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Coronavirus and all that – a concerted effort

This week's most important investment decision is to start shorten duration of government bond portfolios. We also recognise that a shift towards a risk-on episode is in the offing as the government support programmes are detailed.

Meaning we will no longer advice against investment in equities. But this is not the time for all-in as we are still at the beginning of a recession whose depth and duration are not known at this moment. Continue to stay far away from corporate debt with poor credit.

It appears the coronavirus has just claimed its largest victim yet: the European philosophy of fiscal austerity.

Across the world a combination of monetary and fiscal initiatives is rapidly being put in place in order to mitigate the already visible recession. It amounts to a safety net under the world economy once we move past the current sharp downturn.

As this happens, we are looking at as shift that will change the global savings/investment balance with a likely effect on the interest rates and bond yields – and indeed the entire investment climate. This could mean an end to the ultra-low interest rate regime that has been in place for years.

The demise of austerity

Forced upon the EU by Germany and several other smaller countries, Europe insisted on public sector cutbacks as the financial crisis struck in 2008. The idea of cutting deficits in the middle of a downturn was implausibly named a "stabilisation pact" and indeed it proved to be exactly the opposite. This author stated in 2008 that insisting on fiscal stability would lead to a deeper recession and a slower recovery than generally expected back when.

As it were, we got a decade of slow growth in Europe, a global Savings/Investment balance that forced down interest rates and inflation in house and asset prices. Oh, and a ballooning German current account surplus and a huge surplus on the German Federal budgets.

Recently the heads of both the ECB and the Federal Reserve have clearly signalled that fiscal policy is needed to pull out of a downturn. The central banks cannot do more. Seen in hindsight, Fed Director Powell's comments on 12 February 2020 proved prescient. Last week ECB chief Lagarde joined in. Governments listened.

Monetary and fiscal policy

In the next edition of this missive we will give an overview of the monetary and fiscal initiatives winding through the political decision systems worldwide. We are encouraged to see that it looks like a global consensus to launch for fiscal stimulus to the tune of 5% of GDP paired with loan or guarantee provisions towards cash-strapped companies in the order of 15% of GDP.

The packages are a mix of fiscal and monetary actions some of which are targeted at the companies who have seen their business evaporate over the past 4 weeks. Other initiatives target the employees who are being laid off. Some are medium term initiatives that will support demand as we pull out of the coronavirus onslaught.

Not entirely surprising, US initiatives are being held back by political partisanship. Powell's careful words about the limits of monetary policy are a welcome exception to the political infighting taking place over the use of the federal budget. Democrats are trying to craft initiatives aimed at the people losing their jobs and making help available to companies conditional on the help NOT being used to further share buybacks.

There are grim examples of household company names who in recent years financed share buybacks and dividends by issuing loans in the bond markets or via the Trump tax cuts in 2017. Republicans want to (again) introduce corporate tax cuts, loans to the bigger companies and a time limited paid leave scheme. But at least both parties agree that consumers should receive a cheque directly from the government to keep consumption going.

Investment observations

We suspect the causality and thus persistence of yield increase is the fundamental change mentioned above. It is not a temporary demand/supply liquidity issue - in this world's largest asset class. As a result: reduce duration of government bond portfolios.

Important measures are being brought in to put a safety net under the global economy. This in itself should favour investment in equities.

However, the measures will not make the recession go away. It will carry the economy through the coronavirus pandemic. There will still be companies that do not survive or will come out bloodied or badly bruised. We suspect those who are in for a bloody nose are those with the weakest cash flow. *Stay away from corporate bonds*.

The impending recession may be deeper and sharper than the current consensus. Forget about a near-term economic v-recovery. For now, people are being locked up in their homes, with no corona cure in sight, and the world economy is grinding towards full stop.

In the short term, the stock market sell-off ended once the US stock market had digested the news that Federal Reserve did not possess the weapons to fight the recession. But since the introduction of fiscal measures the stock markets have been taking a rather more sober attitude.

We believe that dynamics are changing in r´the short-tern as government safetynets are being prepared in support of the economy and by extension in support of the stock markets. So investors should now prepare for this revelation to sink in - and to follow-up when it does.

By the way: if you expect to be bored on this coming Tuesday afternoon, check the IHT Markit release of flash indicators at 0900 GMT