extremely cost effective as each component can be procured from the cheapest available source.

However, as recent events have made clear, while efficient, these models are also fragile: a single break in the chain can threaten the entire production line. It is possible that companies will respond by prioritising the robustness of their supply chains over their cost. If so, it is reasonable to expect higher production costs to be passed on to consumers through higher prices. In other words, shortening global supply chains may lead to higher inflation.

DEBT

Around the world, policy makers have sought to mitigate the economic impact of efforts to contain the pandemic through a huge increase in government spending. This spending must be funded. Consequently, an enormous amount of government debt has already been issued, with much more still required – as much as $17 trillion according to the OECD. Though governments have – arguably justifiably – done 'whatever it takes' to limit the already significant damage caused by the pandemic, thoughts are inevitably turning to how the debt will be paid off.

A traditional approach would see governments rein in spending and increase taxes for many years to come. However, the aftermath of the financial crisis has raised serious questions about the efficacy of austerity as a policy to tackle excess government debt. Reduced spending and higher taxes are a headwind for economic growth. If these headwinds are too strong, the economy stalls and debt levels as a proportion of economic output can actually rise instead of fall.

Though higher taxes are perhaps inevitable, we believe policymakers will consider less orthodox ways of reducing the burden of debt. Firstly, central banks may well continue to buy up huge swathes of the government bond market. This should prevent interest rates rising, making it more affordable for governments to service the debt. Secondly, central banks could be persuaded to exchange their holdings of traditional government debt for permanent, non-interest-bearing notes. Though somewhat technical, this measure would effectively see central banks forgive governments their debt while avoiding an official default.

As per the experience of the 2008 financial crisis, unorthodox policy measures may well prompt much hand wringing, not least over their inflationary implications. However, a degree of inflation is in no ways undesirable, assuming it is controlled.

INFLATION

Inflation is a powerful force and serves as an effective lubricant to economic growth. If consumers expect prices to rise, they will make purchases now rather than later, stimulating demand and supporting economic growth. It also tilts the balance between borrowers and lenders: inflation erodes the value of anything with a fixed price, including debt. With debt levels at elevated levels around the world, and with much of it owed to central banks, there is a compelling argument to allow somewhat elevated inflation to effectively reduce the value – and therefore the burden – of this debt.

The debt-fighting nature of inflation may incentivise policy makers to abandon austerity and pursue more radical ideas to reduce the debt pile. It may also encourage central banks to maintain lower interest rates than they ordinarily might.

SAVINGS & CONSUMPTION

In theory, low interest rates and high inflation should encourage individuals to spend rather than save. However, the experience of some European nations over the past few years suggests this theory may have its limits. With low interest rates reducing income on savings, many individuals have responded by saving more, not less. With this in mind, it is interesting to see that savings levels have increased markedly through the lockdown period in many countries including the UK, Spain, Italy and the US.

It is possible that increased savings reflect the dearth of spending opportunities that have been available in lockdown. They may also indicate that government policies to support workers' incomes through the recession have been successful. However, if savings are being increased against the threat of job losses once these policies end, or if the pandemic has simply made people more risk averse, they may forewarn of a slow economic recovery and persistently low inflation.

OUR CONCLUSION

Though the human and short-term economic impacts of the coronavirus pandemic have understandably been dominating the headlines, there are myriad other issues for investors to get to grips with. Many are related to the pandemic and the efforts to limit its spread. Some will come to a crux in the next few months, others may take many years to unfold. All are likely to have a material impact on financial markets and the returns investors might expect from them.

As the world continues to feel its way out of lockdown, and as it grapples with each of the issues mentioned above – and doubtless with many others – we will endeavour to keep you abreast of developments and how they may impact your investment portfolios.

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