Sparinvest

Monthly comment by
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# Equities rising on expectations of reopening of economies

Equity markets and other risky asset classes delivered very high returns in April. The MSCI World Index (EUR) gained 11.1% in April. High-yield corporate bonds increased by about 4.5%, albeit with major differences between sectors. Bonds issued by energy companies, travel agencies, airlines, etc had an extremely hard time in April, and several prices reflect very high default risk, impending conversions to share capital or other reconstructions.

The relatively strong rally in equity markets is generally due to a continuation of recent years' trends in factors. From a factor perspective, investors have thus continued their belt-and-braces approach and sought out large shares, which are generally expected to have easier access to capital markets and therefore to be less risky than other shares during a dramatic economic downturn. In addition, Value shares are still underperforming the broad market, most likely because investors still regard them as more risky than other types of shares.

In return, the performance in Growth shares (where the main part of earnings and thus the investment rationale are expected to lie further into the future) has been so strong that their already expensive pricing has become further strained. The so-called Minimum Volatility shares, which are more defensive, delivered decent returns until the end of April when the trend shifted markedly. It is interesting to note that the Small Cap segment actually delivered a significant excess return in the last few days of April, which could indicate a reversal of this trend.

The rebound of the broad equity market to the level it was trading at in mid-2019 should be seen as an indication that equity investors expect that the current, very deep decline in economic activity is highly temporary and that, within a few weeks, we will see a general reopening of the economies, the majority of which have managed to contain the coronavirus.

## Coronavirus outbreak contained – for now

In most countries by far, the virus outbreak appears to have been contained, which also ought to be the case given the draconian measures taken against it. With the current trend in the numbers of infected, hospitalisations and deaths, it appears that the majority of the hardest hit (and thus important) countries will have close to zero new cases, hospitalised persons and deaths, if we fast-forward to a few weeks from now.

But close to zero does not equal zero, and most authorities and analysts probably realised weeks ago that hoping for complete eradication of the coronavirus is futile given its wide spreading globally. Therefore, the near future will bring a slow reopening of economies and rollback of the authorities' restrictions on gatherings, cafés, restaurants, transport, etc, which in turn is likely to result in more, local outbreaks.

This has been the case in Singapore, for example. Having learned from the lesson of the SARS epidemic, they have handled the covid-19 outbreak far more effectively than many other countries. In spite of this, Singapore has experienced a large, local outbreak among foreign construction workers, whom the authorities had not given the same degree of attention. For this reason, the authorities' aim will be to implement very extensive and continuous testing of the population and to track and isolate infected persons.

The communities' – and the virus's – sensitivity to changes in government regulation is subject to a fair amount of uncertainty. How soon will we be seeing renewed outbreaks, and how severe will they be? This is the implicit question investors should ask themselves and be given some kind of answer to. In my opinion, the markets – especially equity markets – are fairly optimistic at present as regards the authorities' ability to manage a controlled reopening of economies and keep the subsequent outbreaks at a tolerable level.

Another aspect that contributes to increasing the probability of a controlled reopening is the clinical trial results for the broad-spectrum antiviral agent Remdesivir announced in late April. Preliminary results indicate that Remdesivir contributes to reducing the time to recovery of hospitalised patients with advanced covid-19 from 15 to 11 days. Remdesivir also appears to reduce the fatality rate of coronavirus, although the effect is statistically insignificant. Based on the available data, Remdesivir can apparently reduce the need for hospitalisation considerably, thereby countering the much-feared pressure on the health care system.

## Central banks' limitless monetary policy

In recent weeks, central banks - taught by the financial crisis - have stepped in with extremely extensive measures aimed at supporting the locked-down economies. The Federal Reserve, for example, is launching a purchase programme of up to USD 3.2 trillion so far. Not wanting to tire the reader of this monthly comment, suffice it to say that the scale of these programmes is unprecedented and almost defies description.

