GADD
WEALTH MANAGEMENT

Market Insight

SPRING 2020

As fast as possible, as slowly as necessary

In our special note on Covid-19 of March 19 entitled "Spring is at the end of the tunnel", we noted that the exit from the tunnel is certainly closer than that dictated by our fears. Spring did arrive on Friday, March 20, and the bottom of the market followed on the following Monday. A turnaround that some believe is premature given the magnitude of the coronavirus recession. But what matters to the markets is that the health situation is under control all over the world and that deconfinement takes place "as quickly as possible, but as slowly as necessary", to use an expression already become cult of Alain Berset, the Swiss Minister of Health. We expect a U-shaped recovery, but we note that the speed of equity markets reversal makes them today significantly less attractive than when they bottomed out on March 23.

Covid-19 peak marks market trough

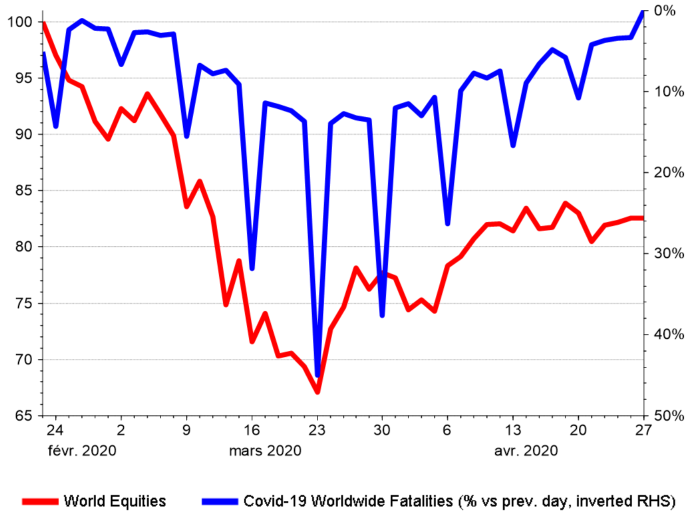
No doubt, March 2020 will be remembered by economists and investors, whose nerves have been put to the test. They started falling on February 24, and quickly lost 10% of their value, then find colors at the beginning of March to relapse heavily from March 4. So, when on March 12, Christine Lagarde gave her first crisis press conference as President of the European Central Bank, the expectations from economists and investors was immense but… she completely misses its ordeal by fire.

The markets were clearly awaiting a strong signal, a "Whatever it takes" part 2, a reference to that limitless determination displayed by Mario Draghi in 2012 which made him become legendary. At the time, the euro had to be saved. Today, we are talking about the world economy. To be true, when the new President of the ECB stated that she did not want to promise everything, arguing further that the number of Covid-19 cases cannot be countered with monetary easing ... the markets could only take a stronger nosedive.

Many voices then called for closing the stock markets, for investors to find some rationale and, especially for markets to stop falling as heavily. They ended up finding their way back up on March 23. On that day, the Fed announced limitless quantitative easing: hay to "Monetary Bazooka", the US Central Bank pulled out the nuclear weapon.

The bazooka was drawn by Christine Lagarde a few days later, as a "mea culpa" to correct her first intervention. Investors and economists appreciated her statement that "an extraordinary period requires extraordinary measures". Without repeating the strong formula of her predecessor, the President of the ECB displayed the same determination by declaring that the attachment to the euro is limitless, and that the central bank will use all the tools at its disposal to preserve economic integrity and financial services of the euro area. She added, as at the time its predecessor: "... within the framework of our mandate" but the markets largely ignored that detail; the will to act counts as much, if not more, than the actions themselves.

