# MARKET COMMENTARY

بنك الامارات للاستثمار

EMIRATES INVESTMENT BANK

## Broad-based selloff

As a result of the adverse economic impact brought on by the novel coronavirus, the end of the longest financial market expansion in history has been swift and brutal. In less than one month, the S&P lost 33% of its market value, while the Euro Stoxx 50 and the MSCI Emerging Markets are down 41% and 35% respectively.

The ride has been very volatile with liquidity drying up across many asset classes, especially fixed-income. After trading around 20% for most of the last 12 months, the volatility gauge VIX has taken off like a rocket in the last few weeks. Since February 24th, the average daily movement for the DJIA – up or down – has been 5.33%!!!

Such has been the speed and intensity of the drop that many investors have been unable to reduce risk, and global loss of investor wealth is estimated at $ 20 trillion.

So where do we go from here?

In order to answer this question, we must know where we stand. At this time, most industry veterans would agree that the financial markets are better off than in 2008. The infrastructure of the financial system is not failing, processes have been put in place, and there are fundamental, logical reasons for the market to fall.

Central Banks and governments have stepped in quickly and substantially to mitigate the damage. Some of the significant measures taken are a cut in rates by the US Federal Reserve of a combined 150 bps, the injection of USD 1.5 trillion of liquidity, and a restart of asset purchases by another $ 700 billion. The ECB launched a EUR 750 billion Pandemic Emergency Purchase Program, while the BOE cut rates to a record-low 0.1% and restarted QE. Meanwhile, fiscal easing and/or bank lending guarantees were announced by the UK, Spain, France, Italy, Canada and Central Europe.

## Near-term recession a consensus view

Despite these massive monetary and fiscal stimulus programmes, there seems to be consensus that a near-term recession is inevitable. The vulnerability of major economies, including the U.S., has risen as growth has slowed and the ability to absorb shocks has diminished. The impact that it has on the economy will depend on (a) how deep will it be? And (b) how long will it go on for?

If we look at the history of the impact of prior epidemics – SARS, the 1968 H3N2 ("Hong Kong") flu, 1958 H2N2 ("Asian") flu, and the 1918 Spanish flu – in almost every case the recovery path has been V-shaped.

Several economists are expecting a similar impact for Covid-19, with a contraction in GDP of c 5% in Q1 and a more severe one in Q2, should a treatment not be found in the interim period. This will likely be followed by a rapid recovery in the next several quarters. This is based on the expectation that the infection rate will peak in late April/early May, with the additional possibility of meaningful progress on a vaccine or medicine, and with governments and central banks continuing to make the necessary interventions and fiscal policy changes.

## Is the negativity priced-in

For fixed income, a very large part of the sharp drop in prices is attributable to a rush by investors for the exit. This is particularly true of US Treasuries, Bunds, etc. In our view, and while some lower credit issuers are expected to come under some stress, it does not make sense to sell at these depressed levels. In fact, it would not be unreasonable to take the view that credit spreads are finally starting to provide fair risk-adjusted returns and to slowly start adding exposure to selective names. A few words of caution though: Bottom-up credit selection is more important than ever. In particular, one must be aware of the fallen-angel risk given that c 54% of the credit market is rated BBB and could easily slip into "junk" status given the scale of the disruption. Also, market liquidity is not great, so judicious use of limit orders is strongly recommended.

For equities, we do not believe markets are completely pricing-in the full extent of the adverse economic impact to corporates and individuals. Should we see clear signs of a potential treatment to the virus, then we would change our stance accordingly. Until then, our preferred view on the overall asset class is to remain underweight risk. For long-term investors with the ability to absorb interim volatility, there could be an opportunity to add small exposures to sectors such as Technology, Energy and Healthcare.

Additionally, the recent drop in gold prices by approximately 10% may be used as an opportunity to add the commodity as a hedge to your portfolio. A large part of the recent drop in gold prices is attributable to extreme cash demand, in part due to margin calls. Once this stabilises, and given the additional quantitative easing from central banks, one should expect the US Dollar to weaken and for real rates to become negative again. That should be a powerful tailwind for gold.

