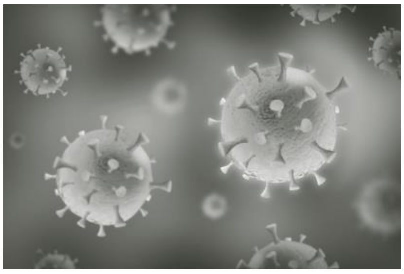
Recession is unavoidable but policymakers seek damage control



Is it time to buy?

MARKET FLASH

15 MARCH 2020

The outlook for the global economy has changed dramatically over the past few days following announcements of total or partial quarantine of the population by governments in Europe and the United States. It is quite possible that these measures will be further strengthened in the coming days. Travel bans, school and business closures are imposed in order to create social distancing, the only way to curb the coronavirus outbreak. The immediate impact is a significant decline in the volume and productivity of labor, in other words a recession. The economic cost will increase as long as these measures are in place, but health priority prevails, needless to say, over economic targets.

In the current circumstances, economic forecasting is a work-in-progress, which must be constantly updated according to exceptional developments in the capital markets and historic decisions taken by governments.

A few things can be taken for granted. First, it is a global crisis and not a local one unlike other recent outbreaks (SARS, Ebola). Secondly, it is a crisis which suspends, at least temporarily, globalization. Global value chains and travel are disrupted, China, the global factory, had to close for several weeks. So there are cascading effects from one country to another. Finally, this is not an ordinary economic or financial shock, but rather what is called a "black swan". As human life is at stake, this crisis has a high potential for panic, paranoia and over-reaction.

What is unknown at this stage is the duration of the economic disruption. Social distancing is effective in curbing the epidemic, but only after several weeks. China took this type of action in late January, Europe only in mid-March. The return to normal life will be accompanied by a strong rebound in economic activity, but no one can give its exact date. At best, it won't be until late spring.

Three types of information can affect investor sentiment in the short term.

First, news related to the epidemic itself. It is widely acknowledged that the peak is far from being reached. In the short term, the headlines will focus on the increase in the number of cases and deaths, in short bad news that may increase panic.

Second, data on the real economy. The business climate and household confidence indices have started to deteriorate. With countries in quarantine, the risk is that bankruptcies and unemployment will increase. Ugly data are set to come out over the coming months. It is one thing to expect a recession, it is quite another to measure its extent and duration.

Third, economic policy reaction. On this point, one can only be impressed by the recent decisions taken by central banks and fiscal authorities. Both the Fed and the ECB have made it clear that they are ready to intervene without limits to ensure the proper functioning of capital markets and the banking sector. It is out of the question to allow a resounding bankruptcy to occur, like that of Lehman Brothers in September 2008. This time, we observe massive liquidity injections, an increase in asset purchases, and a relaxation of regulations on banks. Overall, the banking sector is better capitalized and better supervised than in 2008. Fiscal authorities are ready to cover the cost of the economic disruptions with loan guarantee, moratorium on taxes, etc. In an emergency, there is no limit to public deficits. Both the German Chancellor and the French President have been very clear on this point. To the extent that the ECB provides ultra-low rates, refinancing sovereign debt will not be a problem, even in countries already heavily indebted. The reaction of policymakers is brutal in order to stop the market panic.

All in all, the economic shock will certainly be severe, but there are still good reasons to believe that it will be transitory. In our view, the current crisis is not the repetition of 2008.

Market update

First, it is too late to sell if you were invested in risky assets. The violence and scale of the correction movement no longer favors significant relief.

What have we done?

We had reduced the Equity exposure for the most defensive portfolios (e.g. Polaris Moderate from 30% to 20%) with an objective to preserving capital. For the balanced portfolios, as the investment horizon is longer and the ability to accept higher volatility is greater, we had either tactically reduced the weighting of Equities by a maximum of 8%, or modified the sensitivity of the portfolios by favoring the companies best able to withstand the crisis. In this way, we reduced the most cyclical companies and those most exposed to the virus (travel, leisure, etc.).

On the credit side, at the beginning of February we sold all our High Yield positions in anticipation of a possible credit crunch, as spreads were so tight and did not take into account the risk of a reversal in growth. We had increased the duration of the portfolios by giving preference to Investment Grade bonds, considering that the support of the central banks and the probable limited duration of the crisis would make it possible to absorb the shocks of the other assets.

On the currency side, we closed 75% of our positions on the dollar, considering the fact that the FED had the most room for maoeuvre (rate cuts and liquidity injections).

What should we do today?

We remain underweight but start to buy back some of the underweight (1/3). Only quality companies are elected, offering good visibility on their cash flows with strong balance sheets. The outlook for contagion of the virus does not yet allow for a more aggressive positioning. News flow will continue to be anxious in the coming weeks regardless of the behavior of Central Banks or governments.

No repurchase of Hy bonds at this stage, especially as the fall in the price of a barrel of oil increases the risk of bankruptcy of US shale gas producers, which represent 13% of the indices and weigh on the segment. Lower interest rates due to marked illiquidity, return to a neutral duration in line with the investment horizon. Example 3 years on moderate.

Markets in Europe dropped slightly below book value in periods of extreme stress in equity markets. The US markets consolidated typically at 2x book value. So, if we believe there is no long-term crisis, we can think that we can buy at these stress levels.

If the equity markets continue to deviate by around -10% compared to Friday's closing, we will return to neutral positioning. Preferred sectors will depend on the measures taken by the authorities and the expected impact on growth. Depending on the spread levels we will also be tempted to return to the High Yield.

If the equity market falls by 20% compared to Friday's levels, we will switch to buy mode with significant positioning on the most discounted asset classes, with a long-term investment perspective.

The extreme and unprecedented conditions in which we are living force us to be cautious but should not make us forget the essence of our business: to detect investment opportunities over the long term and offer value creation to our clients. We assure you of the total mobilization of all portfolio managers. We will make sure to communicate regularly on the state of our portfolios as well as our understanding of the markets.

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