State of play

28 May 2020

In the midst of this unprecedented global event, our Investment Specialist Simon Durling, provides you with the latest COVID-19 developments, alongside our market and investment insights:

"In this week's blog I reflect on the financial impact and response measures taken by central banks and governments, and how this is influencing different asset classes."

COVID-19: An update

The successful implementation of lifting lockdown measures critically hinges on a combination of test, track and trace. The partial re-opening of junior schools and nurseries due in England on 1 June is now supplemented by the planned opening of non-essential retail shops on 15 June following an announcement from UK Prime Minister Boris Johnson over the bank holiday weekend.

Germany, in comparison to the UK, Italy, Spain and France has suffered significantly fewer deaths and appears to have been more organised against the virus spread. Observers point to the army of tracers who support the prompt testing of new cases by tracking down the individuals who may have come into contact with the people who test positive for the virus. Alongside the medical professionals, the authorities recruited police officers, army medics, social workers, planning inspectors and students. The thousands of volunteers have worked long hours, seven days a week, tracking, tracing and speaking to every potential contact, convincing those who tested positive to enter quarantine for 14 days alongside others in their household in an attempt to stay on top of the crisis. It remains a "blueprint" for others to follow and learn from.

The change of approach from the UK Government, which moved from "stay at home" to "stay alert", has been criticised by many as being confusing for the public. The roads have become busier as many attempted to return to work, whilst the bank holiday weekend produced accounts and pictures of questionable social distancing on show, and queues for car parks and densely populated beaches. It may take at least two to three weeks to understand if this has ramifications for the infection rate increasing back above the 'R0' rate of 1.

The Governor of New York, Andrew Cuomo rang the opening bell at the New York Stock Exchange for the first time since it fell silent on 23 March, showing a sign that life is returning to something close to normal, although the US experience of handling the disease is a cause for caution. Financial markets have continued to trade throughout the lockdown by temporarily moving to a fully electronic trading platform to avoid traders having personal contact.

Economic impacts and response measures

The Chancellor of the Exchequer, Rishi Sunak, has signed off a new support measure called "Project Birch". The bailout plan to save strategically important companies was revealed to the Financial Times over the bank holiday weekend. The plan outlined by the UK Government would be to rescue individual companies whose failure would "disproportionately harm the economy".

Under the project, HM Treasury would provide a bespoke bailout for "viable companies which have exhausted all options", including government loan schemes. Examples may come from many different sectors of the economy like aviation, aerospace and steel, alongside big employers, such as Jaguar Land Rover. Whilst Jaguar Land Rover has overseas owners, the company employ approximately 40,000 people in the UK, and would have significant impacts in terms of those individuals and down the supply chain, which employs three to four times as many.

While Project Birch is intended to address the short-term crisis, Mr Sunak is being urged to consider a more radical medium-term plan for the state to become part-owner of companies to stop them collapsing with enormous debts. Mr Sunak's supporters play down the idea that a Conservative led government could engage in a huge wave of part-nationalisation, but the Chancellor is facing calls to take this approach as some see this outcome as inevitable.

As if to provide an insight to what might become a more familiar outcome, Lufthansa has agreed a rescue deal worth €9bn (£8bn) with the German Government to save it from collapse. The German airline has been devastated by a sudden drop in people flying due to COVID-19. It has already had to close its budget airline Germanwings in April. The German Government will take a 20% stake in the firm, which it intends to sell by the end of 2023. The deal is not yet over the line as it still has to be approved by the firm's shareholders and the European Commission. The European Union (EU) has strict rules on state bailouts or financial interventions providing advantages for one company over another in the single market. This case is somewhat of a test case to gauge the European Commission's appetite to adapt the rules due to the global shutdown.

Towards the end of last week, the EU, led by German Chancellor Angela Merkel and French President Emmanuel Macron, announced a break through initial agreement to support the EU with €500bn aid package to help economies recover from the COVID-19 pandemic. It represents a step closer to tighter integration. This solution takes a different approach by targeting the member states that have been worst affected by the crisis. Importantly the bonds issued by the European Commission would be repaid from the EU budget, with the largest contributors being Germany and France. The plan marks an important step in efforts to support the European project and a win for President Macron, who's been calling for Germany and the richer northern states to do more to help those in the South who've suffered most. As yet the plan is still only at the starting gate. A final deal will need the backing of all 27 members, and Austria signalled immediately that it remains opposed to direct handouts.

