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CIO Flash

Circuit breaking Covid-19

Investment Solutions

23 March 2020

Some politicians have referred to the Covid-19 pandemic as a war against an invisible enemy. Financial markets have reacted to the spread of the virus with sell-offs and drying up liquidity that looks similar to the reactions seen at the start of the twentieth century's two world wars.

As the economic expansion lengthened and broadened last year, and for the US economy became the longest on record, a key question in investors' minds was how the cycle would end. The traditional pattern of rising inflation forcing monetary policy to turn restrictive looked increasingly implausible. As a result, an external shock started to seem the most likely alternative. At the start of the year, investors did not know what that shock might be, and looked for geopolitical threats. We know now the answer to that question.

Near-complete shutdowns of entire economies for months will inevitably have a deep impact on near-term growth. An economic contraction of possibly unprecedented depth looks likely in the first half of this year.

Nevertheless, our expectation is that, as public health measures (see chart 1) taken in Europe and North America start to become effective, the decisive fiscal and monetary measures put in place by governments and central banks will eventually kick-in. For this reason, beyond an inevitable recession in corporate earnings in the first half of this year, we expect the second six months of 2020 to see an economic recovery that returns company reporting to positive territory before the year's end.

The road here

2019 ended with higher-than-expected returns across most asset classes, thanks in particular to the policy U-turn by central banks and early optimism over the US-China trade truce that had halted the escalation of new import tariffs. At the start of this year, we still faced low but stable growth and a low interest rate environment, but consumer spending had proven resilient.

At that time, we favoured carry strategies for multi-asset portfolios, such as emerging market debt in hard currency, real estate, infrastructure and high yield credit. In contrast, we maintained a slightly underweight position in equities and, with negative yields on sovereign bonds, had a number of alternative portfolio hedges in place, including gold and put options. By the middle of January, we began adding US Treasuries to portfolios, which offered both yield and a hedge.

As quarantine measures have moved from Asia to Europe and North America, containment efforts are slowing and shutting down economies. Based on the epidemic's trend in China and South Korea, markets are expecting that a peak in cases in the rest of the world is still a number of weeks or even months away.

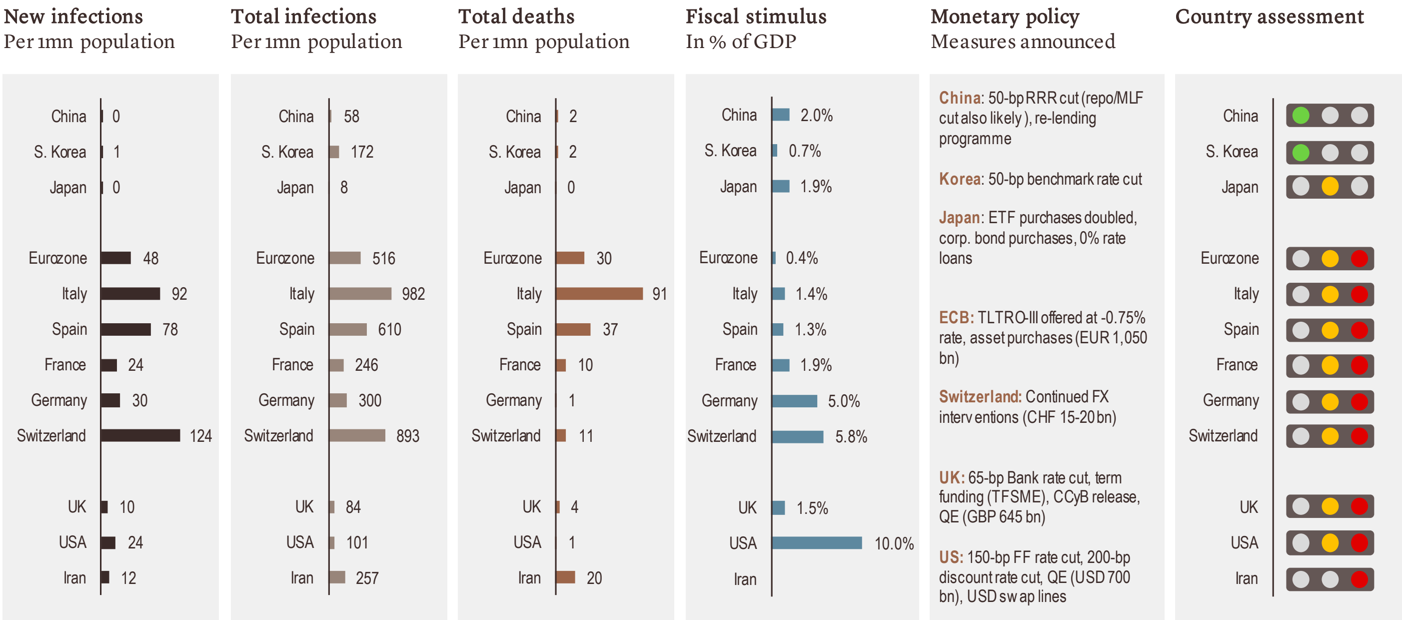
Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- The near-complete coronavirus shutdowns will have a deep impact on short-term growth
- We expect a second-half recovery this year as fiscal and monetary stimulus kicks-in
- We have implemented JPY and gold hedges and rebalanced our equity allocations to account for market drift
- We cannot rule out a longer and deeper impact with widespread corporate defaults
- Whether the global economy faces a short shock for weeks, or something worse, now depends on public health measures
- The fiscal and monetary framework for a recovery is mostly in place already.

