MARKET VIEWS

Market & Strategy Update Q2 2020

PROBUS GROUP

Executive Summary

The COVID-19 pandemic has hit the global economy as it was emerging from a manufacturing slump and global trade was starting to recover. Governments around the world are attempting to flatten the infection curve, as China appears to have done, by imposing lockdowns and social distancing measures that will have severe economic consequences, especially given the record global debt levels. Encouraging signs are emerging in countries that have been in lockdown for a month, with new cases and deaths peaking, while others could be a few weeks away. The question of the withdrawal of these measures and the possibility of additional waves yet remains.

It is evident that the economic slump will be significant in the short term. While hopes are for a quick recovery, it is likely that social distancing measures will have to be withdrawn and re-instated periodically until an actual cure is found. This means that economic activity may recover from the initial slump but not to pre-COVID levels, as the collapse in demand due to job losses and modified consumer patterns could be prolonged.

Governments have announced drastic fiscal packages that aim to replace lost income by handing out cash and/or raising unemployment benefits, and providing loan guarantees to corporations in order to limit bankruptcies. These fiscal measures, better qualified as life support than stimulus, are complemented with enormous central bank interventions via rate cuts and balance sheet expansions. The Fed has even moved to directly financing government deficits, something that has never happened outside of wartime and risks pushing inflation much higher. These massive, debt-fueled increases in the supply of fiat currencies and budget deficits continue to favour a rise in gold.

Equities have gone through a historic correction as the virus has swiftly spread around the world. The depth and velocity of the pullback shattered many records, as investors struggled to price the extent of the damage caused by the outbreak. Investor sentiment reached extreme levels of pessimism and, following policy makers' support measures as well as early signs of slowing rates of infection, the market is undergoing a significant rebound.

Executive Summary

While the persistent negative sentiment suggests that the rally could stretch further, we would be wary of chasing equities at current levels and prefer to remain defensive. This rally is likely to prove temporary as the true extent of economic damage comes to light. Current market valuations seem to imply that the economy will be up and running in a few months which seems highly unlikely. Moreover, the level of volatility remains too high for comfort and inconsistent with a sustainable rally.

In Asia, Japan strikes us as particularly attractive given its corporate balance sheet strength, which is net cash, and the government's significant fiscal package (20% of GDP). Japanese equities could prove more resilient in the downturn and have the availability to maintain shareholder distributions. This is contrary to EU and US companies, many of which have already announced large dividend and buyback reductions.

Emerging markets have however been hit particularly hard, as record outflows pushed their valuations to extremely compelling levels. Certain Asian economies still have room to ease on both monetary and fiscal fronts, and will be big beneficiaries of cheap oil prices.

Oil has been one of the major casualties of 2020, as Russia and Saudi Arabia embarked on a price war just as demand was collapsing due to the COVID-19 outbreak. While a production cut of 10m barrels/day has been successfully orchestrated by Trump, the lack of reaction in the market confirms the idea that the oil glut is there to stay in the short term. Investors should however hang on to their undervalued and high yielding oil stocks.

Macroeconomic Context

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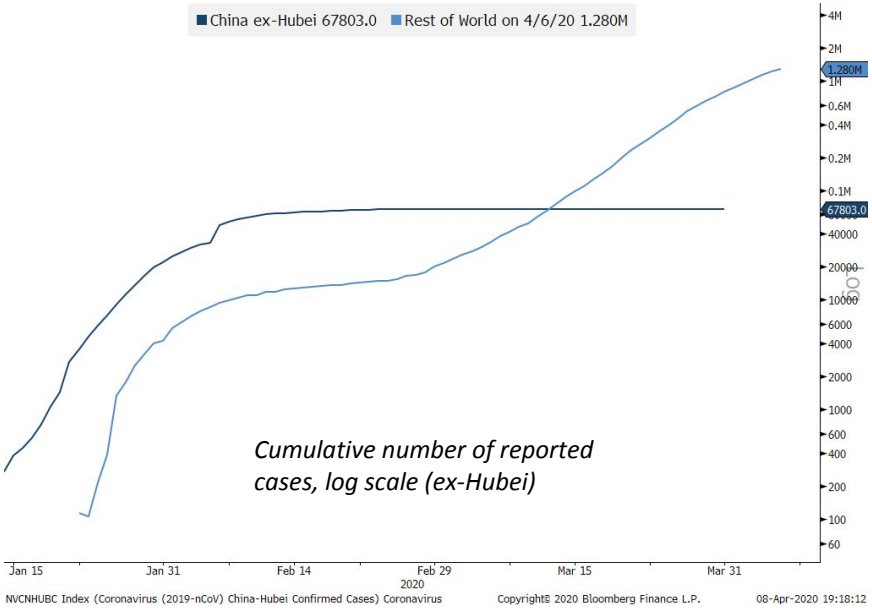
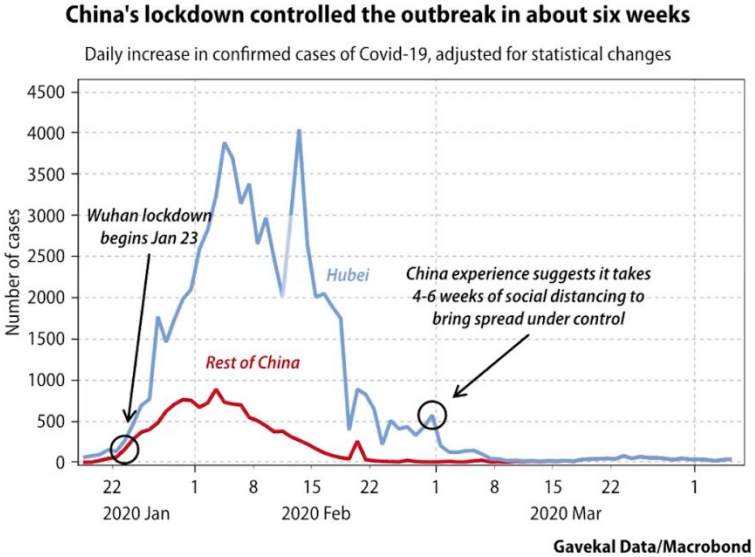
The COVID-19 pandemic rips through the globe

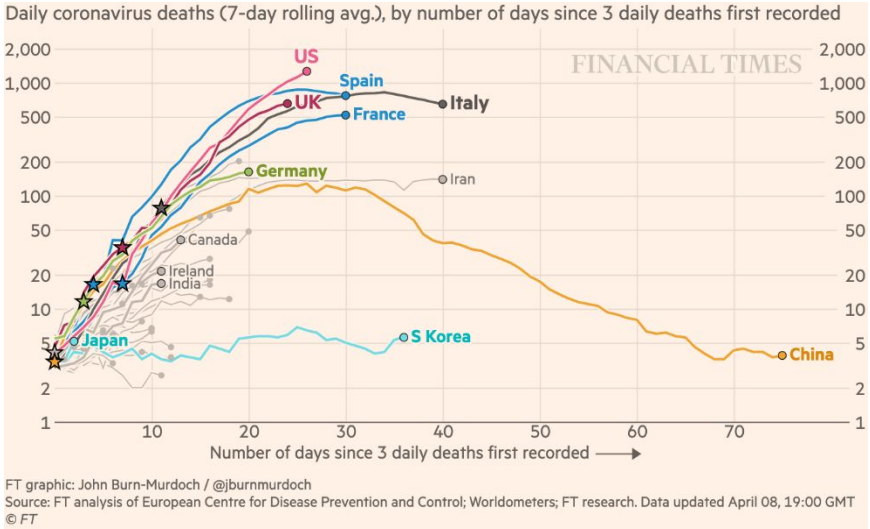
China seems to have stopped the spread of the virus but confirmed cases for Covid-19 continue to surge globally.

The Chinese experience suggests that a 4 to 6 week lockdown period is needed to control the spread of the virus, and there are early signs that Europe's most hard-hit countries, Italy and Spain, are witnessing their peaks in daily deaths.

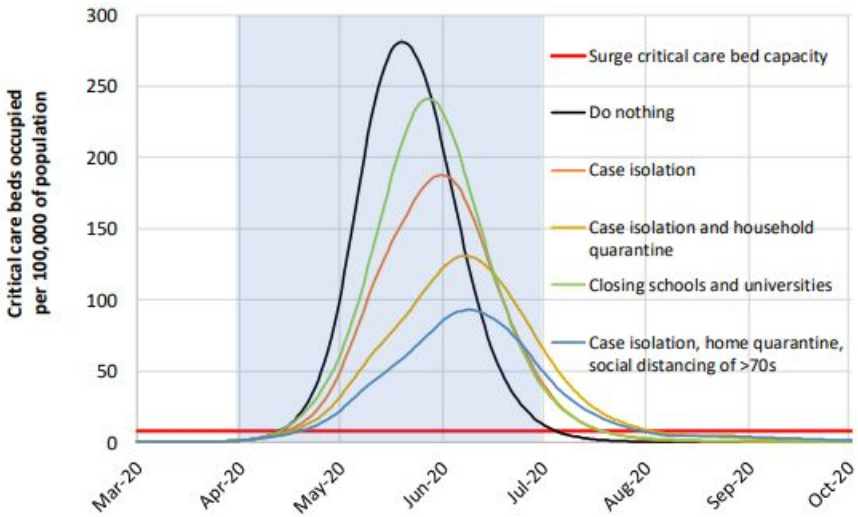
The US and UK, due to their delayed response, are facing larger epidemics and estimates point towards a peak in new infections by the end of April or early May.