1. The peak in the number of casualties from Covid-19 marks the through in Equity markets



Source: Refinitiv Datastream / MacroGuide

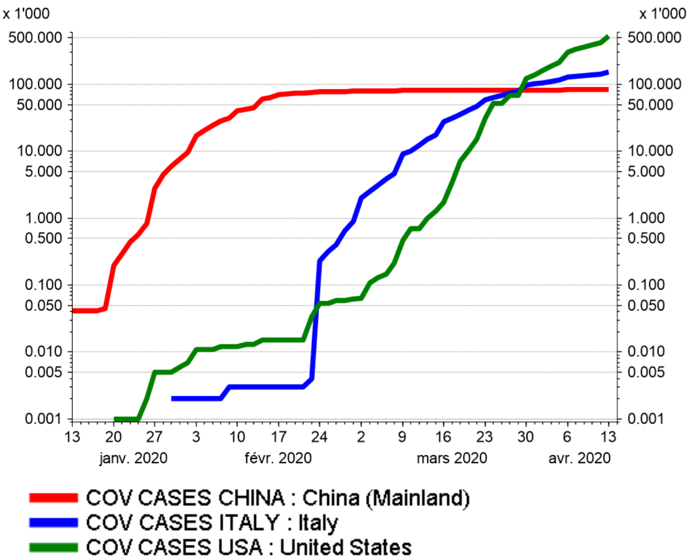
Christine Lagarde is but right to point out that we cannot stop the increase in the number of Covid-19 cases with many a rounds of interest rate cuts or quantitative easings, no matter how massive they are. Thus, it is probably also for another reason that the markets played their phoenixes on March 23. This day marks the peak in the number of victims of coronavirus worldwide, as evidenced by graph 1.

On this graph, the blue curve indicates the daily percent variation in the number of victims from Covid-19. The percentages are plotted on an inverted scale to the right. On the left scale, the red curve shows the evolution of the world stock market, as measured by the MSCI All countries index. The peaks of the blue curve mark the increases in the number of victims recorded on Mondays. Monday March 23 marks the "horror peak" for the number of Coronavirus victims, up almost 50% from Friday March 20. The very good news visible on this graph is that there was no increase in the number of victims on Monday April 27, unlike previous Mondays.

Inflection of the infection is the key

For the market turnaround to be lasting, we see a double condition, namely the very one that underlies the market trough on March 23. On the one hand, the slowdown in the increase in the number of Covid-19 infections must continue and ultimately lead to a steady fall, to allow adequate management of treatment in hospitals before a vaccine is found.

2. Infection inflection is the key



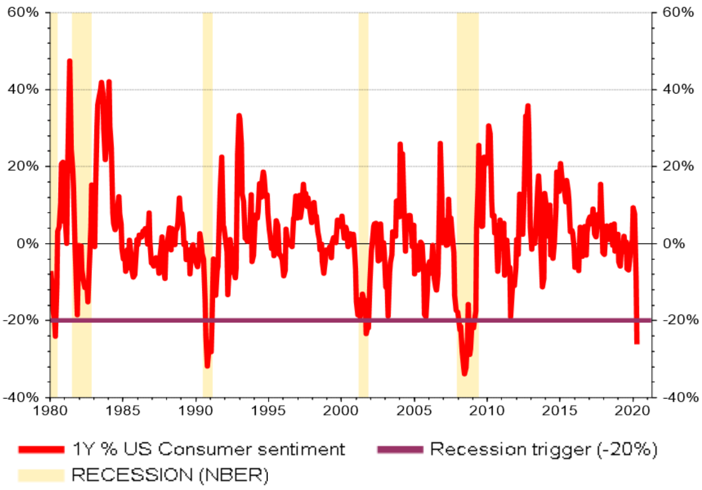
Source: Refinitiv Datastream / MacroGuide

The second condition for markets to recover on a lasting basis is that everything is done to prevent the liquidity crisis facing companies from becoming a solvency crisis, which would lead to cascading bankruptcies as well as massive and lasting job losses. This is where central banks, and especially governments, must come into play.

Debt as a source of crises and remedy to get out of them

In our March 19 note, we noted that debt overhangs - whether from the public sector, the households or the corporate ones, or even all three - is very often the cause of economic and financial crises. What is true of crises with an endogenous origin obviously does not apply to exogenous recessionary shocks such as the coronavirus. Here, debt is no longer the source of the problem, but the solution to prevent the recession from turning into a depression. The danger is real, as shown in Figure 3.

