



## The cost of fear

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Periods of panic are the mirror image of periods of exuberance. They take their start from concrete facts which are then escalated into extreme anticipations

**How should we interpret the abrupt correction that hit equity markets at the end of February, whereas they had previously stood up remarkably well to the Covid-19 epidemic? And how should we respond as investors?**

Coming as it has as a complete surprise, the new virus is a sort of “black swan”. Not necessarily because it’s devastating, but because we have too little in the way of comparable precedents to be able to draw any instructive parallels. The novel coronavirus can apparently be spread quite easily by people who may not show symptoms of the disease, which makes it harder to contain than the SARS or MERS outbreaks. How little we know at this stage about the virus is obviously a major problem, but looking at the growth in the number of cases of infection (an imperative for epidemiologists) nonetheless provides a degree of insight into the epidemic’s trajectory.



In China, the initial phase of exponential growth typical of epidemics rapidly gave way to a subsequent slowdown phase – thanks in no small part to the drastic measures adopted by the Beijing authorities. That explains why financial markets continued to fare well until mid-February. From then on, however, the virus spread to other countries due to the initial porosity of China’s borders and the length of the incubation period. As those countries entered their initial phase of exponential increase in infection rates, the spectre of epidemic began to loom large in the western world.

The emotions that tend to surface as such risks get closer to home are clearly powerful enough to generate major stress reactions in the public. Those reactions in turn exert considerable pressure on governments and businesses to introduce extraordinary prevention and control policies (like shutting down public places, cancelling events and travel, and confining infected persons) that can undoubtedly help contain the spread of the disease, but have a disastrous short-term impact on economic activity. In other words, the current market panic reflects fear over the economic cost of Covid-19, which is due in large part to the public health precautions adopted to effectively stem the epidemic.

Periods of panic are the mirror image of periods of exuberance. They take their start from concrete facts which are then escalated into extreme anticipations as people fall victim to groupthink in reacting to the unknown. So before going into the possible outcomes, we feel it is worth putting the recent sequence of events into perspective.

## Unlike 2008, the Covid-19 outbreak constitutes an exogenous, rather than endogenous, shock – and should therefore be viewed as temporary, however damaging

An essential point is that the current health crisis constitutes an exogenous shock similar to the 9/11 terrorist attacks in 2001 and the Fukushima disaster in 2011, rather than an endogenous shock like the 2008 credit crisis, which grew out of deep economic imbalances that by definition can't be corrected quickly or easily. This suggests to us that, assuming the current health crisis doesn't spin totally out of control, we should view it as a temporary phenomenon (however damaging) and start thinking as of now about the economic panorama likely to come afterwards and how financial markets will be affected.

### The coronavirus outbreak has occurred against a very specific economic and financial backdrop

It should be recalled that, in the last quarter of 2019, the US Federal Reserve and other leading central banks began serving up a highly explosive cocktail. In addition to rock-bottom interest rates, their policies included an out-and-out return to expanding the money supply (by making cash purchases of fixed-income assets in the market). The result was to drive markets up to historic heights over a five-month period. The downside of this exceptional central-bank activism is that the Fed is now reluctant to shift those policies into overdrive in order to let investors know that they can count on the US central bank to prop up markets even after a few days of swoon. So while hopes for a few cuts to the Federal Funds rate have revived, it would be a mistake to overestimate the impact of those hopes on an economy in the throes of pandemic angst. That explains why markets plummeted so dramatically in late February from their previous heights.

At the start of the year, leading indicators for the global business cycle pointed to stabilisation or even a mild pickup following the significant slowdown in manufacturing during the two previous years. Due to its high sensitivity to cyclical trends, the European economy was in a good position to reap the benefits of that brighter outlook, particularly in sectors catering to emerging-market demand. Europe's strong links to China have thus led to a double whammy: not only has the continent's economic activity suffered an immediate demand and supply shock affecting a major trading partner, but it also has fairly direct exposure to the spreading virus itself. Even if the public health issue gets resolved quickly, Europe – a region with a more open economy than in the United States – will be at the mercy of China's success or failure at kick-starting its own growth engine.