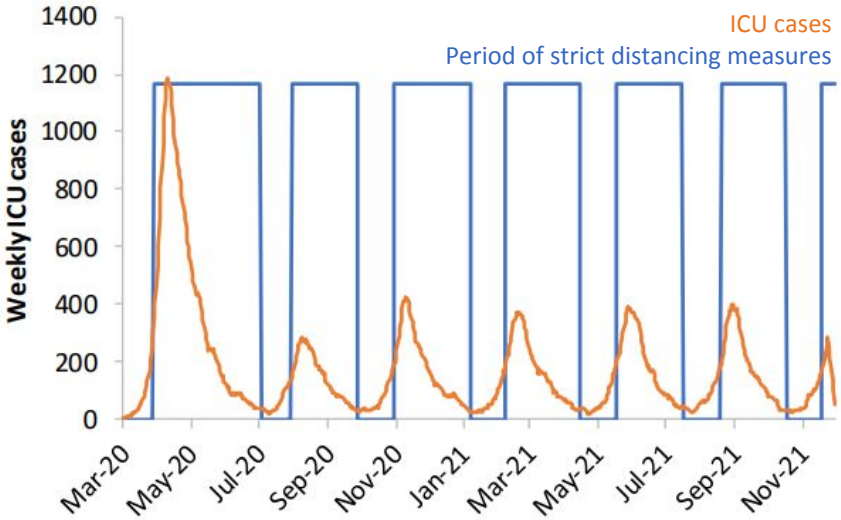






Once the curve is flattened, what then?



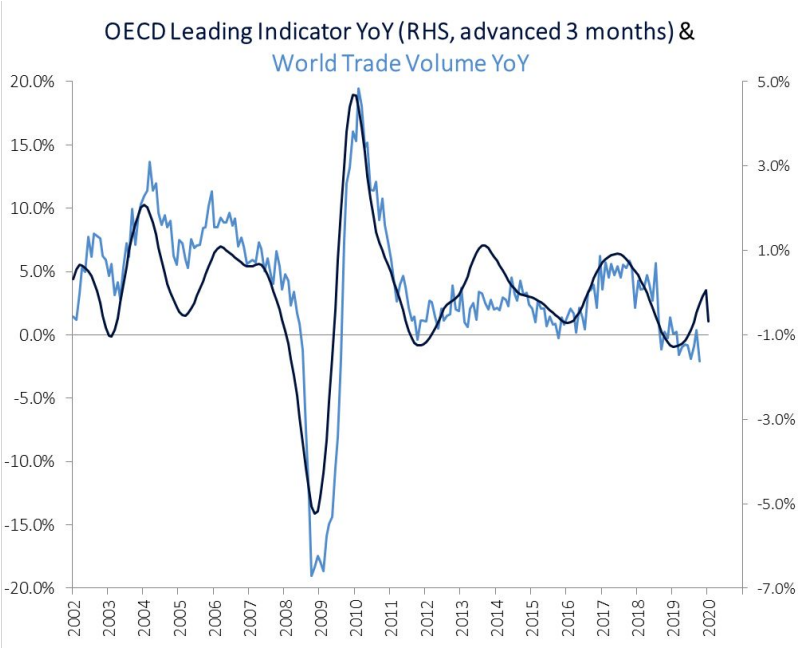


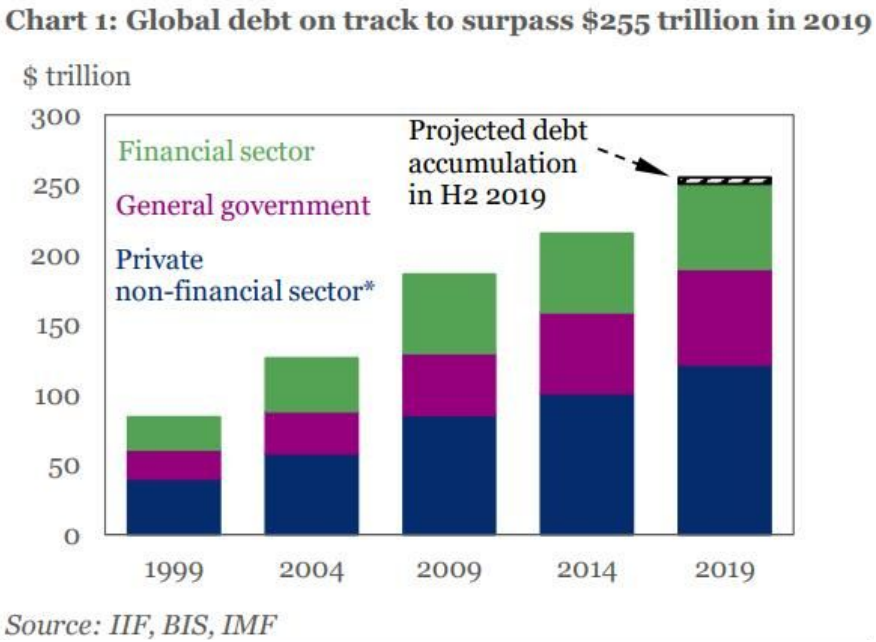
A study from Imperial College London, modeled how a range of distancing measures could help prevent health services from being overwhelmed, i.e. keeping the number of critical cases below the number of available hospital beds. Governments opted for the most severe measures with the aim of delaying and suppressing the peak in critical cases.

Once the number of active critical cases drops sufficiently below the threshold line, we may see some relaxing of the strictest measures. Should the number of cases reaccelerate, another period of dynamic distancing measures could follow; eventually populations will reach adequate herd immunity or a successful drug could be found.

The second phase of relaxing social distancing measures could be on the table in the coming month and could be problematic, as new infections could easily resurface. It is likely that economic activity will not recover to pre-COVID levels for many months, especially on the consumer front, until an actual cure is found.

An economic shock for an already vulnerable economy





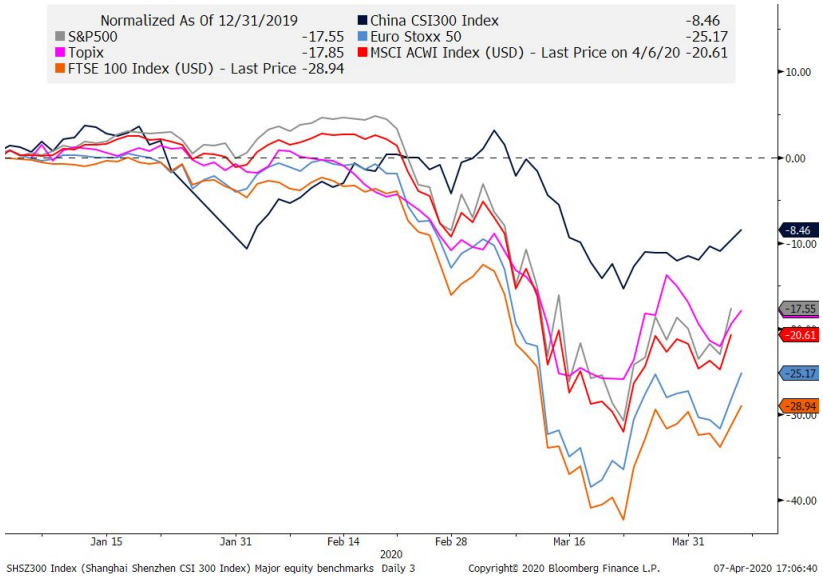
The virus has struck at a time when the global economy was barely recovering from the repercussions of the US-China trade war and the recent manufacturing slump; the OECD leading indicator's year on year growth had only just turned positive and is now back in negative territory. Trade volume growth, which was also expected to recover, is now estimated to decline by over 30% in 2020, according to the WTO.

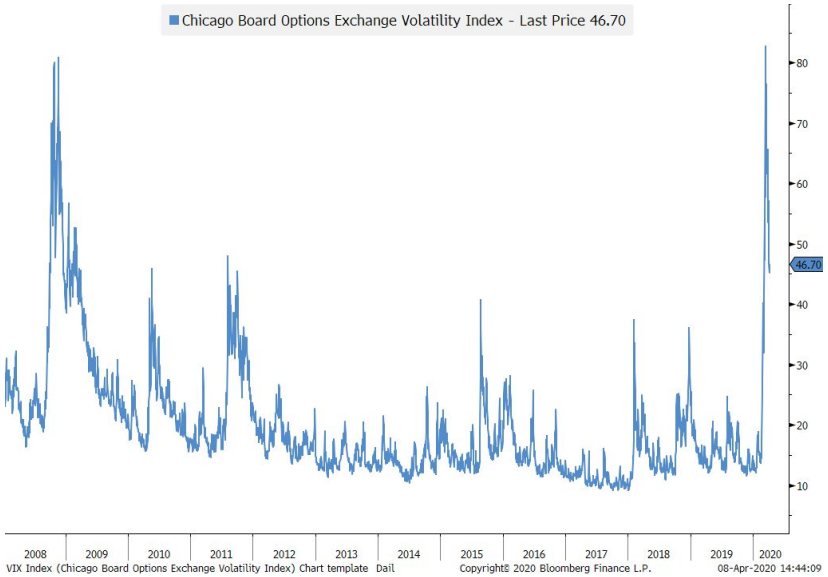
While the duration of the economic shock is impossible to predict, it seems likely that 2019 levels of activity, which were already quite weak, are unlikely to be recovered in 2020. Given the fragility of a global economy crippled by record debt levels, the severity of this economic slowdown is likely to be exacerbated and investors would be better off focusing on companies with healthy balance sheets.

