COVID-19: 13th MARCH UPDATE

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IN A WORD:

Therefore, our overall scenario is uncertain in the short term because psychology is dominating (as is the irrational response to the pandemic) and panic is widespread. We are still persuaded that this phase is transitory.

On 13 March there was a strong rebound in the equity markets after previous day's crash. The high volatility seen over the past two weeks is continuing.

With regards to the Covid-19 epidemic, the number of new cases of infection in China is practically zero, and the figure is stabilising in South Korea. In Europe, on the other hand, the number of infections continues to soar. And in the United States, it remains low and the risk of a significant acceleration in the coming days is widely expected.

Financial markets are rebounding, as the news of a stimulus plan focused on economic policy is increasingly likely to come in the form of a general fiscal and monetary package. In the United States, the Federal Reserve has injected a large amount of liquidity into the money markets; its meeting on Wednesday 18 March is likely to result in a further cut in the Fed funds rate and perhaps a resumption of Quantitative Easing (QE), consisting of purchases on the corporate bond market, above all. As sovereign yields are already terribly low, a new wave of government bond purchases would not help

much. In Europe, the ECB has taken significant measures that have somewhat disappointed the markets, but the additional monetary stimulus package has arrived (increase in QE, new targeted long-term refinancing operations, or TLTRO).

On fiscal policy, in particular, several changes are underway. In Europe, Mr Macron has made it clear that the priority is health: 'health has no price'. Budget constraints appear to have secondary importance. In Germany, several members of the government, including Mrs Merkel, have announced that unlimited cash will be available (if necessary) to help businesses/households through this crisis. The European Union plans to lighten budgetary constraints because of the crisis clause in international agreements. We recall Draghi's 'whatever it takes' scenario during the regional crisis to save the euro. What is happening right now is beginning to look like a 'whatever it takes' budget scenario to curb the Covid-19 pandemic.

In the United States, a negotiated deal between the Republicans and Democrats for a series of measures to combat the effects of the epidemic is making good progress. A vote in Congress could take place soon (this point needs to be confirmed because Mr Trump has not communicated on the new budget programme).

In terms of risk, we need to continue to monitor the credit/corporate lending markets where tensions persist and liquidity is tight.

WHAT ARE THE KEY PILLARS OF OUR SCENARIO?

1) Will the Covid-19 epidemic take the same path in all countries as the one in China, where thanks to harsh isolation measures, things calmed down after a month and a half? To know the answer, it will be necessary to monitor each specific case; and the next country is South Korea, where the number of cases of infection is peaking at present. This would mean that European countries still have several difficult weeks ahead. Meanwhile, the number of cases is only just beginning to rise in the US.
   There is much uncertainty about Covid-19, but one fact is common to all our analysis: this epidemic will be transitory.
2) In view of the very negative short-term impact on economic growth (and on financial markets), policymakers will do whatever necessary to restore confidence, first, by implementing appropriate health measures, and second, by using all the tools at their disposal in terms of economic policy.
3) We have adjusted our economic growth scenario; a global technical recession (two quarters of contraction in activity) is now our base-case scenario. But with the economic policy stimulus coupled with the predictable inventory cycle, the rebound in growth in the second half is likely to be strong. We are definitely in a U-curve scenario, and no longer a V-curve scenario, in view of recent developments (pandemic).
4) This U-shaped profile shapes our targets for financial markets: cuts in short-term rates (accommodative central banks) and falling long-term rates (lower inflation and safe-haven approach by investing in risk-free assets) seen in the

first quarter and then a substantial recovery in the second half of the year (see our targets in the table below).

5) Equity markets will follow the same trend, with a decline far exceeding our previous scenario, and then a strong rebound. Corporate profits will be revised downwards in many sectors, all those linked to international trade (airlines, tourism, food service industry etc.), and all those with global supply chains that depend heavily on China. Let's not forget the oil sector, which will suffer immensely from the collapse in oil prices. The rebound in equity markets should precede the economic rebound, but the trough is extremely difficult to identify during times of panic. There are few historical examples of such extreme tensions in sentiment indicators, and rarely has pessimism been so dominant. Stock markets could potentially return to early 2020 levels at the end of the year, as valuations have clearly improved.
6) Our new forecast range for oil prices is $45/55 for the Brent. Thus our base-case scenario is that the price war will lead to a significant correction that will last for at least half a year. The adjustment in the supply of American shale oil will take a few months, and the bounce in demand will materialise when the rebound in global growth occurs in the second half of the year. In a less likely scenario, negotiations between OPEC and Russia could resume, as this price war will be very painful for everyone, except oil importer countries.

