27TH APRIL 2020

"The virus is rampant, business is frozen, and our governments are throwing money all over the place, even though tax revenues will plummet. What can go wrong?"

Overheard yesterday on my weekly supermarket run.

Since the last time I wrote, financial markets seem to have returned to a calmer state, certainly when compared to the moves in March.

Having said this, there is nothing calm about what is going on:

- We now have confirmation that we are facing the greatest economic contraction since the Great Depression (1929-1933): in the past 3 weeks alone, more jobs have been lost than were created in the last 10 years.
- The human race is facing the worse pandemic since the Spanish Flu (As a Spaniard, I should point out that the 1918 pandemic is forever associated with Spain, but this strain of H1-N1 was discovered earlier in Germany and France. However, like the response to first cases of COVID-19 in Wuhan, China, First World War censors buried or underplayed those reports).
- Crude Oil price experienced the steepest decline since David Beaty first discovered it at his home in Warren, Pennsylvania back in 1875. For the first time ever, WTI Oil traded at negative prices.
- The greatest central bank/government intervention of all time has just started (more on this later in this note).

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When Will Economies Reopen?

Since my last note there have been many developments, including a very encouraging "flattening" of the Coronavirus contagion curve.

Different countries are at different stages of this flattening and within large countries, such as the US, progress differs by state. In some places the number of daily new cases is continuing to rise, in others the curve is flattening and new cases are declining. There are also places that had good results initially but are seeing rebounds as rules are relaxed and people start to return to their normal behaviour.

There are still many questions we do not have an answer for, including the following:

- Will testing and contact mapping facilitate keeping infected people out of circulation?
- Will we be able to test people to learn whether they've had the disease and developed antibodies, such that they can go out in public without fear of reinfection?
- Will herd immunity develop? Will it be permanent?
- Will warm weather be helpful? (positive last-minute update: as per a study released last week by the US Department of Homeland Security Science and Tech lab, UV sunlight is extremely detrimental to COVID-19 in saliva droplets on surfaces and in the air).
- Will the virus morph into other forms, requiring new cures?
- Will a vaccine be developed, and when?

One of the thorniest questions remains how to make the trade-off between minimising deaths from the virus and restarting the economy. The longer people stay at home and the economy remains shut down, the closer we'll get to containing the disease. Simultaneously, the more damage will be done to the economy and the harder it'll be to restart.

As a society, we do not yet have a widely established formula for deciding whether to favour life for a few (or for thousands) versus economic improvement for millions: On one hand, choosing the economy seems hard-hearted. On the other, we permit many activities that result in large numbers of deaths, such as driving. In the US, 40,000 people die each year from driving, and yet we do not ban automobiles as this would affect economic activity enabled by faster transportation.

In any case, a reopening of the economy is likely to be gradual and, until a vaccine is perfected or herd immunity is reached (which is not a given), subject to alternating periods of progress and retreat. As my fellow Spaniard Tomas Pueyo (who has become a COVID-19 celebrity expert) says, after the "hammer" (lockdowns) we will all need to learn how to "dance" with the virus' infection curve.

Is Reopening Economies A Sufficient Condition For Growth To Pick Up Again?

No. It is needed, but not enough.

I am shocked at how much attention is given to the pace at which economies should reopen, and so little at the behavioural impact of the virus (which is not going anywhere) on humans as consumers (Consumer spending accounts for about 70% of Western World's GDP).

For growth to pick up significantly, consumers must also be willing to spend as much as they did before the crisis…. which will be very unlikely.

Fear is destined to define consumers for years to come, if not a generation: this is the second great economic trauma in little more than a decade. For many millennials and Gen Z, one mantra will dominate spending habits from now on. Many of them will say to themselves: "Never again will I be financially unprepared for a crisis".

For decades, stagnant real wages have left debt as the only option for many households:

- In February alone, (before COVID-19 struck) US consumer debt grew by $22 billion.
- More than 40% of Americans do not have enough savings to last three months without a job (this figure is not much lower than the rest of the developed world).

Financially-fearful consumers will no longer trust that debt is a sustainable path to a middle-class life. Not when COVID-19 may have several more waves and another pandemic seems inevitable. Not when people who are laid off may never be rehired due to automation.

I mentioned before, we are facing the deepest recession since the 1930s. Did the personal savings rate of Americans increase then? You bet: it soared from near-zero to as high as 28%.

Conclusion: Uncertainty will bring fear. Fear will bring frugality

So, is the much-touted V-Shaped recovery impossible?

A V-shaped recovery is impossible unless the rebound in consumer spending is V-shaped….

…which is unlikely.

Given China is the birthplace of the pandemic, it is likely a canary in the coal mine for the rest of world. In March, retail sales were down 16% compared to March 2019. They are a figure to monitor closely as China keeps reopening its economy.

What could the recovery look like, then?

Like a very elongated Nike's swoosh sign:

Let's talk Markets. Where Are We?

Any market sell-off has 3 main phases:

1st Phase:

DE-RISKING - selling to reduce the chance of losing more money as outlook deteriorates. We saw this in February and early March.

2nd Phase:

PANIC - indiscriminate selling, when investors are scared or must raise cash. In this phase even safe-haven assets fall sharply. We saw this for a couple of weeks in March.

