SINGALLIANCE

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Reasons for confidence in market appreciation

« Post tenebras lux » Motto of Geneva

The Covid crisis has interrupted the longest growth cycle in the post-war period, ten years in the United States between 2009 and 2019, the overall cost is high, the scars on certain sectors will be indelible but five factors sustain the optimism of the financial markets.

The possible acceleration of potential growth:

Two ideas stand out: less pessimism about the current year and more confidence in the future. In June, international forecasts feared an 8.5% decline in US GDP for 2020, the probability today is a 3.7% recession. For China, expectations were between 0 and negative, today they are positive 1.8% for this year. The same is true for many countries in Southeast Asia and other regions.

The reason for these revisions is the strength of the crisis response by States. Overall, the IMF estimates that $12 trillion has been spent to cushion the crisis, equivalent to nearly an unprecedented 15% of global GDP. Of these fiscal budgetary efforts, a portion was used to finance partial unemployment measures and to offer guarantees to companies to alleviate cash-flow crises, but a significant percentage was injected into longer-term plans, infrastructure development, promotion of new technologies, energy transition, assistance with relocations.... These are all investments that can improve competitiveness and raise growth potential and will primarily benefit OECD countries.

The transformation of companies:

The second factor of confidence in the financial markets, the capacity of companies to adapt, the acceleration of the digitization of companies, the reorganization of work flows, the envisaged reduction of the real estate stock, the consolidations of production by proximity, also corporate mergers, in the banking sector for example, today in Spain and soon in Italy. These are various measures likely to improve profitability in the near future. And the Stock Exchange is right to look beyond the year 2020, with corporate profits inevitably “in shock”.

The reinforced integration of the European Union:

The third driving factor, greater economic integration in Europe with the adoption of the €750 billion recovery plan (not yet implemented), Community financing of part of the partial unemployment with the SURE compensation plan, the extension of the ESM (European Stability Mechanism) to protect the banking system, the ECB injections of €1.35 trillion, the blacklisting of Poland and Hungary that are ready to flout democracy but always ready to benefit from Community windfalls. The ECB's monetary support, the Commission's budgetary aid and the measures decided by each State have been evaluated, the risks of a solvency crisis are contained and the risk of a new financial crisis in the peripheral countries is averted.

One should remember that during 2011 Euro crisis, Portugal's 10-year rate exceeded 17%, today it is nearly 0. Greece was juggling restructures with multiple financial rescue plans, arm wrestling with the EU amid internal political crisis leading to the breakthrough of the extreme right-wing Golden Dawn. Today, though, Greece’s 10-year rate is at 0.6%, far off the 37% by early 2012.

In light of such integration, the interest rate compression proliferate amongst highly indebted countries and the paragon like Germany. By end of 2020, the interest rate differential on a 10-year bond between Germany, with 75% of its GDP in debt, and Italy, with nearly 160% of its GDP in debt, is down to south of 1.2%!

Optimized debt management:

The fourth factor of confidence is the action of central banks, which was welcomed in 2008 but has been amplified this year. In response to a $15 trillion increase in world debt in one year, in response to this drift of the planet's debt from 3.2x GDP to 3.65x, central banks in the United States, Europe, England and Canada have adopted bold monetary injection policies unprecedented by scale.

Since the beginning of the crisis, CBs have acquired more than $10 trillion in public debt. Massive demand, firstly, crushed the long rates, driving 10-year US rate to 0.9%, compared to 6.5% during the 2000 crisis and 1.9% at the beginning of 2020. Secondly, the bonds outstanding at negative rates now amounts to a whopping $17 trillion beyond all expectations.

In this interest rate management exercise, the major countries borrowing in their currencies, $, Euro, Yen and Yuan, enjoy clear advantage because emerging countries are affected by the fall of home currencies, thus an increase in foreign currency debt would constraint the fall of their interest rates through imported inflation.

China targets to consolidate its public enterprises, letting some enterprises like Brilliance Autogroup, Tsinghua Unigroup default. Such defaults are not cause for alarm, given a default rate of 0.5% which is line to that of Europe, and 1.4% of the US. The longer term objective is to build further confidence with foreign investors because currently they do not hold more than 3% of the Chinese bond market.

The disqualification of populist regimes:

Fifth reassuring factor for the markets stems from the setbacks suffered by the populists, the end of the agreement between the first Power and illiberal or even autocratic regimes. Without Covid, Trump would have been re-elected and the disintegration of democracy would have continued.

Without Covid, Bolsonaro in Brazil might not have failed miserably in the Brazilian municipal elections, since 49 of the 50 candidates supported by him were defeated, especially in Rio and Sao Paolo, where improbation was high. The poor management of the crisis precipitates a record unemployment rate of 14.6% of the working population and a deep recession.

Without the initial carelessness in the management of Covid, Boris Johnson's United Kingdom would not have recorded the worst figures in Western Europe: a recession at -11.5%, a budget deficit of -19% of GDP, compared with -11% in Spain, perhaps the most affected country in the European Union. As the weeks go by, he exposes his country to an exit from the European Union without agreement, with an immediate cost of 2 points of GDP in the coming year, according to estimates by the Office for Budget Responsibility (“OBR”).

In India, Modi is grappling with an unprecedented crisis, as GDP is expected to fall by more than 10%, public debt is expected to drift to 75% of GDP, and bad debts will explode to 9%. The banking system will be weakened and, for a population still growing and poorly protected because much of its employment still captured in the informal economy, and for farmers faced with unpopular reform, the crisis will be much more severe than to the West.

In Turkey, Erdogan's imperialism in the management of the economy in recent years is striking. He had wanted to ignore international realities, had lowered interest rates, but the currency collapsed, the rise in import prices pushed inflation to over 12% officially. Consequently he had to change the finance minister and the director of the central bank, lift interest rate to 15% and try to stop the depletion of foreign reserves. There posts great risk of deepening the recession, already at 6% this year, because credit will be slowed down. To keep the political support of the nationalists, Erdogan multiplies aggression on the international scene but, in the run-up to the 2023 elections, political figures are asserting themselves like the mayor of Ankara, Mansur Yavas and the mayor of Istanbul, Ekrem İmamoğlu after Erdogan lost the major cities in the 2019 municipal elections.

The restoration of multilateralism:

The ousting of Donald Trump signals the end of a unilateral policy and domination, the failure of his policy of customs duties to stop China's development. The growth of China's trade surplus and the growth differential in favour of China illuminates this failure and financial markets can take comfort in Biden's irenicism, with a return to multilateralism and less unpredictability.

Conclusion: "Pessimism has never won a single battle" Eisenhower.

The rise in equity markets is not an anomaly but a recognition of the potential offered by this unprecedented crisis. The evidence of the opportunity initially appeared for the pharmaceutical and technology sectors (e-commerce...). In recent weeks, interest has been focused on cyclical sectors, industry, transport, energy, finance, as they have begun to reorganize.

Please stay tune for our next letter on our outlook across asset classes.

Geneva, December 7, 2020

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