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Investment Strategy

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The coronavirus epidemic

. The Covid-19 pandemic is an unprecedented health disaster in this past century. The peak was passed in Asia and is likely to be reached imminently in Europe. Nevertheless, it remains remote and unpredictable in the United States, the next hotspot of the epidemic.

A global recession

. We have entered a global recession, and it is deeper than every single recession since World War II. Economic stimulus policies have been implemented quickly and massively, and all monetary and fiscal policy tools are being used.

A U-shaped scenario

. We expect a U-shaped scenario for the economy, interest rates and equity markets. Volatility remains high and the short term remains uncertain. Current stock market levels offer investors an opportunity to reinforce positions with a medium- to long-term perspective.

Coronavirus: latest update

During the month of March, the general environment was completely transformed. The Covid-19 epidemic, first a local problem in Asia, and then in Italy, Iran etc., turned into a global pandemic. At the time of writing, this major health shock counted 1.4 million confirmed cases of infection, 82,000 deaths with more than 4 billion people locked down around the world. The economic impact is an immediate and deep recession. The consequences on financial markets have been a crash in equity markets, a flight to quality (along with a fall in interest rates), a strengthening of safe-haven currencies (dollar, Swiss franc, yen) and a rebound in gold. As the month of April begins, the markets are somewhat calm. What is our analysis of this unprecedented situation?

The Covid-19 pandemic

The epicentre of the pandemic is moving from East to West. The epidemic broke out in China in December 2019 (and in other Asian countries), before peaking a month after harsh confinement measures were put in place, starting in Wuhan on 23 January. The number of new cases declined in March. On 7 April, China announced that it had registered no new deaths related to Covid-19 that day.

The number of cases began to rise sharply in Italy in early March; a nationwide quarantine was decided on 9 March, the first European country to do so. The outbreak apparently peaked in early April, and this should be confirmed within the next few days. Spain and France are following the Italian situation with a 7- to 10-day lag. The epicentre of the pandemic is still Europe, but a plateau in terms of the number of new infections is emerging.

Meanwhile, in the US, the number of infections is soaring. Lock-down measures are not in place everywhere, but if they exist, they are not very strict. It is very difficult to say when the peak of the epidemic will be reached there. We are just beginning to hope for a plateau in the number of new cases in New York State. But this forecast of the Covid-19 epidemic peaking in the worst-affected American State is very random. There is immense uncertainty in the rest of the country, and bad news can be expected.

Economic impact: a major recession, massive political reactions

There is no doubt that this pandemic has already turned into the worst recession in the global economy since the Great Depression of the 1930s. Activity is at a complete standstill in several sectors (catering, hospitality, airlines, etc.). Moreover, confinement is taking a heavy toll on sectors where teleworking is possible because activity is slowing down, without totally stopping. A widespread estimate is that every month of general lock-down 'costs' GDP 3 percentage points or a 35% contraction in activity in one year!

The first economic data published since the Coronavirus lock-down confirm the huge damage. Purchasing Managers' indices, considered the leading indicators of activity, have never been so low (since these series began) as they were in March. Usually, Services cushion a recession in Manufacturing. Now they are amplifying it.

Unemployment figures are catastrophic. In the US, although confinement is not widespread, 10 million Americans filed for unemployment benefit in the space of two weeks. Jobless claims are now in the millions in all European countries.

As a result, all governments and central banks have decided to use all the tools at their disposal to counterbalance this development. Monetary and fiscal policies were set in motion immediately and massively in a bid to curb the recession. Particular attention will be paid to liquidity issues facing companies or households that no longer have revenue to pay for unchanged fixed costs (see our table which summarises the main economic policy decisions). Through their Quantitative Easing, central banks are particularly attentive to liquidity issues in the financial markets.

