SingAlliance

Letter n°9

Worsening inequalities and market impacts.

« *Vertigo, collapse, confusion, ruin, woe* » Rimbaud – Les Poètes de sept ans, 37th poem.

Last week in our note, two ideas emerged: globalization was not the cause of the pandemic and therefore deglobalization cannot be a solution for the future. Today, let us put the spotlight on the markets. More oriented to hope, less inclined to vigilance, investors have returned to the stock market, the optimism has been surprisingly rapid and indices have erased some of their losses. We would like to have premonitions, but there is a fear of a slow economic recovery and a turning point in investors' optimism. Let us not be too quick to prejudge, we shall examine the worsening inequalities between states, between companies and between individuals to draw some consequences for the investment strategy.

Worsening inequalities between States :

The correlation between GDP per capita and health spending is undeniable, as is the correlation between a country's financial situation and its ability to recover. The hierarchy within states is thus clear, and with all due respect to the proponents of convergence between states, is only going to be more pronounced. Let us consider Europe and then the rest of the world.

Notwithstanding the ECB's promises to inject up to EUR 1 trillion this year and to offer EUR 540 billion in mutual aid, the widening of bond spreads between countries indicates that the markets are worried about Italy. The spread between the Italian 10-year with the German 10-year was at a low of 1.60% before the crisis and recently reached 2.60%. The prospect of an agreement on a European recovery plan should allow us to expect this spread to narrow. The Italian rating is BBB- and should not be downgraded immediately as the ECB is expected to acquire EUR 220 billion of the EUR 450-500 billion issued by Italy this year. Helping Italy now is less costly than tomorrow if it were to declare itself insolvent.

Within the Eurozone, the hierarchy is clear. Unsurprisingly, Germany stands out for the efficiency of its health care system and the financial resources deployed. Strengthened by its financial situation, its debt reduction since 2012 from 80% of GDP to 61% at the end of 2019, compared with a slight increase in debt in Italy to 135% over the period, Germany is allowing itself to release much more, EUR 1.2 trillion to help companies and support the economy. In other words, the inequality between Germany and Italy will worsen and, when the crisis will be over, Germany's debt will not exceed 75% of GDP, while Italy's debt will reach 155% of GDP, i.e. EUR 2.6 trillion. If Germany's 10-year debt is at -0.45%, France will be at 0%, which is a privilege. The interest burden on the French public debt was only 1.5% of GDP in 2019, Euros 40 billion, and will be even lower in 2020, EUR 36 billion, despite a public debt that will rise from 100% to 115% of GDP. But Germany has a greater capacity for intervention than France and will emerge from the recession more quickly: the equivalent of 38% of GDP offered by the German government in the form of guarantees for companies compared to 14% of GDP in France, the equivalent of 7% of GDP in the form of public aid or tax cuts compared to 2.5% in France.

For the rest of the OECD countries, South Korea will show the least decline, with a slight recession over the year. The country has been able to avoid confinement, limiting the fall in GDP to 1.4% in the first quarter and is showing renewed confidence.

In the emerging world, there are fears of impoverishment: Turkey, South Africa, Brazil and Nigeria have suffered substantial capital outflows, and thus a depreciation of their currencies, and inflationary pressures that are hampering the ability of their central banks to lower interest rates to counter the recession. All of them are suffering from lower remittances from expatriate workers, reduced fiscal capacity and a contraction of their resources, some as a result of falling commodity prices, others because of the disappearance of tourism

revenues. Inequalities within OECD countries are increasing sharply and investment in their local stock markets will be avoided. Given the accumulation of risks and the repayment schedules, $2-$2.3 trillion for high-income developing countries in 2020 and 2021 and $0.7-$1.1 trillion for middle-income and low-income countries, the United Nations Conference on Trade and Development (UNCTAD) proposes the vital need for debt relief or restructuring. It is even worse for sub-Saharan Africa which imports $35 billion worth of food every year and this is now more expensive. A resurgence of famine in the world is feared as 820 million people, 260 million of whom are in Africa, are already suffering from malnutrition. In sub-Saharan Africa, there are 6 to 7x fewer doctors per 1000 inhabitants than in Europe, few beds and respirators, and for the first time in 25 years, the IMF anticipates a recession of -1.5% in 2020. The G20 countries have decided to suspend debt service payments for the world's poorest countries through the end of the year. The idea of cancelling the EUR 340 billion of African public debt is gaining ground but will have to obtain the approval of China, a creditor to the tune of 40%. The IMF cancels an initial six months of debt payments for the world's 25 poorest countries, grants emergency aid to impoverished countries, has an intervention capacity of $1 trillion, four times more than in 2008, but due to the American veto, it could not increase the Special Drawing Rights (SDRs), to allocate more to poor countries. In short, we remain negative on emerging countries and favour developed economies, mainly Europe.

Worsening inequalities between Companies :

As with states, the least indebted companies will be favoured in our allocation. Although many governments offer guarantees on bank loans to companies, but their debt ratios will be higher causing ratings to eventually be lowered, then they will be condemned to restructure, economize, defer investments and lose market share. Conversely, cash-rich companies will be able to make cheap acquisitions and increase market share. For a conservative or balanced portfolio, the choice of securities will be based on this criteria. Diversification towards cyclical stocks that have fallen sharply this year will be purely speculative, one-off purchases limited in percentage terms.

