Investment Strategy Group

Updated thoughts on Covid-19

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It has now been a little over two months since the number of Covid-19 cases globally (excluding China) first exceeded 1,000 and clearly plenty has happened since then. Total confirmed virus cases now tops 2.4 million, many of the world's governments have put in place lockdowns in some shape or form, and policymakers have ramped up an unparalleled level of policy stimulus in an attempt to support businesses and households through a period of economic 'hibernation'. Developments in financial markets have been meaningful too, with not only this period seeing the fastest bear market in US history (equities falling 20% from their highs in the space of just 22 days), but also one of the most aggressive rallies in history as well. Since the S&P 500 troughed on March 23 (after falling 35% in total), it has recovered by over 30%, to now be down only around 15% from its previous all-time highs.

Considering we are facing what is likely to be one of the largest shocks to economic activity in history, it is perhaps the latter observation around the recovery in equity markets that might come as the biggest surprise to many. Our inclination through this crisis has been that due to: 1) the nature of this shock (i.e. a true exogenous event rather than something necessarily wrong 'inside' an economy); 2) the speed at which the equity market sell-off occurred in the first instance; and 3) the amount of policy stimulus that has been provided, that there was a strong possibility that the recovery in equity markets on the other side could be just as rapid as the initial weakness (even if picking the timing of that recovery was extremely difficult). However, even we have been surprised by the speed and extent of the bounce in equity markets over the past few weeks.

So, what has driven this rally and what scenarios for the future have markets now priced in?

We believe there are two major, and justifiable, reasons why equity markets have bounced back as strongly as they have. The first is the virus itself. Compared to the middle of March, when new cases of the virus were rising sharply in Europe and the US, we have now seen a clear slowing in its spread as containment efforts have succeeded in 'flattening the curve'. In fact, in some parts of Europe, the number of 'active' cases is now falling. While there are certainly still hotspots around the world, the discussion from authorities has now shifted from how to contain the virus to how to reopen economies, thus giving markets a little more clarity on timelines. In addition to this, there has also been encouraging developments with regards to treatments, testing and contact tracing. Certainly, as each day has gone by and the world's scientific community has thrown its resources behind one common goal, more and more has been learned about the virus, which is leading the market to believe that the worst of the global infection is behind us.

The second factor relates to the actions of policymakers in being able to potentially avert some of the most negative downside economic scenarios. Fiscal stimulus has been large and targeted, whether in the form of direct equity injections into businesses, cash handouts, loan guarantees, tax rebates, wage subsidies and expanded benefit payments, it has been on a scale that far exceeds what was delivered during the Global Financial Crisis. In addition, as well as easing monetary policy, central banks have also introduced several support measures to ensure global credit markets continue to function smoothly. It has meant that the risk of widespread insolvency from the collapse of cashflows due to lock-down measures has been alleviated for now, which is an important development as it has reduced risk premiums (i.e. higher prices) for equities and credit.

Of course, the news hasn't been all positive. We have clearly started to learn about the significant economic and corporate earnings damage caused by the containment measures, no better illustrated by the astounding jobless claims numbers coming out of the US, or the plunge in business and consumer confidence seen in many economies. Corporate earnings estimates are being slashed, with some analysts forecasting overall market earnings for the S&P 500 this year to be down 40% from 2019 levels, and on par with what the average company earned way back in 2012.

Yet it appears as though investors are happy to look through this pain because there are now hints of recovery (or at least scenarios that show that recovery is possible) when that wasn't evident only a few weeks ago. In other words, investors are largely ignoring the large hole in 2020 corporate earnings and instead focusing on the expectation that 2021 earnings will be stronger. Given the prospects for medical solutions that will allow the reduction and removal of lock-down measures, together with solid policy support (that has reduced near-term insolvency risk) and the fact that equity valuation is driven by long-term cashflow generation (and not just cashflow over one year), that feels like a reasonable approach to take.

The difficulty of course with this approach is assessing what an appropriate estimate for 2021 corporate earnings should be, as that will depend on several forces, not least how quickly economic activity rebounds as lockdown measures are eased. With uncertainty elevated, there is unsurprisingly a wide disparity in these 2021 earnings estimates from our various research partners, each with their own implications for what the current level of market prices says about valuations. Our view though is that following the strong lift in equity prices over the past few weeks, the market is now arguably fairly priced for a relatively rapid recovery in economic activity over the coming 18 months.

What that means is that even though we are optimistic ourselves from a medium-term perspective on equity markets and economies more generally, the recent rally appears to have banked in a decent amount of that future better news already, arguably now leaving markets prone to potential setbacks. What could those setbacks be? Well, there is of course the risk of second waves in the virus outbreak itself (like what is being seen in Singapore now, where new cases have risen once again), that force authorities to reintroduce containment measures, and further delay the economic recovery. Several viral outbreak experts suggest second waves of the virus are quite possible until vaccines are available. Setbacks for the market could also come from the shock factor of actual earnings downgrades and poor economic data that is only now just starting to come through. Companies are having to put their fingers in the air so much that it's a surprise that some are even attempting to give guidance at the moment – this mass uncertainty and lack of clarity is, by definition, likely to create surprises in this or future earnings seasons.

For the MAS Funds, we continue to run with an exposure to equity markets that is modestly below where our strategic target asset allocations would imply. In that regard, our overall stance could still be classed as cautious. Given the level that stock markets have now risen to, and our belief that there will be ongoing volatility ahead, we are holding off adding to our equity exposure here until we either have stronger conviction in the economic outlook or more attractive levels present themselves. That being said, our overall cautious stance has not stopped us from actively seeking out strong opportunities when they have presented themselves and over recent weeks we have started to build larger positions in solid companies that we believe will benefit once the economic recovery does take hold. This disciplined approach is something we will continue to take over the coming weeks and months.

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