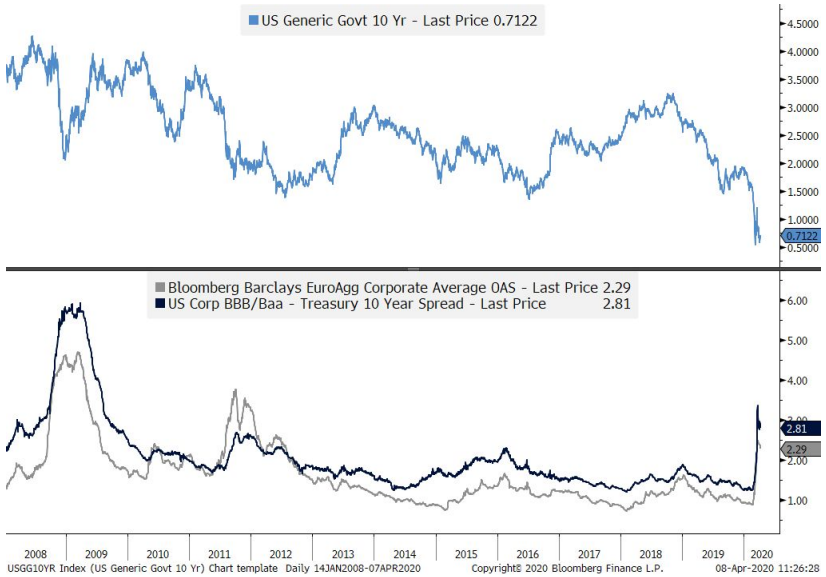
Markets have gone through historic dislocations

Financial markets have been quick to react to the virus' spread outside of China:

- Equities have gone through a record-breaking correction in terms of depth and velocity;
- Bond yields have collapsed (to record lows in the US) while credit spreads have blown out;
- The volatility index in the US has reached a peak higher than the 2008 crisis;
- Growth sensitive commodities collapsed, with oil down 65% from peak to trough.



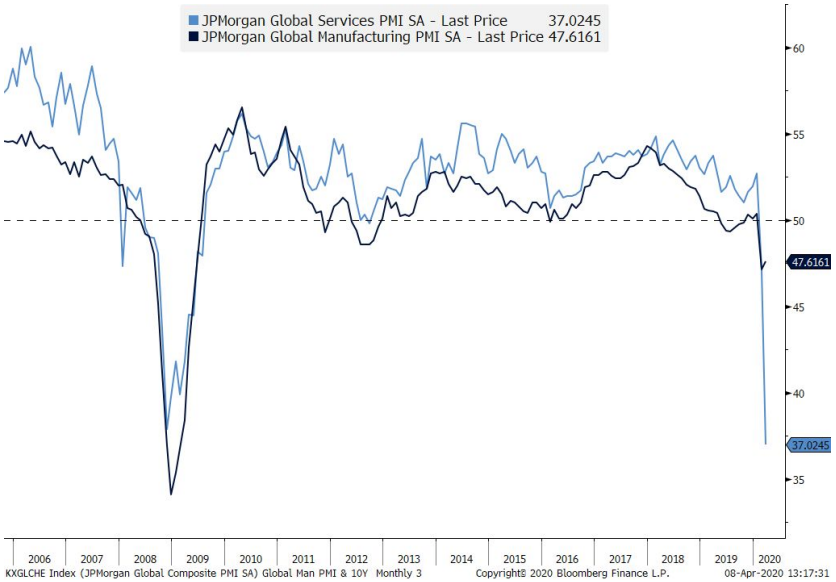


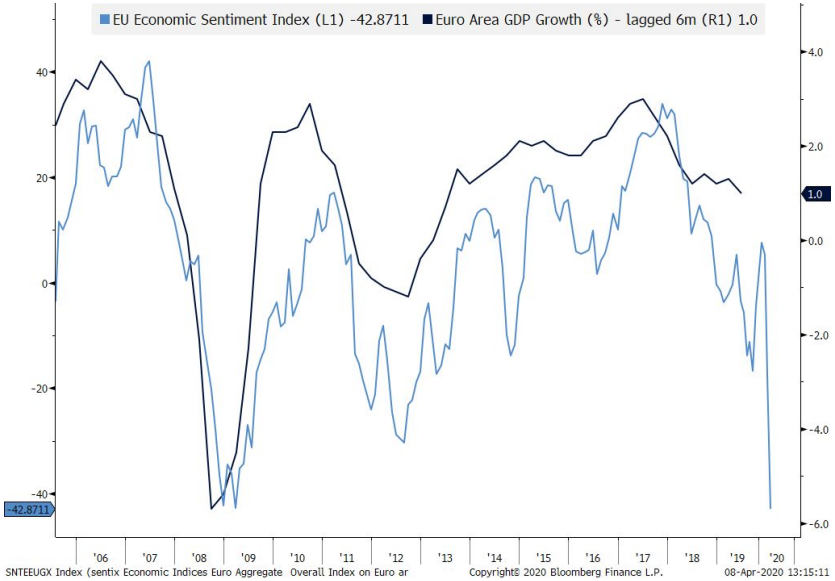


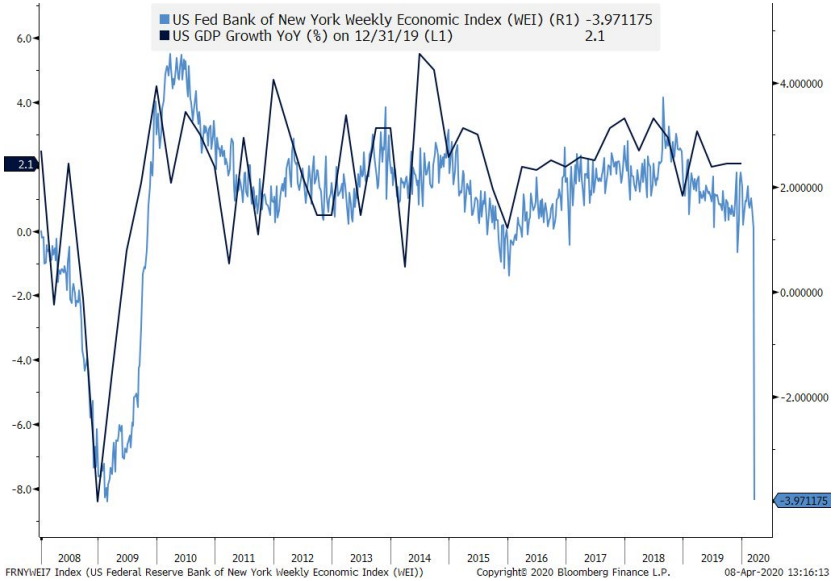
Early signs suggest that the economic fallout will be significant

Early measures of economic activity suggest deep contractions in GDP growth. In Europe the economic sentiment index, which has a tendency to lead GDP growth by 6m, has collapsed to levels unseen since 2008. In the US, the Fed of NY's weekly economic indicator is also back to 2008 levels, which is also consistent with a deep fall in GDP growth.

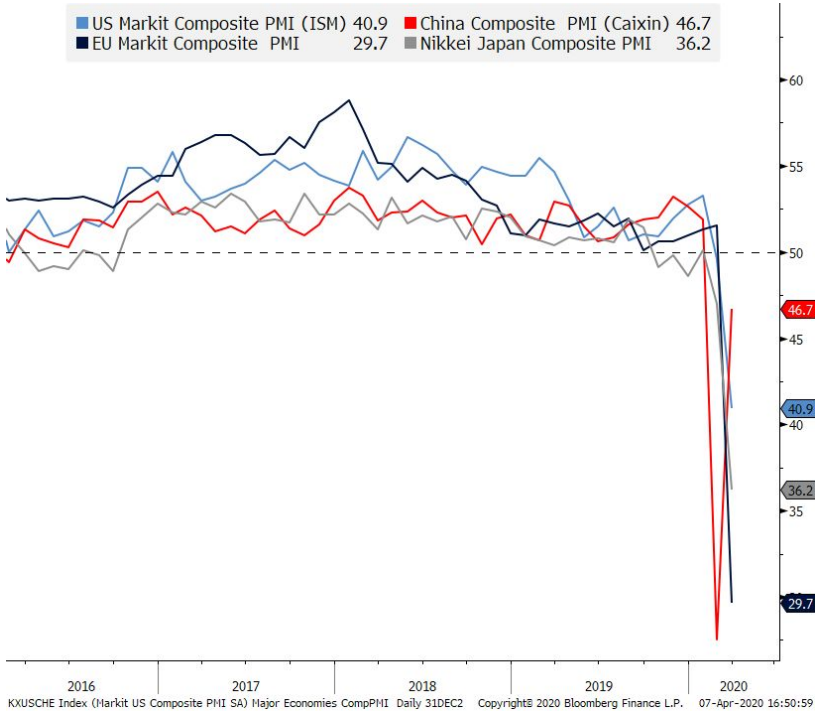
Global manufacturing and services PMIs, based on company managers' estimates of economic activity, have also fallen into contraction territory, with a deeper and likely more prolonged fall in the services PMI.