Among the sectors likely to do well, technology, robotics, digital technology and artificial intelligence are coming out on top at this time, contributing to overall productivity gains and accelerating economic transformations. Developments in e-commerce, telemedicine for diagnosis and monitoring, telecommuting, distance learning, remote banking, automatic payments in stores, are all productivity gains for companies. For the same reasons, we will be cautious about the financial, distribution and commercial real estate sectors, as more closures of banks and small businesses materialise, job cuts can be anticipated.

Within each sector, some companies stand out from the others. This is the case in health care, another sector to be overweight. Among others, we can look at Sanofi, Roche, Moderna, which are competing in the race for the Covid-19 vaccine, as well as BioMérieux in diagnostics. In the luxury goods sector, Hermès stands out from LVMH and Kering. Its 7% decline in sales in the first quarter, was half that of the other two, Swatch and Richemont come thereafter. In the automobile sector, among the generalists, we can distinguish Toyota and Volkswagen from Renault, which is seeking state-guaranteed bank loans; among the specialists, Porsche from Aston Martin. Even within the energy sector, contrasts are pronounced. We will avoid all shale oil producers in the United States and Canada, and will buy, with a one-year perspective, Total, which has lowered its break-even point from $100/b in 2014 to $25/b, holds10 billion in cash and a debt ratio of 16%. We can also look at Chevron in the United States, Sinopec in China, which is benefiting from a recovery in demand, and Technip in oil services. All of these companies are cash-rich and have little or no debt. In industrial gases, Air Liquide, which has lost only 7% this year and is confident that its operating margin will increase, is interesting.

To sum up, we maintain the typology presented in a recent note, a tendency to overweight technology, pharmaceuticals, medical equipment manufacturers, food (Nestlé is holding up well with organic growth of 4.3% in the first quarter versus 1.7% for Danone) and energy with a one-year perspective. We are negative on transport, tourism, aeronautics and neutral on telecommunications (we note that Ericsson nevertheless posted an increase in gross margin). This is only a sample of our recommendations, but we are available for more information.

Worsening individual inequalities :

In the United States, ***Angus Deaton***, winner of the 2015 Nobel Prize in Economics, had shown in a very good book, "***The Great Escape***", an increase in mortality among the poor of 45-64 years old, a decrease in life expectancy due to opiate abuse and an increase in suicides since the end of the 1990s in poor states such as

Montana and Louisiana. In the face of the current epidemic, the country has 30 million people without medical insurance, 26 million more people looking for jobs in one month, a probable unemployment rate of 16% at the end of June and a black population particularly affected. All over the world, Covid-19 affects more working-class areas and mortality is higher among disadvantaged groups. In addition to the numerous aid packages promised and detailed in our previous notes, the US government had no other choice this week than to issue an additional $480 billion relief plan, 2.5% of GDP, in favour of small businesses, hospitals and employment. This is on top of the "helicopter money", a distribution of $1,200 per adult. Inspired by a proposal by ***Milton Friedman*** in 1969, this measure was preferred to a tax cut because it is supposed to stimulate consumption more quickly, but the public debt will be aggravated and the budget deficit could reach 18% of GDP, or $3.7 trillion, the highest percentage since 1945. Impoverished, many households will save some of the money distributed, reduce their demand for durable goods in the short term, this will have a negative impact on the valuation of these sectors on the stock market. One example is the automobile industry.

In the rest of the world, ***Abhijit Banerjee*** *and* ***Esther Duflo***, winners of the 2019 Nobel Prize for Economics, remind us, in a very good book published in March, "***Good Economics for hard times***", that the increase in income of the poorest 50% of the world's population was much faster between 1980-2016 than the 49% above them (in particular the middle classes of Europe and the United States). Only the richest 1% remaining have had a faster income growth, with a capture ratio of 27% of the additional GDP. The United Nations reports that the share of people living on less than $1.9 per day has halved since 1990. These improvements are likely to be undone by the pandemic.

Conclusion :

Having had no other purpose than to address the linkages, market impacts and growing inequalities, let's draw some conclusions. In response to growing inequalities between states, debt write-offs for the poorest countries are likely and the IMF is likely to end up acting beyond its current capacity to intervene, which is estimated at $1 trillion. At the European level, there is no pooling of existing debt, but community financing of a recovery plan. Unlike the 2008 crisis, it is not certain that the United States will be the first to return to previous production levels. Symptomatic of this is the lack of appreciation of the USD. For these reasons, the European market deserves to be overweight compared to the US market.

In response to the worsening inequalities between companies, some states could nationalise or temporarily provide financial aid to weakened companies in strategic sectors, some in transport, others in energy, and even tourism in some cases. Faced with rising default rates, banks should avoid state support but will seek to strengthen their capital ratios.

Liquidity injections will trigger new asset price bubbles, this will benefit asset holders who are nevertheless exposed to market volatility. These injections are not expected to cause inflation, except in the unanticipated event of a return to protectionism.

In response to individual inequalities, even if they deny it, governments are likely to increase taxation on wealth with a twofold aim: to finance part of the expenses and to preserve social cohesion at a time that is considered critical.

In other words, the management of the 2020 crisis will be very different from that of 1929, even if the aftermath of the crisis is also characterised by weak demand. No fears of inflation, the speed of reaction of governments, the adaptation of capitalism, the scale of measures, the solutions provided by science, European solidarity rather than narrow parochialism. No naïve optimism, but the interest of each State is well understood. "***States have no soul, they only have interests***" as **Montesquieu** wrote.

Geneva, April 27, 2020

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