Santander Asset Management

A Quarter in the Markets

Q2 2020

We are pleased to introduce our latest edition of 'A Quarter in the Markets', which provides an insight into financial markets from the Multi Asset Solutions team at Santander Asset Management UK.

Key factors influencing markets

Global stock markets performed well over the second quarter, despite many countries around the world introducing social distancing measures and entering varying degrees of lockdown due to the COVID-19 pandemic. As economic activity fell to low levels, central banks and governments announced extraordinary amounts of support to cushion the downturn, which in turn proved positive for investors.

Government Bonds and other lower-risk investments also performed well over the quarter. This was partly due to low interest rates, but an uncertain economic outlook and concerns about future spikes in COVID-19 cases also contributed.

So, what happened during the quarter?

Unsurprisingly, COVID-19 - followed by the economic crisis it caused - was the main driver of markets over the quarter. The period opened with many countries having imposed social distancing measures or even strict lockdowns to curtail the spread of the virus. Europe and North America were the hardest hit regions early on in the quarter, and the economic shutdowns caused manufacturing and services activity to fall to unprecedented lows.

During this time, investors grappled with two competing forces. The first was that the various states of lockdown meant many businesses were shut down for the foreseeable future, while still more were experiencing significant drops in revenue due to reduced footfall. On the other hand, there was the positive force of central bank and government support aimed at cushioning the economic shutdown.

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The support measures from policymakers were seen as a positive and helped stock markets to rise across the board in spite of the uncertain outlook. With interest rates having been cut to low levels and central banks buying up Bonds, investors were encouraged to take more risk.

Meanwhile, the world continued with attempts at containing the COVID-19 outbreak and searching for breakthrough medical treatments. By the end of the quarter, the US became the country with the highest number of confirmed cases, followed by Brazil and Russia. The UK saw the highest number of cases in Europe, whilst countries in Asia had largely contained their outbreaks early on in the quarter and were focusing on preventing further flare-ups.

Subsequently, those economies in Asia and Europe where infection rates have fallen to low levels, are progressively re-opening. However, the US is facing stubbornly high infection rates and many states have had to reverse the re-opening process after a spike in cases. Meanwhile, many Emerging Markets, such as India and most of Latin America, have struggled to gain control of the virus.

How did different economies react?

It may have been a positive period for stock markets, but the situation for most economies was rocky. The UK saw a significant fall in gross domestic product (GDP) - which measures the value of goods and services in the economy - with the Office for National Statistics reporting that GDP fell by 10.4% in the three months to April. At the same time, it revised GDP for the first quarter of the year to a rate of 2.2% – the worst seen in 41 years. However, as the UK government began to re-open the economy in May, business activity started to rebound. The manufacturing and services sector saw increased activity in June as businesses slowly started up again and people started to go back to work, but levels remained below pre-crisis levels.

Away from the pandemic, there were renewed concerns that the country could be headed for a no-deal Brexit as talks between the UK and European Union appeared to stall. The Bank of England said the prospect of negative interest rates were under active review, and the central bank increased its bond-buying programme, known as Quantitative Easing, by £100bn.

In the US, there was a major debate between President Donald Trump and state governors about the economic effect of the restrictions imposed due to COVID-19. The economy began to re-open in May, which investors viewed as a positive move. During the quarter, the Bureau of Economic Analysis reported that growth fell by 5% during the first quarter of the year. This is the sharpest drop since the 2008 financial crisis. Meanwhile, the lockdown measures left around 40 million Americans out of work, although new jobless claims later in the quarter had improved. Similarly, the Conference Board's consumer confidence index went up more than expected in June, driven higher by the re-opening of the economy and an improvement in unemployment figures.

Turning to Europe, many countries resumed activity in May and June, after a lockdown period that caused business activity to slow down remarkably. Both the manufacturing and services sectors across Europe saw large contractions in activity, with Germany's purchasing managers' index (PMI) – which measures business activity – falling to 36.6 in May (a reading below 50 suggests falling activity). Conditions across the continent improved in June as the re-opening process continues, with PMIs for the services and manufacturing sectors having rebounded from the lows seen at the height of lockdown. Though, it is important to stress that this was from a low base. For example, Germany's manufacturing PMI for June stood at 45.2. That said, data from the European Commission showed that business and consumer optimism had increased by the end of the quarter.

In China, where the virus originated, the government began reviving the economy after it introduced a shutdown to fight the outbreak. Early indicators suggest that China's economy was on the recovery path throughout the quarter, which was seen as a positive sign for the rest of the world. By June, China reported that factory activity was expanding at a fairly strong pace after the government increased investment. That said, it faced weak export orders, suggesting that the impact of the pandemic will continue to affect the economy for the foreseeable future. China's official PMI showed a rebound of activity in the manufacturing and services sectors in June, although export orders continued to contract.

What is the outlook for markets?

As we reach the halfway point of the year, the outlook for the economy as well as stock markets remains uncertain. Judging by the number of cases still being reported worldwide, we cannot be certain that we are through the worst of the pandemic's first wave yet. We are also only beginning to understand the extent of the economic damage it has caused. While public health officials have gained a better understanding of how to control the virus and prevent hospitalisations, this does not mean future outbreaks are ruled out. Against this backdrop, the likely economic recovery is difficult to predict as there are several variables at play. That said, COVID-19 has now become a known risk to markets. Its ability to move stock markets has become lessened by the fact that central banks and governments are prepared to support the economy as required.

Looking ahead, the prospects for global stock markets are mixed. The US faces several risks in the coming months, including spiking COVID-19 cases, a US election where President Donald Trump is trailing in the polls and the prospect of a renewed trade war with China. Should the Democratic Party win the presidency as well as the US Senate, it will pave the way for more left-leaning tax and regulatory policies that could have a negative effect on shares prices. Europe, by comparison, appears more attractive for investors as the €750bn fiscal deal reached by Emmanuel Macron and Angela Merkel raises the prospect of providing financial support to economies worst hit by the pandemic.

How are we positioned for the major risks to our outlook?

We maintain a neutral stance on risk overall as the COVID-19 situation and economic downturn progresses. We do not expect to see stock markets make any major upward movements in the months to come, at least not until an effective treatment or vaccine for the virus is discovered. Within stock markets, we are investing in cyclical sectors and regions that we believe will provide returns in the short-term, such as European Shares or technology companies. We have made only minor changes to the portfolio over the month, having added exposure to Europe and technology companies and reduced our broad US exposure. We have also added Gold to some portfolios as a diversifier.

We have a neutral weighting in the Bond market with a focus on quality. In this area, our focus is primarily on investment grade Corporate Credit and Government Bonds.

Overall, we are maintaining highly diversified portfolios that are positioned for the current economic and market environment, and provide some cushion should there be further market falls.