



**BROMPTON**  
ASSET MANAGEMENT

## Covid-19 commentary

12 March 2020



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### Official response should fuel strong recovery once virus case numbers plateau

The Covid-19 outbreak was officially described as a pandemic by the World Health Organisation on 11 March 2020, a day that brought a major co-ordinated policy response from the Bank of England and the Treasury to combat the impact of the disease on the UK economy.

The Bank of England went first, cutting its base rate by half a percentage point to an historic low of 0.25% and announcing measures to encourage bank lending. Banks will be able to borrow for up to four years at base rate on the condition they lend this capital to small and medium-sized businesses. The BoE is making up to £100 billion available on these terms, equivalent to approximately 5% of all bank lending.

At the time of the credit crisis, over-indebted banks were at the heart of the problem and incapable of fulfilling their crucial role as a means of channelling cash into the economy. Since then, regulators have forced banks to raise capital on their balance sheets to much higher levels and introduced a specific counter-cyclical capital buffer. The buffer required banks to hold specific reserves to ensure capital was available for new lending to counteract shocks to the economy. This buffer was due to increase to 2% by the end of 2020 and has now been reduced to zero, which will free up approximately £200 billion of capital for investment.

Rishi Sunak, the new chancellor, went next and announced an end to austerity. Public sector spending is forecast to increase by 2.8% next year, a faster pace than the economy, as a result of investment in the public sector spending and investment in physical and information technology infrastructure as well as targeted measures such as changes to business rates to counteract the impact of Covid-19 on smaller businesses and those most directly exposed to the impact on consumer spending such as retailers and hospitality and leisure businesses.

The Covid-19 outbreak is primarily a supply-side shock to the economy as workplaces close and supply chains are broken. Monetary policy measures such as interest rate cuts, which are aimed at stimulating demand, may in consequence have limited impact in the short term. They could, however, prove vital in ensuring that good businesses can weather any immediate liquidity squeeze and, in due course, ensure a strong recovery when the impact of the virus wanes. The current oil-price dispute between Saudi Arabia and Russia, which has led to a sharp fall in the oil price, could provide an additional source of stimulus.

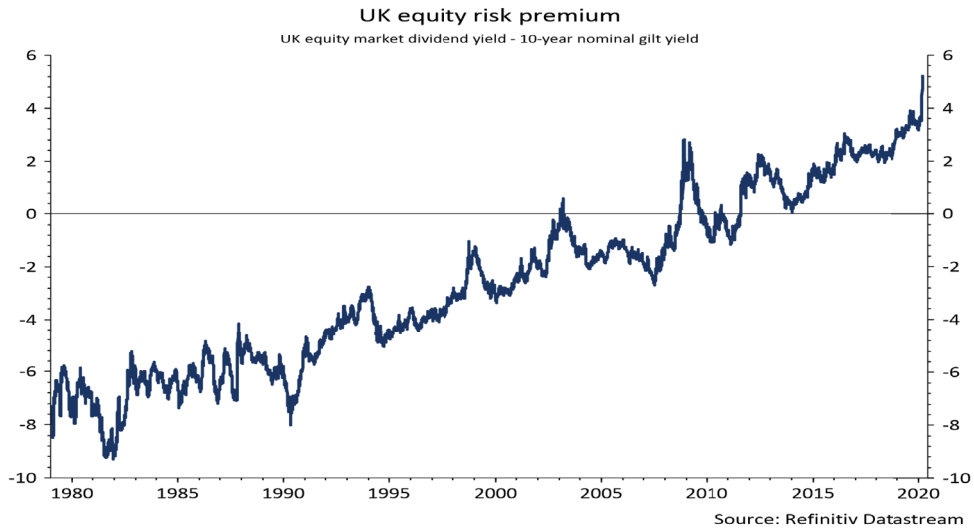
Equity markets fell sharply as the virus spread beyond China. The chart overleaf shows the UK equity risk premium, the excess income investors in UK equities may receive from dividends compared to the income from low-risk investments such as longer-dated UK government bonds. It is a measure of the compensation equity investors require for the risk they are taking.

As the chart shows, this measure is at a 40-year high of 5.15%. The yield on bonds has, of course, been depressed by interest rate cuts and quantitative easing but an historic yield of 5.45% from UK equities is attractive in an environment of low interest rates and inflation, particularly in light of the policy response from governments and central banks. Equity markets are likely to remain weak and volatile until there is evidence that the numbers of new cases has peaked but for longer-term investors the recent sharp falls may prove to be an attractive buying opportunity.



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