



Where next for investors?

August 2020



We may all be suffering from 'Covid fatigue' but the pandemic will remain critical for investors well into 2021. Attempting to resume economic activity while suppressing the virus will be the main concern for governments until a vaccine arrives. Complicating this dance between Covid-19 and humanity will be the gradual unwinding of emergency economic support from the government.

There are plenty of other events for investors to focus on, however. The 2020 US Presidential election is now barely three months away and could have significant implications, particularly if the Democrats prove willing and able to implement a radical policy agenda. If the Democrats win control of both the House of Representatives and the Senate, a definite possibility, we will see a much less business friendly Administration, even if some executives would welcome a less erratic presidency.

There will also be plenty of attention on the nascent recovery. Following the end of lockdown measures, we saw a sharp rebound in economic activity, which appears to have stalled in recent weeks, particularly in the US where we have seen a resurgence in coronavirus cases. For the meantime, much depends on how successful efforts to combat the virus are.

The outlook for Covid-19

While Covid-19 appears to be under control in much of the world, including most of Europe and the Asia Pacific region, the pandemic continues to be a major problem globally. The total number of confirmed cases is still rising, most notably in the US, although there are some signs of stabilisation in states such as Arizona.

America may be better at identifying cases due to more widespread testing than countries such as India, Brazil or Mexico but – to President Trump's consternation – its high positive test rate suggests the virus remains widespread.

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The mishandling of the virus appears to have stalled the economic recovery, with real-time surveys showing that the unemployment rate has stopped falling. If people do not have the confidence to resume more normal spending patterns – such as going out to eat – then this will ultimately hurt the wider economy.

Some countries have had success in suppressing the virus and opening their economies back up, however. This is true of much of the Asia Pacific region, while Europe has also done well. Nevertheless, the past few weeks have demonstrated how difficult it will be to keep on top of outbreaks, with Spain in particular seeing a renewed upsurge in cases. The broader message from the first half of this year is that the virus can be controlled (even with more normal level of economic activity), but effective government leadership is critical.



A 'v'-shaped recovery?

Economic activity has recovered strongly from the lockdown, as one might expect given that many businesses are effectively no longer banned from trading. A strong initial bounce in PMI surveys, particularly for the US and France at the beginning of June, appeared to confirm the v-shaped recovery narrative that has taken hold across markets. While there are grounds for optimism, we do not expect a v-shaped recovery, especially given that the full effects of Covid-19 are only likely to be felt in the next six to twelve months.

We expect the world to largely follow China's recovery path, with manufacturing tending to bounce back stronger and a weaker recovery in the retail, travel and leisure sectors. This is more of a problem for developed markets, where these sectors account for a larger proportion of the economy than in China. The potential for lockdown measures to be re-imposed, even if for shorter periods of time, elevates the risks to the service sector in particular.

Individual countries will face their own circumstances of course. Nowhere is this more true than in the UK, where transition arrangements for leaving the EU are due to end on 31 December 2020. Even if – as we suspect – a deal is agreed, UK businesses will face increased regulatory costs when trading with the European mainland, with this likely to hold back the UK's recovery.

The market reaction

For some readers, the above may lead to a puzzling question; if we are not out of the woods yet, why are markets behaving as though we are? A large part of any answer must be the response mounted by governments and central banks, which have collectively pumped trillions into the global economy.

Throughout the rest of 2020 and into 2021, there will be a rolling debate about whether to provide more support – and whether certain measures are simply delaying an inevitable economic reckoning. This debate can be seen most obviously in the US at time of writing, where some Republicans argue that proposed additional stimulus simply keeps jobs alive that will eventually be lost once support is removed.

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The risk for investors is that a lack of further fiscal stimulus triggers a renewed sell-off. At the very least, markets are going to have to re-learn how to climb the wall of worry over the next six to twelve months, rather than being propelled up it by a rocket ship of fiscal and monetary support.

Conclusion

Aside from the clear winners in the digital/technology space, many companies will be relieved to survive relatively intact from the pandemic. The same might be said of individual countries such as Italy, where government debt to GDP is expected to reach just under 160% of GDP by the end of 2020. It remains to be seen whether certain responses to the crisis, such as tentative steps towards greater government burden sharing between EU members, become more permanent and take on broader historical significance.

All this has clear implications for investors. Companies with strong balance sheets will ultimately be able to weather the crisis more easily and may emerge stronger in some respects than before if competitors are forced under. More broadly, governments across the world will try to follow a policy of financial repression, keeping interest rates below the rate of inflation in an effort to help repay the debt. This leaves few attractive areas for investment in the bond market. Similar to much of the past ten years, investors will likely be forced further into the stock market if they want a return.

Markets are going to have to re-learn how to climb the wall of worry over the next six to twelve months, rather than being propelled up it by a rocket ship of fiscal and monetary support.