Markets Review - to end February 2020

THORNTONS INVESTMENTS

Market Returns

(Total returns in £)	1 month	3 months	6 months	1 year
UK Equities	-9.0%	-9.6%	-7.0%	-2.7%
Global Equities	-5.3%	-4.7%	-3.3%	9.7%
UK Gilts	0.9%	3.5%	0.9%	11.5%
UK Property	-0.1%	0.2%	0.9%	1.3%
Gold	3.2%	9.9%	-1.1%	25.6%
Commodities	0.9%	3.5%	-2.7%	-0.3%
Sterling	-2.3%	-0.9%	5.0%	-1.2%

Returns to 29th February 2020. Source: Thomson Reuters

Market Overview

The positive outlook held by financial markets as we entered 2020, has now been wiped out by the spread of new coronavirus, Covid-19. The initial outbreak in China has destroyed economic activity there, in February, as measures were put in place to try and contain the epidemic. As the supply shop to the world, there has also been a dislocation for anyone reliant on some part of their supply chain involving China. However, the dramatic falls in stock markets at the end of February were triggered by the spread of the virus to the rest of the world, especially Italy. It will take a good few weeks before we know how effectively the global spread of the virus is contained, in the meantime the Federal Reserve Bank has cut interest rates in the US by 0.5% in response to the weaker economic outlook.

With the headlines now dominated by coronavirus, other significant developments are having to play second fiddle. The UK/EU trade negotiations have got off to a frosty start and we can only hope that they are not further delayed by Covid-19. The new Chancellor, Rishi Sunak, more than has his work cut out with the budget on 11th March, however, some hard decisions can be delayed to the fiscal spending review or autumn budget. In the US the Democrat primaries appear to have whittled their candidates for President down to two gentlemen older than the incumbent.

The drop in stock markets was somewhat foreshadowed by the fall in bond yields and commodity prices due to concerns over the economic impact of Covid-19 and stalled Chinese demand. The oil price has dropped 25% since the start of the year, with the potential for global demand to drop this year for the first time since the recession of 2008/9. As market participants rushed to perceived safe haven assets, like government bonds, yields have collapsed to all-time lows. The UK 10-year gilt now yields less than 0.4%, half the level at the start of the year.

The plunge in the price of oil has also been shadowed by steep falls in other commodities such as copper and iron ore. This reflects the significance of China's demand for raw materials and that the prices of commodities are spot prices that are sensitive to near term shifts in supply or demand. It remains to be seen how much demand is affected in the west, but the encouraging news is that production in China is beginning to start up again. Restrictions are being removed as the spread of the epidemic there now looks to be under control. In the meantime, the price of gold has spiked up over $1600/oz as investors seek insurance against risk.

UK property continues to deliver a steady income, but capital appreciation has ground to a halt. Strong demand for industrial property has been offset by the headline problems on the High Street. Rental rates for retail properties are now in decline. Brexit has also impacted international and institutional demand, with steady outflows from some property funds.

Commodity prices peaked early in the last decade driven by demand from a huge stimulus programme in China. Increased supply and subdued demand then saw them trough in 2016, since when there has been relative stability. Surging US oil production has weakened OPECs control, helping keep the price of oil well below $100 per barrel. Although there are pockets of food inflation, such as pig prices following the decimation of Chinese pig herds from African Swine Fever, there are few inflationary threats globally.

The last decade has seen huge change, politically, economically and environmentally. The ubiquity of smart phones and connection to the internet has transformed the way we communicate and increasingly transact. Disruption comes hand-in-hand with this. The rise of internet shopping and banking is eroding the High St presence, newspaper demand has plummeted, and media is increasingly being accessed by streaming. Societies are also aging, Japan's has even begun to shrink, affecting productivity and growth. Against this background and following the global financial crisis, economic policy response has been dominated by quantitative easing (QE, or the massive purchase of debt by central banks) and the introduction of negative interest rates. This has dramatically reduced the cost of borrowing and led to a huge increase in the amount of debt in issue. However, rather than engendering a surge in productive investment, its main impact seems to be a widening in the gap between the haves and have nots. From the Arab Spring to Hong Kong demonstrations, perhaps political upheaval is not that surprising.

Normally with a retrospective, there is some sort of prospective; so, what is the next decade likely to hold? Disruptive change, lots more of it. Machine Learning, Artificial Intelligence and the 'Internet of Things' will bring substantial change to the way we live and work. With wind and solar production of electricity reaching the cost of conventional production, or grid-parity, storage and distribution solutions will allow a second age of electrification and a decarbonisation of economies. Environmental damage has risen to the top of societal concern, some of the technological advances will help here, but it will also require changes to how and what we consume. Global politics is likely to remain febrile as governments struggle to cope with the degree of change and wealth disparities. Investing in this environment will not be straight forward, especially as valuations are at elevated levels, but change brings opportunities and some of the changes will be very positive.

Short term, growth expectations for this year have now been undone by Covid-19. There has already been a significant impact on the travel and leisure sector, and companies from many other business sectors have also warned on outlook. Given that the extent of the epidemic is still rapidly evolving, it is impossible to know how much business will be lost and how much will be deferred. Markets will be volatile while they try to price in the unknown. Financial aid packages, as well as interest rate cuts, have been announced to help businesses and economies through a difficult period. If Covid-19 can be controlled as quickly as in China, then there is reason to see good investment opportunities in the weeks ahead.

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Market Outlook

Equities	The sharp stock market gains in 2019 now seem distant following the dramatic falls at the end of February. The spread of new coronavirus around the world, and halt in China's economic activity, has shaken confidence and reduced growth expectations for the year. The outbreak in China is rapidly being brought under control and economic activity restarting. The focus now is on how effectively the outbreak in Italy and Europe can be contained. If it can be relatively contained, then the economic damage should be limited, if not then the damage will be severe. It will be several weeks until we know how this unfolds and we remain alert to the dangers, as well as the investment opportunities that may result.
Fixed Interest	Government bonds have surged, and yields collapsed, as investors seek safety against the new coronavirus and potential economic damage, with negative bond yields in Europe prevalent. Corporate bond yields are higher, but still look expensive for the risk involved.
Commercial Property	The UK commercial property market has had a difficult few years, with its liquidity risk highlighted by fund dealing suspensions. The Brexit uncertainty and hollowing out of the High St has also hit capital appreciation, however, industrial and office demand remains healthy and rental yields and investment diversification offer attraction.
Alternative Assets	Infrastructure investment funds offer attractions for exposure to physical assets, often with attractive inflation linked contracts, and growth connected to improved connectivity and de-carbonising economies. However, as with private equity, there has been significant capital applied to these investments, reducing investment yields and increasing vulnerability to a rise in the cost of debt. Absolute Return strategies have been tested by low bond yields and we continue to choose sparingly.
Cash	A 'safe haven', but with very low return; below inflation. Investment opportunities elsewhere will offer greater long-term returns.

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