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Investment Strategy
Private Clients

2/4

April 2020 · 2nd quarter

Key highlights

- The COVID-19 epidemic has morphed into a global shock that will inevitably cause deep recessions in many economies.
- Policy is moving is the right direction and the Chinese and South Korean examples also offer some support for our baseline scenario of a severe but transitory global economic contraction.
- The US was late to react to the public health crisis but has since deployed massive, indeed unprecedented, monetary and fiscal policy responses.
- The euro area economy stands to be particularly hard hit, given the extent of the epidemic across the continent and the lack of coordinated fiscal action.
- After a historic 1st quarter contraction, China is rebounding strongly as the curbing of its COVID-19 curve paves the way for a normalisation of activity.
- Japan has (so far) been an exception in the flatness of its infection curve and general movement restrictions – meaning that it has a shot at economically outperforming its G7 peers during the inevitable 1st half recession.
- The conditions for a sustained market rebound are not yet in place – leading us to maintain our slight equity underweight. Elsewhere, we have pursued efforts to reduce portfolio risk and enhance liquidity, moving underweight on emerging and high-yield debt, recommending option strategies, and adding to Japanese yen and gold exposure.
- At this stage, our baseline scenario of a 2nd half economic recovery, argues for a weaker dollar relative to other G10 currencies – as US yields converge downwards.

Quarterly publication of
Lombard Odier Investment Solutions – Strategy

Important information
Please read the important information at the end of the document.
Data as of 30 March 2020

A world in shock

It is clear by now that the current downturn will be neither brief nor localised. The COVID-19 shock is of a global, and profound, nature. Central banks and finance ministries cannot resolve the immediate – public health – issue. Public policy measures to contain the spread of the epidemic take absolute priority. But monetary and fiscal policy can help sustain the fabric of the economy, making sure that markets function, companies are able to access credit, broad-based defaults are avoided, and unemployment costs do not surge.

The path forward will be determined first and foremost by the course of the pandemic. So far, we have seen successful containment efforts in Asia, with the remarkable "flattening of the curve" in countries such as China and South Korea. We are also starting to see some first signs that measures taken by European countries – where the epidemic hit next – are putting downward pressure on the numbers of new infections.

China, having imposed lockdown in its Hubei province on 17 January, lifted it in late March (with the exception of Wuhan, where it is scheduled to last until 8 April). This timeline gives an idea of what may happen if Europe follows a similar path – with the lag implied by the fact that governments in Europe imposed confinement measures in March.

A lot remains to be seen: whether the progress in Italy will persist, whether countries at an earlier stage such as the UK and the US will manage to "flatten the curve", and whether "second waves" might emerge in Asia.

We have built our baseline scenario around the key assumption that the successes in Asia will be sustained and that they are likely to be repeated elsewhere. In this scenario, the containment process takes several weeks, inflicting pain of a transitory nature (akin to a natural disaster) and followed by a sharp recovery.

We also consider a downside scenario of more prolonged and sustained weakness, rather like an open-ended war. This could materialise if containment fails or if economies re-open too soon and then have to suffer new lockdowns. The impact in such a scenario would be much worse.

To give a sense of scale, in the baseline scenario we expect a 2% US GDP (gross domestic product) decline in 2020, with the very steep contraction currently under way followed by a sharp recovery during the 2nd half of the year. By contrast, in our downside scenario, full-year GDP would drop 7% as no sharp recovery would occur in the 2nd half (see chart 1, page 04).

Assuming the epidemic is a shock of transient nature, it is certainly possible that the recovery from it will be sharp. This is what happens with natural disasters: a great deal of pent-up demand is released once the crisis ends.

But for this to happen, the right policy measures need to be in place for the duration of the crisis – especially as the current medical emergency is lasting much longer than, say, a hurricane. While shutting down economic activity to fight the spread of the virus is perfectly sensible public policy, it inevitably causes economic harm to households and businesses whose incomes depend on the affected activity. In order to minimise economic loss, it is therefore paramount that policymakers

Note: Unless otherwise stated, all data mentioned in this publication is based on the following sources: Datastream, Bloomberg, Lombard Odier calculations.

help companies survive the crisis and employees keep their jobs.

We have seen policy support of unprecedented size. The combined firepower of monetary and fiscal measures put into action has been greater than what we saw during the global financial crisis, and has come together in much quicker fashion. Not all the measures are as well targeted as they should be. The approach adopted by Germany or the UK, allowing companies to keep workers on their payroll during the period of inactivity with the state covering a large portion of their salary (80% in the UK), can be very meaningful in limiting employment losses. By contrast, the US approach of focusing on expanding unemployment benefits may fall short. Tax cuts and favourable business loans may prove useful but insufficient, given the scale of the current crisis.

But the determination shown by policymakers to tackle this emergency head-on is an encouraging sign that, even where response has so far been lacking, new and better measures will come into force, limiting the fallout and ensuring a sharp recovery. This is our other key assumption.

China's example offers some support for our baseline case of a severe but transitory shock. Key Chinese economic indicators that we monitor (e.g. property transactions, coal burn by manufacturing plants, freight activity, traffic and migration trends) took some 40 days to reverse their decline, which had begun in late January. Applying such a pattern to the US and Europe would mean an economic rebound that could start sometime in May.

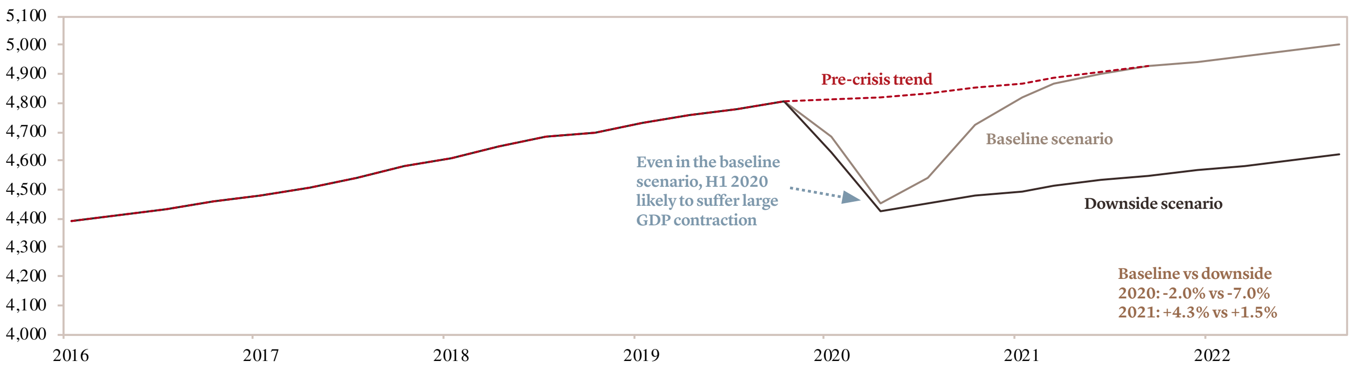
Importantly, though, that would require following a disciplined and sequential strategy of, first, waiting for the new infection curve to flatten thanks to strict lockdowns; meanwhile, ramping up testing capabilities; and, finally, implementing a systematic testing and tracking system, all the while keeping social distancing measures in place.