3rd phase:

CONTROLLED SELLING - markets become more predictable in direction as investors are more discerning: share prices of companies that should not suffer from the economic slow-down outperform those that will, and companies that are more financially secure benefit accordingly. This is the phase we are in at the moment.

So Are Markets Out of The Woods?

No. Markets rarely rally in a straight line.

From a behavioural perspective, market movements represent a continuous tug-of-war between the bulls and the bears: after the optimistic buyers of the initial dips have responded to the low prices and bought, the pessimists find the new, higher prices unsustainable and engage in another round of selling. And so it goes on for a while.

In next few weeks/months, we will probably see other Sell-Off waves. Likely causes of this include a relapse of COVID-19 post easing and painful realisation of just how badly affected the real economy has truly been.

So Should We Be Concerned About The Stability of the Financial System in General, Like in 2008?

No. Actions of central banks and regulators suggest that the worst financial market stress will be averted, particularly in the corporate bond markets.

Also, the banking sector of the economy is better placed to withstand this massive shock. They do not operate in a vacuum, mind you, so an L-shaped recovery would threaten their progress. We should also be reassured by bond holder friendly actions in the banking sector. Following guidance from their domestic regulators, banks have been cancelling dividends and share buybacks to improve their financial strength and their resilience to a downturn.

You Were Concerned in March That The Fed Seemed To Have Run Out Of Ammunition. Has This Changed?

Yes. Over the last few weeks, the Fed, SEC and Treasury have announced an unprecedented program of stimulus, support, rescue and regulatory relief. They continue to bring new actions forward and expand the size and scope of existing ones.

Crucially, the Fed has expanded its corporate lending programs into an entirely new area, including ETFs of companies that are rated below investment grade.

To put it simply: The Fed is putting its balance sheet at the service of the private sector.

Didn't The Fed Do The Same in 2008?

No. In 2008 TALF (Term Asset-backed Securities Loan Facility) accepted only triple-A-rated securities and it made money on the loans.

The Fed is now saying that it will now accept much riskier credits including commercial mortgage securities and collateralized loan obligations (CLOs).

Translation: The Fed will in effect buy debt in some of the most indebted companies in the US.

This Is Good News For Financial Assets, Right?

You bet. But the mid to long term implications are very sobering.

- Governments all around the world are adding debt on a scale never envisaged before. The cost of that will be borne by the younger generations and taxes will rise for those who can contribute to paying the debt off.
- Ultra-low interest rates and expansionary policy can only end up with inflation rising. Not a problem for a while, but it is coming.
- This bailout will in time haunt the free markets: How can you lever up to do buybacks (and make executives richer) then ask for a bailout and most importantly have no firepower to buy back your stock when it is cheap because you were so irresponsible?
- QE went to inflate asset values and increased inequality by benefiting the super-rich (this increase in inequality brought us populist politicians, democracy's Achilles Heel). Current bailouts come with printed money, which effectively deflate the wages of the middle class.
- Markets work best when participants have a healthy fear of loss. Capitalism without bankruptcy is like Catholicism without hell.

So what should a typical Asset Allocation look like, then?

Exactly like we are positioned.

Entering 2020 with London & Capital strategies having the lowest equity exposure since 2009 has helped enormously, and this is still the right approach. Within equities, bias needs to be towards stocks that have the balance sheet strength and Profit & Loss resilience to see through this crisis. As earnings will be all over the place, the focus will shift from P&L and valuations to Balance Sheet resilience and strength. This bodes extremely well for STAR stocks. This is also a good time to identify equities that will be beneficiaries of a New World until we discover a cure to COVID-19.

On the Fixed Income side, we must focus on sectors that entered this crisis in a position of strength (large banks and insurers, for example), while largely avoiding (despite Fed's recent announcement of support to the sector) non-financial High Yield bond exposure.

We cannot control (or predict) how long this crisis will last, but we should always remember the lessons of the past:

- All crises expose and penalise the weakest links most severely.
- Winners are always those companies that survive through time.

Our core focus will continue to be on companies that are best positioned to be self-sustaining through times of turbulence. These are the owners of their own destinies.

We Have Updated Asset Allocation a Few Times Lately? Why The Moves?

I am not keen on changing exposures often, but given the fluidity of markets, the need to be proactive and do the right thing at all times, trumps tradition.

In addition to running low equity levels before markets started sliding in February and capitulated in March, the most crucial decision we have taken this year, when corporate bond markets hit a pocket of empty air in March, as bond market makers had to adapt to very sudden and dramatic new remote working arrangements, was not to panic.

What we did in mid-March is what one should always do when a crisis strikes: pause, breathe, go back to the drawing board to incorporate new information available and decide if market prices reflect the underlying credit worthiness of the securities we hold. Other meaningful recent asset allocation moves include the following:

- Partial reduction (i.e. taking profits) on areas where the risk and reward picture is not as compelling as in the past (like some AT1 financial bond exposure).
- Taking gold exposure to levels where it continues to make a positive impact on portfolios as an effective hedge in an environment where true safe havens are in extremely short supply.
- Maintain cash exposure at elevated historical levels to be ready to capture opportunities (mainly in equity markets).
- Introduction of a Sovereign Strategy designed to help cushion volatility.

As always, we all continue to work hard to deliver when it matters most for our clients.

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