Commentary
Markets

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Oil Spills, Equity Bounces and Stark Signals from the Economy

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One month on, a differentiated picture is building. Equities are showing some of their old form, gold is behaving perhaps predictably well.

On the other hand Oil is in freefall and may decimate High Yield as collateral damage.

The economic story is as might be expected but are there signs of improvement?

Things Are Looking Up?

A month on we've seen a performance bounce almost across the board, with European equities leading the way and global, US and UK equities all chalking up double-digit gains.

Gold also had a strong month, benefiting from continued hedging and diversification demand. Clearly the exception to the positive sentiment was the oil price, which continues to drop, with the near-term WTI future famously going negative, as the demand destruction caused by lockdowns across the globe destroys any positives from an apparent ceasfire in the Saudi–Russia oil war.

What happens next continues to depend heavily on the shape of case and mortality curves globally, but it is certainly true that investor risk appetite has improved markedly over the last month or so.

Some Movement in Factors

So, a positive-sounding equity performance across regions and countries. But, how has that played out through sectors?

This hasn't been a classic risk-on bounce. For a start, one of the top-performing sectors was defensive Healthcare — for obvious reasons — and the only sector with a positive YTD.

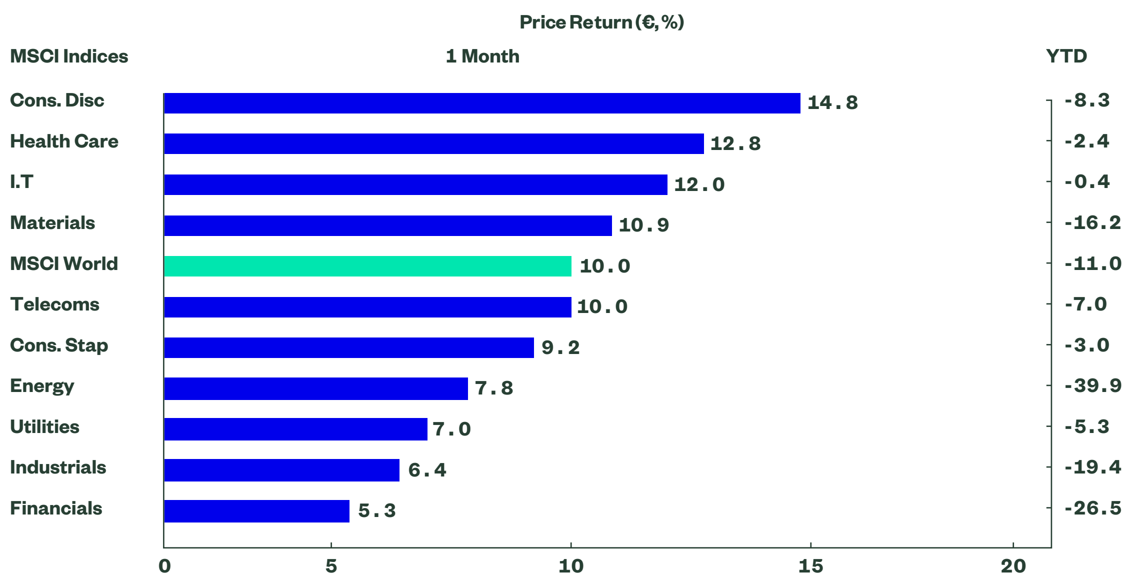
Technology has continued its strong performance, and as we'll come to in the factor section, momentum continues in the Technology sector, which is almost flat YTD.

Something of a return to risk is seen in the strong performances of Consumer Discretionary and Materials sectors, the former reflecting some optimism on the reopening of China, the latter more driven by chemicals companies which should be beneficiaries of the low oil price.

However, financials and particularly energy stocks have continued to underperform, and once again, with interest rates looking to remain very low historically for a very long time, it's hard to imagine financials seeing any short-term respite, and regions and countries with a high weighting to the financial sector will feel a drag as well.

