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Unidentified Economic Object

MARKET FLASH

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Something unprecedented is happening to the global economy. In entire countries, the economy is at a standstill except for essential activities, primarily in the healthcare sector. People are obliged to stay at home, not working at all or trying to work remotely, making the best of the various personal, technological and psychological constraints. This implies a sudden fall in labor volume and productivity, i.e. economic growth. Economic uncertainty has reached new heights, surpassing even the levels in autumn 2008. Until the epidemic "curves" flatten out, there is every reason to believe that anxiety and risk aversion might increase further.

Growth forecasts will now be massively reduced. Here again, the scale of the revisions will likely exceed what was seen following the Lehman Brothers collapse. From September 2008 to March 2009, the global GDP growth forecast for the next 12 months was reduced by 3.3 percentage-points. Before the coronavirus emerged, global growth was expected to be in the region of 3%. It will now be negative. This is the first time this has happened in the post-1945 era. The wave of poor economic statistics for both activity and employment is only at beginning.

With some sectors largely at a standstill (catering, tourism, air transport) and others severely hampered by the confinement measures (manufacturing output, durable goods trade), it is possible the level of GDP could fall by 5%, 10% or more in a few weeks in several countries, depending on the duration and severity of the confinement measures. After 1945, the sharpest quarterly contraction in real GDP was -4.7% in Germany in Q1 2009, and -5.3% in France in Q2 1968.

This last example, although quite old, may shed some light on the impact of the economy shutting down. In May-June 1968, France suffered a general strike which accompanied the student protest movement. As a result, production collapsed. Once the uprising and the strike were over, it then rebounded by 8% q-o-q. The coronavirus is likely to be tougher than students in the Latin Quarter.

While the shock is clearly of historic proportions, it is worth bearing in mind that the response to the shock is similarly unprecedented. In just a few days central banks have reactivated all the tools that had been applied, albeit with some fumbling around for weeks or months, at the time of the financial crisis of 2008-2009. We have had aggressive cuts to policy rates, new asset purchase programs, the re-creation of liquidity facilities, international cooperation to prevent a dollar shortage and an easing of regulatory constraints for the banking sector. The central banks are offering an unlimited guarantee to governments and banks to support the economy. The goal is to avoid the global credit crunch seen in 2009. This is what can make the difference between a very severe yet short-lived crisis and a very severe crisis which has cumulative effects.

The reactions of the fiscal authorities differ from one country to the other, but the general line is to guarantee loans to companies (notably SMEs) and increase spending on unemployment benefits. In a nutshell, the public sector is replacing the private sector whose activity is disrupted, without taking into account what this means in terms of additional debt. The fiscal decision-making process is also longer than is the case with monetary policy.

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Party politics can sometimes have an influence, as shown by what is happening in the US. Congress has been discussing a stimulus plan for more than a week now. It has yet to be finalized or voted on.

The economic crisis goes beyond any standard framework. Modesty compels us to say that no one can tell how it will play out. The direction of the economy will, in the short term, continue to be dictated by how the health crisis unfolds.

For the moment, the direction is downward but if we manage to get our economies back in working order in a few weeks – with China apparently showing the way – the rebound could be just as spectacular as the fall that preceded it.

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Market update - In the unknown…is it time to buy?

We will try to answer this question by figuring out which indicators can drive markets in this very complex environment. First, price / earnings (P/E) ratios are not accurate anymore as "Earnings" has become a random function after this unprecedented shock. Let's focus on three key indicators:

1. The dividend yield.
Of course, questions arise as many companies are going to be compelled to cut their dividend. Right, but peak to trough dividend fall in 2008 to 2010 was around 30% in the Euro-area. Let's assume a 50% cut now, Europe would still offer a 2,5% return over the 10y year Bund yield.

2. The equity risk premium.
As a reminder it is the difference between the expected equity return measured by 1/(P/E) minus the sovereign 10 year yield. Not that easy to assess as the "E" is again a parameter of the equation. But rates haven't really changed, and valuations have collapsed.

3. Price to book
In Europe we have reached levels seen in 2008 at 1x time the book value. It is usually a buy signal. We are not there yet in the US, where stocks look more expensive under this criterion.

Finally, market losses are over 5 times the entire aggregate profits of 2019. In such a short period (the peak of the US market was reached less than 1 month ago) it is not a fall; it is a total collapse! It may sound weird after this first exercise, but valuations are not that important in this moment.

1. It is the narrative of the infection wide spreading that matters. Where do we stand, do we see any inflection point? Any vaccine, any medication or more quarantine?...
2. Then, and maybe as important, it is all about confidence in the measures taken by the governments and central banks.

And let's say it sound and clear. This is an impressive move at a record pace. The combination of the FED action and the strong coordination with the Treasury constitute a powerful support to activity and the markets for the coming months.

The possible next step will be the buyback of shares (such as the Bank of Japan) and/or yield curve control if tensions are confirmed in the Treasuries market. Then it will be helicopter money. But as we speak it seems that there is no limit in the central bank reaction. Even the ECB has entered a new era with a 1 trillion package.

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Of course, there is convincing evidence that the scale of contagion is going to be huge and that a significant increase of unemployment is going to arise (up to 30% if you listen to fed governor Bullard). But fiscal and monetary measures can create a backstop to get through this crisis.

So, all in all, policy framework is the most important indicator to limit the increase of the cost of capital. We repeated it a couple of times: avoiding the credit crunch is key for risky assets to stabilize.

It is time to be constructive, not naive as contagion is far from being contained but the authorities' behaviour is a massive support for long-term valuations.

Start to buy

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