Investing in the age of coronavirus

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During the four months after a Chinese province reported the first cases of an as-yet unnamed viral infection, the world's equity market indices slumped by an average of 35% in one month, before recouping their losses (with the Nasdaq even ending higher) in the next two months. These astounding swings reflected a no less astounding sequence of events. First came the decision by governments to put half the global economy in an artificial coma in a bid to stop the coronavirus from spreading. Then, from mid-March onwards, an unprecedented arsenal of fiscal and monetary policy support policies was deployed in order to tackle the consequences of that decision.

Issuing economic forecasts under these extraordinary circumstances would be highly presumptuous, as it would require forecasting how the virus itself will play out – something most epidemiologists are unwilling to do. The job of predicting stock-market trends might seem much easier in comparison. Economic uncertainty clearly has little bearing here, given that unconditional central-bank support has become simultaneously the driver, parachute and barometer of those trends to a previously unheard-of degree.

In the short term, to navigate these choppy market seas we need to view changes in government intervention as our compass, and economic uncertainty as our horizon.

In the medium term, somewhere between the extremes of "Nothing new under the sun" and "Nothing will ever be the same again", we may see a more subtle reality emerging that will have momentous implications for investors.

The world has gone Keynesian

In response to the Great Recession of 2008, most Western governments left central banks [illegible] the task of reviving the economy through unconventional policies that consisted of massively buying bonds. The resulting injection of liquidity into the financial system [illegible] markets, but neither the real economy nor the inflation outlook managed to pick up enough steam to allow central bankers to take their foot off the stimulus pedal, as their relative attempt to do so in 2018 starkly demonstrated. What explains that relative macroeconomic failure is that, while subsidised interest rates made it possible to avoid the worst, they didn't provide much incentive to invest for companies and governments whose top priority was deleveraging (or even pursuing extreme forms of fiscal austerity in the kind imposed on southern Europe). This time truly is different, however. Owning up to their responsibilities, the governments that took the decision to put private-sector spending in deep freeze resigned themselves to a huge increase in public spending. The US Federal budget deficit is likely to rise to nearly 20% of GDP by year-end, while the aggregate eurozone deficit should reach 10%. The world has gone Keynesian. And this time, central-bank asset-buying is the logical companion to those spending programmes in that it makes them easier to finance.

Such extensive coordination between fiscal and monetary policy obviously throws up a whole heap of questions. In fact, it's beginning to look a great deal like outright "monetisation" of what promise to be exorbitant public debt levels. This eventuality, which we already discussed in our previous Note in April, (« **Holding steady** »), is what led us to add large gold-mining holdings to our global portfolios, for example.

Moreover, by increasing the importance of public investment for GDP growth, the new state of play also signals a shift in the macroeconomic landscape that will be crucial for investors. It's too soon to gauge how effective those public investments will be, but if past experience is any guide, they may well prove detrimental to productivity. Diverting available capital away from private-sector investment to fund projects with uncertain profit-generating prospects has rarely been conducive to growth. Specific, large-scale environmental projects might, however, be an exception to the rule if they adroitly involve the private sector so as to combine responsible investment with economic benefits. Several of our funds are heavily invested in this theme.

At the time of writing, US fiscal stimulus is equivalent to nearly 15% of GDP, most of it in the form of direct grants. The European Commission's proposed recovery plan is more modest in scope (however tricky such comparisons can be). Furthermore, before it can be implemented in 2021, it will have to make it past the European Parliament and member-state legislative bodies, some of which may put up a fuss. Even so, this amounts to a first-ever proposal for fiscal transfer jointly sponsored by France and Germany, and fully deserves the warm reception it has received from the stock market.

The economy is being "re-opened" although the risk of contagion is still there

Both the belated response by most governments (Taiwan being a notable exception) and the highly contagious nature of Covid-19, especially when compared with the SARS epidemic in 2003, paved the way this time for an extremely swift, global spread of the virus, despite the drastic lockdown measures. Over six million people worldwide have been infected. This means that, in contrast to what was done in 2003, it will be impossible to stay in lockdown until the infection rate declines to zero. The economic cost would simply be too high. So the economy is being "re-opened" although the risk of contagion is still there. True, as the lockdown is gradually lifted and aggressive financial support policies kick in, consumer spending will certainly bounce back in the third quarter after being largely on ice for months. That process of re-opening the economy is to a large extent what financial markets have been celebrating over the past month.

But even with such a welcome revival, is there any reason to imagine that industries catering to large crowds of people – starting with air travel and mass tourism – can simply pick up where they left off as long as social distancing remains a primary concern? It's worth recalling that even in countries like Taiwan and Sweden that refrained from lockdowns, the behaviours adopted to avoid contagion were enough to depress ordinary consumer spending. (In Sweden, for example, clothing sales slumped 35% in March.) Another crucial difference with the SARS epidemic in 2003 is that this one has spread to the entire planet. Every country thus has a strong incentive to limit its interaction with other nations until the virus has been tamed around the world (and how long the discovery, approval and global distribution of an effective vaccine will take is anyone's guess).

Along with fear of contagion, a further obstacle to the resumption of consumer spending is fear about the economic future. With the US savings rate at just 8% of GDP last year, people will almost inevitably increase their precautionary savings in the face of soaring jobless figures. In broader terms, even though the country's labour market can both expand and contract flexibly, the US economy will necessarily take a beating from the loss of disposable income and the trauma associated with some 40 million redundancies in just a few weeks – not to mention the 100,000 deaths caused by the epidemic. The US consumer confidence index has sunk from 130 at the start of the year to 86.6 in May. In Europe as well, it seems likely that companies will rapidly go into cost-cutting mode and that more precarious employment conditions will lead workers to favour precautionary savings over discretionary spending. The European Commission reckons the eurozone savings rate will rise from 12.8% in 2019 to 19% this year.

