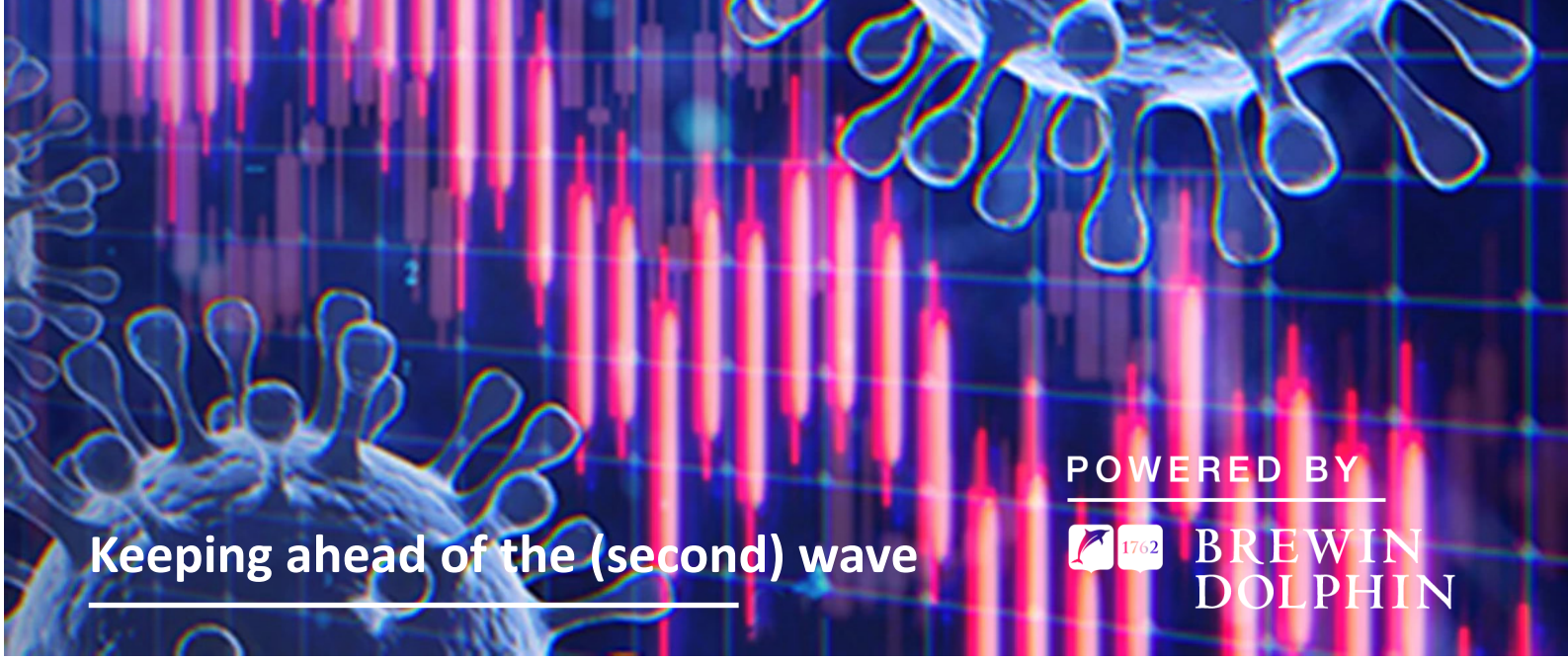

Keeping ahead of the (second) wave

For months there has been concern that, with the onset of winter, Europe may well face a second wave of Covid-19 infections. Now it looks as if it may be coming sooner than many had expected. Our Head of Research, Guy Foster, assesses what investors should expect in the coming months.

We cannot say that this turn of events has come as a complete surprise. Across Europe the number of Covid-19 cases has been increasing for weeks.

In France there have been regional restrictions in place since the summer. In Ireland, a three-week restriction has been put in place to limit people from leaving Dublin (except for essential reasons), as well as other social interaction measures. In the UK, tighter restrictions have been announced in all four nations with the prime minister, Boris Johnson, warning that they could potentially be in place for the next six months.