Therefore, our overall scenario is uncertain in the short term because psychology is dominating (as is the irrational response to the pandemic) and panic is widespread. However, we are convinced that this phase is transitory, as are the recession and the current flight-to-quality. We maintain our expectation of a rebound in economic growth, interest rates and stock markets in the second half of the year. The trigger for the rally could be a concerted action by central banks and governments. The UK is an example of this.

OBVIOUSLY RISKS EXIST.

a) Covid-19 is an unknown. Another jump in the number of infected people in China or South Korea is a risk scenario, prolonging the pandemic's duration. For now, the number of new cases is falling steadily in China and South Korea.
b) An inadequate response from the authorities (concerning health or the economy) is not our scenario, but we are not ruling it out. This risk materialised in the reaction of financial markets on 12 March, the day after the disappointing speech by President Trump that the ECB's decisions did not manage to appease.
c) The most serious (and best-identified) risk is credit risk. Companies will face cash problems, while tensions on credit markets and leveraged loans are deteriorating financial conditions. The shale oil sector in the United States is highly leveraged and represents a large slice of the High Yield segment. With the technical recession (we are expecting), default rates will rise. Therefore, watch out for the ‘snowball’ risk of this segment in the financial markets.

SUMMARY TABLE OF OUR CHANGES AND RECOMMENDATIONS

	T	T-1M	WE LIKE	TODAY CHANGES
EQUITIES	+	+	Region: EU, US, UK and emerging market. Sectors : Energy, Europ. Tech, Europ. Construction Materials and Health Care. Value to outperform Growth and small cap to outperform large cap.	Fundamental and technical considerations back a strategy of using price weaknesses as buying opportunities. We upgraded Health Care to positive and consumer staples to neutral. We downgraded financials to neutral.
BONDS	-	-	EU and US IG, EM bonds in LC. Eurozone convertible bonds.	We revised our targets for 10-year government bond yields to 1.25% for the US and -0.40% for the US. We downgraded US high yield bonds to negative and Emerging market corporate bonds to neutral.
COMMODITIES	+	+	Oil and Gold	We expect gold to trade in the $1535-1735/oz range within one year. The oil price (Brent) is expected to move back into a range 45-55$ over that horizon.
FOREX				We revised our EUR/USD 3-month target to 1.14 and our 12-month target to 1.16.
REAL ESTATE			We keep a positive view for a "value-added commercial investment strategy".	
ALTERNATIVES			Long-Short, Macro and Event Driven	

MACROECONOMIC SCENARIO

Our central case for 2020 is now a technical recession in the first half of this year, as we believe that an appropriate policy response would help the economy to rebound once the shock fades. It would however be a U-shape recovery. Drastic measures to limit contagion, in China and South Korea, have generated promising results. This does however come with a significant short-term impact on economic activity. If the financial market correction lasts too long, it could weigh much more on the real economy. Indeed, the sharp fall in equity prices and widening credit spreads could worsen the outlook through sentiment and wealth effects, and it could even affect the ability of companies to deal with a shock to their cash flows. This is not our base-case scenario.

As discussed in more detail below, we expect a combination of fiscal and monetary measures targeted at reducing the negative impact of the virus outbreak in the main economies. The UK has been leading especially in terms of fiscal measures. The main risks to our scenario are i) another rise in the new infections in countries like China and South Korea, ii) early signals of a so-called credit crunch, i.e. companies face liquidity constraints while keeping a healthy solvency in the medium term. In such scenario, default rates would rise sharply. Governments and central banks are aware of this risk and appear to be committed to limiting it.

WE ARE CHANGING OUR ASSUMPTIONS ON MONETARY POLICY AND BOND YIELDS.