Looking at Europe, this helps explain why country equity markets like Spain and Italy with 50–60% in Utilities and Financials underperformed last month, compared to Germany which has a much higher weighting in Discretionary, Tech and Healthcare.

Figure 1
MSCI World Sector Performance



Source: Bloomberg Finance, L.P., as of 17 April 2020. Past performance is not a guarantee of future results. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income. Performance returns for periods of less than one year are not annualized.

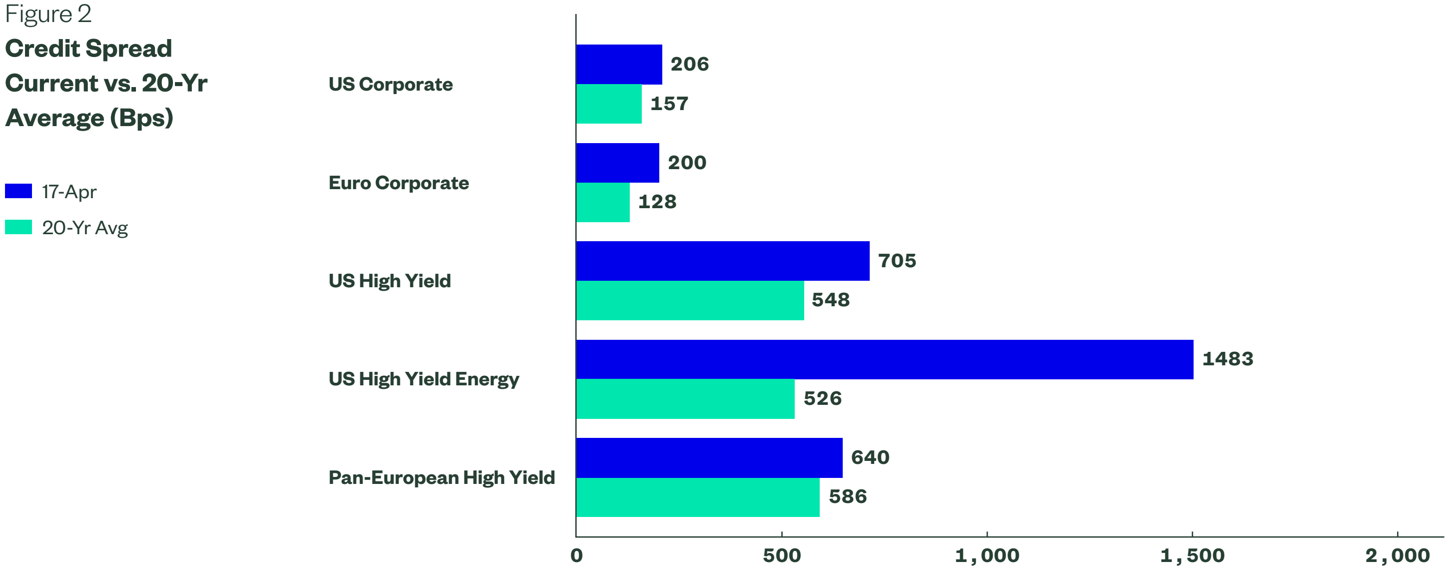
Oil Threatens High Yield

The Fixed Income market also shows a very clear demarcation of risk and return. As we move up the risk spectrum, we see one-year returns drop and yields increase. Outside the US, we also see duration drop as risk increases, so on a risk-adjusted basis (yield per unit of duration), some of the riskier portions of fixed income are looking a lot more attractive than at the start of the year.

UK gilts with 50bps yield for over 10½ years' duration look very unattractive by this measure, when compared with Sterling Investment Grade or Global High Yield. Although in the case of the former, liquidity has been challenging of late, and in the latter, risks still abound.