3. The recession threshold is reached in the US

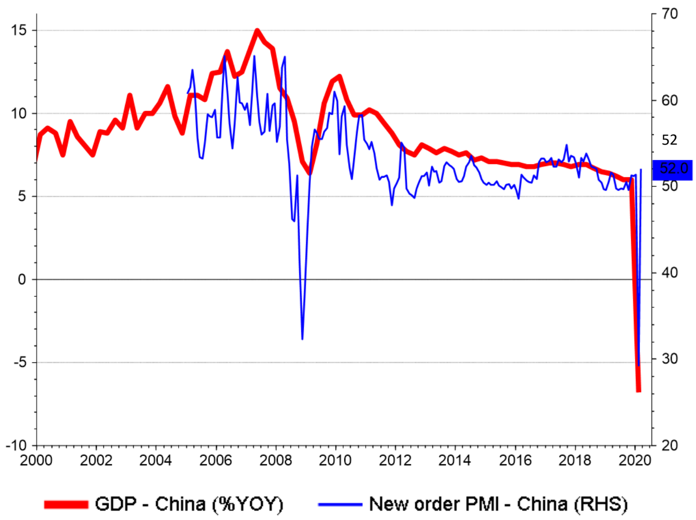


Source: Refinitiv Datastream / MacroGuide

Consumer confidence is our favorite indicator to signal the beginning and, above all, the end of recessions. Unsurprisingly, it clearly tells us that it has now started in the United States. This applies of course to the rest of the world as well. One exception, perhaps, China, where a V-shaped scenario seems to be emerging through the indices of manufacturing activity: the figures showing a swift turnaround need to be taken with caution, however; recent experience with the number of Covid-19 cases has taught us to be careful about the reliability of statistics from China ...

The time for "helicopter money" has come. It is about providing governments, businesses and households with the cash they need to survive the coronavirus crisis. In normal times, liquidity injections by central banks go through commercial banks. Whether it is by reducing the price of money - interest rates - or increasing its quantity through asset purchases, the purpose is the same: to boost credit. It does not al-

4. A V-shaped recovery in China ?



Source: Refinitiv Datastream / MacroGuide

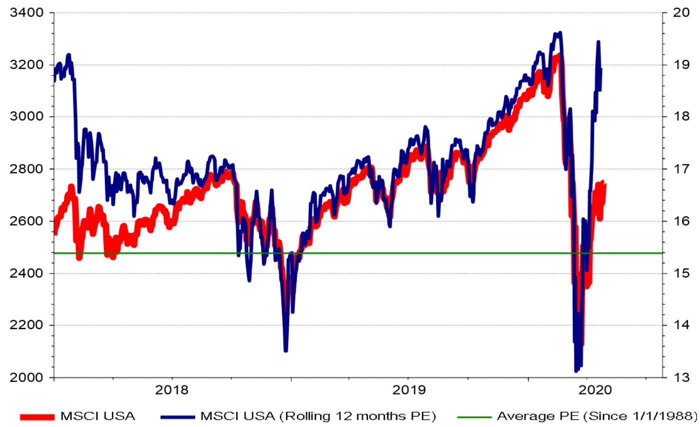
ways work and for a good reason: if banks find it less risky to invest this fresh liquidity in the capital markets rather than grant new loans to households or businesses... the transmission mechanism between the monetary policy of central banks and the real economy is broken. This is why in times of absolute crisis, central banks must do without commercial banks and ensure that the link between the printing press and the economic actors - states, companies, individuals – is a direct one. This is the principle of helicopter money, which is advocated by the supporters of Modern Monetary Theory (MMT).

Is MMT really modern? Not really. The theory that public debt can be monetized without problem and that sustainable economic growth requires public spending is the credo of Keynes and his supporters. What has changed with this new packaging of old precepts is that an increased weight in debt financing is today made possible by the fact that the price to pay for its monetization, namely inflation, has disappeared.

Gérald Darmanin, the Minister of Action and Public Accounts in France, is right to point out that "When the house burns, we do not count the liters of water to put out the fire! " Without a doubt, we must be supporters of MMT today. But the question that arises is: when we will have brought the fire under control, how will we support growth? By continuing to operate the money printing machine 24/7? For us, this strategy is high risk, in that it can generate the most terrible form of inflation: that which arises from the loss of confidence in the fiat money and which pushes people to raid the stores before the prices go up. This is the nightmare scenario of hyperinflation that arises from the acceleration of the speed of circulation of money. And as far as raided shops are concerned, the coronavirus has already given us a taste that we prefer to forget as soon as possible…

To the water we have to use without counting when the house is burning, we prefer that of the sugar to be taken urgently when we have a hypoglycemia attack. Just a few cubes and here up and running again, but... must we decree that we must regularly swallow sugar to be well in normal times? We are convinced that the solutions we need to advocate to get out of the crisis could bring us back quickly in it if we continue to use and abuse from them in normal times.

