Monthly Letter

March 2020

Economic environment

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The upswing in equity investors' risk appetite gathered further momentum early this year, having been sparked last October by easing trade tensions and accommodative monetary policy. Economic activity continued to show weakness, but some signs of stabilization appeared last January, greatly contributing to maintaining a feeling of euphoria in the equity markets. In addition, when the first cases of coronavirus were reported in China, investors initially believed it was a temporary and isolated shock, and that economic growth would rebound sharply thereafter.

However, it seems that this V-shaped scenario – a bid drop in GDP in Q1 2020, then a symmetric rebound in Q2 2020 – was based on two wrongheaded assumptions. Firstly, investors initially believed that the global economy was able to absorb the blow quite easily. Yet, global growth fell to 2.9% in 2019, the slowest pace since the global recession of 2008 and above all, far from the 4% recorded during the SARS crisis in 2003. Historically, growth around 2.5% is perceived as being likely to increase the probability of recession. Indeed, when economic activity is too soft – the so-called stall speed – it becomes difficult to absorb new entrants into the labour market and, consequently, the unemployment rate starts to rise, and the business cycle then tends to turn around.

Furthermore, investors have likely downplayed the magnitude of the shock to China itself, but also its induced effects on other countries. Daily Chinese indicators such as the consumption of coal and electricity, as well as air and rail freight, have been signalling a sharp slowdown in China for several weeks. The business confidence indexes published by the Chinese statistical agency showed a very sharp contraction in activity in February, both in the manufacturing and services sectors, reaching a low since the publication of this statistic (2005). In fact, the scale of the fall undoubtedly demonstrates the significant negative impact of the outbreak.

China having become a significant export market, but also a key element of the global value chains, the coronavirus acts jointly as a shock of demand and supply. What's more, tourism represents more than 7% of world exports and the current situation is hitting hard actors of this market. Contrary to what was anticipated by some analysts, the spread of contagion outside China has accelerated, prompting many companies and government to impose restrictions on travel, visits and demonstrations, which will have serious repercussions on the service sector.

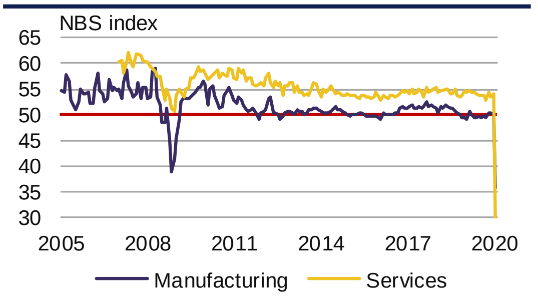
Italy has become the most important center for the largest number of coronavirus cases recorded outside China. The government has detailed tougher quarantine measures in hopes of stemming the

Performances in local currency

	Price as of 02/28/20	1 month % change	2019 % change
Equity markets			
CAC 40	5 310	-8.5%	-11.2%
Eurostoxx 50	3 329	-8.6%	-11.1%
S&P 500	2 954	-8.4%	-8.6%
Nikkei 225	23 657	1.9%	18.2%
Currencies			
1 € = ...USD	1.10	-0.6%	-1.7%
1 € = ...JPY	118.99	-1.0%	-2.3%

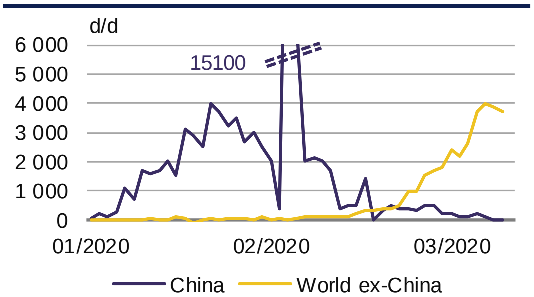
		Price as of 02/28/20	1 month bp	2019 bp
Government bonds				
3 M	Eurozone	-0.64%	-6	0
3 M	United States	1.27%	-27	-28
10 Y	Eurozone	-0.19%	25	-4
10 Y	United States	1.15%	-36	-77