A U-shaped profile ahead

- Economies will take time to recover. What's more the recession will persist for at least two quarters after the beginning of confinement measures. Let's look at the Chinese case: the end of the health crisis was confirmed at the beginning of the second quarter. But activity is about 25-30% below the level seen at the start of the year. The recovery is timid because it is hampered by the lack of demand for exports (the pandemic is global). The authorities have just decided on further stimulus measures. In Western economies, the recession is only just beginning and poor economic figures are looming. We estimate that the recovery will only emerge in the second half of the year, but it will be strong, supported by stimulus measures, and growth will be back on track in 2021.
- Financial markets will anticipate the economic recovery. The vertical downward bar is behind us. We are already on the horizontal bar of our U shape. On stock markets, the recovery is already robust (and resembles a V-shape for the moment). We will monitor three factors going forward: i) the peak of the pandemic, probably already reached in Europe but not yet in the United States; ii) economic policy decisions, with other stimulus programmes to be announced, an already positive point; and iii) the markets' sensitivity to bad economic and financial news. For the markets to turn around durably, they would need to demonstrate that they are insensitive to bad news, in the form of economic data or downward earnings revisions. The third point will take place in the coming weeks, particularly when the reporting season for the first quarter starts. Companies will guide to lower 2020 profits and dividends. In other words, we are not sure whether the bottom of the stock market cycle has been reached.
- Our conclusion is that investors must take advantage of this phase to reinforce positions, by smoothing entry points. We like the US, Emerging and European (eurozone and UK) markets. We concentrate on quality companies in view of the challenging and uncertain environment. And we focus on long-term investment themes such as digital consumption, innovations in health care, 5G and artificial intelligence. For further details, please refer to our 2020 Investment Themes.

What are the risks surrounding our U-shaped scenario?

Other scenarios than ours (i.e. the pessimistic L or the optimistic V) are subject to three questions:

1) The duration of the pandemic could be longer, for example in the event of a second wave of infections in Asian countries. They pay particular attention to imported cases from Europe or the US. The problems of coming out of confinement are complex. Conversely, a health breakthrough is imaginable with a vaccine or a new drug, which would alleviate the risks attached to the duration of the pandemic.

2) Oil prices have plummeted since the start of the year, following a 25% drop in oil demand. Producer countries have failed to reach an agreement about cutting production, leading to a price war. The optimistic scenario: an agreement is reached between OPEC, Russia and the United States (which the markets have been anticipating for a few days) and prices rise rapidly. The pessimistic scenario: the price war continues. We believe that the adjustment (a cut in US output and a pick-up in global demand) will occur in the second half of the year, and prices will return to around $45-55 by year-end.

3) A credit crunch could take place. The problems of indebted companies and individuals would grip the credit market, putting the financial sector under pressure. This negative scenario replicates the mechanisms of the 2008/09 crisis. We believe that central banks can manage these issues by injecting massive amounts of liquidity. The markets have more or less returned to "business as usual" in recent days and we are seeing numerous bond issues, particularly in the Investment Grade universe. Moreover, some States are putting in place guarantees for many business loans and more flexible systems of partial unemployment than before.

Changes this month

The general environment changed last month, but we are focusing here on the changes to our investment recommendations:

- We have revised up our 12-month rate forecast on the Bund (10-year German bond) to 0%. We had previously expected a negative rate of -0.40%. Our target remains 1.25% for the US 10-year rate. With the recession underway, public deficits will grow sharply on both sides of the Atlantic, and despite Fed and ECB bond purchases, the upward pressure on rates to attract savings is likely to result in a (modest) rise of 50bp in rates compared with current levels.

- We have turned buyers of peripheral eurozone Sovereign bonds. Spreads have widened as pandemic pressures have intensified. However, we will see appropriate financing arrangements put in place: negotiations are underway between European partners. A compromise will be reached because the stakes are high.

- We reiterate our positive opinion on Investment Grade Corporate bonds. Spreads have widened and we believe the risk-reward ratio is good in view of purchases of central banks. In IG, we do not expect too many defaults. In our view, this default risk seems too great for HY (High Yield), particularly because this universe is going to see an increasing number of companies getting into difficulty. Rating downgrades by credit agencies are only just beginning.