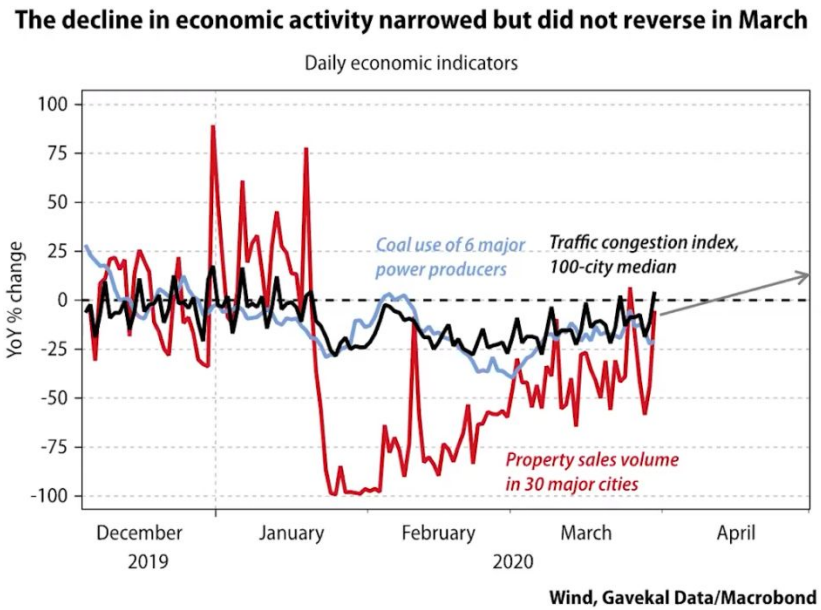






Markets hope that the economic slump will be short lived

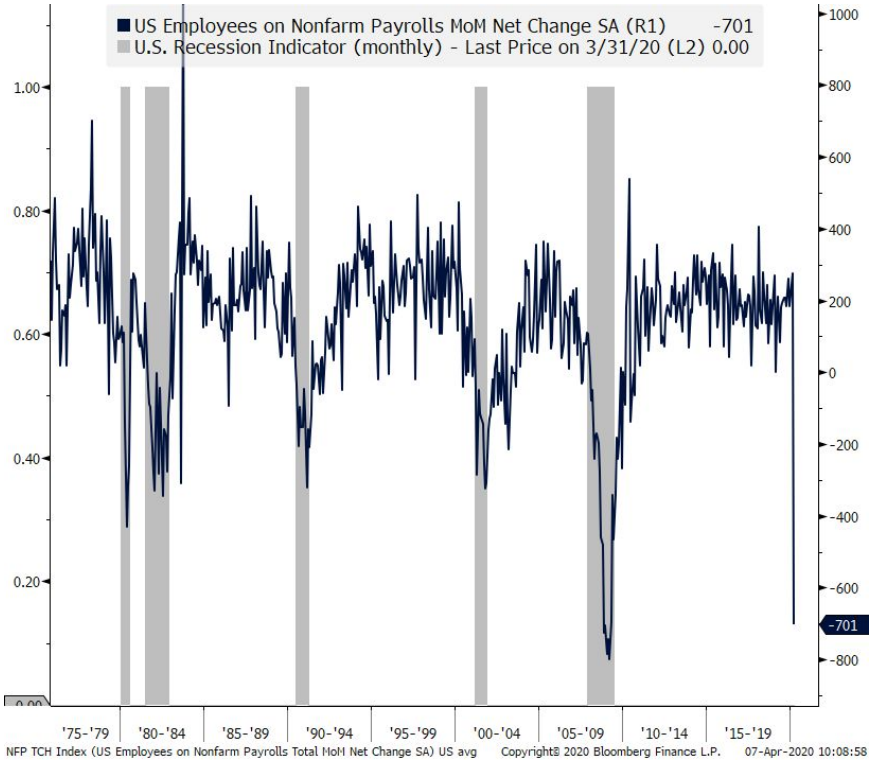


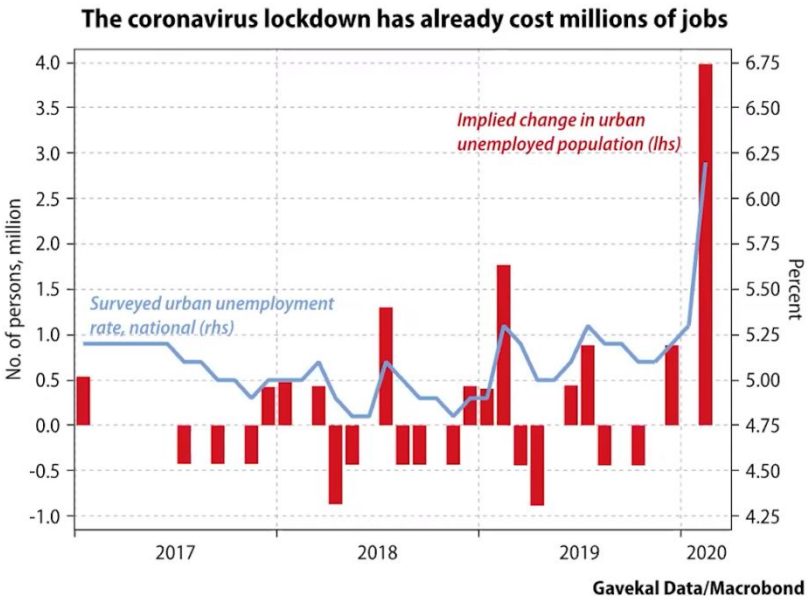


Global expectations are for a very short lived economic slump, as the Chinese roadmap could suggest. While China's PMI collapsed in February as the economy was at a standstill, March saw quite a strong rebound as high frequency indicators suggest that economic activity has recovered to around 80% of 2019 levels. It will likely prove harder to go from 80% to 100% than from 0 to 80%.

While this could also be expected for other global economies once lockdowns are lifted, it seems very unlikely that growth gets back to pre-COVID levels any time soon. First, Chinese economic activity has not made up for what it lost in February and is still not back to 2019 levels. Second, the impact of the lockdown is likely to harm the services industry longer, with potential shifts in consumption patterns. We indeed saw services PMIs fall harder than the manufacturing indices and yet rebound less.

But disruptions from mass layoffs could be deeper than expected

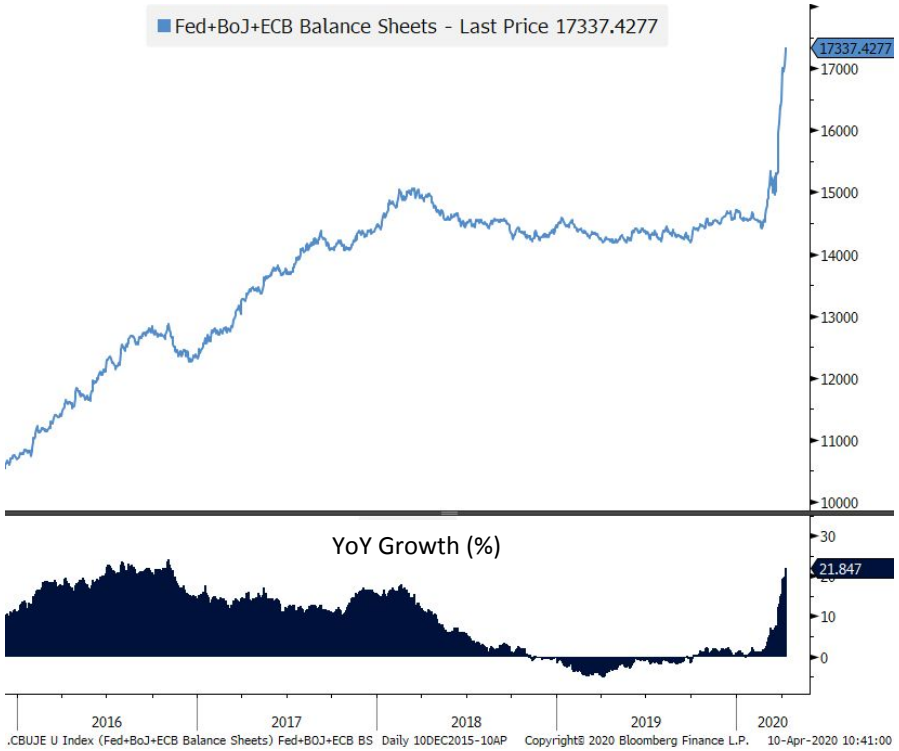


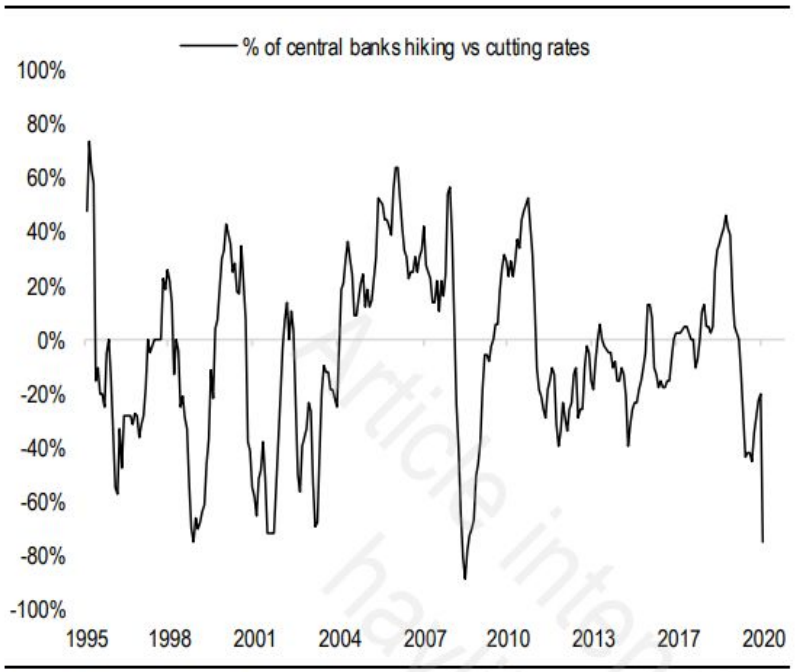


Global lockdown measures have brought economic activity to a standstill, particularly hitting non-essential businesses for whom remote working is not possible. 81% of the 3.3bn global workforce have had their workplace fully or partly closed according to the International Labour Organisation, and the UN believes the loss of working hours due to the virus equates to 195m full-time jobs. As such, layoffs have soared.