The Federal Reserve has resumed bond purchases in response to the sharp market correction. It has also increased its injections of liquidity into the money markets as interbank rates show signs of mild but persistent tensions. We anticipate a rate cut of 75 basis points at the 18 March FOMC meeting, taking them into the 0-0.25% range, as during the 2008 financial crisis. The Fed may be tempted to buy private debt, as the ECB is doing. However, it needs congressional approval, unless it invokes the extraordinary nature of the situation. This is what it did in 2008 to buy commercial paper (very short-term debt issued by companies or financial corporations). Once the health situation stabilises, risk appetite should return and the Fed could then raise interest rates slowly with the objective of returning to pre-health shock conditions. The Fed fund rates range could therefore be 0.50-0.75% in 12 months.

In the eurozone, the ECB's 12 March meeting disappointed the markets because it acknowledged the limited role it can play in this crisis and did not lower the deposit rate. However, it took strong measures to soften the economic impact of the coronavirus and avoid a wave of bankruptcies, by increasing its bond purchasing by EUR 120 billion and offering refinancing solutions. Banks will be able to obtain financing from the ECB at a negative (-0.25%) or even very negative (-0.75%) rate if they lend to companies. The ECB seems reluctant to lower its deposit rate (-0.50%) but could be forced to do so if the euro appreciates too much against the dollar. We believe that the ECB will eventually need to further increase its bond purchases, which could force it to expand the pool of available assets.

As for bond yields, volatility is likely to remain high in the short term and yields could even fall to new lows if governments delay providing fiscal stimulus. On a 12-month horizon, yields are expected to be higher than today as the health situation should improve and the impact of fiscal and monetary measures is felt. We see the US 2-year yield reaching 1% and the 10-year yield reaching 1.25%. For Germany, we expect -0.70% on the 2-year yield and -0.40% on the Bund yield. Thus, our bond yield targets reflect a scenario of economic recovery in the second half of the year. Inflation expectations should also stabilise. The US yield curve would be slightly steep (10-year yield higher than 2-year yield) and German yields would remain negative, as a consequence of the shortage of AAA bonds in the eurozone.

We changed our views on US high-yield bonds (from 0 to -) and emerging market corporate bonds in hard currency (from + to 0) on 9 March.

US HIGH YIELD BONDS

Credit spreads have widened sharply as a result of the massive fall in oil prices. Indeed 14% of HY companies are in the energy sector, particularly in shale oil. Many of them are over-indebted and two-thirds of those active in exploration and production are trading in the market at distressed levels. Access to funding could become problematic for them and defaults are to be expected. In addition to this, the panic created by the spread of the coronavirus is greatly weakening sectors such as travel and leisure. Liquidity is shrinking on the asset class, as is usually the case in periods of high-risk aversion. This could trigger a spiral where funds would be forced to sell their assets at deteriorating prices to free up liquidity to meet redemptions. In this context, we have turned negative on this asset class.

EMERGING MARKET CORPORATE BONDS IN HARD CURRENCY

These bonds have appreciated strongly thanks to the massive fall in US bond yields, which have hit historic lows and it is reasonable to assume that they will not go much lower. Thus this source of performance for emerging market corporate bonds in hard currency seems to to have been exhausted, in our view. In addition, companies linked to the energy sector, in the Middle East for example, will suffer from the fall in oil prices. Default probabilities are likely to increase in this sector. Therefore, we prefer to close our positive view (initiated in June 2019) and adopt a neutral view. Using a benchmark index the investment generated a 5% performance. The average yield is close to 5%.

High levels of exchange rate volatility should persist until clearer signals of a stabilisation regarding the spread of virus are seen. Combined with lower US yields, the USD carry advantage has faded, and should not recover in the short term. These factors should weaken the USD. We have thus revised our 3-month target up to 1.14 from 1.12.

Over the coming year, we believe that the narrowing of bond yield differentials will be the main driver. Also, the US fiscal response should lead to a wider current deficit, weighing on the currency. Moreover, the presidential elections due in November should bring further uncertainty and this could add some dollar volatility. The structural USD overvaluation remains a second key long-term driver relative to the Euro. Consequently, the near term environment proves more supportive for the euro than previously. We adjusted our 12-month target to 1.16 (from 1.14).

WHERE ARE THE PRICES PER BARREL GOING?

In the scenario of a prolonged price war, we expect—after a short period of extremely low levels—Brent prices to rebound gradually in the $45-55 range during the second half of 2020. But a faster rebound is possible in the event of a fresh cooperation within OPEC+

What happened?