In such a scenario, beyond the further weeks of difficult news flow, equity markets would offer material upside and risk premia would normalise in the high-quality credit space – save for assets exposed to the oil market given the ongoing price war between Russia and Saudi Arabia. If, rather, the current efforts to contain the virus are not successful and the world economy goes into a prolonged slump, the implications for investors would obviously be very different. Let us hope that will not be the case.

Samy Chaar, Chief Economist
Bill Papadakis, Macro Strategist

1. US economic trajectory: baseline vs downside scenario

Quarterly US GDP (in USD billion)



Sources: BEA, Lombard Odier calculations

Will policy response by central banks lead to runaway inflation?

In our humble opinion, the answer to this question is no.

First and foremost, we are undergoing an exogenous demand shock, of historical magnitude, caused by legitimate lockdowns aimed at containing the spread of the virus. Economic activity will remain disrupted for some time, even as the world recovers from the shock. Some workers will lose their jobs, despite policy responses. This will have strong disinflationary/deflationary consequences, which should more than offset the supply chain disruptions that some fear as being potentially inflationary longer-term. Clearly, it will not be an environment that allows economic agents to raise prices.

Further, the world is not awash with liquidity. Ongoing central bank injections are merely attempting to offset disruptions in the two usual main sources of liquidity for the real economy: commercial banks (via loans) and financial markets (via credit and equity). Put differently, central banks are responding to the liquidity anaemia induced by the current credit stress. Broad measures of monetary aggregates (M2 & M3) are indeed depressed, a reflection of impaired loan growth. Once the situation normalises, central banks will reduce and then terminate their asset purchase programs, as they did after the 2008 Great Financial Crisis (GFC). A period following which, if need be reminded, we did not experience much inflation.

Will the large fiscal packages announced in Europe and the US lead to sovereign defaults?

Here again, we humbly beg to differ.

During crises, it is absolutely necessary for governments to substitute themselves for private economic agents, who tend to reduce their spending and increase savings. Moreover, at current interest rate levels, the public sector is literally being paid to spend what households and businesses are no longer spending. Should it fail to do so, and all sources of spending drop simultaneously, the economy would not be able to escape a scenario of prolonged depression, in which the risk of outright default would be much more prominent.

Once the economic situation normalises and private agents resume their spending, governments will benefit from tax revenues as activity restarts and will thus be able to reduce their spending – just as was the case post the GFC and in the aftermath of World War II.

Bottom line

In times of crisis, massive monetary and fiscal expansion is neither irresponsible, nor dangerous. Rather, it is the right action to take.

Samy Chaar, Chief Economist

United States
Fed and Treasury have gone all-in

In a nutshell

- The US was late to react to the public health crisis but has since deployed massive economic policy responses.
- The Fed has cut rates down to zero and reinstated unlimited QE, as well as a facility to support corporate credit – essentially countering the credit market freeze.
- Meanwhile, the fiscal package just adopted by Congress has come into shape in extremely rapid fashion and – adding to 10% of US GDP – is of unprecedented scale.

The negative take on the US pertains above all to its belated acknowledgement of the COVID-19 issue – despite new cases exhibiting the same exponential growth as elsewhere. Late adoption of public health measures means that efforts will need to outpace those of Europe and Asia. Very flexible labour markets also mean that unemployment figures will be brutal. Indeed, weekly claims have already soared above 3 million – with many more layoffs to come.

On a positive note, however, nowhere has the monetary and fiscal response been as massive as in the US. The Federal Reserve (Fed) led the charge by cutting its policy rate to zero. It also went all-in on the quantitative easing (QE) front and announced a facility to support loans to small- and mid-sized enterprises (which account for 83% of nonfarm payrolls). As for the Treasury's fiscal package, it is impressive both in its scale and comprehensiveness – not to mention the speed with which it became law. As a point of reference, the post-World War II Marshall plan amounted to USD 17 billion, i.e. USD 1,300 billion in current terms. The COVID-19 response is an astounding USD 2,000 billion: the biggest fiscal stimulus ever to be implemented in the US.

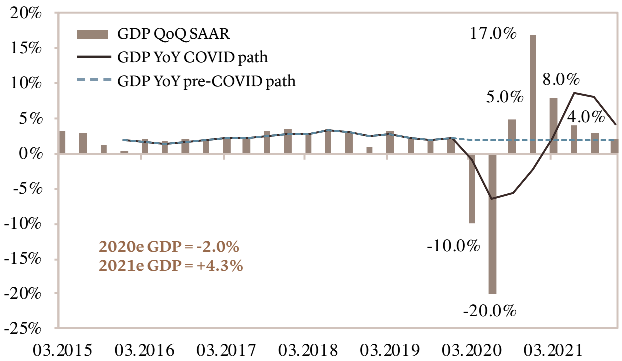
From a qualitative standpoint, many of its provisions are very positive, notably the USD 130 billion for hospitals and other means of fighting the virus, the USD 200 billion in corporate tax breaks (even though how they will be targeted is unclear), or the USD 367 billion for small businesses grants (administered through banks). The USD 150 billion allocated to states to fight the virus will, however, probably not prove sufficient. Also, while the combination of unemployment insurance and direct checks will provide a safety net for many of the most vulnerable households, we prefer the European route of covering furloughed workers pay, to the extent that it keeps employment relations intact.

In conclusion, the depth of the recession will depend on the effectiveness of the public health response and the time necessary for the stimulus money to arrive in the hands of consumers. Our baseline scenario is one of a sharp contraction during the 1st half (down to the 2016 level), followed by a similarly sharp recovery – putting full-year GDP at a negative 2% (see chart 2). But we cannot rule out a longer shock, in which public health measures prove inadequate, leading full-year growth to drop by a much larger 7% (see chart 3).

