Sparinvest

Monthly comment by
Chief Strategist David Bakkegaard Karsbøl

Equity market bloodbath

At the beginning of March, it had become increasingly clear that COVID-19 was turning into a pandemic and that authorities would have to resort to very comprehensive measures to contain the virus and control its spread so that hospitals would not be overwhelmed. The examples of China, Italy (and now also Spain) are scaring equity investors.

Unfortunately, March showed that experience of virus outbreaks did not give a reliable indication of equity market performance. As previously mentioned, authorities have, over the past half century, been able to contain epidemics before they turned into pandemics with a devastating impact on the global economy.

The equity market impact is a result of authority responses, which have involved a lockdown of major parts of the service sectors and some parts of the manufacturing industries because of the requirement of social distancing. Social distancing also has a negative impact on corporate productivity when staff are required to work from home while at the same time looking after their children etc. Economists refer to these effects as "supply effects", as they have an impact on total supply and production.

Another equally important effect is the negative impact of uncertainty about jobs, earnings and spending opportunities on total national demand when businesses are closing in large numbers.

The necessity of the lockdown and its expected duration have caused equity prices to plunge. Actually, the speed of the decline is unprecedented in recent history. Even though the total equity market decline in March was "only" 13%, investors could have doubled their losses, had they bought and sold at the worst possible times during the month.

Very large aid packages

When the global economy is faced with very large negative supply-side and demand-side shocks, finance ministers and central bank governors respond. Finance ministers seek to stimulate the supply by supporting the labour market and earnings by offering wage compensation and subsidies for rent and other fixed costs and initiating public works. Central bank governors seek to underpin demand by lowering interest rates to new, historically extreme lows and expanding asset purchase programmes without a defined "end destination".

Already in the wake of the financial crisis, and in response to almost constantly declining inflation expectations, central banks have taken extraordinary monetary policy easing measures, while finance ministers – particularly in Southern Europe – have not yet burnt off the debts from the crisis, despite a fair amount of fiscal conservatism.

Therefore, the room of manoeuvre of political decision-makers has reached panic dimensions by now, and as observers, we risk becoming "speed-blind" because of the size of the amounts communicated by the politicians. What were last year "huge amounts", causing political negotiations to drag on or collapse, now seem to be peanuts that disappear into oblivion after a few strokes of a pen on a political deal. This applies in Denmark as well as abroad.

Has anyone seen the European collaboration?

The Danish economy stands strong at the start of this crisis – households, the banking sector and the central government have significantly lower debts and lower funding costs than at the start of the financial crisis, but this is definitely not the case in Italy and Spain, which are therefore exceptionally hard hit by the current crisis.

To spell it out, all budgetary discipline and all Eurozone requirements have gone down the drain a long time ago. What remains to be seen is the facial expressions of the Germans and the Dutch when they get the bill for the Southern European problems. Even though Denmark is not part of the Banking Union or the Eurozone, we will probably be footing part of the bill as usual.

It is hard to imagine the European collaboration failing more horribly that it does right now. Several countries have announced national export bans on key medicines, medical equipment and protective equipment for hospitals – even within the EU. Italy and Spain have had to resort to supplies from China, which knows how to cause trouble in the European collaboration. At the same time, even Italian pro-Europeans have started sounding like Matteo Salvini, leader of the Eurosceptic League party. Even Mario Monti, one of Italy's most respected and serious centre-left figures (and former Prime Minister), flat out warned Germany in one of Italy's largest dailies, Corriere della Sera.

According to Mr Monti, there is a risk that the Southern European countries will vote over the heads of the Germans in the European Central Bank (ECB) to print money to pay their bills. So if Northern Europe will not voluntarily send money through fiscal policy, they may (other things being equal) be forced to pay through higher inflation caused by a monetary policy revolution.

Have inflation expectations bottomed out?

Sometimes it is useful to take one-step away from the market to get a broader view. The day-to-day development is not so hard to understand if you read the headlines, but you risk being carried away by the same panic, fear, greed or joy as the rest of the market participants.

Doing this exercise these past few months, I inevitably end up concluding that especially inflation expectations seem unsustainably low. That was my opinion even before the coronavirus outbreak when the so-called 5Y5Y euro inflation swaps were trading at 1.2-1.3% (i.e. the average inflation level expected by markets in the period 5 years from now to 10 years from now).

After the coronavirus outbreak, 5Y5Y inflation swaps have dropped to an extreme low of 0.7%. The announcement of the ECB's asset purchase programme has subsequently caused them to rise to about 1%, but this is still far below normal and far below the ECB's 2% target.

Very few countries (besides Germany) would be unhappy about higher inflation and inflation expectations. Also, funding the huge aid packages required by printing more money would, in the short term, be the least painful approach. We cannot raise taxes in Europe; they are already so high that raising them would harm growth and employment (and consequently tax revenues). It is also hard to see how the already strained European bond markets should be able to absorb more giant issues, so the help of the printing press will be needed, as also indicated by Mr Monti.

In my opinion, investors will therefore have to prepare for an upward inflation outlook – after four decades of almost constant declines. Such an outlook would normally cause interest rates to rise, but higher rates in the current climate is probably the last thing that central banks would accept, and with ever changeable monetary policies, rates are set to remain relatively low for quite a while yet.

A higher inflation outlook is likely to be good news for commodities, which have been permanently unattractive investment objects since the financial crisis. Real estate and equity markets in general will also – all other things being equal – benefit from higher inflation.

Does the U.S. have it under control?

One of my main concerns is whether the U.S. has the coronavirus under control. President Trump may have closed the borders to Chinese nationals soon after the virus broke out, but apart from that, he did not do much to prepare for its arrival in the U.S. Now the virus is spreading rapidly, and the U.S. is set to be hit very hard. As the U.S. equity market makes up more than half the global market, the virus' spread in the U.S. will have a major impact on global investor confidence.

The individualistic culture of the U.S., which I usually praise, could also prevent the implementation of effective measures against the spread of the virus. Add to this the somewhat fragmented approach and lack of coordination between states.

Equity allocation

The momentum and volatility indicator (MomVol) has gone down quite a lot since end-February and is now below the threshold value of 0.6, for which reason we may expect weak equity markets in April, other things being equal. The publication of the OECD leading indicator for the entire OECD area has been suspended due to the coronavirus, and there is reason to believe that the upward trend that could be discerned up to and including the last value published would now be strongly misleading. So because of the negative momentum and the strong uncertainty surrounding the coronavirus, I recommend that investors in the near term underweight equities and risky assets relative to their long-term target allocation.

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