At the meeting in Vienna on 6 March, OPEC + oil ministers failed to agree on a proposal to further cut oil supply by 1.5 million barrels a day. This proposal from OPEC countries was conditional on Russia's participation. The latter refused and Saudi Arabia declared that it was no longer bound by the previous agreement, threatening to increase production to 13 million barrels per day, thereby exceeding Russian production.

The fall in oil prices was immediate and brutal. The West Texas Intermediate (WTI) lost 30% to $31/barrel and the Brent to $33.

What are the various scenarios?

Neither party can win a price war. Saudi Arabia has already tried this strategy (from the end of July 2014) and gave up after 1.5 years in January 2016, realising that the shale oil industry has adapted through technological advances. Saudi Arabia already has a budget deficit of 6% of its GDP.

The aim of the Saudis is probably to demonstrate that cooperating to stabilise prices is better than fighting for market shares. Recent events have a significant geostrategic dimension. So an unexpected resolution allowing both to save face is quite possible.

Crude oil prices should rise even in the worst-case scenario

If the price war continues, the shale oil supply is expected to decline after 4-5 months due to reduced investment as access to funding will become increasingly difficult. Let's remember that shale oil wells have a relatively short lifespan and must be constantly renewed, thus a drag on insufficient cash flows. At current low prices, producers are no longer able to tap financing on the stock markets or the high-yield bond markets.

In a few months, once the pandemic is over, demand should start to rise again. A synchronised rebound of the world economies should amplify the phenomenon. Demand growth in 2020 should be close to zero (compared with a forecast 1 million barrels per day before the Coronavirus), but estimates for 2021 forecast growth are around 2.7 mb/d.

The surpluses should remain significant, however, which calls for an increase in the $45-55 range and not beyond in the absence of involuntary disruptions.

What are the conclusions for investors?

The best way to take advantage of a rapid (unpredictable political agreement) or slow (max 1 to 1.5 years) recovery is to invest in the stocks of major oil companies. Investing in petroleum ETFs has a dual disadvantage if this process lasts: the absence of dividends and contango. ETFs indeed invest in oil futures contracts which must be regularly renewed at a higher price than the contract for immediate delivery (the contango situation is one in which futures prices increase according to the maturity) . In 2015, the contango cost was between 15% and 20% over 1 year. This means that the rebound had to be higher for the investment to be profitable (which was ultimately the case). At the time of writing, the 1-year contango on the Brent was 27% (May 2020 vs May 2021).

VOLATILITY WILL REMAIN HIGH ON EQUITY MARKETS

A good buying opportunity with a medium-term horizon

Stock markets registered their worst trading session on 12 March since 1987 and endure their worst week since the Global Financial Crisis of 2008. They started the year in deep overbought territory, and were in need of digesting their 24% gains amassed in 2019. What was supposed to be a period of consolidation turned out to be a period of sharp correction and entered a bear market, on 12 March. The latter found its origin in the emergence of an exogenous factor, the Covid-19 virus, officially declared a pandemic and an economic shock in both supply and demand. The fall was accentuated by the crash in the oil price after the collapse of the supply agreement between OPEC members and a group of non-members driven by Russia. The MSCI World AC index is down 26% since its early February record high, when we adopted a buy-on-dip strategy. Stock markets are back at their early-2017 levels.

The short-term outlook will be determined by the rate of progression of new cases of people infected by the virus. According to some specialists, a slowdown could take place in the coming weeks. Meanwhile, several technical indicators send encouraging messages, such as the VIX (at its highest level since November 2008), the gap between bearish and bullish US individual investors (which surpassed 20 percentage points), the strong rise in trading volumes (indicating capitulation), the 20% gap between the market level and its 200-day moving average, to mention just four of them.

We maintain our recommendation of buying on weakness. We thus consider that **current levels are very attractive taking a medium-term view**. A gradual normalisation of economic activity spurred by an improvement in the pandemic, coupled with the positive impact from the monetary and fiscal stimulus measures and the reflation policy implemented after the oil price crash will fuel a return of risk appetite.