Samy Chaar, Chief Economist

2. **Baseline scenario: deep contraction in H1 2020 followed by a recovery**

Quarterly growth projection (in % YoY*)

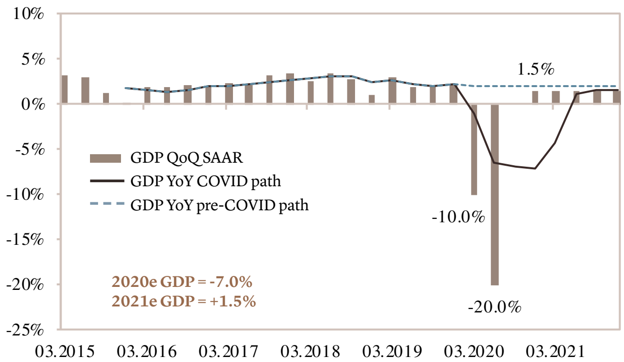


* year on year

Sources: Bloomberg, Datastream, Lombard Odier calculations

3. **Downside scenario: economic shutdown extends beyond 2020**

Quarterly growth projection (in % YoY)



Sources: Bloomberg, Datastream, Lombard Odier calculations

Europe
Coordinated fiscal response is long due

In a nutshell

- The euro area economy stands to be particularly hard hit by the COVID-19 crisis, given the extent of the epidemic across the continent and the lack of coordinated fiscal action.
- The idea of issuing common debt to finance public health policies ("coronabonds") seems a no-go, given the reluctance of creditor countries.
- The ECB is doing its part, having deployed a EUR 750 bn Pandemic Emergency Purchase Programme (PEPP), but there is a risk that it ends up "pushing on a string".

The global spread of COVID-19 has ensured a deep recession for the 1st half of the year. Europe faces particularly large risks due to the combination of a severe domestic impact from the epidemic, an incomplete policy response, and a chronic reliance on external demand.

The medical emergency is a clear priority. Most governments have imposed strict measures aimed to reduce the spread of the virus. Italian data suggest this process has begun, with the new infection rate there now subsiding (see chart 4). Assuming this trend persists in Italy and extends to other countries, the economy will soon become the focus. Fiscal and monetary policy will be key in maintaining its functioning during this health emergency and in establishing the conditions for the recovery once the crisis is over.

European countries with fiscal leeway seem ready to deploy the required resources (see chart 5). Abandoning its austere stance, Germany has approved a package of fiscal measures amounting to almost 5% of GDP. It is also re-deploying the shorter work-time program (Kurzarbeit) that proved successful in limiting job losses during the financial crisis – and inspiring other countries to act similarly.

Unfortunately, some of the hardest-hit European countries are those with the weakest fiscal positions, such as Italy and Spain. Their response has been less ambitious, given the fear that large expansion may lead to debt sustainability concerns.

Centralised fiscal capacity in Europe could not be needed more urgently than today. Yet, for all the talk of "coronabonds", the reluctance of creditor countries makes their issuance unlikely. To date, the EU has allocated all of EUR 45 bn (not a typo!), or less than 0.5% of GDP, to crisis-fighting programs.

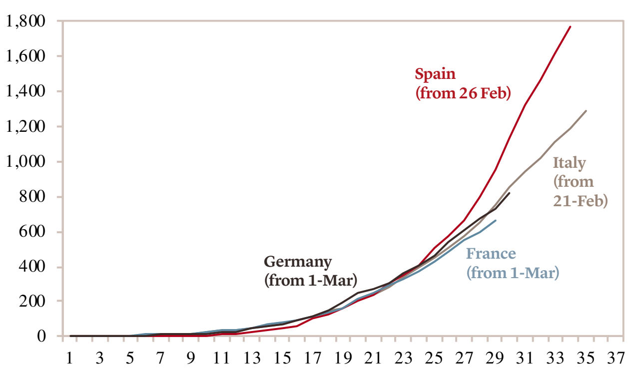
This has left the European Central Bank (ECB) as the sole euro-wide actor trying to fill the gap. It has not disappointed: its EUR 750 bn PEPP involves vast firepower, expanding asset purchases and removing prior constraints, while also providing bank funding through generous targeted longer-term refinancing operations.

Still, the absence of a large coordinated fiscal response raises the risk that aggressive monetary policy may end up "pushing on a string". For all the central bank liquidity, loans – however cheap – have to be repaid, and losses accounted for. Without state support, this may prove hard for many companies, even in a sharp recovery. Imbalanced, uncoordinated, or under-sized policies may well leave economic scars long after the pandemic. Time to see whether European policymakers learnt the lessons of the last crisis.

Bill Papadakis, Macro Strategist

4. Signs of curve flattening in Italy, where the epidemic hit first

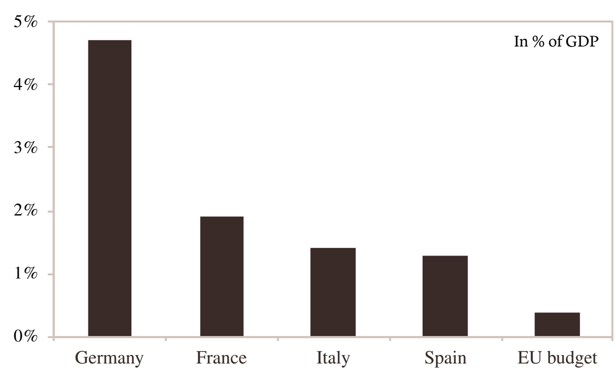
Confirmed cases per 1 mn of population



Sources: WHO, Bloomberg, Lombard Odier calculations

5. European fiscal response still inadequate – leaving most of the burden to the ECB

Fiscal measures announced in response to the COVID-19 crisis



Sources: Finance ministries, IMF, Lombard Odier calculations

China
Still at the forefront

In a nutshell

- After a historic 1st quarter contraction, due to the national public health response to the COVID-19 outbreak, China is rebounding strongly as the curbing of its epidemic curve paves the way for a normalisation of activity.
- Policymakers will add significant monetary and fiscal stimulus during the 2nd half to boost domestic demand, with a substantial easing of restrictions on home purchases also a distinct possibility.
- Such support, alongside improving pandemic conditions, should allow China to maintain its solid recovery.

