Letter from the CIO

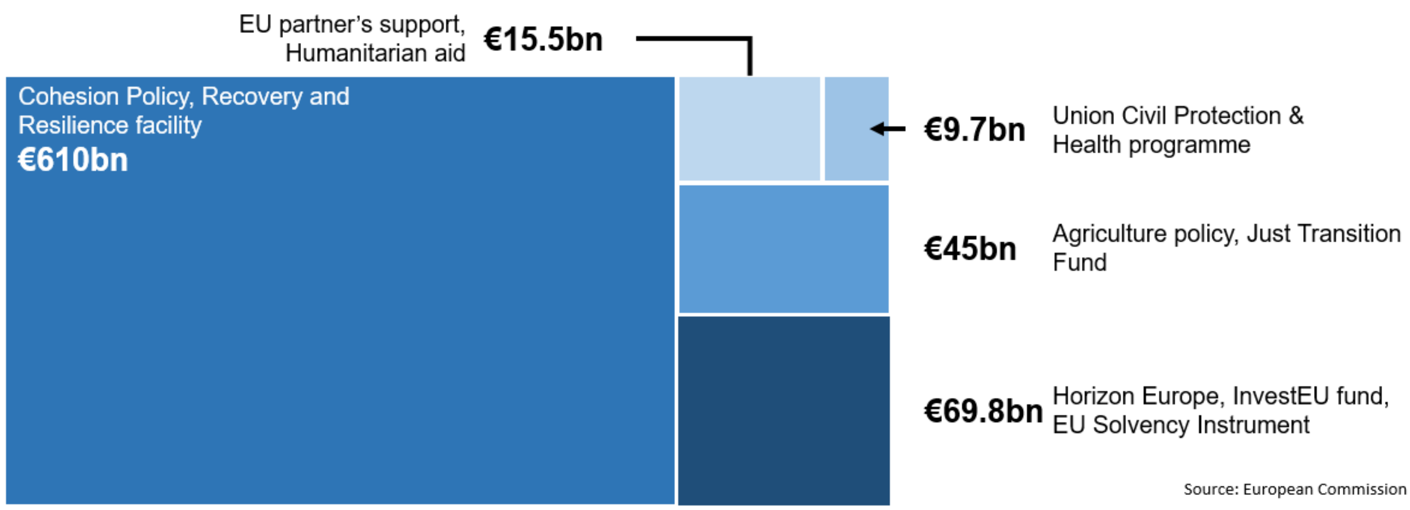
3rd of June, 2020

Europe follows in US Rescue programs

EUR 750 billion – what a dizzying number! This is the size of the recovery fund that the European Commission's President Ursula von der Leyen unveiled last week, which will be used to help the European Union's 27 members to cope with the fallout from Covid-19. "*This is Europe's moment*", said the president. When added to an earlier €540bn initial rescue package as well as to a proposed €1.1 trillion budget for 2021-2027, that would amount to a total of €2.4 trillion fully dedicated to the European economy, which in 2020 will be going through one of the strongest recessions in its history. Almost already "approved" by France and Germany, but subject to negotiations between the member countries, this package would be made of €500bn in grants and €250bn in loans. Italy and Spain will be the biggest beneficiaries, while Germany will receive relatively little. And the EU plans to pay back investors via its own budget over a long period – as much as four decades!

Although it may seem normal following the various fiscal and monetary measures announced by the United States, this is a real revolution in the history of the European Union. Never before has the Commission proposed the issue of such a large scale European pooled bond. And the fund's mechanism also makes a big difference, i.e. grants rather than debt. Indeed, the proposal implies the sharing of debt as the rescued countries would not be burdened with unsustainable debt loads and at the same time, the wealthiest contributors would make larger repayments to fund the initiative. It clearly breaks with the long-held taboo of debt mutualisation within the Euro-Zone.

Where will the €750 billion be invested?



To say the least, this announcement has breathed new life into equities, which were struggling to find a clear direction since the beginning of the month of May. With a decline of more than 5% during the first three weeks, equity markets have rebounded sharply since the joint proposal on May 18th made by Germany and France to issue a massive rescue plan. Since that day, the Stoxx 50 Index has risen by more than 7% outperforming the S&P 500, which rose by 4%. It seems that Europe is taking over the FED's put option, feeding the equity markets a little more, which further widens the gap between the financial markets and the economic reality.