Equities	
Global	• **Accumulate, with the objective of participating in a medium-term recovery** fueled by a normalization in the second half and unprecedented stimulus. • **Volatility will stay elevated** because uncertainties and downgrades of expectations will take some time. This is how the proverbial wall of worry will be escalated.
Markets	• **US stocks remain a core holding** given their weight in global indices and diversity. • **Euro Area stocks** are our favoured developed market play on the expected second half recovery. • **Recovery potential for the UK market**, provided by extreme discount valuations. • **Emerging Markets** offer above average earnings growth potential and good value.
Sectors	• **Positive on Healthcare, Energy and Insurance.** • **We downgrade US Energy to neutral but stay positive on EU Energy.** • **In Europe: positive on Technology and Construction Materials.**
Bonds	
Govies	• We are **negative on German govies**, whatever the maturity, and on long-term US govies. • We **are positive on the front-end of the US yield curve for USD-based investors** as short-term yields have limited upside. • We **turn positive from neutral on periphery debt** (Portugal, Italy, Spain, Greece) **on a buy on weakness strategy.**
Investment Grades	• We **prefer corporate bonds** over government bonds. • **We like EUR and US IG bonds with a duration at benchmark** (5 and 8 years, respectively)**. We broaden our positive stance on all US IG rated issuers, vs quality issuers before. We stay positive on EUR IG bonds.** • We are **positive on eurozone convertible bonds.**
High Yield	• **We turn neutral from negative on US HY and we remain neutral on eurozone HY**
Emerging	• **We are positive on EM local currency bonds**, for both USD and EUR based investors, and **neutral on EM hard currency bonds (sovereigns and corporates).**
Forex	
EURUSD EURCHF	• The main drivers remain in favor of the euro short- an near-term. We keep our latest targets at 1.14 and 1.16 respectively over the next 3 and 12 months. • The franc Swiss kept strengthening in February before broadly stabilizing in March. Since the risk-off mode should linger short term, we see the EURCHF remaining steady around 1.06 (from 1.08) over the next 3 months before depreciating to 1.12 over the next 12 months.
Commos	
Oil	• With our without OPEC+ agreement to cut production, Brent prices should recover around $45-55 at the end of 2020 thanks to the rebounding demand and lower US supply.
Gold	• We remain positive on gold. Real interest rates should remain extremely low for an extended period. We expect gold to trade in the range $1535/1735/oz.
Base Metals	• Neutral on the short term but positive for 2021. Downside risks should remain elevated in the coming weeks as global demand is hit. But the probability to have a synchronized recovery in H2 should not be underestimated
Alternatives	
Real Estate	• Positive for a 'value-added' commercial investment strategy, executed by first class asset managers. We downgrade the real estate emerging market part as the impact of the virus is not yet fully priced
Alt. UCITS	• Positive on Event-Driven, Macro, Long-Short equity. Cautious on relative-value strategies.

