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Update on current market developments

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Central banks have acted decisively to stop the current market slump from becoming a full-blown credit crisis. As we saw in the financial crisis a decade ago, this would limit banks' ability to lend to struggling businesses exactly when they need a lifeline to survive.

Until last week, moves unveiled by politicians and central bankers were aimed at solving the temporary cashflow shortages caused by lockdowns to prevent the virus spreading. However, it became obvious that funding pressure in markets was starting to become an issue. Central banks took rapid action to keep markets liquid, ensuring money could flow to where it was needed. This was welcome and correct.

The biggest move came from the US Federal Reserve, which increased the amount of dollars it provides globally and pledged to do as much quantitative easing as was necessary to support both the financial system and the broader economy. In a startling departure from its long-standing mandate, the US central bank even announced it would be setting up a special purpose vehicle, backed by the US Treasury, to extend credit directly to private sector companies. Washington is also likely to agree a $2 trillion fiscal stimulus programme, representing 10% of America's GDP.

These decisive moves have helped bring some calm and reassurance to markets. Financial conditions have eased a little, with more order seen in both sovereign and investment grade corporate bonds markets, with equity markets rallying off lows.

Another factor that has been boosting equity prices is a technical issue. Many institutions – and this is particularly true for pension funds with large amounts of money to invest – have rules that dictate what proportion of its portfolio should be in equities and what should be in bonds. Stock market falls means they are now 'underweight' in their holding of shares compared with the rules governing their funds. Managers will need to rebalance the portfolio by buying more equities. This should not be read as a market timing move by big industry players.

Even though moves to support markets and the real economy have been significant, it is still too early to call a decisive turn in equity markets. Economic data will show that the global response to Covid-19 will have caused the sharpest and most substantial correction in global economic activity seen since the Second World War. There will certainly be a collapse in corporate earnings for at least two quarters.

Whilst there is much bad news discounted by equity markets, for a sustainable rally to develop we must see two things happen. The first is that the economic and financial market environment we are now entering is socialised as broadly as possible. The second is that the path to a more normal economic environment becomes clear.

The first of these will occur in the days and weeks ahead. However, the latter is likely to take longer as it will rest on evidence that the global policy response is gaining traction and that efforts to stem the spread of the novel coronavirus infection are bearing fruit.

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