Coronavirus and all that – margin call

Through more than a month we have recommended zero allocation to risk assets and only to invest in recession assets. We have been adamant in our dire warnings about the global stock and credit markets and see no reason to change that.

The actions by the US administration and the US Federal Reserve in the weekend proved momentous – but not in the way hoped for.

We believe that the weekend marked the end of one phase and the beginning of a new phase. The panic phase ended with investor capitulation, led by the most leveraged mandates as they are forced to close all positions in a margin call. We believe this is the dynamic we are witnessing these days.

The new phase could be described as a fact-finding phase. The world is now exiting denial with respect to the scope of the COVID-19 virus outbreak and its economic impact. Central banks attempts to shore up the demand side have failed spectacularly. However, serious scale measures targeting the specifics of this recession of a twin shock to demand/supply are being put in place. The US are lagging behind in every respect of the crisis response.

This is not the time for cheery statements of an "improved risk/return relationship". Has the risk really fallen? Does anybody seriously believe that the markets will go up by 50% to reach levels seen in mid-February any time soon? Really?

National Emergency in the US

Trump introduced a national emergency in order to fight the coronavirus. Flanked by health officials and CEO's some larger companies, declared a national emergency over the coronavirus. The emergency declaration allows the administration to set aside federal legislation and regulation in order to speed up the response to the epidemic hitting the USA.

After 80 minutes of press conference on Sunday, the uncomfortable truth emerged; nobody knows how many infected persons there are in the USA, nobody knows how to test potential carriers of the virus on a grand scale, nobody knows when enough test kits will be available.

The worst thing is that nobody in the US government has an idea of how to handle the situation if or when a large number of virus sufferers will need hospital care, given that the excess capacity in the US hospitals is very limited. There is a small overhead of empty beds, limited capacity in the Intensive Care Units and a desperate shortage of ventilators, needed to help sufferers of the coronavirus.

It is fair to say that in comparison to the determined efforts of European governments to control the outbreak, the US administration does not have much of a plan at this moment in time. So maybe the only important message was that Trump finally conceded that the virus is not a "liberal hoax".

The US is failing to show leadership on the healthcare crisis. But now every US citizen is be aware there is a problem and that the government is doing something about it.

Fed threw the kitchen sink at the problem – it did not work

Fed Chairman Powell announced Sunday that the interest rates would be cut to near zero and that the Federal reserve balance would be expanded another USD 700bn. However, the market reaction to the previous emergency rate cut on 28 February 2020 reflected a growing revelation that traditional monetary policy would not work.

This time, the Feds action unintendedly made it clear to everyone, that the market participants does not believe monetary policy will have any effect on the real economy.

The world is facing a recession which cannot be described as neither a demand side nor a supply side chock. Demands falls away, workers cannot go to work, supply lines are in disarray. Earnings evaporate from many companies, and USD 700 bn will not help this at all. Instead the added liquidity will just be added to the already existing USD 1,600 bn excess reserves held by the US banks. The money multiplier is rapidly nearing zero or in plain terms - we are in a credit squeeze!

The solution should instead comprise a targeted policy aimed at avoiding liquidity issues for companies as a result of what we all agree is a temporary problem. Several countries have understood this and have already set up facilities in order to help companies with short term liquidity.

Europe – a blueprint for the road ahead?

While US as so often takes the colourful headlines in finance, Europe are getting into targeted mitigation of the twin demand/supply hit to the economy.

EU's van der Leyen seems to be gently nudging the European countries for coordinated action targeting the twin demand/supply side shock. Germany have earmarked EUR 500 bn via KfW, France EUR 300 bn as state guarantee, Sweden set aside nearly EUR 50 bn. Denmark acted swiftly to provide credit to the private sector, freeing up a much -hated contra-cyclical capital buffer at the right moment, providing temporary compensation to the private sector employees and offering to swap to interest-only repayment schemes for mortgage owners – all to resist a s defaults. Paid sick leave is already normal in Europe, contrary to the rest of the world including US, something they will now watch with envy.

Governments in Europe follows a relative simple recipe a) keep the credit flowing from the banks to the companies, particularly in the SME segment b) make sure that employees who are on forced leave either because of sickness or social isolation initiatives from the government do not suffer a catastrophic loss of income, be given to companies as a subsidy or to employees in the form of a temporary tax reduction of some magnitude. Further, governments appear ready to defer payment of corporate and income taxes and the like.

Will all of this have a positive effect on the real economy?

We still have no idea of the depth of the recession that has likely already started. However, judging by the estimates slowly published, it is clear the Covid-19 will be with us in the autumn of this year and that travel restrictions and social isolation measures will stay. It appears increasingly likely that global growth for 2020 will fall below 2.5% is – meaning recession in the Western countries, a recession that could last into the autumn.

Many companies will remain in a liquidity crunch for months, and the longer this situation lasts, the more likely becomes a major incident in the corporate bond market.

According to the IMF, global corporate debt currently amounts to about USD 48-49tn. About USD 19tn are High Yield bonds, first in line to see defaults in the issuers run into liquidity problems. Of the remaining USD 30tn, referred as Investment Grade, about half carry the rating of BBB.

This is the lowest rating allowed before the bonds are classified as High Yield, an event that would force nearly every institutional investor to reshuffle their corporate bond portfolio and to get rid of some High Yield bonds. In such a situation, we find it exceedingly likely that liquidity in HY bonds will dry up faster than a water puddle in Sahara and that the HY segment will be badly hit.

Add that there will be an outright increase in defaults in the same segment.

It should be noted that the private sector debt at this point stands at a higher level relative to GDP than before the start of the 2008 financial crisis. Many listed companies have earnings insufficient to pay the interest on their loans. One well known such "zombie" is named Tesla. Many companies have been taken private over the past decade and to the extent data are available, such companies on average have debts of six times their annual earnings, twice as high as the level that would classify a listed company as "junk".

Answering our own question – will the US actions of last week improve the economic situation – we believe that this is indeed not the case. The bumbling US response to the coronavirus crisis will make the crisis deeper than necessary. Federal Reserve's intervention proved that the recession is not a demand side crisis.

And the world has not really seen that a sharp recession may morph into a financial crisis, not emanating from the financial sector, but from highly indebted private companies.

Investment conclusions

Our framework is not intended to recommend investors to try catch falling pianos. We would like to see the markets stabilise before beginning to invest. Corporate bonds, and specifically HY bonds have not yet been reprised sufficiently.

We find it likely that the 30+ percent loss in stock prices is simply an adjustment of the excess created by successive interest rate reductions in 2018 and 2019. A simple explanation could be that the stock markets have re-discovered risk and lost the belief that central banks will always prop up the stocks.

Trying to establish "valuations" is probably a futile deployment of time. We still do not know how the coronavirus pandemic will play out. We know the world economic activity has fallen off a cliff, but we do not know how far it will fall. We know the world is loaded up with (corporate) debt.

We are not in any hurry to recommend buying stocks or HY at this moment.

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