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WEALTH MANAGEMENT

Market Insight

SPECIAL NOTE : Covid-19

March 19th, 2020

Spring is at the end of the tunnel

« At night all swans are black" was the title of our "Market Insight" newsletter at the end of January, where we expressed our fear that the black swan of the Coronavirus would infect global growth and cause a serious recession. Equity markets valuation were already rich before the appearance of the virus and caution with regard to investments was required. Today, the mood of virus watchers remains grim and, in the markets, the "fear" index - the volatility of the S & P500 index - is often the only one that is rising sharply. At a time when panic seizes financial markets by the throat, the moment is well chosen to remind that, in a tunnel, it is the black color which dominates, but that the exit from the tunnel is certainly closer than the distance dictated by our fears.

The coronavirus is a black swan: an event as highly improbable as damaging. Faced with this unpredictable exogenous shock, financial markets initially showed great complacency and continued to prance high. Until February 24, when they panicked.

Experience has shown us that once again, the efficiency of the markets is quite relative and investors globally may take several days, even weeks, to realize that the economic and financial signs may be grim.

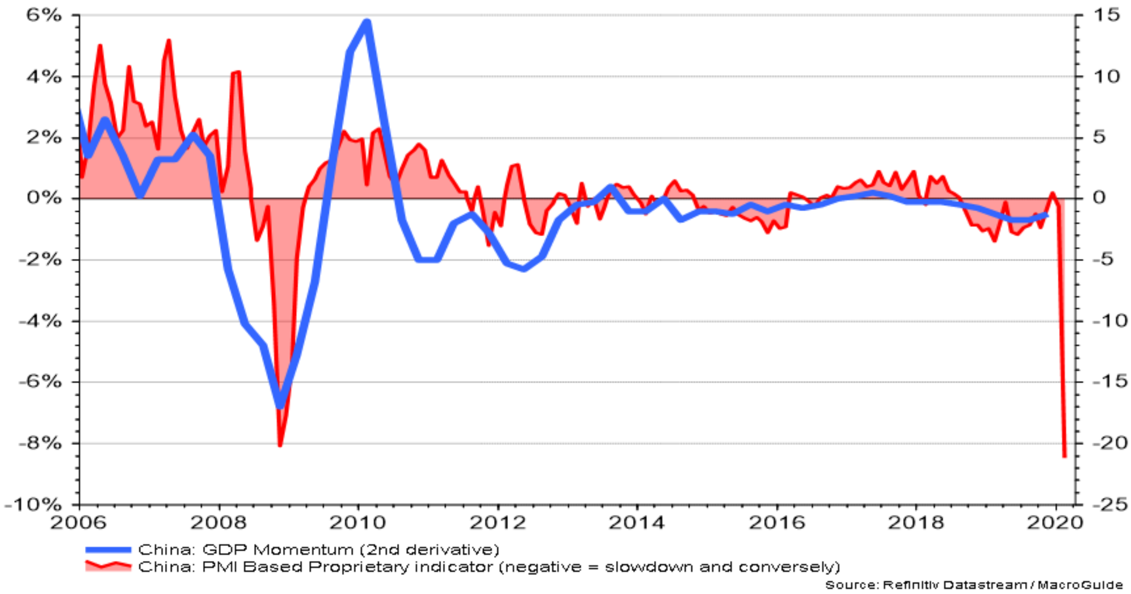
Today we are in the doldrums. The recession will be severe. Its duration is primarily linked to the spread of the virus as well as to the actions of central banks and, above all, fiscal stimulus plans.

The recession will be brief if the radical measures taken in the euro zone and in Switzerland to slow the progression of the number of infected people will be generalized to the United Kingdom, the United States and the rest of the world. Because ultimately, things are quite simple: if the whole world could remain caulked at home for 14 days, the Covid19 virus would be floored.

Let’s be clear: the CAC 40 index will not be able to find a lasting respite as long as the number of coronavirus infected doubles every 3 days in France.

Estimating the impact of the virus on the world economy therefore amounts to following the now famous progression curves of people infected with the virus. In the absence of a vaccine, the only way to cause the second derivative of progression to become negative is ... containment. In this regard, the radical measures taken recently in Italy, Switzerland and the Euro zone are a good omen, even if it will take a good ten days to see the impacts. The state of emergency decree in the United States is also a step in the right direction. So is the fact that the UK is finally acknowledging that the “laissez faire, laissez aller” policy of herd immunity is a high risk strategy.

1. Coronavirus shock to China compares to 2008



Before the virus arrived, growth forecasts for the Chinese economy showed its worst score in the past 10 years. Rather than basing ourselves on the official growth figures of 6% for GDP - before the appearance of the Coronavirus - we prefer to look at the variations of this growth rate in order to capture the momentum of the Chinese economy. Based on the purchasing managers index, our leading indicator is clear: the second derivative of growth shows a 6% drop today, comparable to what China experienced during the 2008 crisis. Relative to the official growth number of 6%, we have therefore fallen to 0%. Compared to what we estimate to be the “true” growth of 3%, the coronavirus shock puts the Chinese economy in decline by 3%.

Elsewhere than in China, growth risks have risen substantially. But in key countries like the United States, it should not be forgotten that this shock comes in an economy at full employment: the world leader remains buoyed by consumer confidence and the latter relies on the solidity of the labor market.

The key to a severe but short recession is that unemployment does not increase too much. And this is where central banks and governments play a key role.

A new « Whatever it takes! »

The central banks will have to take over the famous "Whatever it takes" that Mario Draghi launched when he was President of the ECB in 2012. At the time, it was to save the euro. Today, it is the global economy which is at stake.

