State of play

18 June 2020

Our Investment Specialist Simon Durling shares his thoughts in our latest weekly update.

Since last week's blog a raft of data has been released in the UK that confirms many of the fears about the economic impact of imposing a lockdown. However, some investors may read the announcements and wonder why the stock market reaction doesn't seem to align with the economic reality. Firstly, I want to cover some of the economic and employment data, and then compare market interpretation and why this is very different.

Economic and employment news

The Office of National Statistics (ONS) announced last Friday an unprecedented 20.4% contraction in Gross Domestic Product (GDP) in April 2020. Put simply, the UK economy is 25% smaller than it was at its peak in February 2020. This eclipses the 6% peak-to-trough decline recorded during the 2008-09 recession.

On Tuesday 16 June the ONS published unemployment rate remained stable at 3.9% despite reporting that workers on company payrolls fell by 612,000 between March and May. Job vacancies fell at a record pace over the same quarter, dropping by 342,000 to 476,000. This was the largest quarterly fall since this data record began in 2001 and was driven by large slumps in the retail, food and accommodation sectors. The main driver for the stable unemployment rate is the fact nearly 9 million people are being paid by the Government's Furlough Scheme which runs until the end of October. This is reflected in the record fall of 8.9% in the number of hours worked. The ONS also pointed to a further rise in the number of people signing on for benefits, with the claimant count rising by almost half a million to 2.8 million.

The unemployment rate will no doubt start to spike as the Furlough Scheme is phased out, starting in August when employers will have to start contributing a proportion of their workers salary. The initial signs have already been seen in the last week with large job losses announced by BP (10,000), British Gas parent Centrica (5,000), Jaguar Land Rover (1,100) and the chemical firm Johnson Matthey (2,500). Heathrow Airport said on Thursday that voluntary redundancy had been offered to all of its 7,000 direct employees after COVID-19 had wiped out its passenger traffic. As I mentioned in last week's blog, the crucial factor will be whether the Furlough Scheme protects jobs or just delays mass unemployment.

So, given the somewhat negative picture this paints, how has the market reacted? There have been big swings in stock market values in the last seven days when last Thursday's one day "sell off" saw the largest falls since the 23 March low point, driven by fears of a second wave of the virus. When Friday's poor GDP numbers were released the markets rose nearly 1%. Monday saw a big fall when markets opened but then rallied, spurred on by expectations that the Bank of England (BoE) will extend its bond buying programme by £100bn. On Tuesday morning, all European markets opened up over 2% higher, reassured by the Federal Reserve in America buying large quantities of corporate bonds to support liquidity. Each day different, each time a different reaction for different reasons.

What affects the relationship between economic data and market reaction?

Economic data is always in the rear view mirror

So why this disconnect between economic reality and pricing? Even in normal times, economic data looks back and the stock market looks ahead. By definition, a recession, which is two quarters of economic contraction, is looking back to the last six months or more. By the time devastating economic data is released, the market has typically long been pricing it in.

Markets dislike uncertainty more than bad news

Market reaction to data depends on whether the information is very different to expectations and forecasts. Last month, we learned over 20 million jobs were lost by US workers in April, the worst month for job losses on record. On the day the figures were announced, S&P 500 gained 1.7%. Why? The market was expecting job losses of around 22 million.

Stocks/shares are valued on future earnings

A company's cash flows over the next 12 months is only a small piece of the value of the stock. And that's what you're paying for when buying a stock: the company's future cash flows. 12 months is not a long time for the stock market. From a historical standpoint, price to earnings ratios, which measure how many future years earnings make up the price of a given stock or share are high at

present at around 16 times. But the next 12 months earnings is only worth a fraction of the value of the stock – 1/16th.

What are the alternatives for an investor?

One of the reasons why investors continue to either invest new monies or retain existing investments when uncertainty is high and the economic data is bleak, is the limited alternatives. Interventions by central banks come in different forms, but the most common are described as quantitative easing, or QE, which have caused interest rates and bond yields to collapse, even before the crisis began. After the financial crash in 2008/09, central banks embarked on an unprecedented quantitative easing programme and slashed interest rates. This process is where central banks 'print' or create money to stimulate the economy and support liquidity.

How does quantitative easing (QE)work?

To be honest, I think the best description available is from the Bank of England's (BoE) website. It reads as follows:

"Large-scale purchases of government bonds lower the interest rates or 'yields' on those bonds. This pushes down on the interest rates offered on loans (e.g. mortgages or business loans) because rates on government bonds tend to affect other interest rates in the economy. So QE works by making it cheaper for households and businesses to borrow money – encouraging spending. In addition, QE can stimulate the economy by boosting a wide range of financial asset prices.

Suppose we (BoE) buy £1m of government bonds from a pension fund. In place of the bonds, the pension fund now has £1m in money. Rather than hold on to this money, it might invest it in financial assets, such as shares, that give it a higher return. And when demand for financial assets is high, with more people wanting to buy them, the value of these assets increases. This makes businesses and households holding shares wealthier – making them more likely to spend more, boosting economic activity."

Liquidity builds investor confidence

Liquidity is important to companies and economic activity because it gives investors' confidence that they can access credit or trade an investment relatively easily. When there's no liquidity, you may not be able to find a buyer if you're trying to sell a bond for example. By creating digital money through QE and using this to buy debt, the cash that replaces this is reinvested into the economy or financial assets creating a more liquid market place of buyers and sellers.

'Bear' or 'Bull' mentality driving momentum

Lastly, stock markets are often described as a 'Bear' or 'Bull' market,

as we have explored previously on our insight pages on our website santanderassetmanagement.co.uk. At the moment, stock markets are seeking out reasons to be cheerful and almost ignoring all of the bad news. As I said earlier, markets look ahead and try to anticipate what will happen in the future and the expectation currently appears to be a swift economic rebound as lockdowns are lifted and people return to work and the economy starts to return to somewhere near normal. When the uncertainty and fear was at the highest at the end of February market sentiment turned bearish and shares fell dramatically in value. Since their low point on 23 March, markets have recovered their nerve after prices reached a tipping point and the government and central bank interventions were announced. Since then the markets have been driven by bullish market sentiment and optimism that the global economy will recover quickly.

So, is now a good time for investors?

The million dollar question is always the same when investing - is now a good time or shall I wait for markets to fall? Importantly, whilst market volatility can be very uncomfortable for investors, trying to gauge a good time to invest is almost impossible for the average investor. Clearly, it is important that you seek appropriate investment advice if you are unsure about how to go about investing. When your time horizon is longer-term (five years plus) how stock markets are at the time you choose to invest may not be as important as you might think. A diversified portfolio in line with your attitude to investment risk (in other words how comfortable you feel with risk) should provide an investment outcome to reach your desired goals more often than not. Timing clearly will influence how much your investment returns will be, but broadly, time in the markets is better than timing the markets (a concept we discuss in more detail in **Back to basics**).

Find out more

Listen to our latest **Market Views: Check point** update with John Mullins, Portfolio Manager, as he shares his thoughts on some of the main themes over the last couple of weeks and how they have been driving market behaviour **here**.

Note: Data as at 16 June 2020.