However, it is worth noting that many governments' economic support policies in effect incentivise firms to temporarily lay off employees, and thus unemployment figures in the recovery phase can shed more light on the virus' longer term impacts.

Central banks have reacted with unprecedented firepower





Source: Refinitiv, Credit Suisse research

Global central banks have been quick to implement the drastic monetary measures of cutting rates and expanding the size of their balance sheets at an unprecedented rate in order to cushion the blow from the COVID-19 outbreak.

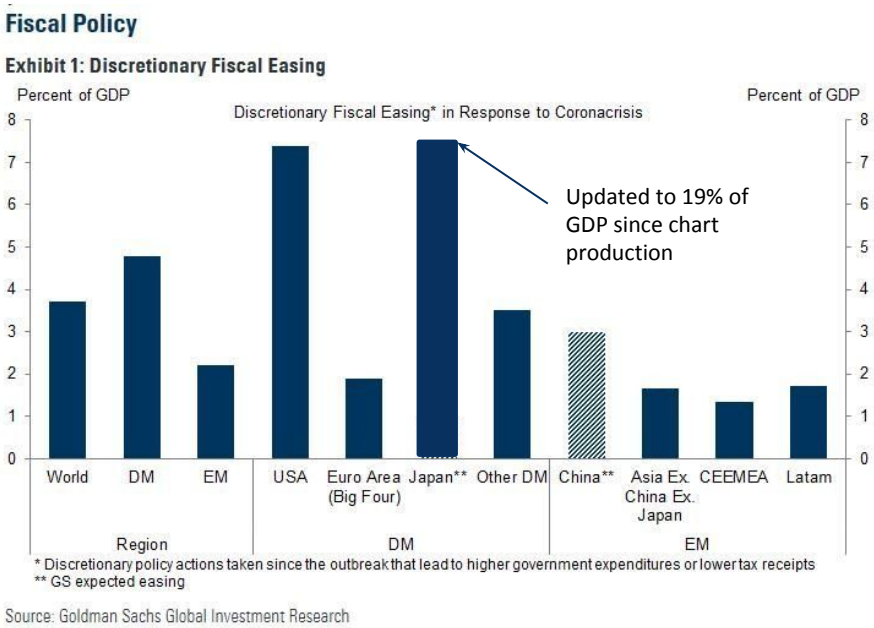
The Fed has moved to directly financing the government deficit (something which has never happened outside of wartime), announced limitless expansion of its balance sheet (which rose by over USD 1.9 trillion in a month!), direct lending to businesses and purchases of corporate debt. The ECB has increased the size of its QE program by EUR 750bn until year-end. All these measures equate to enormous monetary support but with unfortunately limited impact outside of financial markets, aside from lowering borrowing rates.

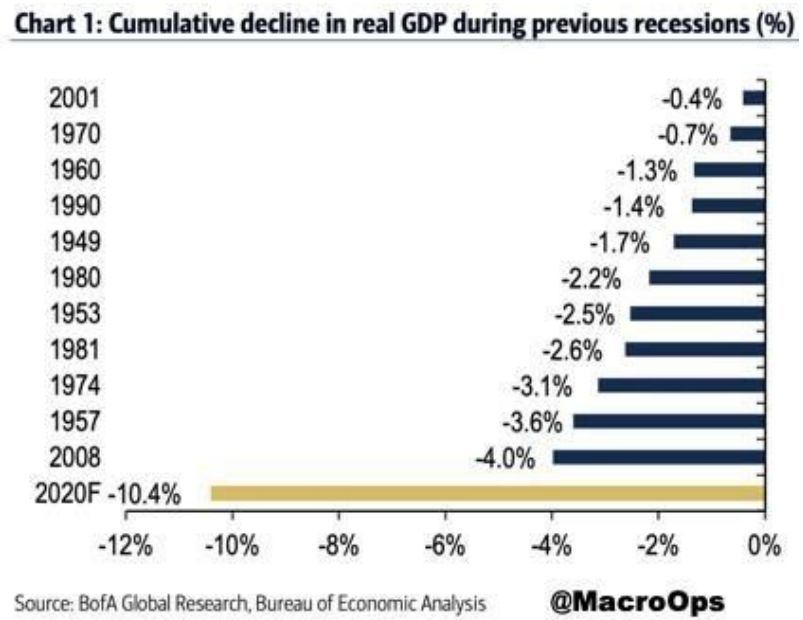
Fiscal stimulus or life support?

Governments have complemented central bank actions with extraordinary fiscal measures broadly aimed at sustaining its citizens' incomes and limiting corporate bankruptcies.

Country	Discretionary Easing	Loan Guarantees	Notes
US	$1.6tn	<$4tn	- Direct $1,200 transfer to majority of households. - Expanded unemployment insurance, giving claimants an extra $600 per week - $377bn in small business loans that turn into grants if workers are rehired. - Easing excludes $500bn bailout of corporates
Germany	€62bn	Up to €953bn	- Finance minister has pledged to guarantee 100% of loans to SMEs (€553 budgeted) - Guaranteed €400bn of corporate debt - Government pays idled workers 67% of their wages on top of employers' social security contributions.
France	€45bn	€300bn	- Unlimited state guarantees and lending provision
UK	£80bn	£330bn	- Largest rise in public spending in 30 years - Government scheme to cover 80% of furloughed employees' wages
Japan	$990bn		- Cash handouts for families and small businesses, tax breaks and zero interest loans
Rest of Europe			- CHF 20bn fiscal easing in Switzerland, €32bn in Spain, €25bn in Italy

Short term life support to turn into stimulus



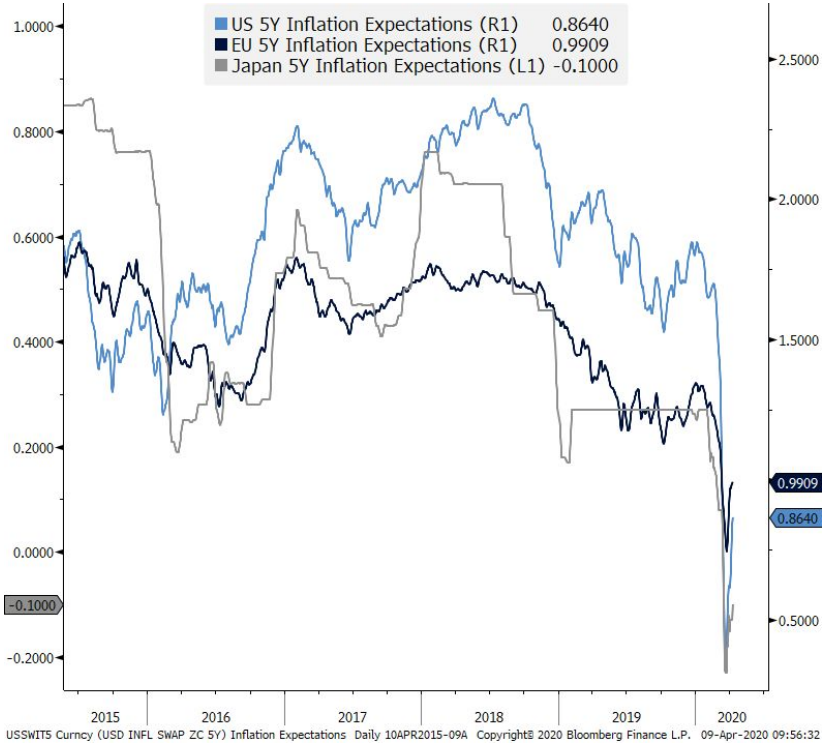


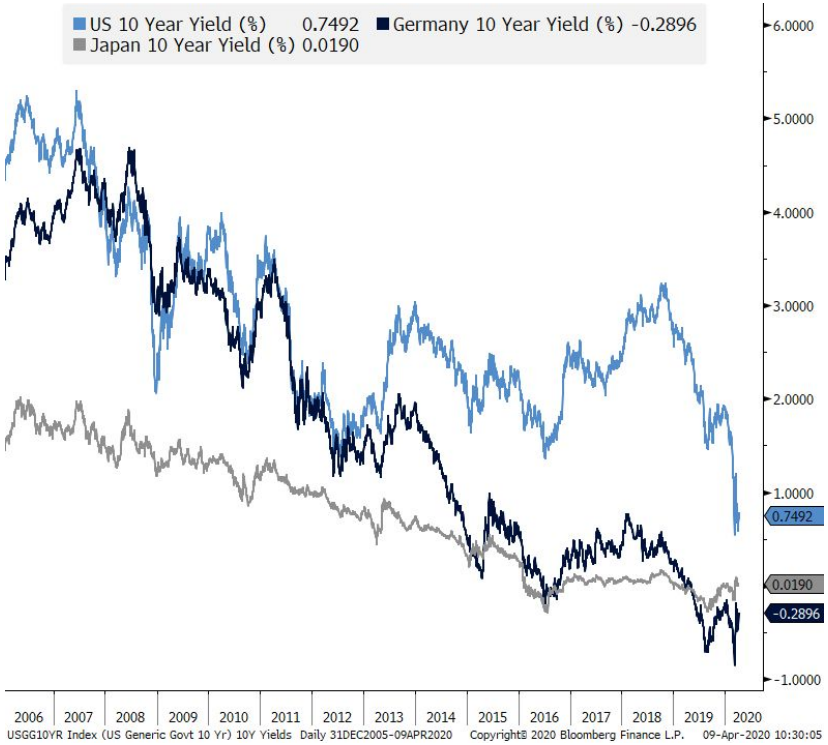
While the fiscal packages announced by global governments are enormous, they can hardly be qualified as stimulus for the time being as they are effectively substituting the collapsing demand from the private sector. As Bank of America estimates, the hit to US GDP growth could be as high as -10% in 2020.