China has been at the forefront of the fight against COVID-19 and will likely remain so for quite some time. Having initially mismanaged the outbreak, authorities took the drastic step of quarantining the Hubei province and partially suspending economic activity in other areas for much of February. This decision, rather controversial at the time, delivered tangible results: the epidemic curve flattened sharply, and other provinces were able to protect their healthcare systems. Unfortunately, this approach of maximum non-pharmaceutical intervention is now the template for other countries, with the virus having gone global.

The economic cost proved punitive, however. We estimate that Chinese GDP dropped a historic 6% in the 1st quarter. This spectacular contraction basically guarantees the worst annual figure for China since it began its standard GDP tabulation in the early 1990s (see chart 6).

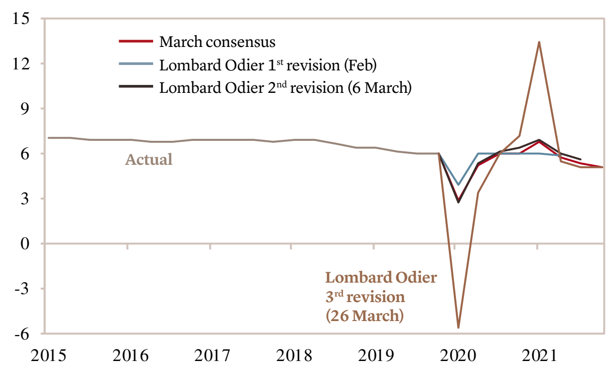
The silver lining is that China was able to curb the epidemic, while accumulating valuable knowledge and experience about the disease itself. The country's early struggle paves the way for a significant recovery during the rest of the year, despite the accelerating downturn in its major trading partners. The rapid expansion of China's testing, case counting, and health care capacities, underpinned in part by its manufacturing prowess, is now safeguarding the process of a gradual return to normality. Key daily indicators suggest that growth recovered sharply in March, an assessment confirmed by the business survey (see chart 7).

As the public health measures created shocks in both supply and demand, policymakers in Beijing have been carefully calibrating their responses to shield households and businesses from the transitory turmoil. This approach could continue to prevail near-term, since the normalisation of activity and inventory replenishment alone could help the country climb out of the unique 1st quarter debacle. Given the uncertain medium-term political and economic ramifications, however, policymakers will almost certainly add significant monetary and fiscal policy stimulus later in the year to ensure that the robust recovery continues and keeps the labour market in balance. The resumption of activity will create the risk of second wave of infections, but authorities should be able to keep that in check. As has already been the case, how China navigates this delicate balancing act will serve as a blueprint for the rest of the world.

Homin Lee, Macro Strategist – Asia

6. China took a huge hit in the 1st quarter

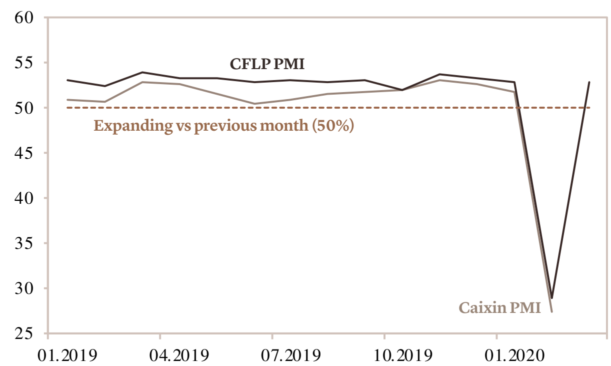
Actual and forecasted real GDP growth (in % YoY)



Sources: Bloomberg, Lombard Odier

7. V-shaped recovery already apparent in the business survey

Chinese official composite PMI (% diffusion index)



Sources: Bloomberg, Lombard Odier

Emerging Markets (ex-China)
Diverging on commodities and public health

In a nutshell

- Facing the trifecta of COVID-19 related demand shortfall in other markets, local vulnerability to the pandemic, and oil price declines, 2020 could be the lowest growth year for EM in more than two decades.
- Asia will likely outperform other EM in next few quarters, as the region is a net importer of oil and has the savings and administrative capacity to better navigate the pandemic.
- The Fed's introduction of USD swap lines and repo facilities for EM central banks will meaningfully improve funding conditions and enhance local easing efforts.

Emerging markets (EM) ex-China will likely experience their slowest year since the 1997 Asian financial crisis. The successive large contractions expected for China and developed economies during the 1st half and the extreme drop in crude oil prices make the math rather prohibitive for the emerging complex, with all key countries suffering from varying mixtures of supply and demand shocks in their core industries.

Starting in the 2nd half, however, three factors will drive a major divergence between different emerging blocs. First, the expected persistence of low oil prices and attendant weakness in commodity prices will boost the terms of trade for net importers while subjecting net exporters to economic pain. Second, the robustness of healthcare systems might matter a great deal as the COVID-19 begins to spread. Third, national savings will determine the scope for extraordinary health or macroeconomic policies that could temporarily worsen public finances.

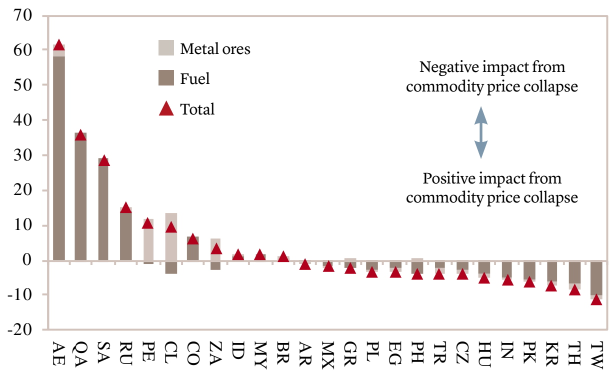
Consequently, many relatively industrialised Asian emerging economies such as South Korea, Taiwan, and Thailand will have a distinct edge in navigating the difficult global pandemic regime. They are net importers of oil and other industrial commodities (see chart 8). They have solid healthcare systems and their administrative capacities to implement nation-wide test-and-trace could surpass that of many developed peers. And, as net creditors to the rest of the world, they have resources to depend on when extraordinary policies are required. Eastern European countries might cope reasonably well for the same reasons, but India, Southeast Asia, Latin America, and Middle East and Africa appear to be more poorly positioned for either oil or public health reasons (see chart 9).