The key is to prevent the liquidity crisis facing the corporate sector to turn into a solvency crisis: for this, the European Central Bank will have to rapidly strengthen the 4th edition of its TLTRO ("Targeted Long term Refinancing Operation") which provides commercial banks with ample credit facilities: companies which face an almost complete disappearance of their clientele (in the leisure sector for example) must be able to continue to pay their employees, by resorting to short-time working. Interest rate cuts and unlimited credit facilities like in the United States or in Europe will not stop the spread of the disease but it will help firms to survive. With a few exceptions like Amazon, it's not about boosting business investment, but survival. The measures announced by President Trump to transfer a total of $ 1.2 trillion to households and businesses is a good decision. And as Gérald Darmanin, the Minister of Action and Public Accounts in France put it so well: "When the house burns down, you don't count the liters of water to put out the fire! "

As far as the markets are concerned, valuations are now less rich than before the virus appeared. However, they are not in the “strong buy” zone. The valuation of global stocks is 12 times the expected earnings for the next 12 months, compared to an historic average of 15.7x. And again, that is without counting on the downward revisions of profits ...

2. The valuation of global stocks is reasonable, nothing more

When the cause of financial crises turns into a remedy

It is my conviction: at the origin of almost all recessions and financial crises since the creation of bank credit, there is almost always only one cause, that of excessive debt, be it from the State, the Corporate, or the Houshold sector, when it is not a combination of the three. And this, since 1472!

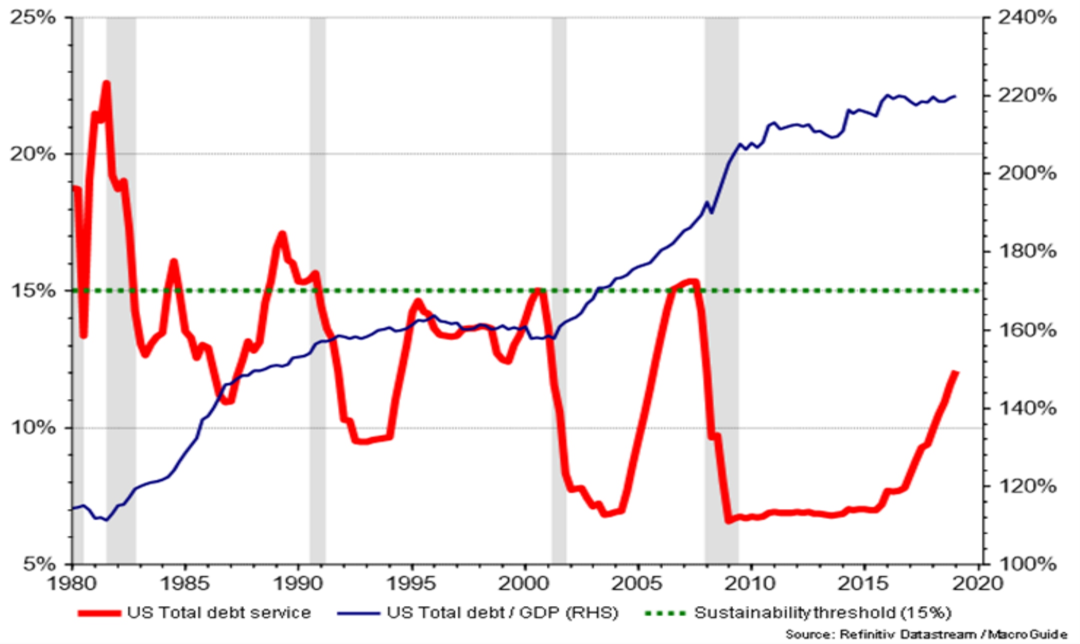
1472… this is the year when the first commercial bank was born. Not in Switzerland, as you might think, but… in Siena, Italy: the Monte dei Paschi di Siena. The first commercial bank to be created actually did itself experience serious problems of excessive debt, and was ultimately saved by ... Italian taxpayers in 2017.

This raises the question of when debt becomes excessive. Answering it is as easy as watching snow fall on the branches of a fir tree and predict when one of them will sag, or even break, under its weight. Tricky exercise to be sure.

The proof is given to us by the observation of the total debt in the United States, namely the sum of the public debt, which is 106% of the GDP, to which are added the household debt (70% of the GDP) and that of Corporate (44% of GDP). This total today reaches the dizzying percentage of 220% of GDP, as shown by the blue curve on the right scale of the graph. Does the observation of this curve help us to anticipate crises and recessions, indicated by the vertical bars in gray? The answer is no. Like the accumulating snow, it is difficult to predict when the debt burden will become unsustainable.

Debt unsustainability is much easier to measure by debt service, the burden of interest paid on it. The red curve shows this well. Whenever this service exceeds 15% of GDP, a recession in the US economy is quick to emerge.

3. Debt can also get us out of crises



The good news is that at 12.5%, the total interest charge is below its crisis threshold. Another good news is that this analysis, which we could describe as "unsustainable debt lightness", only applies when recessions and financial crises have an endogenous cause: the progressive accumulation of debt. When we face the unexpected exogenous shock of the pandemic, debt is no longer the problem, but the solution. Liquidity for businesses must be ensured to prevent the recession from turning into a depression.

In conclusion, the key to a sustainable market recovery is linked to two things: the slowdown in the progression of people with the virus and the assurance that everything is being done to avoid cascading business bankruptcies. We remain confident that we are going in the right direction on both fronts and that we should have the first confirmations by the end of March / beginning of April.

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