

Market Update

14th May 2020

Markets have rallied from their recent lows, and valuations are arguably too high: is there the danger that these valuations will be driven even higher given the lack of options open to investors?

It is true that markets have enjoyed a strong recovery, particularly in the US, and perhaps to an extent that we might not have expected. For the foreseeable future, returns from cash and government bonds look set to be subdued and so investors looking to secure any meaningful returns will have to consider higher risk assets. We do not feel that equity market valuations are looking excessively stretched, however our concern is that as the Covid-19 pandemic runs its course, they will have to absorb a great deal of negative news over a protracted period of time. We are therefore erring on the side of caution over the near term as we feel that we will be given a better opportunity to build higher our risk positions in the portfolios.

What is the investment team's view on the level of sovereign debt, gilts and treasuries in particular, that is due to be issued?

It is clear that governments worldwide are set to issue significant amounts of sovereign debt in order to finance the emergency measures they have put in place to support their populations and businesses during the Covid-19 pandemic. This will prove to be a very expensive exercise. However, central banks have clearly indicated that they are willing to back governments in this debt raising by buying it in enormous quantities through their QE programmes. In our view, therefore, government bond yields should not rise significantly from where they are now. However, once central banks withdraw this support, government bond markets could face challenges. In the meantime, they offer virtually no yield and limited potential upside if we see any further deterioration in the economic outlook.

In previous podcasts, Square Mile's investment team have suggested that, in their view, high yield corporate bonds may offer investors a more attractive risk/reward profile. Is this still the case?

In the past we have not been very active in high yield debt markets, but we feel that the dynamics have changed somewhat. We expect to see taxes increase over the coming years as governments look to repay the debt which they are taking on today. Corporation taxes globally seem certain to rise as a consequence. We therefore believe that equities may face an additional headwind. However, in our view, high yield debt, which offers a comparable risk/return profile to equities, will not be affected to the same extent. Furthermore, those investing in corporate debt enjoy a contractual relationship by which their funding is recompensed through interest payments. This makes the risk/reward outlook for high yield more attractive than it has done historically and we are therefore giving careful consideration to these markets across our portfolios.

In early April, the Federal Reserve surprised investors by announcing that it would buy sections of the high yield market as part of its QE programme, causing prices to rise quite materially. Since then, however, prices in the US high yield market have drifted somewhat, and spreads have started to widen out once more. This is a development that we are monitoring very closely for any opportunities that we can exploit over the coming months.

Jason Broomer, Investment Director

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