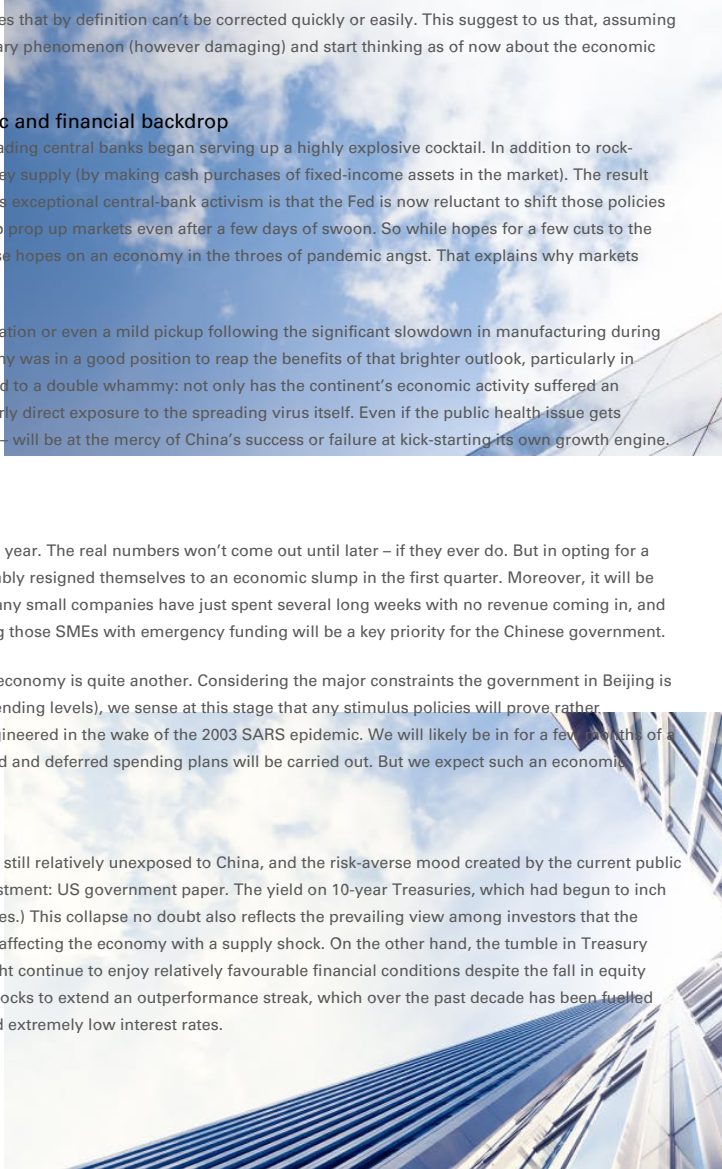
### How high are the chances of an economic upswing in China?

It is now an established fact that the Chinese economy suddenly tanked at the start of the year. The real numbers won't come out until later – if they ever do. But in opting for a drastic approach to stemming the spread of Covid-19, the Beijing authorities unquestionably resigned themselves to an economic slump in the first quarter. Moreover, it will be impossible to make up for much of the damage inflicted on the service sector. A good many small companies have just spent several long weeks with no revenue coming in, and are almost certainly facing a serious cash crunch. So we can safely assume that providing those SMEs with emergency funding will be a key priority for the Chinese government.

However, targeted financial support is one thing; a large-scale programme to reboot the economy is quite another. Considering the major constraints the government in Beijing is saddled with, both external (foreign exchange and trade) and internal (debt and fiscal spending levels), we sense at this stage that any stimulus policies will prove rather disappointing, with much less traction on the global business cycle than the stimulus engineered in the wake of the 2003 SARS epidemic. We will likely be in for a few months of a post-crisis "technical" economic rebound – if only because inventories will be replenished and deferred spending plans will be carried out. But we expect such an economic recovery to be at best U-shaped rather than V-shaped.

### American exceptionalism gets a new lease of life

The United States enjoys two notable economic and financial advantages. Its economy is still relatively unexposed to China, and the risk-averse mood created by the current public health crisis has triggered capital inflows into what remains the ultimate safe-haven investment: US government paper. The yield on 10-year Treasuries, which had begun to inch up at year-end, sank to a record 1.15% low on 29 February. (Yields move inversely to prices.) This collapse no doubt also reflects the prevailing view among investors that the health crisis will first trigger a brutal demand shock – with a deflationary impact – before affecting the economy with a supply shock. On the other hand, the tumble in Treasury yields will also spill over in part to mortgage rates. The upshot is that US consumers might continue to enjoy relatively favourable financial conditions despite the fall in equity and credit markets. The country's privileged position should enable leading US growth stocks to extend an outperformance streak, which over the past decade has been fuelled primarily by those companies' robust business models at a time of weak GDP growth and extremely low interest rates.



## The market outlook

In theory, financial markets can endlessly defy the laws of gravity, as there is no formal limit to how much central banks can expand the money supply, which automatically raises equity risk premia. But in practice, it's impossible to ignore the effects of gravity. The record stock-market rally in 2019 – despite this being a “lost year” of virtually flat average earnings growth at listed companies – led to a degree of technical fragility that was continually in danger of setting off bouts of instability. The coronavirus outbreak was thus experienced as a “cassus belli”.

