Letter n°4

Five risks and one certainty

"When misfortune comes, they come not as scouts but as battalions"
William Shakespeare – Hamlet.

This note reiterates the cautionary advice developed in our previous notes and highlights five risks, even though we are convinced of the determination and ability of governments and central banks to avoid a lasting recession. The current crisis is different from that of 2008. Yesterday a crisis in the financial system, today an imposed halt in production activity and a fall in consumption. Yesterday banks under assistance, today banks as transmission belts for state aid and injections by central banks. Yesterday, in 2009, a 2.9% drop in GDP in Europe, today the will to prevent this risk.

The five risks

Health risk

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Economic risk

No one can assess the extent of the recession. The only figures available, those for China over the first two months, show an 80% drop in automobile sales, retail sales down 20% and industrial production down 14%. Very instructive will be the Chinese GDP figure for the first quarter that we will see in early April. For the first time, it should be negative and jeopardise the target of 6% annual growth, as the rebound predicted by the Chinese authorities will be thwarted by weak international demand. Very important will be the extent of the decline in GDP in the United States, as the Americans are the world's largest importers. The US deficit could reach 10% of GDP, a figure whose magnitude is the result of Trump's mistake of having accepted a 5% deficit at the top of the cycle.

Financial risk

This would be investors' mistrust of the assets of indebted countries. In the OECD, public debt is 1.1x GDP and private debt is 1.5x GDP, and despite the low rates, the financial costs on this debt amount to 2% for governments and 4% for the private sector, households and businesses. This is not very reassuring as potential growth is at best equal to these figures. Emblematic of the doubt is the evolution of the Greek 10-year debt. Just a few weeks ago, it was close to 1%, but on the eve of the ECB's plan, it was over 4%. A similar evolution was noted for Italian, British, American and French debt.

In spite of massive injections, $700 billion by the FED, Euros 1000 billion by the ECB, the central banks are struggling to keep long rates close to zero, the objective being to limit the cost of the budgetary efforts to be made and to avoid the spreads of the most fragile economies in the Euro zone from diverging. The ECB's effort, 8% of the Eurozone's 12500 billion Euro GDP, is a palliative to the likely stoppage of activity for one month. Welcome innovations, the ECB can focus on Greece or Italy and it can cross the 33% limit of buying back a country's debt and acquire non-financial corporate debt.

Paradoxically, there are both doubts about effectiveness and concerns about over-injection. The rise in long rates, concomitant with the increase in margin calls and the appreciation of the dollar, explains the decline in gold, which is considered a safe haven. The issue is the risk of flight from the currency because the public debt of Southern European countries, including France, even before spending is committed, is 15 to 35 points of GDP higher than in 2010.

Nationalization risk

Many company share prices seem attractive but, in the event of nationalisation, the loss to the minority shareholder could be heavy. States will want to protect their national champion and will buy at a low price. Air transport is not the only sector involved, but also industrial flagships that have been temporarily affected. The State will very often make a capital gain because the crisis will be temporary.

Dividend risk

The temptation is to buy high-dividend stocks, especially if companies have "free cash flow" and have never cut dividends in the past. But in exceptional circumstances, exceptional decisions. Who would blame a company for cutting its dividend if it invoked, if not survival, at least the desire not to distribute its profits in order to take advantage of opportunities?

The certainty: "That which does not kill me makes me stronger" Nietzsche, Ecce Homo.

Certainty lies in determination of governments to shorten the recession, to dampen the risk of bankruptcies and to avoid an explosion of unemployment with state-funded short-time working. The tools used by governments are classical, but their extent is unprecedented: zero interest rates, loan guarantees and direct aid.

Zero rates

Within a few days the FED, the Bank of England and Australia reduced their respective rates to 0.1% and 0.25%. At the same time, real long-term rates remain low because there is an excess of savings over demand due to the ageing of the population and the lower capital intensity of our economies. Low short and long rates, a windfall that governments are keen to foster.

Guarantees

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Direct aids

They reach 2 to 4% of GDP depending on which country. In favour of companies, the suspension of payments of social security contributions, deferred VAT payments. In favour of

households, the tentative US initiative to distribute $1000 cheques to all or part of the population because the welfare state is less developed than in Europe, 28 million people have no health insurance. These are all measures for the targeted distribution of money, "Helicopter money", with the corresponding government debt to be absorbed by the central bank.
Cumulatively, this aid exceeds $3 trillion, nearly 4% of world GDP, more for the countries that benefit from it, but this number should be seen in the light of the ILO's pessimistic assumption of a loss of 25 million jobs and $3400 billion in income. States are spending to avert the risk described by the ILO. The reflationary effect will be massive.

Conclusion

There are many reasons to expect, over the next twelve months, stock market levels higher than the current indices and to think that stock market prices will recover as soon as the curve of coronavirus patients has fallen, but in the short term, we will look through these five risks before investing and we stand available to discuss them .

Genève, March 20th, 2020

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