

April 29, 2020

# BILBoard April 2020 – The storm before the calm



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In last month's BILBoard, we presented our revised base case scenario for 2020 in light of the coronavirus crisis. In a nutshell, we see a deep, government-induced recession spanning Q2, and most likely encroaching into Q3. Thereafter, under a torrential downpour of government and central bank stimulus and with a gradual easing of movement restrictions, economies should begin to stabilise. Such a base case naturally carries an air of caution, given the unprecedented nature of the crisis.

MACRO: INTO Q2 AND INTO THE ABYSS

While governments contemplate how to reopen their economies, much of the global population remains under lock and key. The full, undiluted impact of this is about to start showing up in macroeconomic data, and we expect to see the speed of the deterioration peak in May. Already, the fragmented picture we have is bleak. PMIs have tanked, displaying the devastating impact on demand and activity, particularly in the Service sector with tourism and leisure off the cards for the foreseeable future. Until now, the decline in consumption had been cushioned by grocery store shopping and panic buying - this will probably peter out and the true severity of the demand shock will become clear in upcoming data releases.

Determining how bad it

will get is a shot in the dark, given the lack of comparable events in history

- [Professor Yossi Sheffi](#)

[from MIT](#) calls this the "Anna

Karenina principle", paraphrasing Tolstoy; while happy economies are all alike, every unhappy economy is unhappy in its own way. Looking at the current environment, with a simultaneous shock to supply and demand, liquidity tensions and a health crisis, we could borrow empirical examples from the Spanish flu, the Great Depression, 2008 or even China's experience with coronavirus, but the utility of such a model would be limited, given the disparities in the social, economic, technological and political contexts. No two disruptions are the same, each comes with its own cascade of effects, meaning that we face "known unknowns" and "unknown unknowns" - and the latter could render any attempt at forecasting futile.

With government and central bank support bordering on the brink of "unconditional", the main "known unknowns" are behavioural and epidemiological. A post-quarantine economic renaissance hinges on the behaviour of consumers and businesses. Will consumer demand snap back? We expect to see some inertia in the data, given that lockdown measures will be eased gradually to stave off a second wave of infections. Moreover, consumption will be hit by rising unemployment. Despite fiscal attempts to curtail layoffs (e.g. the US CARES Act or the EU's SURE program), businesses are letting staff go. 26 million Americans have filed jobless claims (this will put dynamite under the unemployment rate for April due to be published on May 8th). Whether they will re-hire staff they let go is yet to be seen.

On the epidemiological front, the key unknowns include any potential reacceleration in the number of new cases, testing efficiency and deployment, and finally the time-to-vaccine and widespread treatment. Looking at the “known unknowns” and base effects alone, we don’t expect GDP to recover its December 2019 levels before 2022.

## EQUITIES

Though looking into Q2 is like looking into a black hole, equity prices seem to have skipped past the looming uncertainty and already seem to have a V-shaped recovery in mind. The recent rebound of around 25% seems to be driven by a combination of speculation, hopes and tweets rather than something more tangible and, though we argued previously that markets will rebound long before the economy, the pick-up is perhaps a bit premature.

At the same time, analysts are rapidly downgrading earnings expectations in the opposite direction to prices, leaving valuations a bit stretched (we are now at levels seen in February, before the crisis snowballed). The earnings season itself is unlikely to be a game changer, with companies omitting future guidance. With such uncertainty, we would be surprised if volatility didn’t flare up again.

Until we have more clarity, we’re maintaining our neutral equity positioning, content with the basket of hand-picked quality names added to our portfolios before Easter (including well-capitalised firms with strong balance sheets and low leverage, poised to weather the Q2 storm). In terms of regions, we remain US-centric, where there are more secular growth stories, as opposed to Europe which is more of a value play. We are also maintaining a very small overweight to Emerging Markets (primarily China, which is now setting its economy back in motion after getting the pandemic under control).

## FIXED INCOME

Fixed income assets of all stripes are receiving central bank support, whether direct or indirect. Renewed commitments from the ECB and the Fed to credit were a game changer in markets – investors have returned en masse and the new issue market is alive and kicking again. Both of these central banks are vacuuming up corporate bonds, even “fallen angels” – investment grade names that have been downgraded to junk.

In the government bond space, volatility has normalised but investors are still weighing up the prospects of higher issuance against growing budget deficits. This highlights the growing need to be active in the sovereign debt market; we have already tweaked the layer of government bonds we hold to buffer against equity risk, moving out of peripheral European govies to European Core govies, with benchmark duration. We also have a selection of inflation-linked bonds which will be helpful if fears about government spending with monetary financing intensify.

We remain overweight on investment grade (IG) bonds – with central banks having stemmed the March bleeding, quality corporate paper now offers a solid investment case. After rotating towards US Treasuries last month, we are now doing the same inside our corporate exposure, switching up European credits for the US equivalent, in that approximately 20% of our overall allocation to credit is now in USD IG (EUR-hedged). While the European credit market is undoubtedly being cradled by the ECB, the Fed’s support is even stronger, with the central bank going as far as to buy high-yield ETFs. As a result of this caretaker role by the Fed, total return for US IG has turned positive year-to-date, while the retracement in EUR IG spreads has been more timid.

Despite the fact that central banks are entering the upper echelons of the high-yield markets on both sides of the Atlantic (the ECB is not directly buying fallen angels, but those bonds can now be posted as collateral on repo operations), we are still steering clear of this segment, believing that risk is inadequately rewarded. Likewise, we are reluctant on Emerging Market debt. The rationale behind both of these stances is the fact that the oil price is at record lows, with futures prices even having turned momentarily negative. Energy firms make up a large proportion of the US HY market, and oil is a key export for many EM regions.

All in all, be under no illusions: we aren't out of the woods yet. April showers are said to bring May flowers, but the slate of ominous data from this month will probably pale in comparison to what lies ahead. To navigate this tumultuous investment landscape, we must be unhurried, contemplative and logical, keeping our eyes on long-term investment objectives. To borrow from Tolstoy once again – “The strongest warriors of all are these two – time and patience”.

Current Asset Allocation 21/04/2020		DEFENSIVE		LOW		MEDIUM		HIGH	
		Stance	Change	Stance	Change	Stance	Change	Stance	Change
<b>Global allocation</b>	Equities	●	→	●	→	●	→	●	→
	Bonds	●	→	●	→	●	→	●	→
	Cash & Cash Equivalents	●	→	●	→	●	→	●	→
<b>Currencies</b>	EUR	●	→	●	→	●	→	●	→
	USD	●	→	●	→	●	→	●	→
	Other	●	→	●	→	●	→	●	→
<b>Equities</b>	Europe	●	→	●	→	●	→	●	→
	USA	●	→	●	→	●	→	●	→
	Japan	●	→	●	→	●	→	●	→
	Emerging Markets	●	→	●	→	●	→	●	→
<b>Bonds</b>	Government Bonds - Developed	●	→	●	→	●	→	●	→
	Corporate - Investment Grade	●	→	●	→	●	→	●	→
	Corporate - High Yield	●	→	●	→	●	→	●	→
	Emerging Market Debt	●	→	●	→	●	→	●	→
	Total return	●	→	●	→	●	→	●	→
<b>Commodities</b>	Oil	●	→	●	→	●	→	●	→
	Gold	●	→	●	→	●	→	●	→

Stance: Indicates whether we are positive, neutral or reluctant on the asset class

Change: Indicates the change in our exposure since the previous month's asset allocation committee

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