As previously mentioned, the Fed will be reluctant to ease monetary policy much further in the short run. What is more, if a lasting supply shock were to come on top of the demand shock, fiscal spending would be required anyway in addition to monetary policy intervention. For now, the market instability is likely to persist, in any case as long as the epidemic is still in the peak-anxiety acceleration phase outside of China. This period should ultimately be followed by a period of relief when the public health situation gradually returns to normal. But the key issue in short order will be implementing monetary and fiscal policies that are powerful enough to repair the damage to confidence, to supply chains and to investment.

Greater use of the fiscal spending weapon is still far from garnering consensus in Europe and seems constrained in China. But in the US it doesn't appear to spook any of the presidential candidates. This suggests that the United States might be the first country to take decisive fiscal action – and in tandem with renewed monetary policy easing. If that scenario were to materialise, it just might entail significant US dollar depreciation.

It's human nature to seek insurance after a storm breaks, while wishing that you'd done it sooner. But if the current public health crisis turns out, as we expect, to be a relatively short-lived shock, we feel the most suitable approach for investors at the present time is to maintain moderate equity exposure – while actively adjusting it so as at least to cushion the impact of market instability, and above all to make sure that earnings growth at companies in their portfolios remain high-quality and robust in any eventuality. It is worth pointing out that both the United States and China offer quite a few companies – in healthcare, biotech, connected consumer goods and tech in general – that meet those standards and that have suddenly begun trading at very reasonable prices in a medium-term perspective.



Our strategic preference for growth stocks is in no way an empty, common-sense boilerplate

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In government bonds as well, it makes sense to keep modified duration within limits, but to actively manage it due to the low yields on offer. In corporate credit, we may be seeing dislocations, and this might create attractive arbitrage opportunities. Lastly, holding assets correlated to gold prices is a good way to protect portfolios from a possible decline in the intrinsic value of the US dollar.

Source: Carmignac, Bloomberg, 29/02/2020



## Investment strategy

### Equities

Equity markets have been badly shaken over the past few weeks as concerns about a Chinese epidemic have devolved into panic-driven fear of a pandemic. Market movements have been exceptionally abrupt and extreme. The VIX Index, which reflects expectations of day-to-day stock-market volatility for the coming weeks, has jumped to unusually high levels. The severity of those market movements has been accentuated by the already high equity-index valuations and relatively aggressive investor positioning.

Given how volatile the market environment is, how uncertain the outlook for economic growth is and how hard it is to determine if and when the economy will pick up, we consider it important for equity investors to focus on companies with the most visible earnings growth prospects and to steer clear of those with the heaviest debt loads, as even a brief interruption of business activity could put some of them under a serious cash strain.

Furthermore, we suspect that the responses to the current exogenous shock will come first in the form of even more accommodative monetary policies rather than through any loosening of the fiscal purse-strings. If such a shift does take place, it is likely to support the relative performance of stocks with good earnings visibility.

A robust portfolio composed of solid names with predictable earnings growth throughout the business cycle is therefore the approach best suited in our opinion to what is likely to remain an unstable market environment. That approach also needs to be enhanced with active equity exposure.

### Fixed income

The latest fall in interest rates, a reflection of the threat to economic growth from the new strain of coronavirus, has also been gathering momentum – thereby amplifying a multi-year trend. While long-term yields have sunk to an all-time low, markets have also pre-empted central-bank action, already pricing in a series of rate cuts which they wager will commence in the next few weeks. In response, we have shifted to a technical approach to managing our exposure to the core government bonds considered haven investments by investors. We have gradually upped our exposure to German and US debt during the recent period and will continue to do so, given that bond markets have moved well in advance, as they often do. In non-core sovereign debt markets, we have gradually scaled back our exposure to bonds from the eurozone periphery as yields head downwards.

Spreads in the corporate bond market, previously a fairly sheltered segment, show signs of worsening. We will accordingly maintain our investment focus on select issuers and issues and stick with our cautious approach to market risk as a whole. The same goes for emerging-market debt, where the increase in risk premia since the beginning of the year has been for the most part offset by lower interest rates. EM sovereign debt and credit indices show positive performance that leaves them potentially vulnerable.

### Currencies

Foreign inflows into US financial assets since the start of the year have kept the greenback high. The crucial factor influencing the dollar's strength is that US Treasuries remain attractive due to their safe-haven status and to the country's more vigorous GDP growth rate.

We feel that this trend could change in the coming months, however. For one thing, there has already been a drop in yields on US bonds that makes them less attractive in relative terms. For another, as the central bank with the most room for monetary policy easing, the Federal Reserve could be inclined to do more than its European and Asian counterparts – thereby weakening the US dollar in the process.

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