The silver lining for more fragile emerging economies is that funding conditions could be easier thanks to the Fed's timely intervention, re-introducing USD swap lines and repo facility with foreign central banks. The Bank of Korea and the Monetary Authority of Singapore can now tap directly into the Fed's USD liquidity support via swap lines, and almost all EM central banks can achieve the same by using their US Treasury holdings as collateral. This should relieve the pressure on them to secure USD liquidity and stabilise their currency outlook. In turn, EM central banks could also find it somewhat easier to ease their domestic policy stance. This is a welcome development that reduces the potential for systemic risk in the emerging complex.

Homin Lee, Macro Strategist – Asia

8. Low commodity prices still a cushion for industrialised Asia

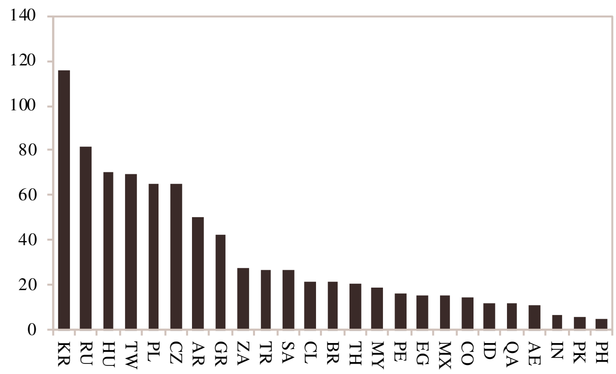
Fuels (SITC 3) and metal ores (SITC 27, 28, 68) balance as a % of GDP (2018)



Sources: CEIC, Lombard Odier

9. Better healthcare capacity in North Asia and Eastern Europe

Number of hospital beds per 10,000 people (latest available data)



Sources: WHO, Lombard Odier

Japan
In a category of its own?

In a nutshell

- Japan is certain to experience a technical recession in the 1st half of this year, with the ongoing global downturn, Olympics postponement, and social distancing to weigh heavily on all key areas of growth.
- That said, the country has been an exception in the flatness of its infection curve and general movement restrictions – meaning that it still has a shot at economically outperforming its G7 peers.
- While the Abe cabinet and the BoJ will further ramp up easing measures in coming months, they will find it difficult to outshine their US or European counterparts, likely leading the yen to strengthen.

In hindsight, the Abe cabinet was very unfortunate in the timing of its last consumption tax hike, which subjected GDP to a deep (-7.1%) contraction in the final quarter of 2019. Since, rather than enjoying a mechanical rebound, the economy has had to face China's historic COVID-19-induced downturn, soon followed by the US and Europe. Trade with these three regions accounted for some 14% of Japan's GDP before this crisis. With the postponement of the Tokyo Olympics and social distancing/travel restrictions also weighing heavily on domestic demand, 1st half GDP looks set to drop 5%.

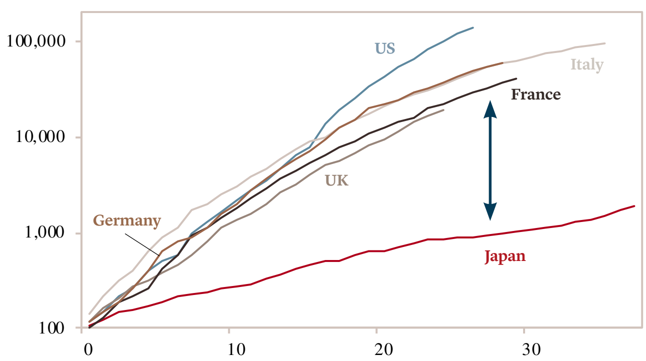
Remarkably, even such poor performance might not make Japan a laggard among G7 countries – thanks to the country's modest success in taming its infection curve without draconian lockdowns (see chart 10). Sceptics would attribute this to the government's deliberate strategy of prioritising the healthcare system's stability at the expense of mass testing and tracing. But a culture that creates natural scope for social distancing or the country's unique advantages in healthcare delivery could also be at play. Whatever the explanation, Japan has been able to avoid complete paralysis of its services sector.

This does not mean that Japan is out of woods. Daily new infections have begun to creep up in the last few days. With the cherry blossom season and generally complacent mood threatening a new potential outbreak, the government is moving to strengthen risk management. Prime Minister Abe could, for instance, declare a state of emergency. His cabinet is also about to add some countries to its entry ban list. Measures that mean more downside risk to the economy.

Cognizant of this, Abe and his political allies will pass yet another fiscal package to shore up domestic demand. The prior two were extremely limited in their scope, but news reports suggest that this one could amount to JPY 56 trillion, ca. 10% of GDP (see chart 11). We suspect that actual government spending, commonly referred to as "mamizu", might be lower than the headline figure. Still, the nature of the stimulus (e.g. cash transfers) hints that its thrust could be more aggressive than, say, in Europe. Meanwhile, this initiative should make things simpler for the Bank of Japan (BoJ), as it will be able to focus on absorbing the additional government debt, instead of worrying about running out of other assets to buy. All told, though, it is unlikely that Abe and Kuroda can outshine the even larger US actions – which means scope for the yen to rally further versus the dollar.

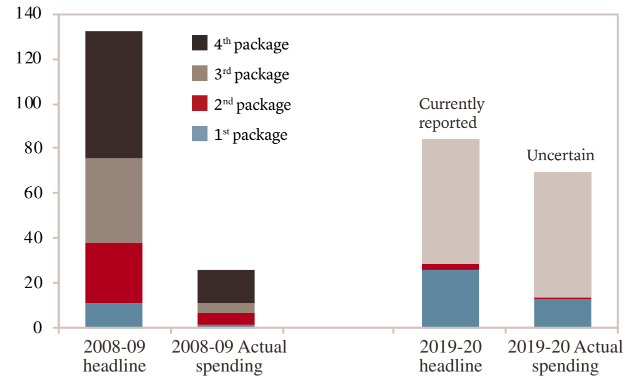
Homin Lee, Macro Strategist – Asia

10. Japan's unique epidemic curve
Cumulative confirmed cases (in log scale)



Sources: JHU CSSE, Bloomberg, Lombard Odier

11. Historic fiscal package in the offing?
Comparison of Japanese fiscal stimulus (in JPY trillion)



Sources: Cabinet office, Lombard Odier

Asset Allocation

News flow to remain difficult, warranting a still cautious stance overall

In a nutshell

- After their brutal collapse, equity markets have recently regained some ground on the back of massive monetary and fiscal policy announcements, as well as some first encouraging signs from Italy on the COVID-19 front.
- The conditions for a sustained equity rebound are, however, not in place – leading us to maintain our slight equity underweight. Until containment measures manage to slow the infection rate, especially in the US, the news flow will remain negative, in terms of economic data, profit warning and credit downgrades.
- Elsewhere, we have pursued efforts to reduce portfolio risk and enhance liquidity, moving underweight on emerging and high-yield debt, recommending option strategies, and adding to Japanese yen and gold exposure.
- While our baseline case argues for a pick-up of economic activity during the 2nd half of the year, an adverse scenario of extended lockdown and recession cannot be totally excluded, which would require more pronounced risk reduction action in portfolios.

