Coronavirus and all that – the safety net is in place

With yesterday´s news that the Japan State Pension Fund GPIF is ready to take a 31% holding in foreign government bonds, one of the final bits of a huge global puzzle fell in place.

We believe that the structure of a safety net under the global economy is now in place and that causes us to recommend a return to equity holdings corresponding to investor´s long term benchmark. This view is supported by the faster-moving elements of our indicator framework. On the other hand, we still recommend steering clear of HY bonds and to reduce duration of government bond holdings.

Saving the world as we know it

A recession is already upon us and it is not going to be plain sailing in the weeks ahead, but the danger of an economic collapse is over for now.

Over the past three weeks or so, both EU and the USA, in concert with the UK and Japan have worked to mitigate the threat of a deep and destructive recession. There is no doubt that the recession will be deep (or that it already is) but the purpose of the coordinated effort is to avoid mass scale unemployment and company closings.

In other words, the world´s largest countries are acting to bridge the gap. Most of the measures put in place are only valid until the end of 2020.

Far from being the "bazooka" to end all problems, a number of different initiatives have been introduced, each aiming at different elements of the problem.

There are various kinds of subsidies to secure that employees or laid-off individuals will not suffer a disastrous loss of revenue. Small companies and self-employed are offered credits direct by finance ministry/the treasury. Central banks have announced that they will hold the hand under the corporate bond market. Federal Reserve will purchase commercial paper, which is a way of offering credit to larger companies quickly. Additionally, central banks have offered various new ways banks can draw more liquidity in case of bank runs.

There is no doubt that there will be major new government bond issues, and the Japanese (who are largely unaffected by the virus so far) are now ready to purchase a good chunk of those bonds.

All of this corresponds in detail to what we a month ago pointed out as being absolutely essential in building a defence against the coronavirus fall-out. So we believe that a major step has been taken towards removing essential uncertainties from the markets.

Of course, there are residual uncertainties. Some are in the domain of politics. The US have attempted to gain support for a new Plaza accord, referring to the 1985 agreement between the then G5 to depreciate the USD against DEM and JPY. This idea has been received rather icily by the other G7 members. Our homemade hillbilly indicator says that the USD is about fairly valued (clue: do you know anybody recently returned from the USA and telling it was very cheap/unreasonably expensive to stay there?).

An obvious uncertainty is whether the coronavirus will behave as we want it to. In other words, are the current efforts to curb the virus effective? If not, the pandemic may well continue all the way into 2021.

Another uncertainty is whether political expediency leads countries to roll back the measures in place to slow the spread of the virus. The USA is one obvious such example with the President wanting to "reopen" the country by Easter irrespective of whether the epidemic has been slowed or not.

Epidemiologists have pointed out that this could be a very expensive initiative measured in human lives, given that the USA has just taken first place in the ranking of the countries with most confirmed cases of the virus and the epidemic is still accelerating.

Several other countries see an increasing resistance against the continues measures from the conservative side of the aile. So far it is not strong enough to threaten the efforts to curb the virus.

Investments

The faster-moving elements in our indicator framework has pointed to adding risk to the portfolios. Specifically, it means that the equity holdings should be increased. In practical terms this means locking in excess performance year-to-date.

Technical factors, Market Intelligence and Risk & correlations are now positive, while the Fundamental factors category remains quite negative. This category contains macroeconomics, which usually is a lagging factor - a situation that is probably more pronounced than normally right now.

The macroeconomic background, ie. the factors that cannot be represented by data with daily or weekly frequencies (if at all) are clearly improving. We have matched an assumed macroeconomic chock with the totality of the new safeguarding measures, and we conclude that there is quite a good possibility that the measures will prove effective. It makes sense to us that with perceived reduction in macro uncertainty, downside to stock prices are greatly reduced. Still under the assumption that the pandemic can be brought under a reasonable degree of control by end June.

This suggest to us that the scenario leading to our initial warnings on 27 January has closed.

Late in January 2020 our model framework observed a major shift in risk & correlations factors, as long duration sovereign bonds began to increase strongly, with bond yields beginning to discount strains on global economic growth. A further analysis revealed that bond yields dropped in concert with our leading indicator for macroeconomic activity, while stocks and other risk assets continued to rise unaffected.

This divergence scenario began to unravel on 21 February as stocks / HY began to drop in a classic “Wile E. Coyote dynamic” (falling off a cliff, red.). The trigger was more obvious than anyone could have imagined. While Italy was ravaged by the coronavirus, US stock markets only discovered the problems as the state of Washington began to report on a large cluster of infected persons. This led to a rapid drop in stock prices and, given the weight and the role of US stock markets globally, the rout on US equities rapidly spread, even to markets where the coronavirus was on the rampage and the country had been locked down for weeks.

Since 20 March our indicators turned as we saw what looked like capitulation. Federal Reserve was suddenly seen as unable to “salvage” the stock markets and market participants began to look for cues to what was really happening in the outside world. We called this a «fact finding» phase because as the world went into tail-spin, there were no quantifiable way to approximate the scale of economic losses and no coherent set of countermeasures was known.

Today we have a better grip on the economic consequences of the lockdown, better tools to mitigate - and should the virus resurge later this year (which would not surprise us greatly), we will by then also have the benefit of experience with logistics of “helicopter money”.

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