China – Business confidence index



Source Macrobond, Rothschild & Co Asset Management Europe

World – COVID-19 cases



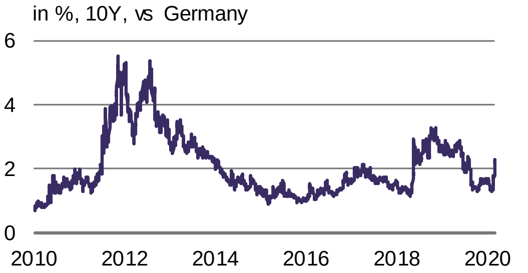
Source Johns Hopkins, Rothschild & Co Asset Management Europe spread of the epidemic as the healthcare system struggles to cope with the influx of new patients. All Italians are now confined to their homes, being able to travel only for reasons related to work or health. The economic cost of these measures will undoubtedly be significant and a technical recession – two consecutive quarters of decline in GDP – now seems almost certain.

Central banks have decided to play a leading role in order to support the economy. On 3 March, the Fed unexpectedly cut the Fed funds rate by -50 bp at an unscheduled or emergency meeting – the first since 2008 after the Lehman Brothers bankruptcy. While the fundamentals of the US economy remain good overall, Fed Chair Jerome Powell nevertheless insisted this was an "insurance policy" cut as the coronavirus poses progressive risks to the economic outlook, recalling, however, monetary policy is not necessarily very effective in the face of a supply shock.

In the wake of the Fed's action, other central bankers stressed that they will not hesitate to use all tools at their disposal in order to prevent the current crisis from escalating. In Australia and Canada, central banks cut their key rates by -25 bps and -50 bps respectively. In the euro zone, given the limited conventional room for manoeuvre – deposit rate already at -0.5% – attention seems to be focused on targeted financing facilities with the aim of ensuring that there are no cascading bankruptcies. The Bank of England is also set to announce a more accommodative monetary policy at its meeting, especially since negotiations on the future relationship between the UK and the EU started on 2 March and already a dull dialogue seems to be installed on both sides.

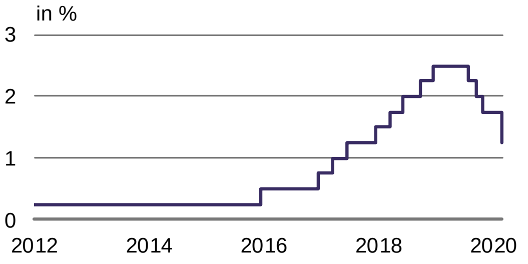
Overall, the global economy and markets are going through a rough patch that have been in the making for some time. Indeed, bond investors have been sending warning signals for many months, yet equity investors have been ignoring them, and only now are they awakening to reality. COVID-19 will have significantly weakened the economic outlook and, contrary to what was anticipated just a few weeks ago, global growth should not firm up, but rather weaken in 2020 compared to 2019. Adding to the stress is a shocking oil price war after OPEC talks collapsed as Saudi Arabia slashed crude selling prices for April, in a sudden U-turn from previous attempts to support the oil market as the coronavirus hammers global demand. Now, the volatility of financial markets is an additional factor that can increase the risk of a turn-around in the global business cycle. Consequently, we are entering a zone of strong turbulence. The IMF and the World Bank have announced they are ready to help the most affected countries, pledging to use available instruments such as emergency financing, policy advice and technical assistance. Yet, the global economy needs coordinated, comprehensive and coherent measures. For now, we are far from it. Will policymakers be able to turn the tide?

Italy – Sovereign spread



Source Bloomberg, Rothschild & Co Asset Management Europe

United States – Fed funds rate



Source Macrobond, Rothschild & Co Asset Management Europe