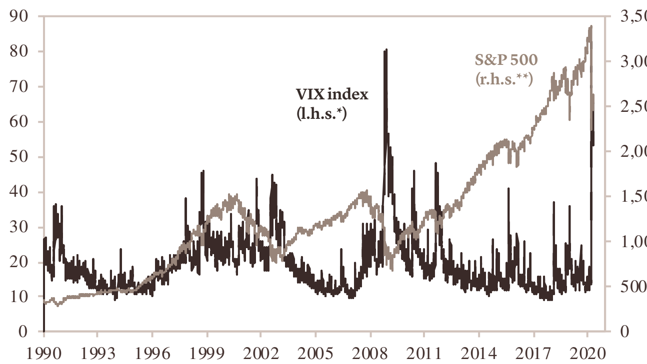
Towards the end of last year, with the US economic expansion having become the longest on record and global growth showing signs of broadening, a key question on investors' minds was how the cycle would end. The traditional pattern of rising inflation forcing monetary policy to turn restrictive looked increasingly implausible. Rather, an external shock seemed the more probable trigger – with geopolitics topping the list of candidates.

We know now the answer to that question. The coronavirus-induced near-complete shutdown of entire economies for weeks on end will inevitably have a large impact on near-term growth. A GDP contraction, of possibly unprecedented depth, will be experienced during the 1st half of 2020. That said, given the substantial public health, fiscal and monetary measures deployed so far, our baseline scenario is one of a transitory economic shock, with a pick-up of activity during the 2nd half of the year.

From a portfolio positioning standpoint, consistent with the stable, low but positive, growth environment prevailing at the time, we entered 2020 with a preference for carry strategies, such as emerging market debt in hard currency, real estate, infrastructure and high yield credit. In contrast, we maintained a slightly underweight exposure to equities and, with negative yields on sovereign bonds, had a number of alternative hedges in place, including gold and put options. By the middle of January, we began adding US Treasuries to portfolios, both as a source of yield and a hedge.

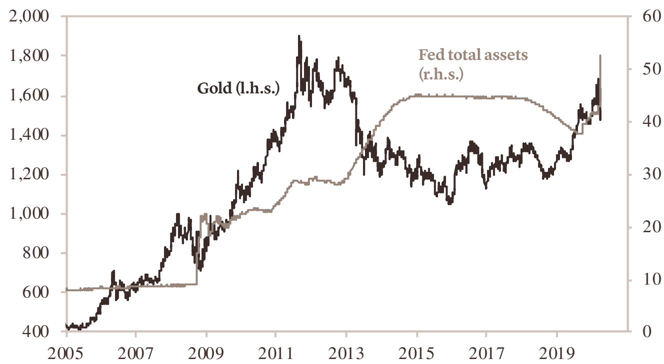
Only a few weeks ago, global equity markets were at all-time highs. How fast things have changed: it took just days for them to fall all the way back down to 2016 levels (see chart 12). During the weeks of market collapse, we regularly adjusted our equity exposure to account for market drift. As such, the portfolios were positioned to benefit from the sharp equity market rally that began on 23 March, on the back of massive monetary and fiscal stimulus announced across the

12. **The equity market move was brutal by historical standards**
S&P 500 vs VIX (equity implied volatility)



* left hand scale, ** right hand scale
Source: Bloomberg

13. **Gold serves as an effective hedge when the Fed increases dollar liquidity – except in 2013 (surge in US real rates)**
Gold (in USD/oz) vs Fed balance sheet (in USD trn)



Source: Bloomberg

board, as well as the first encouraging signs from Italy on a slowing down of infections.

Still, we do not believe that all the conditions for a sustained equity market recovery are in place. Until containment measures bear their fruit (especially in the US), in terms of curbing the infection rate, sometime during the 2nd quarter, investors will have to cope with a worrying news flow, be it record low economic data, profit warnings or credit rating downgrades.

We thus keep a cautious stance overall, not making drastic changes to our equity exposure. Rather, we recommend holding put spreads as a cushion to navigate this short-term period of volatility. Such an option strategy allows for upside exposure to equity markets in our scenario of eventual recovery, while offering some protection on the downside. In a put spread structure, the sale of one put option covers part of the premium for holding a long put option, resulting in an overall lower cost for the optionality.

We also recently took advantage of attractive valuations to increase exposure to the Japanese yen and to gold, as portfolio hedges. For gold, with the Fed funds rate near zero and massive QE across the globe, we now put medium-term fair value closer to USD 1,600/oz (see chart 13, page 11). In the short term, though, the yellow metal will remain underpinned above this level by the still very large level of uncertainty.

In fixed income, with the month of March having served as a reminder of the liquidity issues facing many parts of the market, we turned underweight in all the high beta segments, namely high yield and emerging market debt. Indeed, we see little upside for both local and hard currency emerging debt in this low oil price environment (cf. box, page 13). In addition, some of the biggest countries in the indices are likely to face very difficult domestic political situations as the outbreak spreads, testing their public health systems – although most Asian economies should be more immune to these two sources of stress.

Following – in fact taking advantage of – the market relief rally and improved trading conditions, we also cut 3% of our high-yield position. We believe that credit downgrades are about to step up, with rating agencies having started to communicate on the impact of the COVID-19 crisis. It is highly likely that the number of "fallen angels" (companies that lose their investment-grade rating and drop into the high-yield space) will rise, even as investor appetite for risk is dampened by the worsening default outlook. Last but not least, sectors like energy, industrials, leisure, non-food retail and transportation are the most affected by the lockdowns and represent more than one third of the high-yield benchmark.

