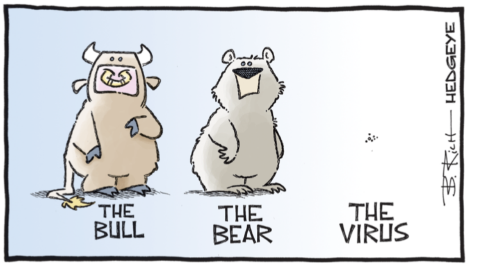
Poison and antidote



MARKET FLASH

APRIL, 2nd 2020

Virus is a Latin word that means poison... And what we are seeing is a poisoning of the global economy. For around three weeks, to slow the spread of the coronavirus and preserve hospital capacities, European countries and the US have put in place lockdown measures covering their entire territories, or a large part thereof. This means limiting travel and activity to what is strictly necessary, in other words shutting down all or part of the economy. The initial field data gives some idea of the cost of this policy. And it is considerable.

According to initial estimates from the IMF, the OECD and statistics institutes in France and Germany, our economies are now operating at 25% to 35% below their pre-shock level of activity. There is no need to point out that never before has there been such huge upheaval in so short a time! Every week of lockdown reduces GDP by at least half a percentage point.

A six-week lockdown is now at the low-end of assumptions in Europe and the US. If the epidemic peaks in this timeframe then a lifting of the lockdown will be envisaged, but it will also take several weeks. It is hard to see life returning to normal before the start of the summer at the earliest. Based on these assumptions, the shock would amount to around 5-7 points of GDP in developed countries. These are acceptable assumptions, with the alternative being a longer lockdown and a more spread-out return to normal. This could double the cost.

A deep recession is inevitable but, in a sense, it is part of the treatment for the public health crisis. However, a *temporary* shock must not be allowed to create *permanent* damage.

The only sensible public policy is to compensate the loss of household revenues, preserve production capacity and make sure that neither the real economy, nor the banks or the markets lack liquidity. This is easier said than done. Economic policymakers have at times fumbled their response, but now the monetary and fiscal measures combined have impressive critical mass.

In the short term, it is less about stimulating demand (this makes little sense as long as supply is constrained) and more about limiting the loss of production potential as much as possible. This is why in most countries, the economic policy measures are aimed at encouraging short-time working rather than carrying out forced redundancies, spreading out the expense borne by companies (tax, rents, loans) rather than pushing them into insolvency, and most importantly avoiding a credit crunch. Supplying liquidity in adequate doses is what will make the difference in this recession. It is now clear that it will be severe, but there is no reason we should be resigned to it being a long one.

To this end, it is important we do not skimp on the antidote, and that it be administered quickly. This is one of the lessons of the financial crisis of 2008. It is not good fantasising about imaginary perils (for example, the inflationary risk following the expansion of central bank balance sheets). Indeed, it is preferable not to restrain the economic policy reaction on account of moral hazard. There may well be free-riders looking to take undue advantage of public aid, but this is not a key problem at present.

The coronavirus shock will severely test the strength of Europe and will open up the wounds of the sovereign debt crisis between 2010 and 2015. Back then, some "virtuous" countries had deemed, with *Schadenfreude*, that the crisis of the "lax" countries was punishment for their excesses. Some are making similar statements now. However, this time, the shock is purely external and it is taking a toll on all countries. Typically, this is where we would expect Europe to make a unified and coordinated response capable of overcoming the differences between countries (these will always exist). In principle, it makes sense to jointly finance the support measures in the coronavirus crisis (the famous and controversial "coronabonds") with, at the same time - it goes without saying – a shared management of this expenditure.

We recognise that the political obstacles are tough to overcome. In the short term, we should not fear a fragmentation of the Eurozone as the ECB ensures that all countries can be financed on very favourable terms. Over the long term, the debate is still open and anything is possible. There is a danger this crisis could stoke anti-European sentiment. The example of the UK and Brexit should serve as a reminder that it can lead to divorce.

Bruno Cavalier

Chief Economist
ODDO BHF

Market update - Where are the opportunities?

The world is with no doubt in the midst of a deep recession. But what is more important for investors is the assumption of what is priced in. With all the humility such an exercise requires, here are our major convictions:

- Growth should recover in the third quarter as the measures taken to compensate for the initial slow response to the crisis are relaxed and existing measures are better calibrated to reduce economic distress. The support measures will last longer than the sanitary crisis.
- Continued monetary support and unprecedented fiscal stimulus should help drive the recovery once businesses reopen and workers return to their jobs.
- Investors should maintain a neutral stance to global equities but start overweight large European quality stocks. Conversely US stocks will lag their foreign peers over the next 12 months.
- The US dollar has certainly peaked. A weaker dollar should help lift commodity prices and limit the pressure on more cyclical sectors of the stock market on a 6 months' time horizon.
- European High-yield credit spreads should tighten over the next 12 months, spreads start to offer enough premium in front of the default risk. But we prefer investment-grade credit on a risk-reward basis through the central banks support.

- Start buying oil. Why now? Without a concerted effort by the main producers - essentially Saudi Arabia, Russia and the US-shale oil producers to rein in production, the global supply of storage will be exhausted, and oil prices will push well below $20/barrel to force output to shut in. Brokers like Glencore or Trafigura have benefited from the contango effect to increase their spot positions _ and then inventories _ and sell their barrels forward. Just as a reminder May 2020 oil contracts are trading at 20 USD per barrel, January 2021 at 33.5 USD. As inventory skyrockets in the wake of both the massive demand and supply shocks, prices will fall to $20/barrel unless politics enter the game. This has already started with M. Trump calling yesterday both M. Poutine and M. Bin Salman. But more than a "productive discussion" we need acts.

As the situation becomes critical, we do expect some output cuts announcements in the coming days. Once the cuts start, prices will rebound. Demand will also start to pick up this summer, which also will help lifting prices. For 2020, we expect Brent prices to recover to a minimum of $30/barrel after falling from 57$/barrel at the beginning of the year, a decent 50% return... Oil prices and high yield bonds have recently lagged somehow in the start of normalization we observed. On a medium to long term basis we do believe they offer a good entry point.

Let us be clear: an *all-in* bet is not our call as uncertainty remains high but market dislocations have created opportunities.

Take care.

Laurent Denize

Global co-CIO
ODDO BHF Asset Management

Jan Viebig

CIO
ODDO BHF TRUST

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