1. COVID-19 Dashboard

New infections, total infections, total deaths, fiscal stimulus and monetary policy as at 22.03.2020



Three levels of response to contain the current shock to H1 2020, limit defaults, and avoid an unemployment spiral

- A public health response: to contain the spread of the virus, and gain time so that cases do not overwhelm hospital capacity
- A monetary response: to avoid a funding shortage and ensure liquidity at a cheap borrowing cost
- A fiscal response: perhaps in the form of tax rebates or income transfers, to partially shield economic actors from the temporary blow

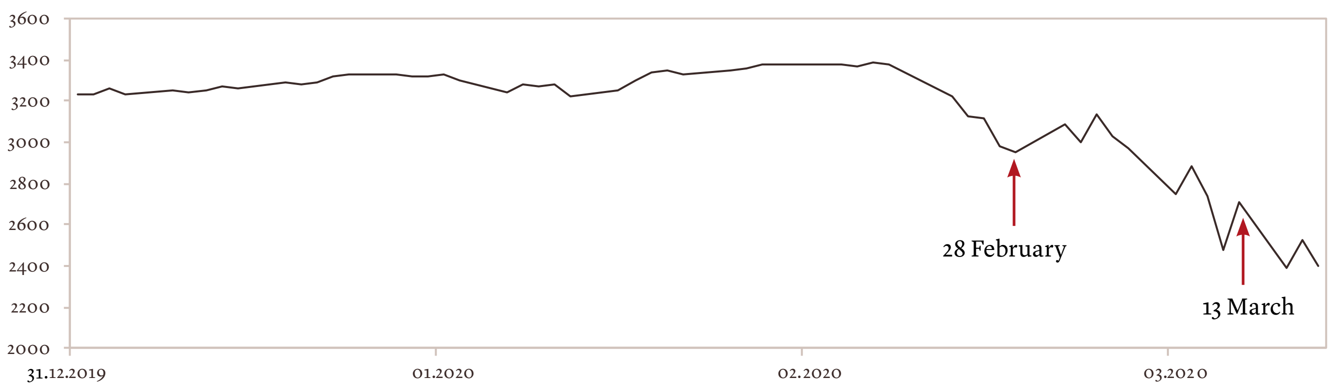
Sources: Bloomberg, IMF, Lombard Odier calculations

Hedging positions

As the virulence and spread of the coronavirus has become clearer, we decided on 16 March to buy Japanese yen as a portfolio hedge. We expect this trade to benefit from the fall in US bond yields, as the yen is most sensitive to such declines. It also provides a hedge should the pandemic worsen further.

We have also kept our slight underweight in equity positions, after rebalancing to take account of the market drift after the declines, so that portfolios can benefit from the eventual recovery. We first adjusted equity exposure in portfolios on 28 February, and again on 13 March, after European equities suffered a fall of more than 30% (see chart 2).

2. S&P 500



Source: Bloomberg

The short-term impact on company earnings will be severe. However, the combination of low interest rates and low oil prices mean that in the longer run, we believe there is more potential upside to gain than downside risk.

The recovery outlook

With governments and central banks taking decisive health, fiscal and monetary steps, we expect the crisis to present a significant but still transitory shock. Above all, we need to see the public health measures begin to show that they are effective over the coming weeks.