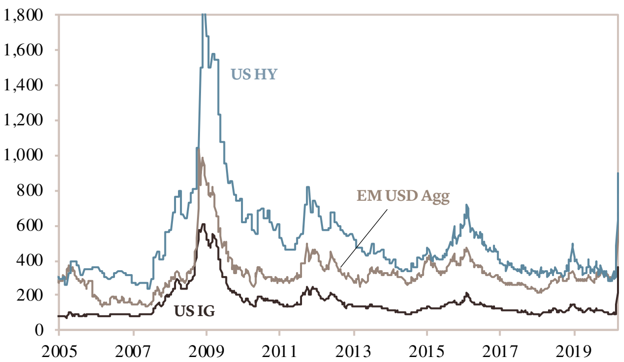
For these reasons, we believe that these two asset classes will react less fast to the eventual recovery in risky assets than, say, equities. Most of the proceeds of the sales are being held in cash, so that we will be able to react rapidly to any positive or negative change in outlook.

Going forward, we will continue to monitor the effectiveness of containment measures and policy response and adjust portfolio risk accordingly. An adverse scenario, in which the lockdown periods must exceed initial expectations and the recession extends beyond the 1st half of the year, can indeed not be totally excluded. It would mean further material downside on equities, in line with the experience of the GFC, and probably also in the high-beta fixed income segments. In such a (worse case) scenario, gold would attract most safe haven flows, which could take it up above USD 1,900/oz, i.e. 20% above current levels. Beyond the option strategies currently in place, a more pronounced and rapid risk reduction process would be required to protect portfolios but, again, this is not our baseline case.

Sophie Chardon, Senior Cross-Asset Strategist

14. Spreads have also widened sharply in the bond markets

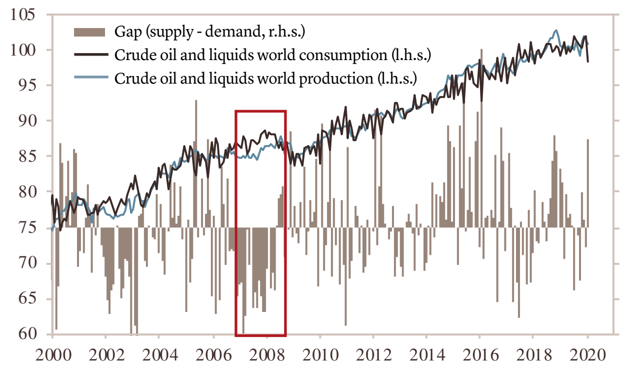
Option-adjusted spreads



Source: Bloomberg

15. The impact of the demand collapse on inventories will be comparable to 2007-2009 – but more temporary

In Mbd



Source: Bloomberg

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

Oil is suffering both a supply and demand shock

The OPEC+ meeting on 6 March during which Russia and OPEC members failed to reach an agreement on production cuts came as a big surprise and triggered Saudi retaliation, setting off a price war. At a time when the world is facing a historical (yet mainly transitory) demand shock due to COVID-19-imposed shutdowns, this price war will translate into sizeable oil oversupply.

In a price war, producers aim to produce as much as possible in order to preserve their market share. Given the Saudis' capacities, they appear well positioned to benefit from this new order. As of now, we estimate that the increase in supply should amount to ca. 2.5 Mb/d in the coming months.

For several years now, OPEC+ had been credible in our eyes with respect to the central bank role it sought to play in the oil market. By maintaining a floor on prices while recognising that excessive levels are detrimental to demand, the Organisation sought to ensure a favourable environment for investment in long-term projects. It was rather active and successful in this undertaking.

As such, the end of the three-year partnership between Russia and Saudi Arabia is a game-changer for the market structure, bringing us back to a more traditional playbook, in which low-cost producers use their spare capacity to force higher-cost producers to reduce output. While we cannot completely rule out an OPEC+ deal in the coming months, in this new context, the fair value for oil should be close to the industry's marginal production cost, which is estimated at around USD 40/bbl – our new 12-month target.

For shale and other high-cost producers, price levels of USD 40/bbl or below will begin to cause acute financial stress and lead to a reduction in output. With a marginal cost estimated in the USD 45-50/bbl range, some companies have already announced they will be forced to shut down economically inefficient rigs. Obviously, the longer the low-price environment endures, the deeper the pain inflicted on US shale producers. That said, some support from the US administration is to be expected, given the strategic positioning of the industry.

More importantly, at least for the very short-term outlook, the oil market is currently and simultaneously also facing a highly uncertain bearish shock on the demand side of the equation. While demand should reaccelerate in the 2nd half of the year, we would not be surprised to see oil trade close to USD 20/bbl during the coming months, with the clear risk of overshooting to the downside. Indeed, as a result of the global economic shutdown, an unprecedented inventory build-up is to be expected – which will fill all types of storage capacities around the world, including floating storage. This backdrop should eventually lead to drastic production curtailment if spot prices were to fall below USD 20/bbl.

Sophie Chardon, Senior Cross-Asset Strategist

Forex
A tale of two dollars

In a nutshell

- In this hugely uncertain context, medium-term currency forecasts are evidently subject to a wide margin of error.
- At this stage, our baseline scenario of a 2nd half economic recovery, supported also by massive monetary and fiscal stimulus, argues for a weaker dollar relative to other G10 currencies – as US yields converge downwards.
- Against most emerging currencies, however, the greenback is likely to grain ground, given the negative impact of the simultaneous oil price crisis on overall EM terms of trade.

The last few weeks were characterised by a nearly unprecedented increase in the level of uncertainty, with steep equity market losses and huge swings in bond and FX rates. This is an environment with far too many risks and moving parts, namely (i) the extent of the COVID-19 pandemic and its evolution; (ii) monetary policy responses (and their efficacy); (iii) timing, size and composition of fiscal stimulus; (iv) the side effects of various country restrictions in place; and (v) developments on the recent USD liquidity squeeze.

