In search of the bottom in the Covid-19 crisis

In an unprecedented time of high uncertainty, different drivers at play move in different directions. This sequence of forces and counter forces makes the exercise of GDP forecasting quite tricky and not helpful for the time being.

Markets are leading the real economic cycle and therefore they will bottom before the end of the pandemic. However, they will calm down and will be reassured on the path forward only when they can anchor expectations on three points:

1. The cyclical pattern of the pandemic, when there will be some signs of improvement on the speed of the contagion. This depends on the “time” variable (the extension of the crisis period) and on the mobilisation (the containment measures put in force in the different states). Early containment with strong measures such as the ones applied in China and most recently in main Western countries could help limiting the virus spreading;
2. the whatever it’s necessary of fiscal and monetary authorities, when monetary policies and fiscal measures will be considered credible and effective to ease financial conditions for the corporate sector or to provide adequate resources to the household sector to face a period of higher unemployment due to the shutdown of the economic activity;
3. the short end of the credit curve, after recent dislocations, and core bonds yields, that have started to raise once the fiscal measures have been announced, discounting higher future debt.

We should acknowledge that we are in a situation similar to October 2008, when uncertainty was very high, volatility was extreme and liquidity vanishing. The market bottomed in March of the following year. Yet, this time extraordinary measures have been put in place at an earlier stage of the crisis (2008 was a lesson) and the stimulus is significantly bigger. Markets will take time to digest all these measures, but will start pricing in that they are unlimited.

However, the policy bazookas will not be effective alone without the falling speed of contagion. Their combination will drive the timing of the recovery and, as far as the pandemic does not seem under control, volatility will persist.

So let’s look at what in our view matter the most to investors, the speed (second derivative) of the pandemic direction. Now the direction is still towards a rise in the number of cases with an increasing speed in the last weeks. When the containment measures will start working the speed should decelerate. This has happened in China first and we now see some signals in Italy as well, that is helping to provide some relief in the market. Yet, normality will not come directly after the pandemic will be contained, as some sort of social distancing (resulting in higher percentage of smart working, higher online consumption, more online entertainment and online education, higher social media usage, increased demand and salary for medical jobs…) will remain in place as long as a vaccine will not be found. This, again, is the case of China, where activity is slowly resuming after the lockdown, but still remains below the normal time.

Most of the countries are still away from the peak, UK and the US are still in an acceleration phase, as well as many EU countries, while some EM countries are just at an early stage. If this global lockdown proves to work pandemic should accelerate towards its peak in the next month, until the speed of growth of new cases should start to diminish.

 Markets will see the bottom when expectations will be anchored on virus outbreak (slowdown in the speed of contagion), effectiveness of policy mix and improving financial conditions. We are moving in this direction, but we are not there yet. ”

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We are moving in this direction, but we are not there yet and we can only expect in the short term a temporary relief from extreme market dislocation, but not a full and stable recovery.

**Covid-19 cumulative number of cases by country**

![Graph showing Covid-19 cumulative number of cases by country]  
Source: Amundi on Bloomberg data, as at 17 March 2020.

**A new financial regime has started: investment implications**

We now acknowledge that “coronavirus” is the name of the invisible hand that drives the mean reversion process, bringing returns on track with long-term fundamental trend. Equity returns had deviated in the last phase of the bull market from it and they even overshoot to the downside the trends in productivity, labor force and earnings growth. A good news for long term sustainability of returns, beyond the short term pain. On credit, instead, the unlimited quantitative easing will in some cases (IG space) postpone the moment of truth, while in the HY space defaults will inevitably rise as the economy contracts.

**S&P500 Index vs Trailing EPS**

![Graph showing S&P500 Index vs Trailing EPS]  

Coronavirus is also the trigger of a regime shift. As we pointed out in our “Road back to the 70s” paper, the next recession (and this is what we have ahead in the coming months) would have brought the monetary and fiscal policy to the next level. We will wake up the day after the pandemic ends with budgetary and monetary stances we would have considered unthinkable: independence of central banks at the service of budgetary needs, helicopter money, unsustainable debt levels, with monetization as possible way out. A re-appropriation from the States of some critical social functions that have been disregarded in recent years (health care for example), nationalization of some companies or sectors (i.e some airlines), -in shoring of activities and a shift towards wages from profits (see as an example, the debate in...
Credit and EM will be the natural candidate for picking up some yield in the public markets but a case-by-case approach will be necessary to deal with rating migrations, defaults or debt restructuring in the transition phase.

In credit we stay cautious and highly selective in the high yield space, while we prefer the IG space that should benefit under the central banks umbrella, as well as the peripheral bonds.

In equity, some bottoming out could start at a regional/country level, in a sort of first-in – first out move from the epidemic: China is a good candidate for it.

Equity markets will remain under pressure until signs of stabilization in the curve of the epidemic evolution materializes. In equity, we see opportunities arising in quality cyclical sectors that could bounce back strongly once the cyclical appeal will be restored approaching the peak of the pandemic. Some bottoming out could start earlier at a regional level. It is the case of China, that is now overperforming the rest of the world (the S&P500 is down almost 27.6% from its peak (from 19 Feb to 24 March, while the Shenzhen CSI300 is down in USD terms only -11.3% in the same period), as it has likely passed the worst of the pandemic and its economy is entering already the bottoming out phase.

The pickup in the dollar is temporary in our view and when the dust settles, it will be clear that looking at various risk premia in emerging markets and at the valuation of currencies, investors are well paid for the risk of further depreciation of the currencies.

In the illiquid world the real impact of the shock will surface as usual with a lag, coupled with necessities to reprice, revisit valuation, review covenants, manage waivers. Ramp ups and pipelines will come to temporary stops. This world is going through this review of the portfolios with the same focus on quality, price/valuation and possible effective liquidation of assets.
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Definitions

- **Asset purchase programme**: A type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Basis points**: One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Credit spread**: Differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.
- **MBS, CMBS, ABS**: Mortgage-backed security (MBS), commercial mortgage-backed security (CMBS), asset-backed security (ABS).
- **Quantitative easing (QE)**: QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **Volatility**: A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

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