Leaving the EU this year would be a lot to handle for the UK when the economy is already reeling from the COVID-19 outbreak, according to a former Bank of England rate setter. "If they don't do a postponement as a result of the pandemic, you're just going to get abrupt dislocations", Adam Posen, President of the Peterson Institute for International Economics told Bloomberg Television in an interview on Tuesday. While Prime Minister Boris Johnson has promised not to extend the current transition, which is due to end on 31 December this year, the two sides remain far apart in talks for their future relationship. That means the UK faces the prospect of leaving the EU's single market and customs union without a trade deal in place. If Britain defaults to trading with the bloc on terms set by the World Trade Organization, this would mean steep tariffs on goods like cars. Yet even an agreement would be of limited benefit, said Posen, who served as a Bank of England policy maker between 2009 and 2012. He said "anybody who thinks the Brexit deal is going to do some good is probably fooling themselves". The split "on top of the retail sector, the tourism sector having to make big changes, agriculture in Britain having to make big changes because of migration issues from both the pandemic and Brexit - you end up putting the economy through a lot very quickly".

Market conditions

In a sign that the market expects more economic stimulus from the Bank of England, the UK broke new ground last week for a UK Government bond sale. The UK sold £3.8bn of three-year UK Government bonds at a yield of -0.003%, the Debt Management Office said. The negative yield means investors who hold the debt to maturity will get back less than what they paid. Given the sale was heavily oversubscribed, this reflects rising expectations that the Bank of England will increase its £200bn bond purchase programme next month. They are attempting to support the economy and lift inflation back up towards its 2% target. Whilst the central bank has rejected the prospect of cutting the benchmark interest rate to below zero for the first time, markets do not appear to be convinced by this.

Based on the weight of stimulus already announced and the additional measures that may be taken in the future, markets continue to be convinced

that with lockdowns easing and the various economies slowly restarting, most major stock market indices drove higher over the week since my last blog. Unrest in Hong Kong over Beijing's proposed national security laws weighed on the Hang Seng Index which was 4.7% down in a week (accurate as at 27 May). Riot police fired pepper pellets on protesters in Hong Kong's main business district, rekindling concern about the protests seen last year that hit the territory's economy.

One asset class increasingly coming under the microscope is commercial property. Ten large funds (tracked by Morningstar) with a total of £6.5bn under management, stopped investors from getting their money out in mid-March despite being open-ended funds, saying valuers could not accurately assess real estate assets in the middle of a shutdown economy with so much uncertainty ahead. With question marks over the future of office working, the retail industry in crisis and the housing market only just reopening, the funds are likely to remain frozen for the foreseeable future. The price of property is set for a major revaluation, but a lack of transactions means the scale of change is still unclear. Two of the largest funds holding retail investors money were also suspended during the 2008/2009 financial crisis and in the aftermath of the 2016 Brexit vote to protect against daily redemptions because the illiquid assets that are held take too much time to sell. Suspensions enable funds to treat customers fairly, preventing a rush for encashment which means those who are slow to act get a lower price for their investments. The funds say these suspensions are related to valuation problems and, unusually, do not follow a flood of redemption requests.

The current crisis has extended further into the £70bn UK property fund sector. For the first time, funds aimed at institutional investors, like charities and pension funds, have also locked their doors. These funds typically only allow redemptions monthly or quarterly. 20 of the 29 institutional-focused funds in the MSCI/AREF UK All Balanced Property Fund Index have suspended or deferred redemption payments, according to a Reuters survey. Institutional funds say their investors take a long-term view, and will continue to favour real estate for diversification and yield. But for those funds which do need to sell assets to raise cash, it will be difficult. To avoid future suspensions, funds may change structure. Certainly, there is increasing pressure from the regulators to change the rules to better protect retail investors.

Find out more

Listen to our latest **Market Views: Check point** update with John Mullins, Portfolio Manager, as he discusses how the team is positioning itself as we continue to navigate the volatile climate during COVID-19 **here**.

Note: Data as at 27 May 2020.

Important Information