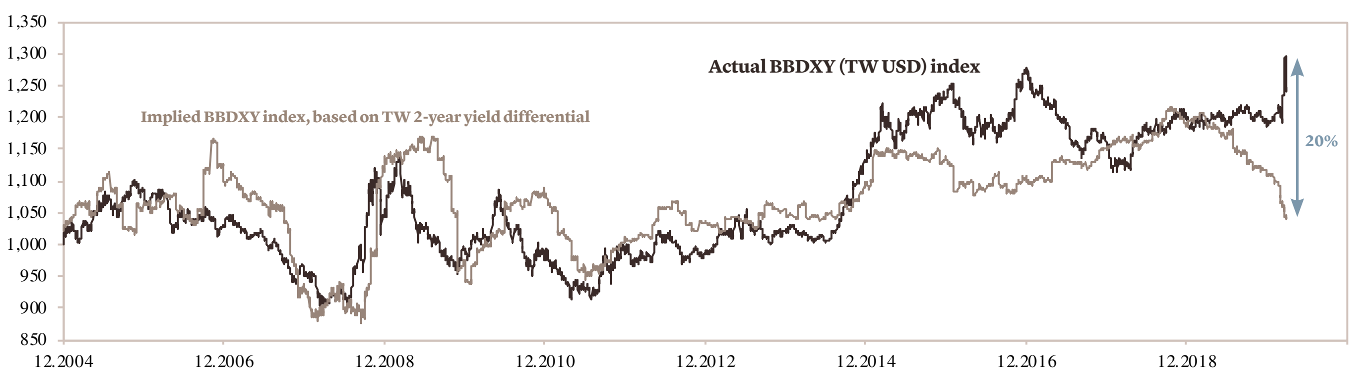
Consequently, our forecasts are subject to an unusually large margin of error. It is impossible to incorporate the uncertainty relating to so many factors in our estimates looking out two to three quarters. The best we can do is interpret the moves, assess their evolution and then lay out our baseline scenario, which remains subject to sizeable uncertainty.

In summary, our working assumptions revolve around the following points:

1. The virus pandemic[1] will substantially supress economic activity in the 1st and 2nd quarters, but the odds are still for a recovery in the 2nd half of the year, aided also by the significant amount of stimulus provided.
2. Monetary policy has responded forcefully, using both conventional (rate cuts) and unconventional QE measures[2]. However, the elephant in the room is fiscal policy. In that sense, size does matter but composition is equally important. Public health measures aimed at "flattening" the virus infection curve are needed, alongside measures that enable firms to sustain the costs related to the abrupt drop in demand and those associated with retaining their employees. In recent days, several countries have made very important steps (see here[3] and here[4] for example), which we believe will be quite supportive. And more is likely to come.

[1] https://www.who.int/emergencies/diseases/novel-coronavirus-2019
[2] https://www.ft.com/content/ef2514c4-18ce-4974-b7e3-2e28c86326d2
[3] https://www.bloomberg.com/news/articles/2020-03-25/white-house-senators-strike-deal-on-massive-stimulus-package?srnd=premium-europe
[4] https://www.washingtonpost.com/world/europe/germany-oks-big-aid-package-to-help-companies-self-employed/2020/03/23/bcc4d16c-6d0a-11ea-a156-0048b62cdb51_story.html

16. Trade-weighted (TW) USD trading exceptionally high relative to rate differentials (i.e. overvalued)



Sources: ???

3. The Fed will (hopefully) eventually manage to address the USD liquidity squeeze in the market, which has been responsible for the surge in the greenback since early March. The announcement of unlimited QE[5] and the (unprecedented) addition of investment grade corporate bonds[6] to the asset purchase list by the central bank are big steps in the right direction.
4. However, and outside the control of authorities, other crucial variables such as energy prices[7] – which are OPEC-driven – will remain a drag for large parts of the emerging markets (EM).

Based on these working assumptions, lower US yields will converge closer to other G10 peers, increasing the importance of rate differentials and eventually putting downward pressure on the overvalued USD, especially against the majors (see chart 16, page 14).

We have pencilled in EURUSD at 1.16 for year-end, EURCHF at 1.08, GBPUSD at 1.28 and USDJPY at 103. However, we bear in mind the very high volatility, which can result in extremely choppy markets of 4-6% around point forecasts.

On the other hand, we expect the USD to be well supported against large parts of EM FX space, given the new "low for longer" backdrop for energy prices which is likely to trigger a significant worsening in overall EM terms of trade (see chart 17). However, we still expect the CNY and parts of Asia FX to outperform after the initial shock.

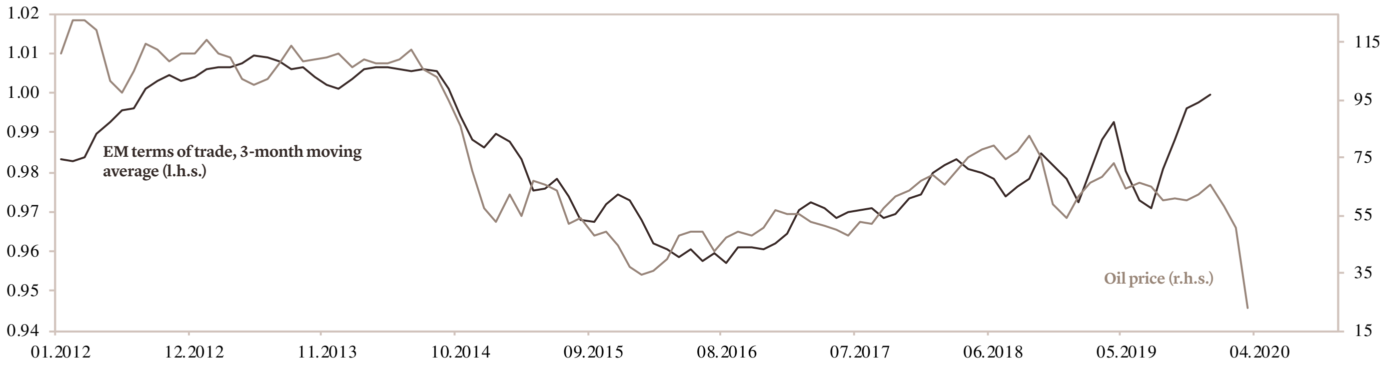
In this sense, it will be a "tale of two dollars": softer against the G10 reserve currencies (EUR, JPY, CHF, and gold) but stronger against EM FX (barring the CNY and parts of Asia).

Clearly, risks to our view are sizeable but also symmetrical. These include (i) the pandemic worsening further and delivering a more severe and longer lasting blow to the global economy (USD-positive via more a severe USD liquidity squeeze); (ii) failure by the Fed to address the USD liquidity stress issue (USD-positive); (iii) a very sharp 2nd half rebound in the global economy (USD-negative); and (iv) OPEC+ countries sorting out their differences and reinstating their alliance (EM FX-positive).

Vasileios Gkionakis, Global Head of FX Strategy

5 https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323a.htm
6 https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm
7 https://www.lombardodier.com/contents/corporate-news/investment-insights/2020/march/the-collapse-of-the-opec-allianc.html

17. Overall EM terms of trade are likely to deteriorate sharply following the oil price collapse



Sources: Bloomberg, Lombard Odier calculations

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