COVID-19: 25 MARCH UPDATE

25 March 2020

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IN A WORD:

This morning (25 March) the financial markets are rebounding for the second day in a row (the Eurostoxx was +4.1% at the time of writing, after the Nikkei closed up 8%). Yesterday's trading session saw the biggest one-day gain since October 2008: the S&P 500 rose 9.4% and the MSCI World All Country index, 8.8%. All risk indicators have been falling, from volatility on equities (VIX and V2X are down sharply) and credit spreads, to gold (the ounce is at $1,606, -1.6%).

Yet negative newsflow continues to flood in. **With regards to the pandemic**, Asia remains stable in the number of cases registered. The growth rate of new infections is slowing down in Europe, but the number of deaths remains very high. Finally, the number of new cases in the United States is speeding up. Private laboratories have started large-scale testing there. The World Health Organization has warned that the pandemic's next epicentre will be the United States. We are closely monitoring the alarming situation in the state of New York. Almost half of American states have implemented lock-down measures, which are much lighter than in Italy, Spain and France.

Turning to the economy, recent data are not simply bad, but dreadful. The Purchasing Managers' Index (PMI) for March showed a very sharp drop in the manufacturing sector in both Asia and Europe. The US is less affected at the moment. Global manufacturing has reached historical lows, already seen in recent recessions. On the other hand, services are sinking into unknown territory, with unprecedented declines! Never before has there been a complete stoppage in the restaurant industry, or an almost complete halt in the airline and hotel sectors. Lock-down in services is having an immediate and full impact.

Yet the financial markets bounced back yesterday, and continue their positive momentum this morning. The US Congress found a compromise between Republicans and Democrats, by agreeing on a $2 trillion stimulus package. The massive interventions of central banks are beginning to ease liquidity tensions in the markets, especially for the dollar. In short, an important step in behaviour has been made. Financial markets are no longer tumbling on bad news, but are starting to look beyond the short term. This relief rally is welcome, but it may be only transitory until the peak of the pandemic is behind us, at least in terms of the rate of increase in new infections.

In the rest of this update, we will briefly answer three questions we have been asked.

Guy Ertz will answer the first two questions and Roger Keller the third one.

1) **Are these massive interventions by central banks and governments likely to trigger the next round of headline inflation?**

   On the inflation front, we expect a further slowdown (and potentially a temporary phase of deflation) on a month-on-month basis. We see no reason to worry about a sharp rise in inflation over the coming years, despite the new major fiscal and monetary policy stimulus packages. Inflation accelerates when demand durably outpaces supply. This is not our expected scenario. Indeed, it will take some time before everyday life returns to normal and demand stimulus effects start to feed through into the economy. Moreover, governments have done everything they can to prevent companies from failing and laying off skilled employees. Meanwhile, supply and demand should recover. At this stage, inflation expectations, measured by financial derivatives (swaps), suggest a deflationary risk.

2) **What is the cyclical situation in China, the first country to take lock-down measures, and now in recovery mode?**

   Indeed, it will be key to follow the speed of recovery in China where the Covid-19 virus originated. There are encouraging signs using High Frequency indicators such as daily coal consumption of the six main power generators, traffic congestion in big cities, sales of real estate floor space, etc. These indicators have started to return to normal levels over the last few weeks. See also the *Financial Times'* Coronavirus tracker.

3) **After stock markets crashed by 35% between the highest and lowest levels, what is the valuation of major stock markets?**

Global equities have lost 34% on average between their record highs and their lows. Have valuations become attractive?

The S&P500 trades on a 2020 PE of 14.9x based on consensus earnings estimates. This seems reasonable at first sight. Earnings estimates are unfortunately much too optimistic and are currently being revised down by strategists and financial analysts in the wake of the health crisis and the ensuing recession.

Since the 1930s, earnings have fallen by 13% on average during recessions. Using this standard, the S&P500 trades on a 2020 PE of 18.5x. This is not cheap but in line with the long-term average.

The same analysis is made for global equities, based on the MSCI World All Country index, resulting in the following multiples: 14.7x and 17.3x respectively. The same conclusion applies: the global equity markets are not cheap but valuations are in line with the long-term average.

If we base our analysis on price-to-book ratios, we arrive at similar conclusions:

- The ratio for the S&P500 stands at 2.7x, almost mid-range between 1.5x and 3.5x (excluding the tech bubble period);
- On the MSCI World AC index, the ratio is 1.75x, also close to the long-term average. The range is 1.2x to 2.7x (excl. the tech bubble).

We do not believe that valuations will return to historical lows. The current recession is deep but it should lead to a rapid recovery in the second half of the year, when economic activity normalises and benefits from unprecedented intervention by both central bankers and elected officials.

We therefore recommend pursuing a strategy of accumulation in stock markets in the coming weeks.

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