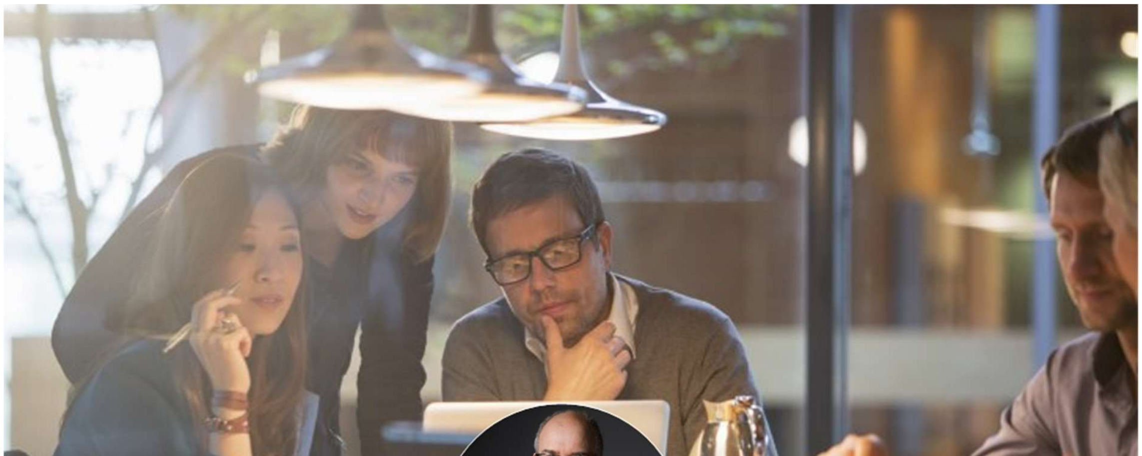
OVERDONE PANIC

12 March 2020



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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.

The 12th of March was another day of huge turbulence on financial markets. Stocks plunged by 7-10% in mature markets, and by even more in emerging markets (-15% in Brazil, for example). Bond yields fell in Germany and the United States. Rather worryingly was they did not fall in Italy or France, so spreads are tightening. The price of oil is also collapsing. Volatility indices are at record levels, and unprecedented since the 2008/2009 financial crisis.

There were two combined factors: first, the WHO declared the Covid-19 a pandemic (it has spread to more than 120 countries). Second, responses from political authorities seem inadequate at this stage of the contagion. More specifically, responses in terms of economic policy (monetary and fiscal), appear to be inadequate and uncoordinated at the international level, while the virus is going global.

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	

NB: A paper will be published subsequently to detail our scenario

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