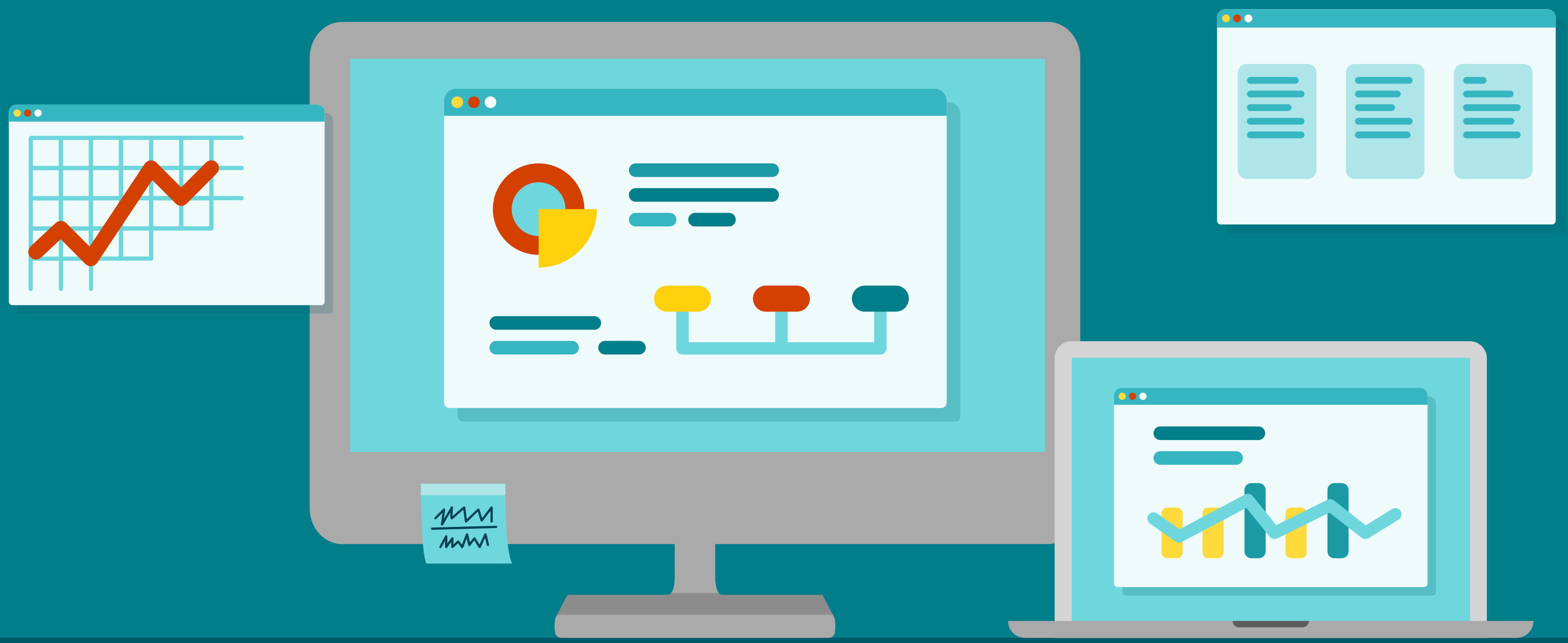
Making sense of financial markets in the midst of the COVID Crash



What is the COVID Crash?

COVID-19, otherwise known as the Coronavirus, has turned our lives upside down. Early reports indicate that public health and safety measures, along with changes in our behaviour and our day-to-day lives, are starting to impact the spread of the pandemic and we, together with everyone else, hope that the crisis will soon abate.

Covid-19 has caused a ripple effect throughout our world and the economy is currently facing its greatest challenge in a century — or perhaps in all of history.

What can governments do about the COVID Crash?

There are two "levers" to influence economies — tools they can use to revive and reinvigorate economies. These are usually the bases for stimulus packages, and can be divided into two broad categories:

Monetary — This is when the central bank (Bank of England in the UK) changes interest rates, or when the government may take action to increase how much money and/or credit is available.

Fiscal — This is when the government spends money, or uses taxation to influence the economy.

Because interest rates are at historically low levels the monetary lever is proving mostly ineffective. That isn't to say they won't work in the long run — these things take time, and often we can't judge whether a measure was effective until after the fact.

What fiscal measures have governments taken?

The government has been pumping money into the economy. The Budget (March 2020) included a financial package of a little over £1bn, which was bumped up to £350bn within a week — all designed to keep people in work, and to keep money flowing through the economy.

Why do we need to keep the money flowing?

Economies are driven by people spending money. People buy stuff from businesses, businesses pay their staff, staff spend money to buy stuff — on and on it goes. When money is injected into the economy, people spend more. That's called the multiplier effect, and it's how economies grow.

The reverse is also true: money that doesn't get spent doesn't help the economy (unless it is saved or invested. For now safe to say that money not spent is effectively taken out of the multiplier). With consumers staying home and businesses shut, there is a slowdown in spending.

People keep on spending money on essentials, but they're holding onto the rest because they don't know what's going to happen next. Even if people's salaries are supported, much of that money isn't going back into the economy in the same way - so fiscal stimulus doesn't seem to be having much of an effect.

What monetary measures have been taken?

The Bank of England (BoE) has lowered the Base Rate to 0.1% — the lowest it has ever been since the BoE was established, back in 1694.

What is the Bank of England Base Rate?

The Base Rate is the official borrowing rate — in other words, the interest rate that a central bank will charge for loans.

Commercial banks and other financial institutions take loans from a central bank, like the BoE. The lower the Base Rate, the cheaper the loan. That means that commercial banks and other financial institutions can then offer loans to customers at a lower rate of interest.

The lower the interest rate, the more people will borrow — so by changing the Base Rate, the BoE seeks to influence overall borrowing in the economy.

How does that stimulate the economy?

When interest rates are lower, there can be a big impact on companies. Businesses are more likely to borrow and expand if they can get money more cheaply. They hire more workers, they pay more people, and those people spend that money — creating a multiplier effect.

At least, that's the idea, but companies are currently nervous about taking on debt. They don't know what the future holds, and stock prices are crashing. So monetary stimulus doesn't seem to be having much effect on the economy, either.

What's happening with stock prices?

Despite efforts made by central banks around the world, stock markets continue to fall. Markets hate uncertainty and often when markets drop people, and funds, pull their money out causing the market to fall further and it becomes a self fulfilling prophecy.

Also a lot of companies are re-forecasting their profit projections (many companies are reviewing these numbers down) and this pulls down investors' expectations of the ability to make money in the market.

What do low stock prices mean?

Low stock prices are good for some and bad for others.

If you were considering entering the stock market then low prices effectively represent a sale - you are buying something you believe to be valuable at a lower price than you were expecting.

On the other hand if you were investing for something specific and time dependent i.e. for buying a home, or to retire, then a drop of 30% in the market means your “pot” has lost 30% of its value which could take years to get back to the value you were expecting.

As is always the case with market movements, the outcome will depend very much on who you are, what you were investing for, and what your time horizon was.

So, what can you do?

One of the best things you can do is to arm yourself with information. The more you understand, the better prepared you’ll be. So stay informed, but more importantly: stay safe.