The chart on the left shows that developed market governments have so far announced larger packages than their EM counterparts, with Japan recently announcing the largest package amounting to 19% of GDP. The nature of those packages vary as well; the US is focusing on maintaining individuals' incomes (and accepting job losses in the interim), whereas the EU aims to sustain the productive capacity of the economy and avoid job losses.

While the duration of the crisis remains to be seen, it is likely that government support will not be withdrawn any time soon, ensuring that the eventual economic recovery will be significant.

Massive fiscal spending could change the inflation picture



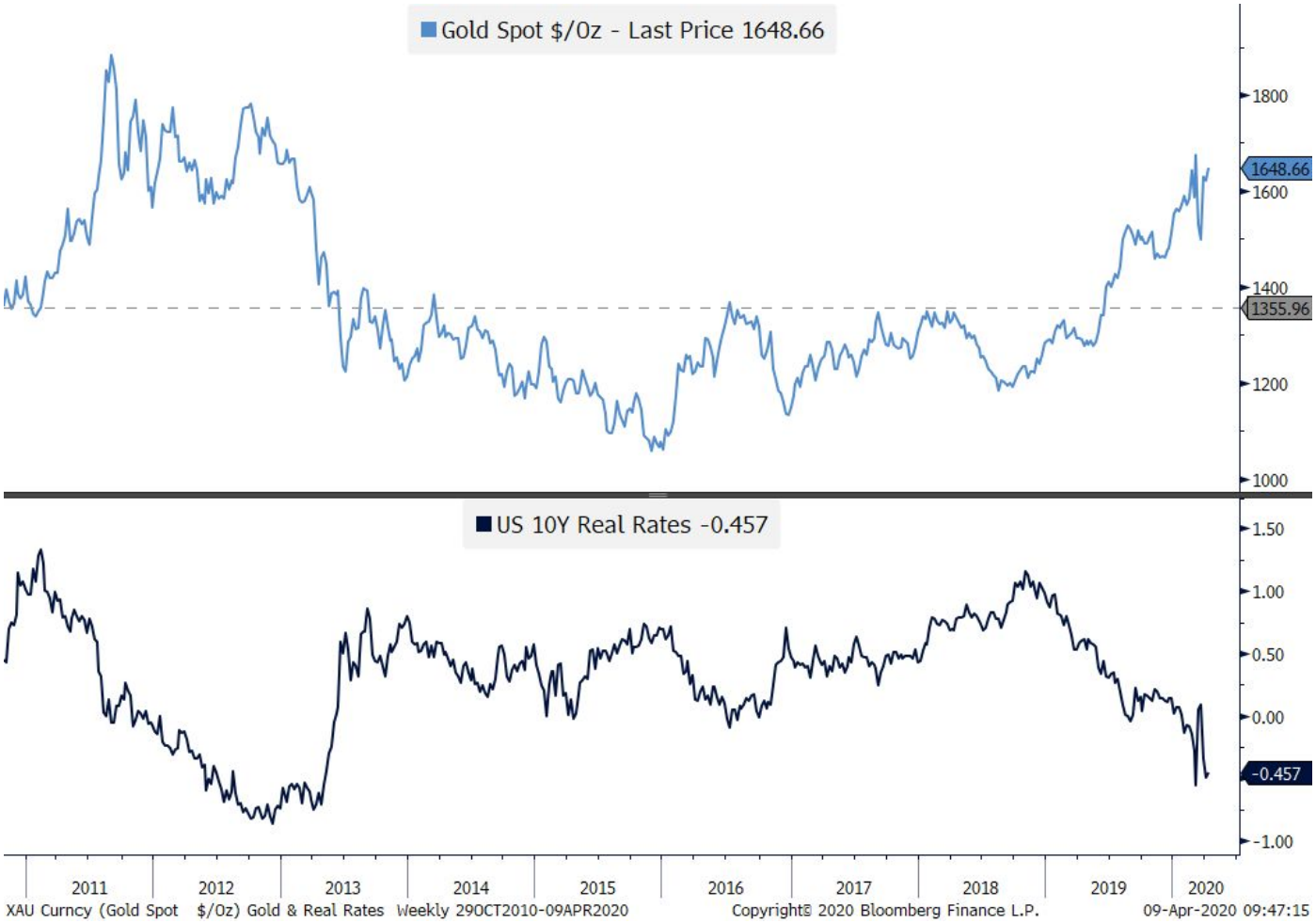


The combination of collapsing oil prices and economic activity has justifiably dragged down inflation expectations and bond yields. Through their asset purchasing, central banks are effectively suppressing bond yields, and as such, helping governments finance the deficits that can support their economies. To keep a leash on financing costs, central banks will probably follow Japan's lead and employ yield curve control measures.

While they may succeed in the short term, the move to directly finance government spending (i.e. Modern Monetary Theory) is unheard of outside of war periods and is dramatically raising inflation risks, especially if the impact of the outbreak proves short lived. While monetary policy has, over the last 10 years, had little impact on inflation outside of financial assets, financing fiscal spending could be the nail in the coffin for the bond market rally and investors should avoid developed market debt.

QE-infinity and fiscal largesse continue to favor gold

Central banks and governments have embarked on the largest monetary and fiscal experiments in history and in effect, debasing their fiat currencies against hard assets with more finite supply such as gold. Whether the crisis persists or the massive stimulus pushes financial assets higher, gold should fare well in both scenarios and should be a part of every investor's portfolio.

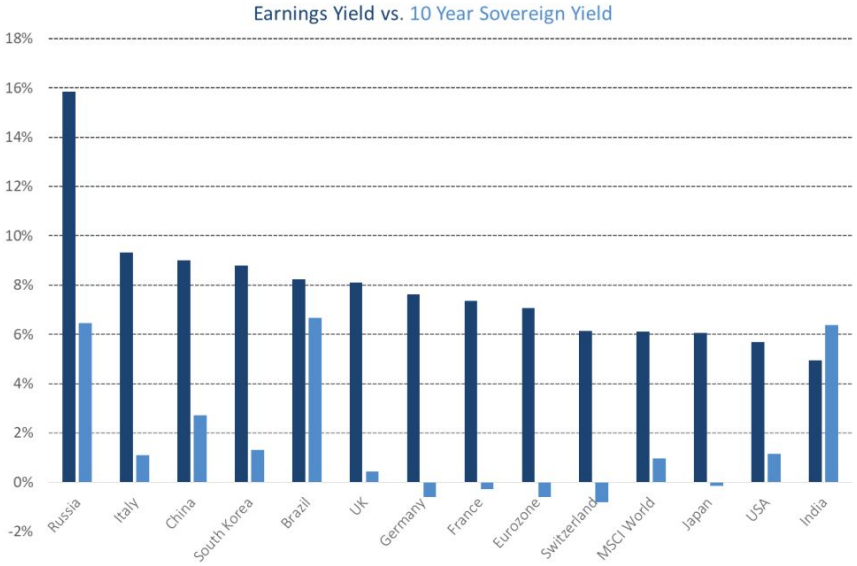


The amount of money created will end up finding its way to equities

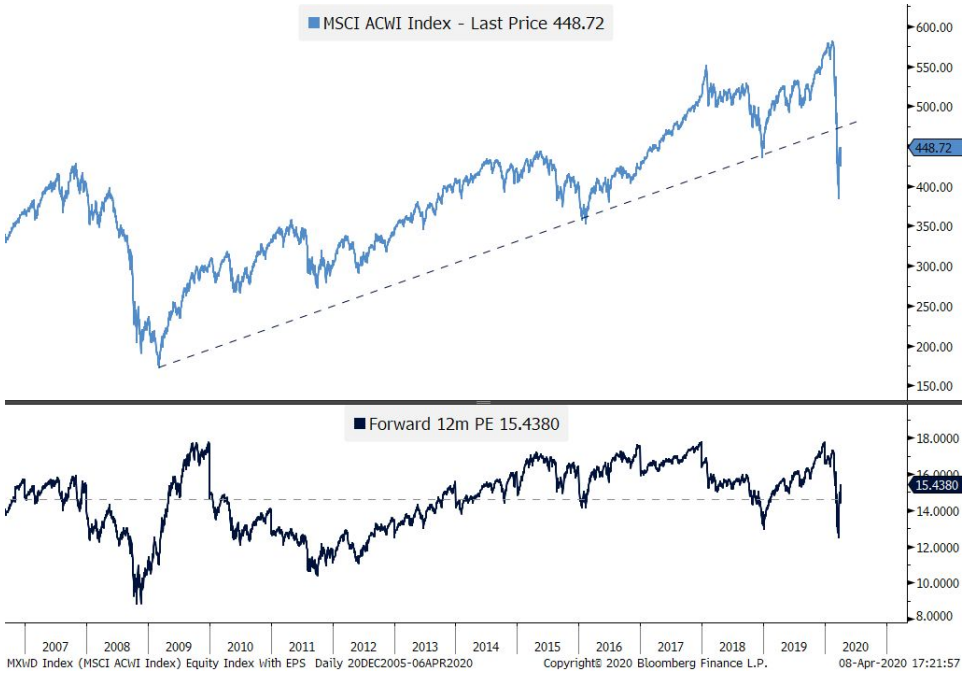
There is a robust correlation between money supply and the stock of financial assets available.

The chart on the right illustrates how the increase in money supply (M2) relative to the existing stock of financial assets leads the performance of the S&P500 by roughly a year. This is intuitive since the increased amount of money available needs to go somewhere and ends up bidding up the value of existing assets (including on financial markets). This is another way of illustrating how fiat currencies are losing their value. This relationship suggests that a significant rise in financial assets could be in the cards in 6 to 12 months from now.