We have seen a pullback in High Yield spreads, over the month, as we can see from the bar chart below. However, given the drop in crude we have seen over the last week or so, the energy sector which is about 10% of US High Yield is still under considerable stress. How the sector eventually recovers and transforms, depends on how much capacity destruction might occur through this crisis, as companies are forced to delay or abandon infrastructure builds. How many defaults occur will also be a significant factor. It's fair to say that the current level of spreads is pricing in some pretty catastrophic scenarios in this respect, but as long as the oil price stays this low, the sector could undergo irreparable damage.

Figure 2
Credit Spread Current vs. 20-Yr Average (Bps)



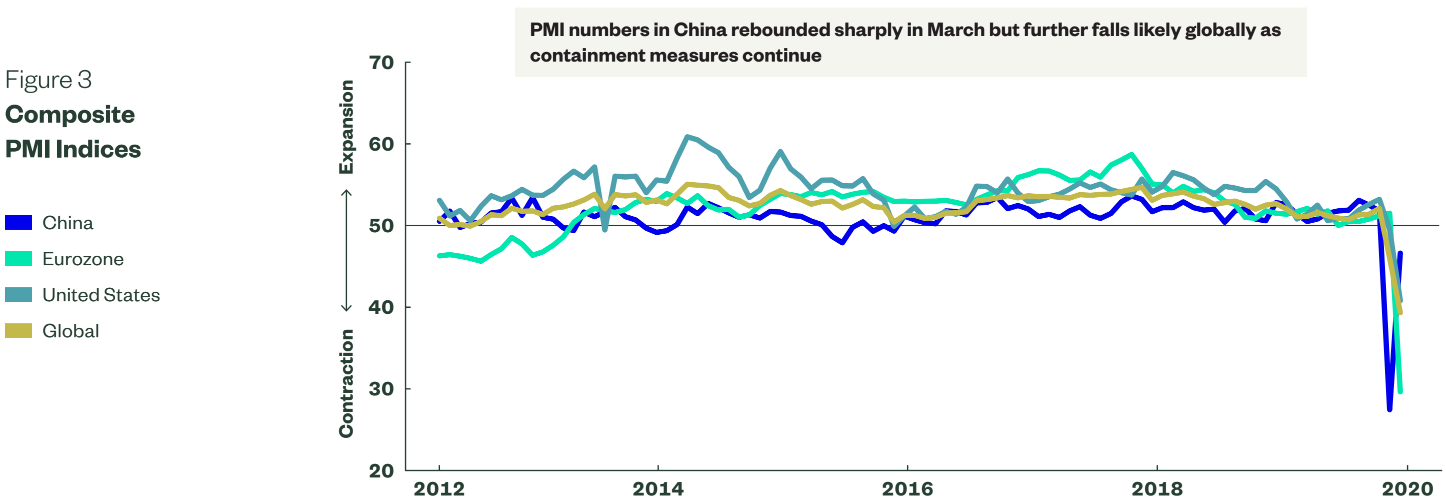
Source: Bloomberg Finance, L.P., as of 17 April 2020. Past performance is not a guarantee of future results. Performance of an index is not illustrative of any particular investment. It is not possible to invest directly in an index. Performance of an index is not illustrative of any particular investment. It is not possible to invest directly in an index.

PMI Data Tells the Economic Story

Going back to the 3 phases of the crisis, the figures indicate we are still in phase 2. The economic data is starting to show through, as is very clear with the PMI data below, where China's "v-shaped" bounce is something of an anomaly, and the collapse in the US and Eurozone measures more reflective of where we are globally.

What should be clear though is that things will continue to get worse before they get better, as more and more of the effects of the forced closures and redirections of businesses and restricted movements of people feed through into economic data.

Figure 3
Composite PMI Indices



Source: Bloomberg Finance L.P, Markit and Caixin as of 17 April 2020. Past performance is not a guarantee of future results.

The 3 Waves of Crisis

1. People realise they have a problem and start discounting asset prices based on their changing expectations of how bad the problem could get.
2. Economic data starts reflecting the scale of the problem.
3. Corporates start discussing the impact of the crisis on their business models and analysts start incorporating them into their forecasts.

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