ROCQ CAPITAL

First Quarter 2020

It was a tumultuous quarter for financial markets, reflecting the upheaval experienced by society as a whole due to the coronavirus pandemic. With many businesses closed or operating well below capacity, and demand severely curtailed by the current circumstances, stocks and corporate bonds experienced heavy sell-offs from mid-February onwards, only really finding their feet in the final week of the quarter as sentiment stabilised somewhat. There were many dramatic moves in individual stocks – particularly those of travel or hospitality companies – and the figures for the headline indices were stark. The US S&P 500 index fell by 20% during the quarter; the losses for the main UK, Eurozone and Japanese indices were 24.8%, 25.6% and 20% respectively. The MSCI World index of global developed markets declined by 21.4%, while emerging market bonds, equities and currencies were all extremely weak. Such declines are rare but not unheard of; however, the drops were unusually swift and dramatic, even compared to past episodes such as the 2008 financial crisis.

Corporate bonds also experienced large price falls by their standards, with global investment-grade indices declining by around 6% and lower-quality issuers dropping by considerably more. Government bonds were largely seen as a safe haven, though they too experienced considerable volatility – for the quarter as a whole, UK Gilts returned +6.3% and US Treasuries also performed well.

Currency and commodity markets saw dramatic moves too, the latter rocked by a rupture in relations between Russia and OPEC (notably Saudi Arabia) that caused a huge drop in the oil price in early March, from which it hasn't yet recovered. Crude oil is 66% lower than at the start of the quarter. The timing of this spat could hardly have been worse for oil producers, with prices having already been under pressure due to concerns over expected economic activity because of coronavirus. Saudi Arabia's move has precedent – they employed a similar tactic in the 1980s to enforce discipline within OPEC and ultimately gain market share, and it was generally successful. The impact on the US is concerning given its shale industry is heavily indebted, though after the dramatic oil price decline in 2014-16 it was able to bounce back and bondholders were generally rewarded for remaining invested.

The hit to the global economy in recent weeks has been rapid and large, but so has the policy response – initially through monetary policy and increasingly through direct government support. The world's leading central banks have announced new initiatives to ensure that this health and economic crisis does not develop into a financial crisis. Measures to improve the 'plumbing' of the financial system and aid liquidity have been implemented quickly and effectively, which has been helpful for all market participants. In addition, commercial banks, which are far better-capitalised than ten years ago, and are being given considerably more leeway to increase lending to companies so as to support the economy. Many governments have also announced levels of spending that would have been difficult to imagine just a few weeks ago as they seek to stabilise their economies through combinations of direct income support and guaranteed loan programmes for troubled businesses. Initiatives that would have taken months even during the 2008 crisis have been put together extremely quickly and may well be added to in the coming weeks.

Outlook

We do not wish to add to the commentaries on the virus itself that are readily available wherever you look. As investors, we face the same questions about the length of time it will take for society to return to something approaching 'normal' that are troubling all businesses and individuals. Uncertainty about the future path of the virus is matched by uncertainty about the near-term path for markets, particularly as we do not have historical analogies to draw upon. We have to be open to the possibility that headlines and newsflow may well worsen in the weeks ahead – in fact that is quite likely. We are particularly concerned about the US situation, as lockdown measures have been far less restrictive than elsewhere and it would therefore be unsurprising to see a surge of cases and deaths in the coming weeks. Poorer countries with under-resourced healthcare systems and households with less ability to self-isolate also look vulnerable.

This does not mean it is right to retreat to cash or dramatically alter portfolio weightings at this juncture. Markets have moved extremely quickly to reflect a large drop in economic activity, in particular via huge outflows from funds. Our network of contacts at fund management firms and brokerages indicate that bond markets in particular have suffered as managers attempt to fulfil redemptions from distressed sellers who will accept almost any price to exit. This is not a group which we would wish to join, and in fact historically such periods have been excellent times to stay invested or even increase allocations to certain markets. We have not reached the point of making such increases, given the daily volatility we are witnessing, but we must be cognisant that there are opportunities opening up in assets that have been sold indiscriminately.

Recent announcements from the UK government of substantial support to businesses and individuals are likely to be highly supportive, as long as the money reaches its targets quickly. This could have a significant impact in ensuring that the economic recovery can occur rapidly once restrictions are loosened. Other governments, notably the US which agreed a very large package of support in late March, are also attempting to neutralise the worst of the economic impact. This encourages us that markets can recover strongly, and indeed we expect stock and credit markets to be significantly higher in the second half of this year than they are today. For now, bad news about the virus itself and its impact on companies and industries is understandably dominating sentiment, but from a longer-term perspective we do see some positive signs for investment prospects – we hope that they are built on over the coming weeks.

We are constantly reviewing positions in portfolios and considering any new risks that may have appeared as a result of the unusual circumstances we find ourselves in.