Given depressed global yields in the developed world and the extent of the measures that central banks will take to maintain them at low levels, equities remain the best alternative once the uncertainty of the crisis subsides. As the chart on the right shows, earnings yields offer a significant premium over bond yields, even after factoring in a fall in earnings for 2020.



But the short term remains far too uncertain to pile back into equities



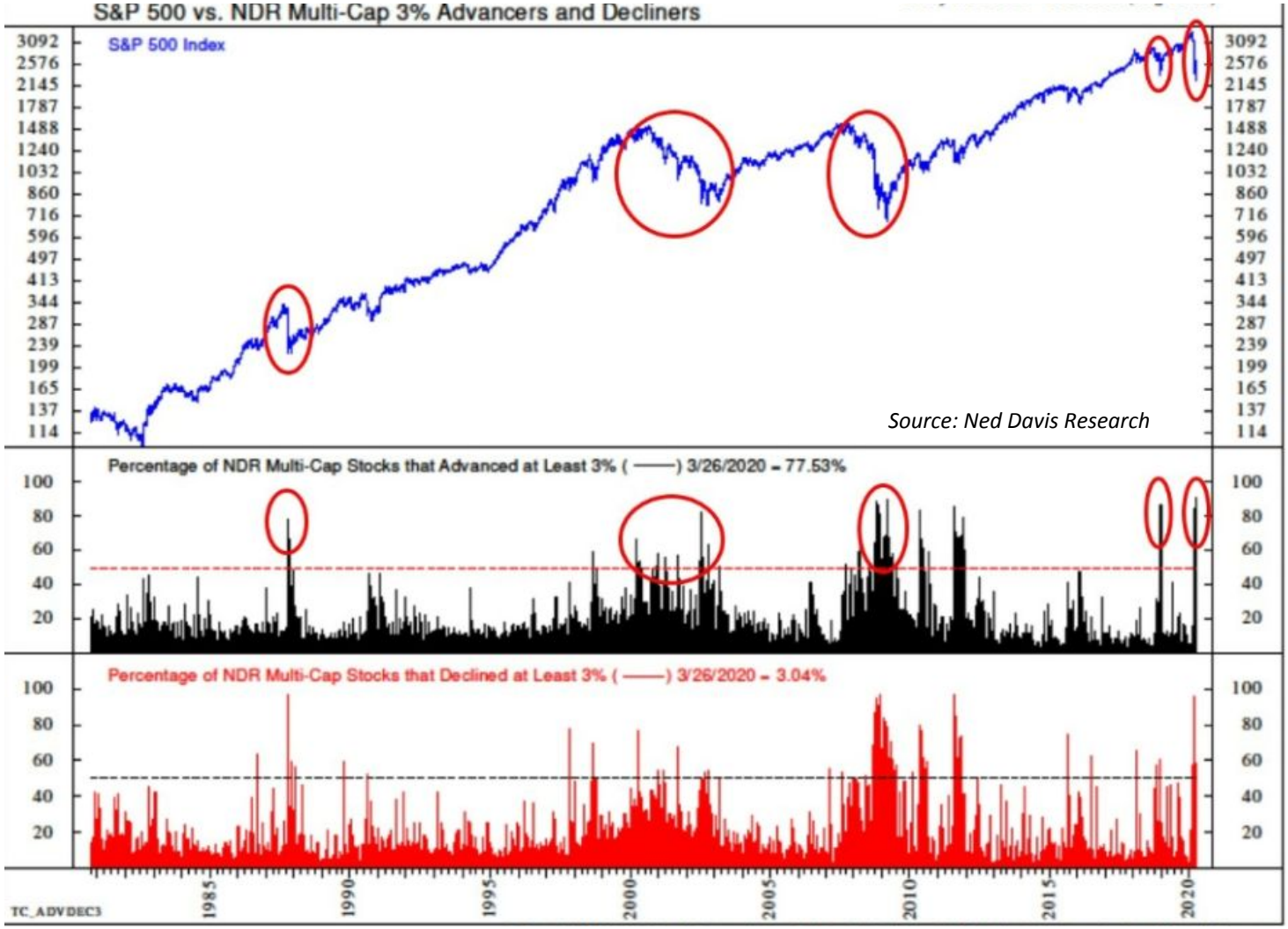
Date of Peak (S&P500)	Trading days from peak to bottom	Trading days from bottom to new high
9/16/1929	708	6497
08/02/1956	319	242
12/12/1961	141	331
02/09/1966	173	178
11/29/1968	388	547
01/11/1973	451	1732
11/28/1980	445	182
8/25/1987	74	462
3/24/2000	664	1622
10/09/2007	370	1231
2/19/2020	24?!	?

After a 35% drop for the global MSCI ACWI index in just over a month, sentiment is being re-adjusted, as early signs of virus-related improvements emerge from Europe. Though this has helped fuel a rapid rebound, it remains very unlikely that the market has bottomed yet.

- Previous bear market durations are inconsistent with a recent bottom (see table);
- Valuations have come down but remain above 10Y averages;
- The market has broken its uptrend;
- Volatility levels are inconsistent with a durable resumption of the uptrend;
- The extent and duration of the economic damage remain to be seen, especially with risks of a second waves.

This level of volatility is rarely seen outside of bear markets

The table below illustrates that periods during which a large numbers of stocks have frequent +-3% daily moves typically occur during bear markets.



Lower shareholder distribution ahead for leveraged companies

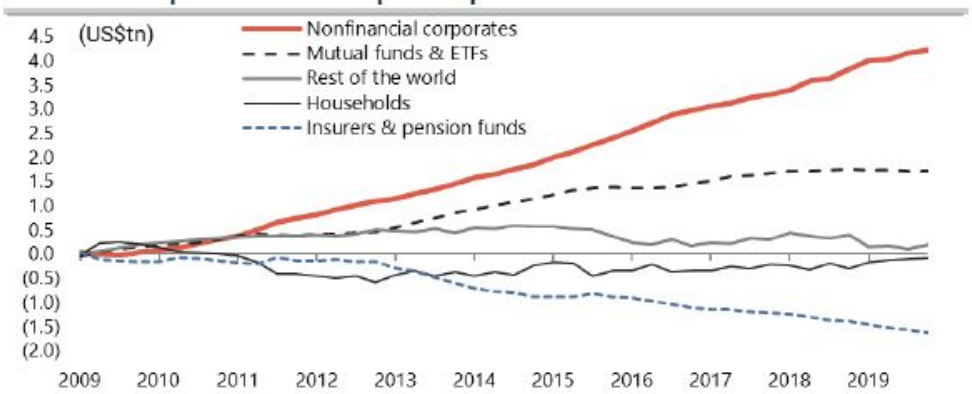
Buybacks have been the major driving force behind the US bull market since 2009 (see top chart). The economic shock is already threatening them, as an increasing number of companies in the US have announced a reduction or stop of their buyback programs.

In Europe, companies have announced dividend cuts given the sensitive topic of privileging shareholders over employees.

Goldman Sachs estimates a 50% drop in capital distribution compared to 2019.

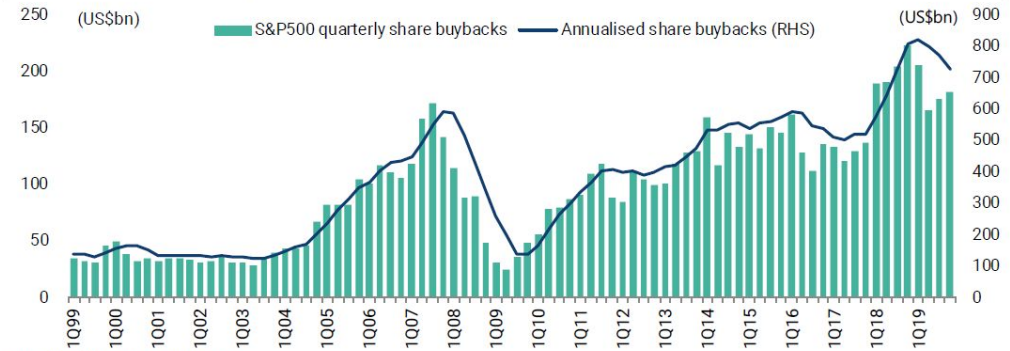
On the other hand, Japanese corporations appear to be on a much stronger footing to maintain buybacks and dividends. Japanese companies have the strongest balance sheet in the world, being net cash. This should allow them to whether this downturn more efficiently and investors should look for opportunities in Japanese stocks, which are extremely cheap.