5. Following their bottoming out, US Stocks are now pricey



Source: Refinitiv Datastream / MacroGuide

Looking at equities, the global stock market index lost 35% to its bottom due to the coronavirus crisis, then rose almost 30% from its March 23 low. From 13 times expected earnings for the next 12 months, the valuation of the US stock market has climbed to a peak of 19 times, which stands well above its historic average of 15.4 times.

Regarding our repositioning in risky assets, we will adopt the wisdom of Alain Berset: the return will be as fast as possible, but as slowly as necessary.

Michel Girardin, *Senior Economic Advisor*

Money-market and fixed-income

The coronavirus ultimately did not stay in China. Rather, it spread rapidly from east to west during the first quarter and gradually became a global phenomenon. To keep the epidemic from spreading out of control, about 3 billion persons worldwide have been told to stay at home. This has triggered a collapse in the global economy through a simultaneous supply and demand-side shock. A wave of panic swept through the credit markets, sending them into a precipitous dive that was halted only through massive central bank and government interventions beginning in mid-March. A financial crisis now appears to have been averted, while the epidemic is slowly receding. In reaction to downgraded economic prospects, the 10-year US government bond yield has neared 0.50%, while the 10-year German bond has stabilized in negative territory at around -0.40%. Spreads, which had widened considerably throughout the yield curve, narrowed somewhat in April but continue to reflect investors' persistent concerns. We have dialled back some risky bond exposures, particularly in high yield, emerging debt, corporate hybrids, and mortgage-backed securities. Bonds account for 39% of the balanced portfolio, including 12% in cash, 3% in short-term products, 8% in government bonds, 7% in corporates, 4% in high yield, 2% in emerging debt, and 2% in convertibles.

Equities

The outlook for a global economic rebound quickly gave way to a worldwide collapse, caused by the rapid spread of the coronavirus epidemic and the resulting lockdowns. The International Monetary Fund forecasts a 3% contraction in global GDP in 2020, including a 5.9% contraction in developed economies. Only emerging Asia may achieve slightly positive growth on the year. The main equity indices have lost more than 30% of their value in just a few weeks. The drop was slowed by central bank and government interventions , which pledged to implement "all the policy tools at their disposal". Investors were ultimately reassured by signs of a return to normal in China after the epidemic, and then in Europe, and began to price in more optimistic scenarios. We have made no change to our equity allocation, which currently makes up 48% of the balanced portfolio. The USA and Europe each account for 17% of our positions, Japan 4%, and Asia-Pacific ex Japan and other emerging markets 7%, mostly in China, India, Korea, Taiwan and Brazil. Among the sectors, techs and healthcare have held up best. In terms of style, large caps have fared the best. We took advantage of US market volatility to do some index trading and expanded our hedges.

Currencies

In a highly-volatile environment, the main currencies are holding at stable levels. Peripheral currencies are trading more erratically. Gold has been the main beneficiary of the prevailing uncertainty. We are sticking to a tactical allocation of 14% in US dollars, 3% in yuan, 2% in yen, 1% in Mexican pesos and 5% in gold.

Alternative

The portfolio was hit by the negative contribution of Multi-Strategy after the liquidation of one of its investments in March. The Event-Driven allocation has also been hit by its close correlation to equities. The other strategies are holding up well, including Global Macro and, to a lesser extent, Equity Market-Neutral. The ancillary cat bond strategies and, even more so, the volatility and gold funds played their protective role. We have reduced our Equity Market-Neutral allocation and lowered alternative investments to 8% of the balanced portfolio.

Outlook

The markets are now pricing in a severe global recession, but of short duration, followed by a gradual restarting of activity, thanks to government and central bank support, as the lockdown is gradually lifted. The IMF forecasts a 3% decline in growth this year, followed by a 5.8% recovery in 2021. The main corporate bond and equity indices have now retraced more than 50% of their initial declines. We believe that these levels price in lots of good news and few uncertainties. The fact that volatility indices are still high remind us that the return to normal will not be a smooth path, even though the worst is no doubt behind us. We will take advantage of market dips to reduce our equity hedges and add selectively to corporate bonds. It is probably too early to return aggressively to risky assets.

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