Meanwhile, in the coming weeks, stock markets should remain volatile, within a context of negative economic data releases and downward revisions of earnings growth expectations. For 2020, we no longer expect an earnings growth rate between 1% and 5% (vs. 8% for the consensus). Because of a sharply negative operational leverage effect in the first half, increased pressure from rising wages and continued progression in financial charges in the US, we now expect global earnings to contract by approximately 10% in 2020. Depending on the pace of economic recovery in the second half, this forecast might prove too conservative.

In terms of valuations, the prospective PE on the MSCI World AC index has decreased from 17x to 14x, i.e. a return to the long-term average. The long-term average is around 14x. Given that we consider that the recession relates to an exogenous factor, it is technical in nature and the economic activity should recover rapidly in the second half of the year, downside risks on stock prices now appear limited in our view. We thus reiterate that we are buyers with a view of capturing strong gains by the end of the year. Stock markets should return at least to their 200-day moving average by the end of the year on the assumption that global growth will continue in 2021 and in view of the absence of attractive investment opportunities in other asset classes. In other words, we base our views on the expectation that there will not be a credit crunch,

political measures will be sufficient and there will not be a re-acceleration in coronavirus cases.

Our regional preferences remain unchanged. Emerging stock markets should take advantage of the fact that Asian countries have curbed the virus before other regions and from a stronger earnings growth potential in the medium term. US equities should capitalise on their defensive character, the eurozone on its moderately pro-cyclical profile and the UK on the largest fiscal and monetary stimulus packaged seen since 1992.

SECTOR IMPACT

We focus first on the energy sector (oil and gas), which was already cheap before the sharp correction now underway. The European majors (BP, Royal Dutch, Total) have fallen to levels not seen since the end of the 1990s. At that time, oil had fallen below $20, while now it is still trading above $30. We believe that such low prices are unsustainable for producers and prices should rise to at least $45 by year-end. In addition, energy companies' balance sheets are stronger today than they have ever been. The dividends of these majors are particularly attractive, with yields in excess of 10%. We recall that even at the worst time of the great financial crisis of 2008-2010, these companies continued to pay good dividends (BP cancelled two quarterly dividends in 2010 during the 'Macondo' disaster but quickly resumed distributions afterwards). The price/earnings ratios fell to around 7x to 8x in Europe and 13.6x in the US. **Energy could remain volatile for some time, but such a buying opportunity has not occurred since 1996! We remain positive on this sector.**

On the other hand, US banks will be hit by the (expected) failures of the weakest players in the energy sector (and perhaps other sectors if the crisis spreads). The expected economic slowdown and the yield curve are now strong headwinds. More interest rate cuts by the Fed are expected in the near future. **As a result, we have become more cautious about US banks (our opinion has been downgraded from positive to neutral as well as on the financial sector in general) until we see more clearly the economic impact of the recent 'black swans'. However, we remain positive on the insurance sector**, given its more defensive characteristics and the relatively attractive valuation levels (price/earnings ratios are now around 8x). Very attractive entry points for European banks (neutral opinion) are also emerging but it is better to remain positioned on the most solid ones.

After the indiscriminate correction in the equity markets and the fall in interest rates, some defensive sectors that we deemed expensive at the start of the year are now much more attractive. **We upgraded the consumer staples sector from negative to neutral after the sharp correction. And our opinion on the health care sector has been upgraded from neutral to positive,** especially since the 'Sanders risk' seems much lower today since the establishment of the American Democratic Party rallied in a very short time behind Mr Biden, who is much more moderate in his views**. The current fall offers superb entry points for this now inexpensive sector.** It has fallen back to price-to-earnings ratios of around 14x to 15x, whereas it should be little affected, and in some

cases even benefit from the Covid-19 crisis. In recent quarters, there has been a return to solid earnings growth, expected to be around +10% in 2020.

In tech, we continue to favour Europe and securities relating to 5G and e-commerce. Consumers and even workers will be increasingly confined to their homes in the coming weeks. This will require better internet connections and will lead to an accelerated development of leisure and shopping on the web.

For other sectors, the medium-term impact is more uncertain and we do not change our views. **The industrial sector (negative opinion) remains very risky and will take longer than others to recover.** In addition to the ailing aeronautics sector, we expect a postponement or even a significant decline in industrial investment in the private sector. The final impact of Covid-19 is still very unclear and we therefore expect persistent volatility at least until the next earnings season in April-May.

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