Last week, the United States recorded more than 100,000 deaths from Covid-19, registering the sad record of the country with the most deaths since the beginning of the pandemic. On the economic front, the US continues to suffer from ongoing lockdown measures. More than 2.1 million additional Americans applied for state unemployment benefits in the week ending May 23. It is the 10th straight week with first-time claims of over 2 million. Pending home sales also saw their biggest decline on record in April because of the coronavirus pandemic, down -21% from March. Although there are little signs of any improvement on the economy, which may only begin to materialize once lockdown measures are lifted in the US, the markets themselves continue to hope. The technology-rich NASDAQ index is up +4% year-to-date at its all-time high, while the S&P500 closed the month just over 3,000 points for the first time since March 2020.

The world will be going through its deepest recession since the great depression and yet equity markets continue to rise after a correction of "only" -30%. Are we yet going to experience the same market situation as in 1929-1932? As a reminder, in 1929, the Dow Jones lost -40% in a few weeks, took its breath, and then lost another 90% over the following years.

S&P500: 1929 vs today

Source: Bloomberg

Even if the economic consequences are the same, this time could be different. If we take a closer look at the S&P500's composition, we notice that the times where industrial and oil giants were dominating the stock markets are gone. Today, information technology accounts for 26% and communication services, which includes Google, Facebook and Netflix, represents 11% of the index. Amazon, which is part of the Consumer Discretionary segment, weighs in at 4%. Healthcare accounts for another 15%. Overall, more than 55% of the current S&P 500 index are companies with a business model that is relatively protected against the current economic shock. And the market likes that!

Negative interest rates everywhere are also a differentiating factor. Cash is definitely not an option in many currencies except for the US dollar. But for how long? As reiterated several times, President Trump is a fan of negative interest rates and the pressure on the FED is growing. For many investors, cash is therefore no longer an asset class to consider since it costs money. Likewise, the better-rated bond market also encounters both, extremely low or negative yields, along with a worrying low liquidity since the beginning of the crisis. Another fact that fuels the equity markets!

Finally, this time may eventually be different as responses from governments and central banks to navigate in the current environment and help the economy to rebound are unprecedented. Indeed, most developed countries have made massive economic responses to the COVID-19 pandemic, ramping up spending and using monetary policy to cushion the blow of lockdowns and other measures that have shut down businesses and left huge numbers unemployed. Some central banks like the US Federal Reserves also went further, announcing assets purchase programs on their own balance sheet to calm markets – and it works! Those "put options" seem to be in place, and the beauty is that the cost for investors is almost zero, we are already at-the-money, and the maturity date is undefined!

Yes, the market actually seems to be in a V-shaped recovery suggesting that the COVID-19 is over and that the scenario of a significant bounce of global activity in H2 is gaining credibility. Really? As past crises have taught us, an initial stock market rally is no guarantee that we are out of the woods. The effectiveness of monetary and fiscal stimulus will only become clearer in the coming months. Growing tensions with China in recent weeks or the internal tensions observed in recent days in the U.S. on racism are also events that could cause a return to increased volatility and new declines.

In May, our portfolios diversification did pay off as every asset class was positive, led by oil prices, followed by stocks, high yield and emerging market debt. We took the opportunity to increase our equity exposure in Europe after the European commission's announcement because we believe that this plan is a clear headwind for the European economy. We also tactically entered into the silver market to benefit from the historical valuation gap between gold and silver. This trade went pretty well as we sold the position a week later with a 10% profit.

Overall, we remain defensively positioned with a slight underweight in equity and a strong overweight in gold. We still maintain an above average cash portion and would not hesitate to deploy it should we identify new market opportunities. The next few weeks should begin to reveal the extent of the damage on the economy, both in terms of unemployment and corporate earnings.

We stay alert and we will not hesitate to either reduce risks or at the opposite further increase the exposure in risk assets depending on economic and geopolitics' development!

Stay tuned!

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