Cumulative net purchases of US corporate equities



Note: Nonfinancial corporates' net repurchases of corporate equities. Source: Federal Reserve - Financial Accounts of the United States

Exhibit 12: S&P500 share buybacks



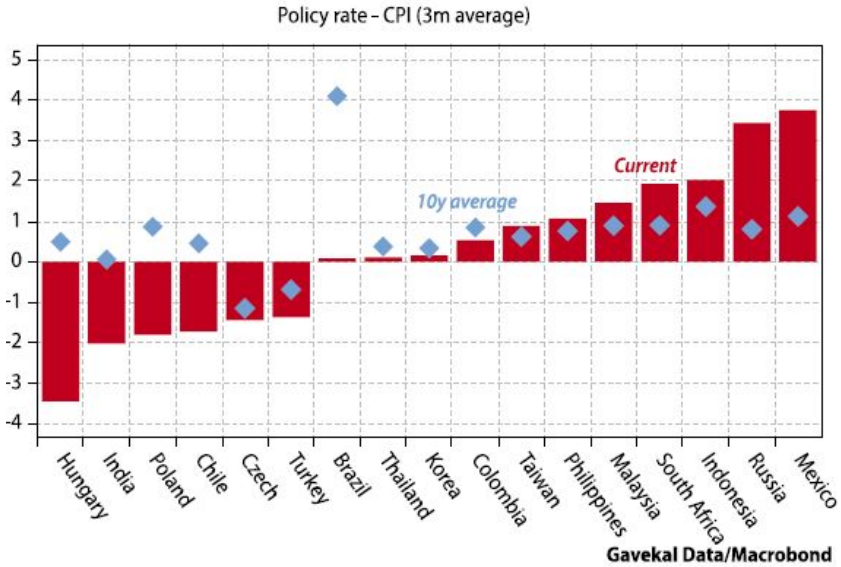
Source: S&P Dow Jones Indices

Higher rates and lower debt mean more room to ease for EMs

EM central banks have also cut rates to help mitigate the virus' economic threat, but unlike developed economies, for whom the zero lower bound may limit space for effective action, some EMs still have leeway for further monetary easing due to their positive real interest rates. The disinflationary benefits from cheap oil would support additional rate cuts for commodity importers.

Moreover, most emerging economies have the capacity to offer sizeable fiscal support since governments' balance sheets are relatively under-exploited.

Some EMs still have leeway for further monetary easing



How fiscal leeway compares with the 2008 situation

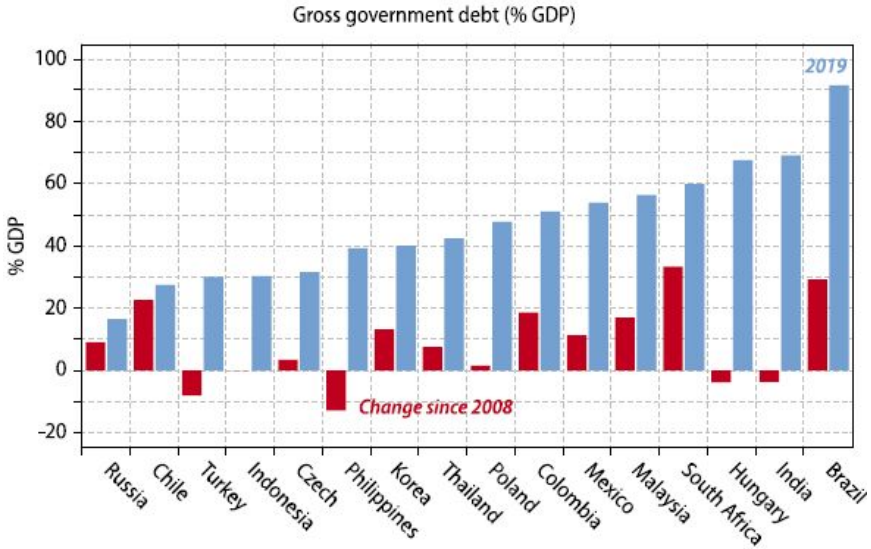
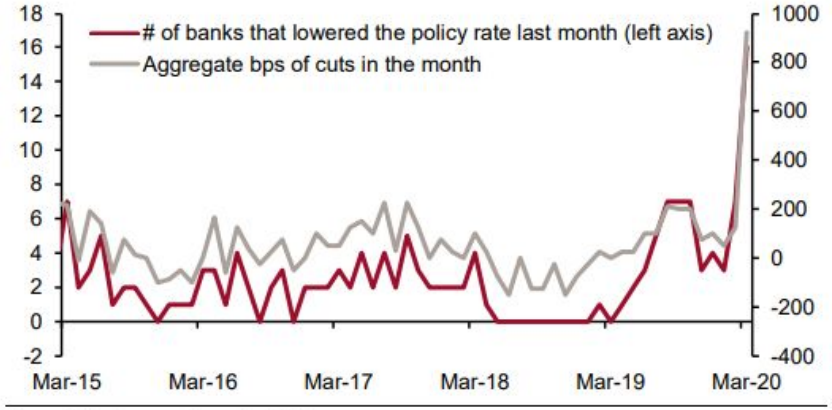


Figure 6: Speed of monetary easing in Emerging Markets

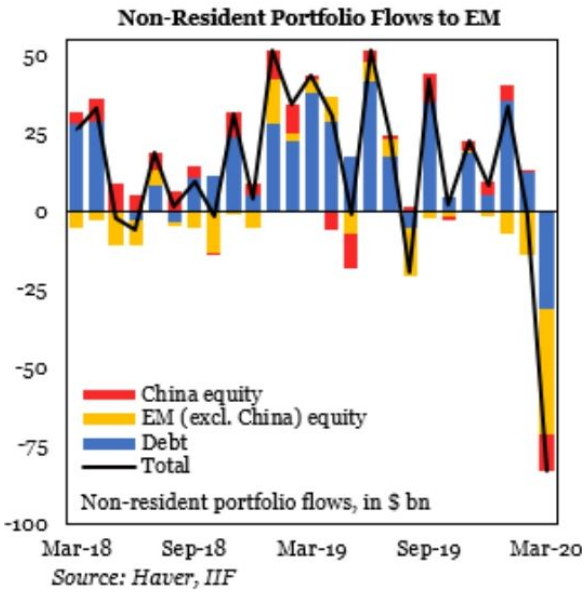
Based on a sample of 18 economies we monitor, excludes Turkey and Argentina



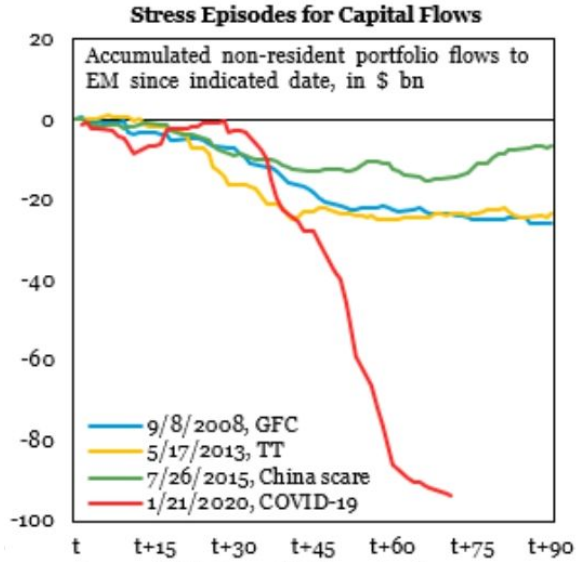
Source: National sources, Haver, Credit Suisse

Among the EM exodus, Asia looks particularly attractive

Foreign investors have fled emerging economies at a record speed, comfortably exceeding any previous crisis-like events. This dramatic outflow has dragged equity valuations down to near 2008 lows. The MSCI Asia Pacific Index is still down 20% from its apex and is not far from book value. When the coronavirus clouds do clear, the global monetary system will be flooded with such liquidity that asset allocators will likely return to favorable emerging markets in their quest for higher prospective returns and yields. With valuations currently at compelling levels, we favor Asian emerging and developed (Japan) economies.

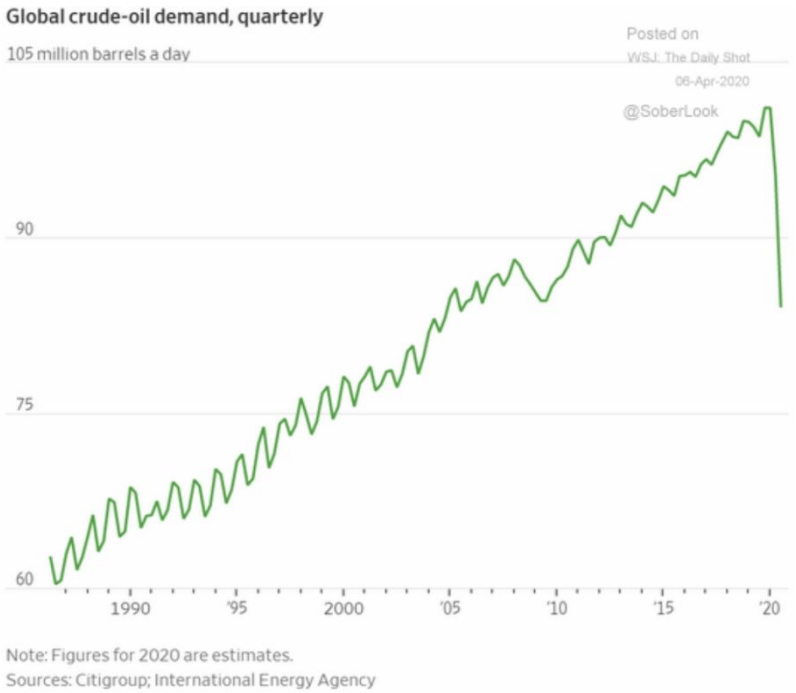


Source: Haver, IIF



Source: IIF daily capital flows tracker

The irrelevance of a production cut?



Oil has been a major casualty in 2020, falling over 65% from peak to trough, as Saudi Arabia and Russia effectively embarked on a price was just as demand was collapsing due to the COVID outbreak.

While Trump, particularly concerned by the damage on the US shale industry, has successfully orchestrated a production cut of 10m barrels/day, the lack of market reaction (prices fell on the news) confirms that the glut is there to stay in the short term given the extent of demand destruction (estimated at 20m barrels/day). A quick economic recovery from the COVID crisis will be key for the market to find a firmer and this is unlikely for the time being. However, with oil close to its key support of USD 20, investors should hold on to their undervalued and high yielding oil stocks, as much appears to be priced in and their long term potential is compelling.

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