The current crisis is expected to accelerate the relentless natural selection process under way for several years now

This conversion to frugality, also a probable response by companies, will not only have macroeconomic repercussions; it will also shift economic activity even further towards the least expensive, most efficient and safest approaches to communicating, retailing, working and teaching.

The current crisis can therefore be expected to accelerate the relentless natural selection process under way for several years now. Companies that have built up commanding positions by leveraging their technological lead to enhance their customer offerings will fare quite well in tomorrow's low-growth environment. For less flexible, heavily capital-intensive firms with shaky balance sheets, grave danger lies ahead. Those factors are what has driven tech stocks' outperformance since the beginning of the year. And while this is merely a reinforcement of an already existing secular trend, we would be mistaken to believe it's been fully priced in by markets. As before, what is called for here of course is careful stock-picking.

The need for a two-pronged strategy

The severity of the shock affecting most economies should not be underestimated. As with earthquakes, we can't entirely rule out aftershocks following a period of quiescence. What appear to be inconsequential cracks today may subsequently develop into full-blown ruptures. A good many companies – as well as countries – are facing looming solvency crises. Moreover, no one can really predict to what extent domestic economic tensions in the United States, China or elsewhere might spark social and political turmoil, or even encourage aggressive foreign policies. In politics, as Alexis de Tocqueville wrote, what is often hardest to assess is what is occurring right before our eyes.

That said, not only will the most agile, technologically advanced firms emerge from the crisis in better shape than before, but natural selection will produce winners even in the hardest-hit sectors. Think of air travel: the more efficient airlines will survive and even thrive on the tribulations of their less fortunate competitors as soon as the economy begins to perk up. And yet such subtleties are hardly reflected in investor positioning and investment flows since the start of the year. As investors, we therefore need to pursue a two-pronged strategy to deal with the extreme uncertainty created by the coronavirus outbreak. That means narrowing our portfolios down primarily to long-term strategic winners, while keeping an eye out for pockets of instability no less than for tactical opportunities.

Source: Carmignac, Bloomberg, 31/05/2020

Investment strategy

Equities

Investors are facing two alternative outcomes: a serious disappointment about the shape of the economic recovery after today's unprecedented deflationary shock, or a reflation dynamic unleashed by unlimited central-bank and government intervention aimed at sustaining investment and consumption. After moving with no clear direction in April and May, equity markets staged an impressive rally driven by clearcut improvement in sentiment as a number of economies geared up for re-opening.

This backdrop has led us in the past few weeks to favour a more flexible, liquid asset allocation, with our core portfolio still focused primarily on names whose good secular growth prospects should enable them to survive in a low-growth environment. Indeed, we believe investors today tend to underestimate the risk of disappointing macroeconomic data. The shares of those companies we have chosen for our portfolio are further being buoyed by the structural shift in consumer spending patterns that the current crisis has accelerated, as digital transformation gathers momentum in retail (including groceries), healthcare and entertainment.

But given the outlook for a recovery of economic activity, the various stimulus programmes implemented by policymakers and the indiscriminate market corrections affecting cyclical stocks, we decided to resume our selective exposure to quality names in sectors like travel (via Amadeus, Safran and Booking) that have experienced a temporary suspension of their business. We also sought to take advantage of the brighter investor sentiment by investing in sector and regional indices in an opportunistic, liquidity-oriented manner. When the market bottomed out, we started gradually lifting our equity exposure to a high level by the end of May. On the whole, however, we are maintaining a cautious stance in what remains an unstable market environment.

Fixed income

Much like equity markets, fixed-income markets have been oscillating between fears over deflation and default and hopes for a reflation trend fuelled by central-bank and government intervention. Progress in Europe towards a recovery plan totalling €750 billion – including €500 billion worth of grants – enabled investors to make up their minds, with the result that non-core eurozone sovereign paper and corporate credit have rallied. In response, we have been managing our fixed-income portfolios actively and flexibly. Following sharp disruptions to the credit market, we moved swiftly to re-expose our portfolios to four key themes: short maturities in the United States, long maturities in European investment-grade bonds, bank bonds, and companies affected by the Covid-19 crisis, whose valuations reflect an excessive view of the risks.

In sovereign bonds, we are maintaining our preference for countries like the United Sates where the central bank still has adequate running room. In the eurozone, after we initially steered clear of non-core sovereigns, the diminishing risk of a breakup of the currency bloc led us to invest once again in Italian debt, while reducing our exposure to safe-haven German debt. Further caution remains a must in relation to the emerging world, particularly to the more fragile economies with high exposure to commodities and/or current-account deficits. However, we continue to favour debt denominated in foreign currency that offers handsome returns. A good example is Romania, a country set to benefit from the EU recovery fund

Currencies

After drawing considerable investor demand as both a means of payment and reserve currency, the US dollar corrected in response to the Fed's intervention, and has subsequently moved rather trendlessly within a narrow range. The euro meanwhile has been buoyed by the progress made by EU member states towards a coordinated recovery plan. For the time being, we are maintaining low exposure to EM currencies now that over a hundred countries have applied for IMF emergency assistance.

As before, our currency allocation favours the euro, the reference currency for our Funds. However, gold remains the key winner today, and could well be bolstered further by mounting distrust in paper money as governments openly print large quantities of it to pay for fiscal deficits. This suggests we may be heading for a phase of monetary instability that could work to the advantage of tangible assets – including gold.

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