Fiscal and monetary measures

	Fiscal measures	Monetary policy measures
Eurozone	**Under negotiation:** **-Healthcare funding plan via the ESM (€200 bn** **-Reinforcement of the EIB's means of intervention to finance cash-strapped SMEs** **-Pan-European Guarantee Fund (€100 bn) to finance short-term unemployment payments** **-Joint debt issuance (Corona-Bonds)** **-Granting of loans (up to 2% of the borrowing State's GDP) via the ESM, under a supervision programme**	The ECB has taken strong measures similar to those taken in the 2008 crisis: Increase in the bond purchase programme by €750 bn (6% of eurozone GDP) bringing the Pandemic Emergency Purchase Programme (PEPP) to €1.1 tn The ECB lifted the limit of buying no more than 33% of a single country's debt Purchase of Greek sovereign debt and short-term corporate bonds (commercial papers) The ECB will accept loans from small and medium sized companies as collateral Refinancing facility (TLTRO) for commercial banks (negative rate -0.25% or very negative -0.75%) The ECB has also lowered capital and liquidity requirements for commercial banks It recommends that banks should not distribute dividends for the next six months
Germany	Easy access to short-term employment Support for corporate liquidity through tax and social contribution deferrals State loan guarantees to the most vulnerable companies Development of existing guarantee systems provided through public bank KfW (€820 bn) Additional expenditure of €1 bn for the Ministry of Health Increase in public investment in 2021-24 (€12 bn) Additional fiscal package of €750 bn €156 bn of new debt issuance to finance additional spending related to the crisis (debt brake temporarily lifted) Funds of €600 bn with €400 bn of loan guarantees, €100 bn for the KfW and €100 bn of equity investments in companies Government announced €30 bn of guarantees for the credit insurance sector Federal States set up their own fiscal stimulus programme	
France	Tax package of €45 bn Late payment of taxes and social security contributions Coverage of short-term unemployment Suspension of the new tax on the use of temporary contracts Increase of loan guarantee schemes for SMEs (€300 bn) Solidarity Fund for small businesses (€2 bn) Companies may require their employees to take up to 6 days of paid leave during the state of emergency	
Italy	Fiscal package of over €25 bn Deferral of social contributions and taxes for companies "Emergency Income" for 5-10 mln workers Mortgage adjustment for the self- employed Commercial loan guarantee scheme (€340 bn). €10 bn in household income support, including financial aid to self-employed people and seasonal workers, parental leave, childcare, suspension of all social security contributions and insurance payments until May 31 Debt repayment holiday Support for the health care system (€1.5 bn)	
Spain	Fiscal package of €17 bn Tax and social security credits State loan guarantees (€100 bn) Financial measures to support the most vulnerable households Debt repayment holiday €3.8 bn in government support to the health care sector	
UK	£30 bn fiscal package £12 bn (0.5% of GDP) for targeted support measures (£5 bn emergency fund to support heath care services, £7 bn of measures to help households and businesses) £18 bn earmarked to longer-term measures to be implemented later this year But also: £20 bn of tax cuts and grants to corporates £330 bn of government-backed loans to corporates Debt repayment holiday £50 bn of additional measures: -Take over 80% of the wages of workers whose jobs are at risk. -Deferral of VAT payment for the next quarter (£30 bn) -Unlimited 12-month interest-free loans for businesses -£7 bn in additional social aid -£1 bn in assistance to tenants	The Bank of England cut rates by 65bp to historical low levels (0.1%) Increase of the bond purchase programme for £200 bn for a total of £645 bn Support programme in the short maturity corporate bond market (CCFF) Reduction of the countercyclical capital buffer rate to 0% for UK banks highly exposed to impacted borrowers
USA	1st fiscal package voted by the Congress (6 March) of $8.3 bn for US health authorities (CDCP, PHSSEF and NIH) -Emergency programme ($300-500 bn) for the payment of employees on forced unpaid leave, sick leave and unemployment benefits -Fiscal package of $2.2 tn Direct financial assistance to households, loans to small and medium enterprises ($400 bn), support to the hardest-hit industries and large companies ($500 bn) with $50 bn for airlines and $100 bn for hospitals Proposals under discussion: -Possible 4th fiscal package of more than $1 tn for small businesses -Additional $250 bn of loan guarantees for small businesses	The Fed cut rates by 150bp to 0-0.25% New programme of bond purchasing and lending to companies (unlimited volume and extended scope) $300 bn credit program for businesses (purchases of corporate bonds in the primary - PMCCF- and secondary market -SMCCF) and households (support for student loans and consumer credit markets - TALF) Support measures to reduce stress in the commercial paper market (CPFF) The Fed launches a programme to support money market mutual funds New launch of financing facilities for large corporates Resumption of a dollar swap policy with other central banks to ensure dollar liquidity

Sources: Financial Times, UBS, Deutsche Bank, les Echos, BNP Paribas

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