Like the impact of a natural disaster, once the number of coronavirus infections pass a peak we expect to see a gradual recovery on stock markets. Based on the apparent successes in China and South Korea in containing the outbreak, this recovery scenario remains our base-case.

We have of course revised our second-quarter earnings targets to take into account the impact that the crisis will inevitably have. However, at 2,900, our updated 12-month target for the S&P 500 would present a gain of 20%. Gold prices should also return to fair value, and, with the Fed fund rates now close to zero and massive quantitative easing by most central banks, should be closer to USD 1,600 per ounce in the medium term. On the other hand, we see little upside for emerging debt in local currencies in the low oil-price environment, and so we sold our exposure to the asset class.

In this scenario, risk premia would also quickly normalise in credit spreads, as defaults will stay limited. The only exception may be assets exposed to the oil market, which, given the price war between Russia and Saudi Arabia, would stabilise at best.

From a macro-economic point of view, such a severe but short-term impact would enable consumers to return to their former spending habits in the second half of this year, with the monetary and fiscal measures already in place providing the global economy with a boost.

'Natural disaster' or 'war'?

We cannot rule out a far more negative scenario. This is a possibility if the virus proves longer-lasting, impacting economies over many months. We may face such a scenario if quarantine measures in Europe and North America prove less effective than in China and South Korea, or the virus returns to Asia in a second wave. In this case, the coronavirus may look less like a natural disaster and be closer to the analogy of war.

In such circumstances, economies would likely suffer extensive corporate defaults because no government can compensate a series of industries for the loss of revenue over many months. A sharp rise in unemployment would inevitably follow, undermining economies' abilities to eventually recover.

There is a risk of a recurrence of a worldwide debt crisis. The economic recovery following the Great Financial Crisis almost twelve years ago was largely fueled by government and corporate debt. If debt were the underlying problem, then more of the same will not reassure markets. This is why we need a fiscal response. Zero or negative rates are an invitation to governments to borrow.

From an investment point of view, an extended recession implies a further 15% to 20% downside on equities, in line with the impact of the Great Financial Crisis, as well as further losses high-beta fixed income. A drawn-out pandemic would put emerging currencies under further pressure and emerging debt in local currencies may fall another 10%, in line with drawdowns seen in 2008 and 2014-2016. That would see gold attract safe haven flows, pushing the precious metal, we believe, to around USD 1,800-1,900 per ounce.

Markets unplugged?

In reaction to the market volatility of recent weeks, there has been increasing discussion about whether it makes sense to shut financial markets to stop panicked sell-offs.

Politically, the Trump administration would certainly be loath to take such a radical step, especially in an election year. US Treasury Secretary Steve Mnuchin said on 17 March that the US administration wanted to keep markets open, but that trading hours may be reduced. The following day, the New York Stock Exchange announced that it would temporarily close its physical trading floor starting 23 March, continuing only with electronic trading after two traders tested positive for the virus.

Exchanges from the US to Japan and India, South Korea and Thailand have triggered circuit breakers in recent weeks. Market circuit breakers provide temporary halts to trading or limits on security trades when indices drop below a set threshold. Each financial market has its own thresholds in place. The mechanism has now halted US trading four times since 9 March.

Decisions to close financial markets are rare, but have been used in China's markets most recently to manage the coronavirus fall out. In this case, the delay of the market re-opening after the lunar new year holidays helped. The decision to close the Greek stock exchange nearly five years ago during the government debt crisis did not stop the market re-opening 16% lower five weeks later. The NYSE's circuit breakers were first triggered on 17 October 1997, and the market shut 11-17 September 2001 following the terrorist attacks. Circuit breakers again stepped in on 1 December 2008 as the sub-prime crisis spread. Hurricane Sandy shut the NYSE in October 2012 and on 8 July 2015, the market hit a technical glitch, shutting the market for a few hours.

We have to go back more than a century, to the outbreak of the First World War, for an example of an extended shut-down. The NYSE closed on 31 July 1914 and the rest of the world's exchanges followed suit, only re-opening four months later.

For now, we are closely monitoring the evolution of infections, especially in Europe and Italy, as well as the public health measures rolling out in the US. Whether the global economy faces a short, sharp shock measured in weeks, or an extended slowdown over months, will depend on how effective these measures are. Much of the fiscal and monetary framework for the recovery is already in place.

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06.2019