The size of the purchase programmes and the central banks' accommodative stance are probably the primary drivers of the relatively high returns on risky assets in April and, so far, nothing suggests that the central banks will withdraw the generous helping hand that is cushioning the markets any time soon.

## Abysmal drop in economic activity

As mentioned above, global activity has dropped faster and deeper than ever before in recent history as a result of the lockdown. Despite intentions to keep trade going, global trade has declined dramatically. Unemployment, particularly in the service industry, has exploded, and airlines across the world have gone bankrupt or are on the brink of collapse.

Inventories of consumer goods are piling up. Oil inventories are bulging (see below), and credit spreads of the hardest hit sectors (energy and airlines) are now at higher levels than during the financial crisis. No matter how easy the monetary policy pursued by central banks and no matter the size of the relief packages launched by governments round the world, it will not change the fact that we will see a host of bankruptcies in the very hard-hit business sector.

Even if we may soon find encouragement in specific leading indicators, such as building permits, it will therefore make no sense to place confidence in them to any major extent. More than anything else, the speed with which the lockdown of the economies is rolled back will determine the growth rates over the coming quarters.

## What is the impact of a negative oil price?

At the end of April, we witnessed a negative oil price for the first time in history, namely the price of West Texas Intermediate crude oil, as the March contract for delivery in Cushing, Oklahoma, expired. Some holders of these futures contracts probably did not understand the risk of owning them, as they also imply an obligation to take delivery of oil. Some of the holders of the contracts have had them to speculate in oil prices or to hedge a risk, and all of a sudden, they were unable to find buyers of the contracts and therefore assumed the obligation to take delivery of the oil. As the local storage capacity in Cushing was almost fully utilised, negative prices were required to persuade those with remaining storage capacity to receive the oil.

The price of WTI crude oil turning negative was probably related to the general weakening of the demand for oil, but it was, to the same extent, caused by a local dynamic setting in. North Sea oil (Brent crude oil), which is traded for delivery in no less than five different places and where delivery may take place by tanker (as opposed to pipelines etc), will probably never experience negative prices in the same way. That said, energy prices are at their lowest levels for decades, causing huge problems for the energy sector. Overall, however, lower input costs are a benefit for the world economy.

## R0 – the new measure to watch

As economic activity and thereby returns in the various asset classes will depend on the speed with which economies are reopened, it will be necessary to monitor the so-called R0 number. In an epidemiological context, this number indicates how many new cases one infected person generates. Before the lockdown, R0 was significantly higher than 1, causing growth in the infection rate of 30-40% per day. The lockdown caused R0 to decrease to below 1, and the number of new cases and deaths has therefore seen a fairly constant, downward trend since February or March (depending on the country).

Now that decision-makers are fairly confident that the spread of the virus is under control, the extremely costly, economic lockdown must be rolled back (albeit with some restrictions), whereby R0 must be expected to increase. Accordingly, an R0 above 1 once again is not unthinkable, but if it increases rapidly to a level significantly above 1, it would cause a highly undesirable setback for the business sector, which cannot withstand additional months of lockdown.

A significant increase in the R0 is therefore the main risk for investors in the coming months.

# Equity allocation

The momentum and volatility indicator (MomVol) rose slightly in April, but remains significantly below the threshold value of 0.6, for which reason we may expect weak equity markets in May, other things being equal. The release of the OECD's composite leading indicators (CLI) for the entire OECD area is no longer suspended due to the coronavirus, but according to the OECD, the CLI cannot be expected to be a leading indicator in the current economic environment, which depends more on political decisions. In other words, the CLI is not a reliable indicator in the immediate future, although one should observe its movements.

As the central banks' monetary policy will support risky asset classes to such a large extent, and as we are facing a gradual reopening of economies, I will expect to see higher returns in risky asset classes than in lower-risk government and covered bonds. However, the MomVol indicator remains quite low and therefore cannot be relied upon for investment decisions. My overall recommendation to investors for May is a neutral equity allocation relative to their long-term target allocation.

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