Meanwhile looking across the Atlantic, the trends are not hugely encouraging. While the third wave of case growth in less populous states has subsided a little, the more worrying trends are in Texas and Florida where cases may be growing once more. This isn't just the result of more testing, as the positive test's ratio is also rising and the rate of decline in hospitalisations has slowed with the lag that you might have expected if the increase in case numbers reflected a true increase in infections. For whatever reason, the virus has not been supressed as effectively as it was in New York earlier in the year.

Which all points to a somewhat downbeat autumn and winter ahead. But does that mean a similarly downbeat time for the markets?

What are the markets anticipating?

Market volatility has been picking up at the same time as the headlines about case numbers and lockdown measures are deteriorating. As ever though, with markets, the cause and effect is a little murkier than intuition would suggest. For example, from the fund managers and counterparties who we speak to, and from surveys we see, it seems the general consensus amongst investors has been to expect consecutive waves of Covid-19 until such time as there is a widely available vaccine. Very few had taken the view that the disease had been beaten with the suppression of the first wave.

Covid-19 has clearly had a devastating effect on the profits of many companies. Profits in 2020 and 2021 are expected to be heavily impacted. Will the return of Covid-19 mean a return to the kind of volatility seen earlier in the year? While many companies have reduced costs their efforts to do so will reduce revenues at their suppliers, which weighs on the economic recovery. At the margin, these things are factors which will determine how soon the economy is able to recover.

The difference between March and now is that the volatility which took place earlier in the year occurred because investors suddenly had to recognise the loss of the next few years' earnings. Furthermore, policymakers were at the time trying to tighten monetary policy, whereas now they recognise they need to loosen it. It was what Donald Rumsfeld would call an unknown unknown – the significance of which dawned on investors very rapidly indeed. That kind of abrupt adjustment is behind us.

The economic effects of efforts to suppress the spread of Covid-19 are now much more of a known-unknown, but with market expectations of ebbing and flowing regional measures to try and slow a second wave, the virus nonetheless remains an important factor. However, we expect it to form part of a 'wall of worry' that the markets will actually be able to climb. This phrase captures the way in which markets are often more resilient in the face of known risks than might intuitively be expected. It is assumed to reflect that investors gradually become resigned to the fact that these issues will be resolved in due course.

It does not hurt that such circumstances also tend to coincide with periods when monetary policy is very supportive.

Indeed, given the worsening picture in terms of the spread of the virus itself, we would expect to see an extension or adaptation of previous stimulus packages, to keep any immediate economic damage to a minimum. That is necessary to minimise the expected increase in unemployment, and seems to be recognised in the UK where the chancellor has announced further employment support measures and cancelled a budget at which he was expected to raise taxes. Similarly, in Europe the

ECB are preparing further measures to boost lending and in the US the Federal Reserve are remonstrating with Congress to pass further stimulus measures.

Other factors at work?

It's also worth considering the current market context. Global equities have staged one of their biggest expansions on record over the six-month recovery period since the extreme turbulence in March.

Sporadic periods of volatility are common in markets anyway, but more so after strong gains as optimism and pessimism ebb and flow. This has been particularly acute this year because of much higher volumes of investor participation in speculative derivatives than previous years. Last Friday saw a number of quarterly options contracts expire simultaneously. When this happens it often leads to more market volatility in the following week, and may have exacerbated things on Monday.

The importance of timing?

Perhaps the only thing worth adding from an investor perspective is the interplay with Brexit. The prime minister, Boris Johnson, has threatened that if a deal with the EU is not reached by October then all hands will be thrown into no-deal preparations, and it is worth pondering whether that is realistic if current trends suggest that October may see the peak of a new Covid crisis. Might we see this can kicked even further down the road?

One thing seems certain; that there will be disruption to life as we know it until well into 2021. While restrictions may not take the form of the national lockdowns seen previously, even targeted measures will still have an economic impact. However, from an investment perspective, the belief that there will ultimately be a resolution will give enough confidence to the markets to look through these extraordinary circumstances to the other side of the crisis.

Guy Foster, Head of Research
Guy leads Brewin Dolphin's Research team, providing recommendations on tactical investment strategy to Brewin Dolphin's investment managers and strategic recommendations to the group's Asset Allocation Committee. He is a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. Guy frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of Brewin Dolphin.