## Equity Valuations: S&P500

Many clients are asking if it's a good time to enter into the market and start adding to quality positions such as Amazon, Microsoft, Apple, Facebook, Visa, Mastercard, JPM, Bank of America, etc.. in short, and while such names have been relatively resilient during this market selloff, we can foresee another 10% - 20% drop in the S&P500 from here.

The S&P500 is currently trading at approximately 2300 and is down approximately 29% on a year-to-date basis. The market's PE ratio is currently 15.1x on a trailing twelve month basis – which might seem like an attractive entry point to some investors. However, if we take into account profit warnings and expected earnings revisions downwards of approximately 20% from 2019 to 2021, then the S&P500 is still trading at a hefty 18.9x 2021 earnings at its current price level. As such, and given that many businesses are struggling to do any business at all across most sectors, we can foresee a continued drop in the equity market from these levels, in our view.

Additionally, certain businesses that have taken on debt over the years under the assumption of a given level of business activity, may have difficulty honouring their debt obligations. The downturn in economic activity could lead to a credit crunch at a time when many businesses are looking for bank funding to refinance such loans. This would only exacerbate the situation that the global economy is in, hurting employment even more, and further impact economic activity.

## Asset Class Clues: 3-Month LIBOR

The price movement of 3-month LIBOR (3ML) has been very indicative of late. While the Fed reduced the Fed Funds Rate by 100bps to the 0.0% - 0.25% levels in an emergency move on March 15 2020, 3ML only fell to the 0.85% levels and has rebounded to the current 1.2% levels since then.

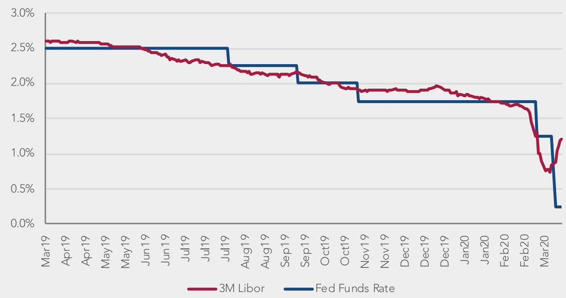
Although not exhaustive, this can be interpreted in two different ways:

I) Positive scenario – expectations that the Fed may reverse course and increase rates sooner than later. This would only happen if a treatment is found for Covid-19 and if the global economy were to return to some form of normalcy.

II) Negative scenario – the move upwards in 3ML could be an indication of the reluctance among banks to lend at lower rates. This would indicate that banks are still very worried with the state of the global economy and the potential credit defaults that can occur as a result.

The negative scenario above is consistent with some equity futures market, which are currently pricing in further downside risk. The expected drop in economic activity, downwards earnings revisions, in addition to credit markets that are pricing in more pain, are likely to result in a further sell-off in the equity markets, in our view.

**3M Libor & Fed Funds Rate**




Source: EIBank, Bloomberg

## Looking forward...

Clearly, the major upside from here is if a vaccine or a treatment plan is found sooner than later. Although several German, French, Chinese and American pharma companies are testing a cocktail of antibodies to treat the coronavirus, we'd be speculating at this point in time if we were to base our investment decision to add to risk and equities on this basis. At this point in time, we have to remain prudent and continue to manage macro and corporate downside risks.

It's also important to note that although there is a global urgency to approve a vaccine as fast as possible, there are no real short-cuts when going through the 3-stage approval/trial process. Until a vaccine is found, the World Health Organization (WHO), has embarked on a global program named Solidarity. Under this program, they have fast-tracked the process to use existing drugs, which have already been approved to treat other infections such as Ebola, malaria and HIV, as a potential treatment plan for Covid-19.

It's been reported that researchers in France have used a combination of drugs to successfully treat patients infected with Covid-19. While further research will need to be completed over the next couple of weeks, the formal announcement of a potential treatment plan will help contain the virus, and eventually calm markets and spur economic activity. Until then, we would advise investors to remain prudent in the short-term and patient and selective on any longer-term opportunities that may present themselves.

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