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Amundi
ASSET MANAGEMENT

INVESTMENT TALKS

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In search of the bottom in the Covid-19 crisis

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In this 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 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.**

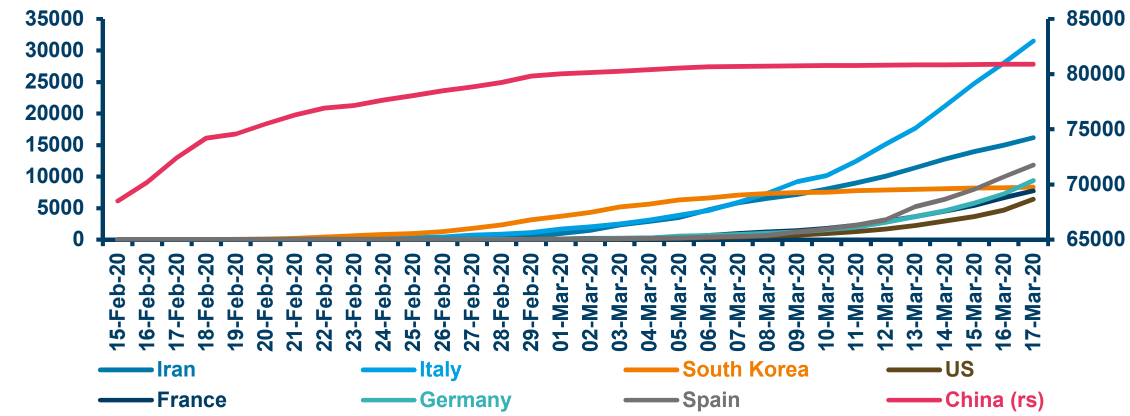
"Markets will see the bottom when expectations will be anchored on virus outbreak (slowdown in the speed of contagion), effectiveness of policy mix and improving financial conditions. We are moving in this direction, but we are not there yet. "

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.**

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



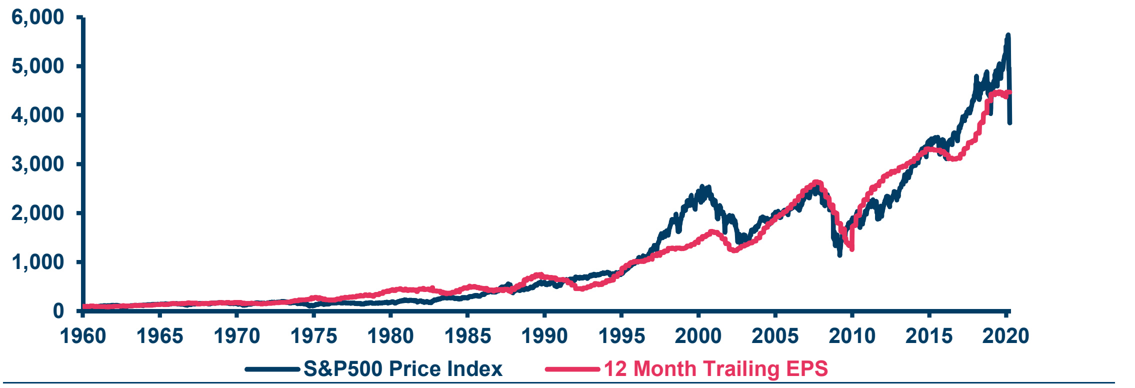
Source: Amundi on Bloomberg data, as at 17 March 2020.

“Coronavirus is the trigger for a new regime shift. We will wake up the day after the pandemic ends with budgetary and monetary stances we would have considered unthinkable.”

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



Source: Amundi on Bloomberg data. Data as of 23 March 2020. S&P500 price index vs Trailing 12 Month EPS, rebased at 100 at 31 Dec 1959.

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 the US to avoid that the fiscal stimulus is used for corporate buybacks or increase of CEO pay) will all be new features of this new regime that will end up being inflationary in nature in the long term.

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 this transitionary phase, as the crisis unfolds it will become clear to investors that **the day after the pandemic ends they will find themselves with lower core bond yields and the necessity to pick some yield somewhere.** Credit markets and EM debt will be the natural candidates in the public markets, but at the moment the pressure on this asset class will remain high and it is not the time yet to call for an aggressive entry points.

On credit, migration of companies on ratings (from BBB IG to HY space), and defaults are the key challenges in a low liquidity environment. In the low quality rating, the attention is on companies that can survive a temporary lock down of economic activity (lower/no earnings) with still regular and sometimes high costs (debt repayment): what was unsustainable before the crisis will be seriously challenged and default. On EM, the current crisis is developing along with the oil crash. While the monetary policy has decent room almost everywhere (thanks to falling inflationary pressure), not all the counties (one is Mexico) will have the adequate fiscal room of manoeuvre to counteract the fall in commodity prices and the freeze of touristic activity: some countries will have to restructure their debt.

"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."

Active management and selection will be key to manage this "in between phase" and in particular the trade-off between performance and liquidity. Now more than never, **robust liquidity management will make a difference.** 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. The continuation of the downward loop in the market could only be justified by a permanent shock to potential growth, but this is not the most likely scenario right now. At current market price levels around 10% default rates are expected (for US HY) and an earnings recession of 10-20% in the US market in 2020. **This is something certainly relevant, but still not an Armageddon.**

In terms of portfolio management this backdrop calls for a still cautious approach, as we recognize **that global risk aversion will persist in the short term, and will legitimately drive a flight to safety into a combination of high quality, defensive and liquid assets.**

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 Shenzen 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.

"In equities, 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."

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.

Important Information

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