Letter n°5

In an unprecedented crisis, increased vigilance

« Man proceeds in the fog »
Milan Kundera – Testaments betrayed

Since 1945, there have been three unusual crises: the 1974 global recession as a consequence of the 1972 energy crisis with a quadrupling oil price, the financial crisis of 2008 with the bankruptcy of Lehman Brothers, and this health crisis. Let us wonder: less than two months ago, everyone was talking about the longest growth cycle in history. It began in mid-2009 and seemed to be sustainable, even if we could deplore a structural weakening of potential growth, if we could regret the modest productivity gains, if we could be alarmed by the drift in debt, if we could worry about the dependence on constantly expansionary monetary policies and if we could perceive a crumbling of the margin rate.

We knew that the world was a risky place: nuclear fire, a conflict between China and the United States, climate change, cyber attacks and the spread of a virus on an international scale. The CIA had identified these threats in a report to Congress and Bill Gates, at a conference in 2015, had raised the spectre of a centennial virus spread. But all these were black swan scenarios that human nature willingly discards, optimistic as it is, until someday one knocks at the door.

There it is. Some will blame the incompetence of various governments, their negligence, their inability to react, to provide masks, to make tests available, to overcome reluctance to take advantage of geolocalisation potentials, to validate chloroquine, to delay the closing of borders or lockdown decisions. It is always easy to criticize, but we will remember the extraordinary economic responsiveness of both governments and central banks, their speed to address situations, the scale of financial resources deployed to guarantee loans to private companies, to support business activity, and to provide a floor to personal income in countries where social welfare is less developed than in Europe. The figures are staggering, but the challenge is unprecedented. Let us remember: a few weeks ago, Mr Trump declared that $2.5 billion would be enough to manage the situation; in recent days he set himself to push through a $2 trillion plan, nearly 10% of the US GDP. The IMF had lowered its forecast for world growth in 2020 by one or two tenths, now it is talking about global recession. Boris Johnson was sceptical of containment before he joined in. There is no reason to mock governments or international bodies, but, as Milan Kundera noted in 1995, “man proceeds in the fog”.

There is no other reason for our caution as stated in the previous notes. We are not facing uncertainty, but the Unknown. European GDPs could decline this year by 5 to 9% depending on which country, the United States could post negative growth of a few points and an unemployment rate higher than the record 10% reached in 1982, China could be in recession for a quarter. Many emerging countries are facing massive capital outflows, sending their currencies to fall by more than 20% this year, thus reducing their resources to fight the virus spread while at the same time retaining enough production capacity to support their economy: all this has no recent parallel in history. Not a single economy offers any room for resistance. Now heavily indebted, China can no longer, and no longer wants to play the role of saviour, as it did in 2009 with the implementation of a gigantic fiscal stimulus plan, and it rightly prefers to use the fiscal weapon and target business supports.

In line with our note from last week, we remain convinced that the crisis will be overcome and that a rebound will occur in 2021. One may regret the absence of a common plan at the G20 or European Union level, but one must note the similarity of policies. No government is skimping on support expenditures, between 1.5% of GDP in Italy and 3% in Great Britain. Even Germany is forgetting its budgetary orthodoxy and in one week it has gone from a support plan of Euro 500 billion to Euro 1 trillion, or 30% of GDP in the form of loans, guarantees and measures to finance partial unemployment. Central banks understood that, without enough liquidity to keep rates at zero, the huge fiscal stimuli would push up long rates and feed investor fears about sovereign solvency. Even German long rates had started to increase, and the 10-year Greek rate which had risen from 1% to 4% in just a few days. Very quickly the Fed lowered its rates to zero and confirmed that it would buy $700 billion worth of public and private bonds, then declared that these purchases would be potentially unlimited. The ECB was not to be outdone with a Euros 1 trillion plan, more than 8% of the Eurozone GDP, facilities to banks at -0.75% to enable them to increase loans to companies, and the unprecedented possibility offered to member states to benefit from the European Stability Mechanism, without justifying reorganization measures, up to 2% of their GDP - a pocket of Euros 410 billion, 3.4% of the Eurozone GDP.

For many companies, the current crisis translates into a one to three month business activity suspension, a 20% loss in annual turnover, a much more serious impact on margins and, for many, losses. The 20 to 30% equity indices drop in recent weeks is not an aberration. The most affected sector is Energy because, following the price war initiated by Saudi Arabia with the tacit agreement of Russia, who wanted to put an end to competition from American shale oil, and following the fall in world demand, Brent prices fell from $65 at the beginning of the year to $23/barrel. Unsurprisingly, with 60% of world crude oil demand normally used for transportation, the drastic reduction in activity results in a 10-15% overproduction for the current supply of 100Mb/d. Here again, this is unprecedented: in 2008 overcapacities reached 4 to 5 Mb/d. What next? At a market price of $23, only Saudi oil, at $3/b for extraction, is competitive, but it only makes for 12% of world supply and the country needs a barrel at $80 to balance its budget. Oil companies have been quick to cut their exploration budget by 20%, additional supply will become scarce, demand will increase again with economic recovery and prices will recover, driving up the share prices and allowing a recovery of alternative energy stocks which have been similarly crushed because they have lost their competitiveness.

The Financial sector is the second most impacted sector. Many fear a "remake" of 2008 and bank failures but since then equity capital ratios have been considerably strengthened, credit constraints tightened and major American / European players seem less at risk as governments presently offer their guarantees on corporate loans. Actual risks are borne by non-bank financial players, in particular private equity firms that have abused debt leverage to inflate returns, or hedge funds that have been taking market share from banks over the last ten years. In the Consumer Discretionary sector, the third most affected sector on the stock market, the decline in revenues can approach 60%, or 20% over the year. The recovery will not be V-shaped and in many sectors, such as cruises, hotels and airlines, it will be slow. In Industry, the fourth most downbeat sector on the stock market, interrupted production lines are challenging the year, but we remain confident for the future. In the Buy lists we are working on, these four sectors are the focus of our attention, but we are also looking at sectors that are resisting the downturn, such as Technology and Health Care, as many governments will increase their spending on cyber security, distance learning, telemedicine, research, equipment and care.

A final point remains the expected deterioration of corporates' balance sheets. Good quality borrowers will be helped by governments but their debt will stay on their balance sheets. Between 2000 and 2007, the stock of BBB bonds in the United States represented only 39% of the total, today 51%. Tomorrow significantly less, as quite a few borrowers will lose their investment grade rating.

In conclusion, in the face of such unknowns about the spread of the virus, the risks of its resurgence and the time required to control it and revive economies, it is difficult to be precise about the extent of the recession and the fall in earnings. Volatility will persist as long as a vaccine has not been found, but let's prepare for the future. As ***Voltaire noted, "Doubt is not a pleasant condition, but certainty is an absurd one".***

Bruno Desgardins

Geneva, March 30th, 2020

Bruno Desgardins
Directeur de la Gestion