OCM Asset Management

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Market Update: 27th February 2020

Market Movements

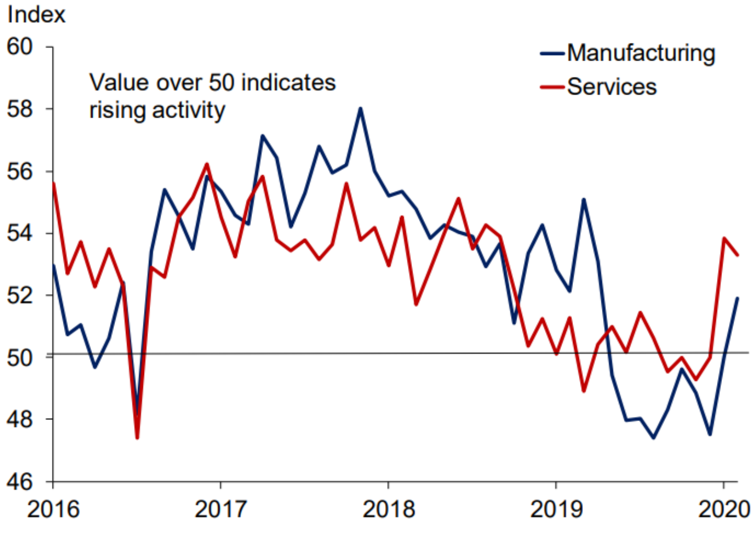
After last week's optimism over progress towards containment of the coronavirus, negative sentiment returned to markets this week as outbreaks of the virus outside of China continue to grow, with numbers rising in Italy, South Korea and Iran. However, last week it began to appear that the growth of new cases and fatalities in China is slowing, and although this is still the case, today it appears that the increase in cases outside of China has spooked markets.

Stock markets have sold off this week amid growing concerns over the business impact of the coronavirus, with most indices erasing the gains made so far in 2020. Gold reached a new seven year high and the US dollar strengthened as investors sought safety assets. It is our view that we are currently seeing a significant overreaction in markets, and while we do think that the coronavirus will continue to bring volatility in the near term, we view this as a short term effect in markets which will be reversed. We remain focussed on economic fundamentals and have continued to observe improving data which supports our expectations for markets to rebound, and the global economy to remain robust over the long term.

The Boris Bounce Continues

A busy week for economic data delivered broadly good news for the UK economy. Notably, the flash purchasing managers indices for February showed activity in both the manufacturing and services sectors grew over the month (noting that a value over 50 in the graph below indicates rising activity), which was reinforced by a surge in business sentiment, with the number of firms planning to invest to boost capacity rising to a record high. The positive data provides even more evidence that the UK economy is benefiting from the Conservative government's business-friendly policies.

Figure 1: UK PMI data shows sharp increase in activity following the UK general election in December 2019



Source: Oxford Economics/CIPS/IHS Markit

Consumer Confidence

Economic sentiment indicators in February provided more evidence of the Boris bounce, with particular improvement in the industrial and retail sectors since the December election, currently at 16 and 19-month highs respectively. The Eurozone sentiment indicator also edged up in February, but unlike in the UK, confidence in the Eurozone's retail sector fell back a bit. This suggests the surge in confidence in the UK's retail sector is due to the more certain domestic political situation post the December election feeding through into consumers' willingness to open their wallets, rather than changes in the global economic backdrop.

Of course, the survey was done before the jump in coronavirus cases in Italy over the last few days, and so would not have captured any drop in confidence due to concerns about the virus. As a result, consumer confidence may fall back in March if fears about the virus continue to grow. However, its in our view that the impact will be purely sentiment based, and don't expect a change in the economic fundamentals. Overall, the survey data backs up the flash Purchasing Managers Indices in suggesting that the economic rebound which began at the end of December continued in February.

March Budget

The recent boost to the UK economy is likely to be supported by a large increase in fiscal spending in next month's Budget. Markets have interpreted the resignation of Chancellor Sajid Javid and appointment of Rishi Sunak as a signal of looser fiscal policy to come. Sunak has implicitly accepted conditions that Javid rejected, namely closer oversight from Boris Johnson and the sharing of special advisors, leading markets to take the view that he will be encouraged to adopt a more expansionary approach to policy. Adding to this, January's fiscal surplus of £9.8bn leaves borrowing in 2019-20 on course to undershoot the Office for Budget Responsibility's full-year forecast of by £3-4bn. With political signals all pointing to a meaningful opening of the fiscal taps in the forthcoming Budget, that undershoot will give the new Chancellor some more leeway in achieving the government's fiscal ambitions.

What all this means is that one way or another a large fiscal stimulus is coming in the budget on March 11th. The Conservative Party touted a £100bn investment package in their manifesto, however recent reports have suggested the Chancellor could unveil investment spending of around £70bn – a much more likely outcome. Either way, the stimulus package is expected to be the biggest loosening of fiscal policy since the height of the financial crisis, helping boost the economy and likely sustaining the recent pickup in activity. We are continuing to watch for any developments in the Budget or changes to fiscal rules. Meanwhile, we expect that the flurry of data releases in the past week will further reduce expectations of an impending interest rate cut.

Outlook & Positioning

Despite the spread of the coronavirus outside of China spooking markets this week, our expectation remains that the impact will be limited to Q1. We believe the current reaction is being driven by fear and negative sentiment, while we remain focussed on the economic fundamentals, which appear to be improving. As it stands, our medium to long term outlook remains unchanged, but we do expect some disruption prior to a sharp rebound in April and May. Overall, we expect to see further volatility ahead in the near term as the economic impact becomes known, however our medium-term expectations remain unchanged.