The economy is shifting into a new lower gear

We reiterate our view that the financial market sell-off in risk assets is likely to deepen and we repeat our recommendation to reduce exposure to stock markets and high-yield bonds. Our preferred holding of equities is 0, zero, nothing.

This is getting hairy. Yesterday WHO declared that we now have a global pandemic. Even if such a declaration does not have any influence on the current state of the Covid-19 situation, it will have a quite significant impact on the global economy. It essentially means that any hopes of a V-shaped economic recovery are likely unrealistic. We are now likely looking at a very problematic situation all the way to 1st half of 2021.

We need to explain this statement in three steps, which each are unfortunately rather technical. For the time constrained, skip to *Summary**.*

Contain, delay, mitigate

By declaring a global pandemic, WHO has effectively conceded that the war against the virus cannot be won. Even if China (and maybe South Korea) appear to have contained the virus, the rest of the world have failed.

Containment means that you track down every single individual infected with the virus and place them under strict isolation until the virus has nowhere to go. As we saw in Wuhan, this requires many tests to be performed and a heavy-handed approach to make people understand that they need to go home and stay there for as long time the authorities deem necessary.

But in Europe (read Italy) the virus had already spread before it was detected. During the 2 weeks of incubation time, the virus can be passed on. And it was exactly what happened.

When the first patients with symptoms began to show up, the virus had already spread beyond the point where it is possible to track every carrier of the virus down so the Government of Italy took the next step, to *delay* the spread of the virus. WHOs decision signals that the global strategy now is to delay.

The reason is simple. An estimated 15% of cases of Covid-19 will require hospital care, in many cases intensive care. The virus is aggressive, is easily passed from one person to the next and nobody has a natural immunity against it. The calculation is that if unchecked, the virus will put the health care systems under severe stress globally.

In order to delay the spread of the virus, governments must close the venues where people meet in large numbers. Schools, train stations, large sports events, many workplaces where people are physically close are all to be closed if the virus is to be slowed. If possible, people should also avoid travelling or even leaving their home.

This is the situation right now – on a global scale. How effective it will be depends on social habits, the strategy chosen by the government, the willingness of the population to follow the given instructions – and the competence of the government agencies in charge.

The *mitigation* phase follows once it is known how many people will likely contract the virus.

The economic effects of the “delay” phase

Italy will likely serve as the example of how to delay the spread of the virus. The country has instituted a lock-down that already heavily influences the business. As opposed to the “contain” phase which is short and sharp, "delay" must go on for as long as required to obtain the desired effect.

As of today, nobody knows how long a lockdown is necessary. We do not know if the spread of the virus will be slowed by the arrival of spring as it happened in 1918. We do not know if the virus reappears in the autumn.

In short, we are potentially looking at a lengthy, widespread and possibly recurring closure of a large swath of a country's economic life.

So, to all the stock market analysts out there: please show us a working model to capture this development. The downturn will take longer time than currently expected and it will be far more expensive.

This brings us to the third point, how robust are businesses to withstand a sharp drop-off in demand, broken supply lines, a large part of the workforce not being able to show up because of travel restrictions or because they have caught the virus?

Excessive debt

At this point we add a particularly poisonous additional element - corporate debt. IMF has repeatedly warned that the combination of low interest rates, tighter bank regulation, bond investors' thirst for yield and the demands from shareholders to see share buybacks and dividends has led to a situation where an economic downturn could lead to a major credit crunch and defaults of corporate bonds. IMF estimated that at the end of 2019, the total amount of outstanding corporate debt amounted to some USD 48,000 bn. IMF stated bluntly that;

"*In a material economic slowdown scenario, half as severe as the global financial crisis, corporate debt-at-risk (debt owed by firms that are unable to cover their interest expenses with their earnings) could rise to $19 trillion - or nearly 40 percent of total corporate debt in major economies - above crisis levels*".

This uncomfortable situation is only now beginning to dawn on the bond markets with the BBB-segment having seen the largest widening of the spreads over government bonds. Why the BBB segment? Because it is the lowest of the "Investment Grade" segments which are the hunting grounds for pension funds and other institutional investors. A downgrade from BBB levels would mean that many institutional investors would be forced to sell their holdings.

Summary…

If we combine the elements of a protracted fight against the Covid-19, an extended period where companies will suffer because of the "Delay" strategy and a corporate sector who has issued a record high volume of bonds, the situation in the stock market continues to looks quite dodgy.

Adding insult to injury, US president Trump has announced crisis initiatives rapidly denounced as being too little, too late. Furthermore, its incoherent form adds to the increasing revelation that neither monetary nor fiscal policy will solve the supply side problems created by the virus – hence, welcome to the Trump crash.

Any kind of assistance from the government or central banks should be aimed at helping companies not to default on their debts as the Covid-19 fight continues in the weeks or months to come. Until such help is forthcoming, neither the stock market, nor high-yield or corporate debt should be the place to have your savings parked.

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This document is for investment professionals only