

CIO Flash

Covid-19 Catch-Up: Ten weeks that stopped the world

Investment Solutions

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In [February](#), we were astonished that Wuhan, a Chinese city of 11 million people, could come to a standstill in an effort to contain the coronavirus. Two months later, an estimated 50% of the world's population is living under a pandemic lockdown and the global economy is suffering as the number of infections in Europe and the US have surpassed those recorded in China.

The [Covid-19 pandemic](#) has now killed almost 70,000 people globally and infections are reported at more than 1.2 million, of which one quarter are in the US. Meanwhile, containment measures around the world have intensified and China has registered new infections only from nationals returning from foreign trips. On the monetary front, the response from central banks has been unprecedented in its breadth and scope, as they continue to reassure markets with short-term liquidity. In parallel, unprecedented fiscal spending is countering record unemployment rates across economies and fortunately comes at a time when governments can afford to borrow at low or even negative interest rates.

As we have argued since the start of the pandemic, these are three components essential to beating the coronavirus.

One positive lesson from the successes of China and South Korea in combatting Covid-19 is the need for intensive testing. Testing capacities and technologies are improving rapidly, including 'serology' tests to spot individuals' immunity. These offer some hope that, eventually, they may help governments get their labour forces moving again. The number of these so-called 'reverse transcription polymerase chain reaction' tests (known as RT-PCR) has risen to more than 1 million as the US, China, Europe and South Korea have significantly expanded testing capacities in the last two months.

Markets reflected the unprecedented economic freeze over the first quarter of the year with brutal declines as the virus slashed production and consumption. As more stringent containment measures came into effect in the US and the pandemic showed early signs of slowing in Italy and Spain, Europe's two most severely impacted states, indices recovered some of their losses. The S&P500 finished the quarter 20% lower and the Euro Stoxx 50 fell 28% over the three-month period.



Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- With half the world's population in lockdown, governments and central banks have responded with unprecedented fiscal and monetary measures
- Market declines in the first quarter reflected a brutal collapse in economic activity
- Forecast curves for a recovery range from the optimistic 'V'-shaped to a pessimistic 'L'
- We see an eventual recovery looking more like a 'tick' and watch risk-appetite vs macro indicators
- We continue to adjust portfolios to remain as liquid and diversified as possible with the cushion of some put spreads in place.

Important information: Please read the important information at the end of the document.

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The shape of the recovery

The question is whether the world's economies can recover as quickly as they stalled. Sadly, the early expectations for a 'V-shaped,' severe contraction followed by an equally fast recovery, are starting to look too optimistic. China has proven that with the careful application of the right public health measures, an economy can certainly bounce back, even in a 'V'. The country's purchasing manager's index last week read 52.0, showing an unexpected expansion in March from February's record 35.7 low. Still, we cannot read too much into this yet. Although China's economy is certainly less export dependent than, say, 12 years ago, it remains highly dependent on consumption in the rest of the world, where markets are more or less frozen.

The alternatives are that the global economy runs the risk of experiencing a 'U-shaped' recovery if coronavirus measures lift gradually. That would imply that companies, jobs and consumer spending can return to normal quickly after a prolonged slowdown. On the other hand, a less optimistic outlook points to an 'L-shaped' fall into a persistent recession if containment measures have to stay in place. Even a 'W-shaped' recovery/decline/recovery is mooted, if economies re-open too soon, only to be hit by a second wave of infections. For now, none of these shapes reflect our working hypothesis.

We believe at this stage that the most likely recovery curve will look something closer to a tick, or a shape sometimes likened to a Nike 'swoosh'; a brutal decline followed by a quick rebound that then tails off.

Of course, a recovery may look nothing like any of these patterns, or be more complex and opaque. But the huge variety underlines just how hard it is to forecast the shape of the world economy over the coming months.

Our attention is focused on coincident indicators. In the current crisis, given that markets tend to be forward-looking, it is useful to monitor risk appetite across asset classes that often reflects economic stress before it is visible in official macroeconomic data. The chart 1 compares risk appetite with a 'current activity' indicator, reflecting slow-moving macro data with the sharp drop in both of them comparable, if not larger, than during the global financial crisis.

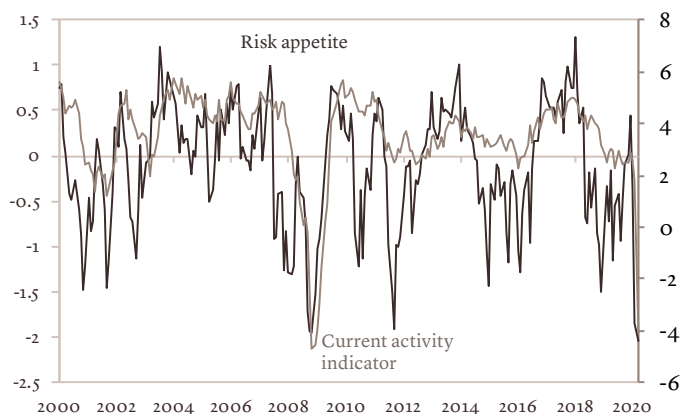
Positioning portfolios

During such a volatile period, it is clear that the key is to maintaining a diversified and liquid portfolio. We have consistently adjusted our equity exposures across portfolios to take account for the market drift that they experience in such a volatile environment and sold positions in emerging market debt in hard currency, holding the cash for now in reserve.

Until the effectiveness of the US public health measures is clearer, we see limited equity market upside from current levels. The market rebound of recent may reverse as negative news on economic data, profit warnings and credit rating downgrades hits. We have therefore bought some portfolio protections in the form of put spreads.

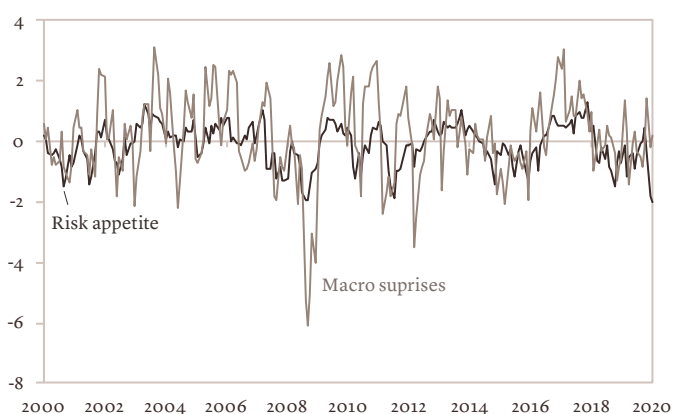
Currency markets experienced some stress on US dollar funding, since alleviated by interventions from the Federal Reserve. However, there were some issues in precious metals where bid-offer spreads widened as much as 10-times normal levels. Liquidity in the bond market remains difficult with limited opportunities to buy good issues. We have not suffered from a shortage of liquidity in our strategies.

1. Risk appetite vs current activity leading indicator



Sources: Bloomberg, Lombard Odier calculations

2. Risk appetite vs global macro surprise indicator



Sources: Bloomberg, Lombard Odier calculations

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