Update on current market developments

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Published 6 November 2020

The lockdown announced for England will further trouble UK markets in the weeks ahead, as the damage to the domestic economy takes hold, against the backdrop of continuing Brexit uncertainty.

By mid-summer, the UK stock market had recovered a full half of the 30% losses recorded as the Covid crisis hit. But since then the recovery has faded steadily and the main market ended October some 25% below pre-crisis levels. Is it now time to throw in the towel, or alternatively an opportunity to invest cheaply?

It is worth noting that the UK market has been amongst the worst performing. For example, powered by technology stocks, the US market has regained the levels prevailing before the crisis struck. It is true that diversification is the only free lunch in investing: exposure to safer asset classes and international stocks has protected UK investment portfolios from the worst of the local market declines and most investors are recording valuation declines well below those implied by the local market.

This might suggest UK stocks now offer particularly good value. It should be recalled though that global equity markets entered the Covid crisis fully priced. The economic approach of the past twenty years has focussed on tightening fiscal policy to rebuild public finances after the financial crisis ("austerity" in the UK), while keeping interest rates very low to support the economy. Those low interest rates also encouraged savers out of safe investments into equities. This trend was reinforced by quantitative easing (QE), which poured newly created money into the capital markets. So, stocks enjoyed a strong tail wind and entered the crisis at less than cheap levels.

The stock market recovery earlier in the summer reflected the immediate policy response to the crisis: fast and massive easing of both fiscal and monetary policy. The outlook for stocks into the year-end will depend on whether the government and the Bank of England can reprise that response. If so, the impact on the markets will probably once more offset the underlying deterioration in the fortunes of the corporate sector and the broader economy, thereby stabilising markets.

We can sense Treasury hesitancy based on the resulting bill as a result of these measures. Budget deficits have broken the mould this year. The legal framework of the European Monetary System for example, requires government deficits not to exceed 3%, even at the worst point of the economic cycle. The major European states are now poised to run deficits in the range of 8-12% of GNP. Here in the UK, the deficit is likely to be an eye popping 16%.

Conventional economic theory tells us that all this debt must be repaid, implying a decade or more of heavy taxation and constrained government spending. But a heretical branch of the economics profession has been challenging this orthodoxy for more than twenty years. Adherents of Modern Monetary Theory argue that it is fallacious to equate government debt with the debts of family households. The latter must be repaid but government debt can be rolled over with freshly issued money.

It sounds wrong, but there has been a noticeable increase in interest in the approach, including among very senior policy makers. Critically, it implies that crisis borrowing can be parked indefinitely. No decades of austerity for future generations. We believe that the alluring nature of the theory will prove irresistible and governments will launch a further wave of fiscal interventions to support the economy during the second wave of the crisis, with continuing full throttle monetary policy support. In turn this should support financial markets, encouraging another stabilisation and recovery in market levels. So, while stocks might not be a bargain right now, it is probably unwise to sell at current depressed levels.

Naturally, we spend much time pondering the longer-term implications of the extraordinary events of 2020. Much will depend on the economic debate: if orthodoxy prevails, nothing can be ruled out, including wealth taxes. But the most likely scenario is that the massive debts will be repeatedly rolled over. Much will also depend on how public spending is deployed to support the post crisis recovery ("build back better" in the UK).

The EU has signalled it will use the fiscal stimulus to launch a green economic revolution. The digital revolution has received a further boost from adaptation to the crisis: how will this transform the global economy? Governments have effectively renationalised sections of the economy, most noticeably transport. Will this be swiftly reversed or herald a retreat from a small government philosophy? Globalisation and free trade will also be under the spotlight, with the critical supply chain vulnerabilities laid bare by the crisis. The re-evaluation of the West's relationship with China will also impact trade and the structure of the global economy. Of course, sadly, it would be unwise to assume that Covid 19 has no role to play in the long term: it might be with us for many years.

At the time of writing it looks very likely the USA will have a new President who will offer a very different policy approach and a very different style of governing to the Trump administration. If elected, Mr Biden will take the virus more seriously and favour stricter lockdowns and protective measures and will wish to adopt a leading role in the Green revolution. He is also likely to continue the cool relations with China.

It is difficult to see that Mr Trump could sustain a successful challenge to an election he had lost by anything other than a tiny margin, with considerable pressure of public and press opinion against attempts to claim large numbers of rigged postal votes. He will need good evidence and a credibly small gap to make it a realistic chance of overturning a declared result. People do not like bad losers.

The final months of 2020 will be a waiting game – waiting for the final result of the US elections and how Brexit and the Covid-19 crisis both play out. If you would like to keep up to date with these developments , visit our website for our latest views.