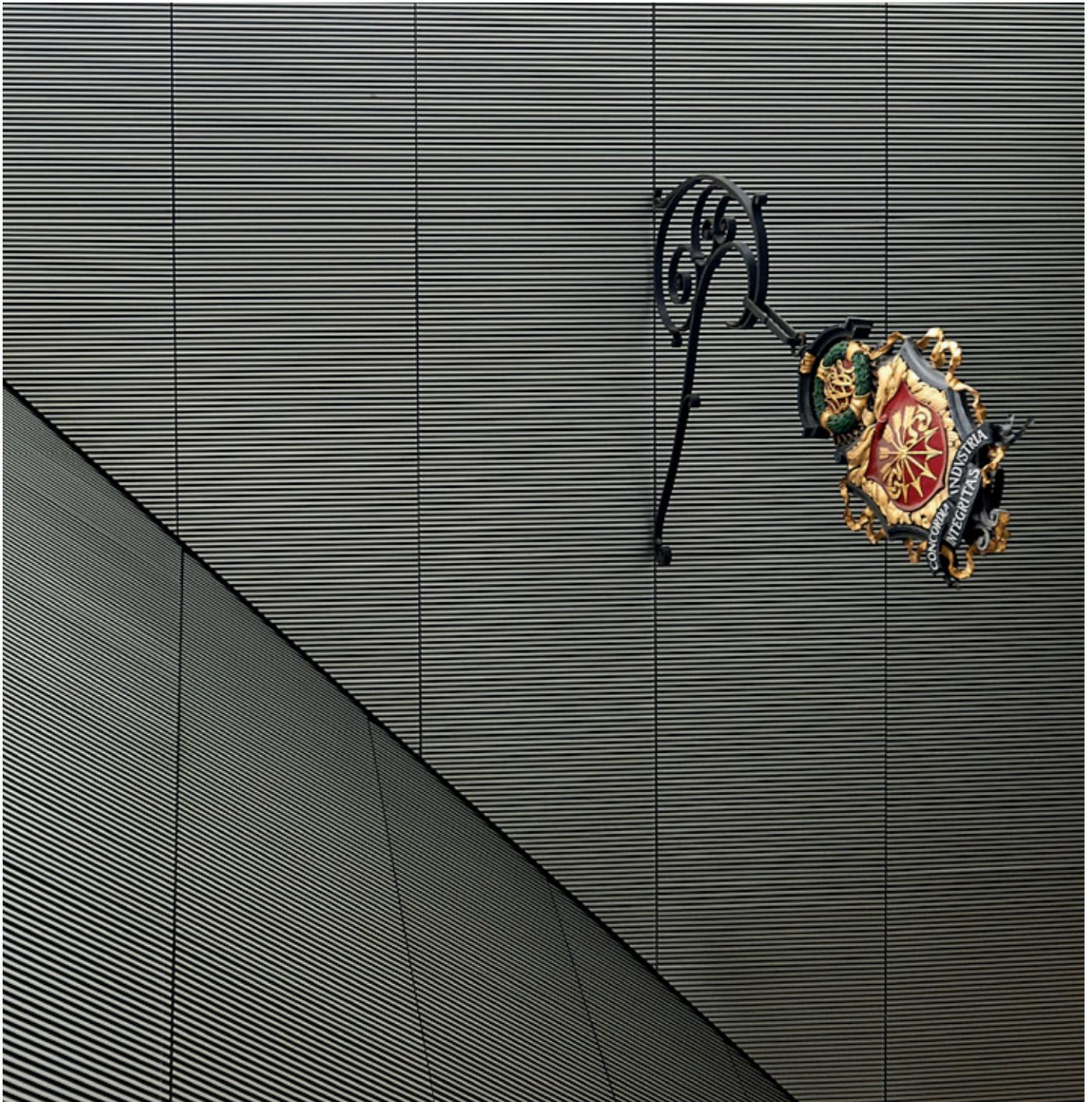


Market Perspective



This too shall pass

Issue 117 | March 2020



Foreword

Just over a month ago an unusually positive consensus was making us wonder if stocks were running out of tactical headroom. Little did we know: the spread of the coronavirus outside Asia saw US stocks in February register their fastest post-war correction (defined as a 10% fall from their peak). Markets have fallen sharply further in March to date.

The tentative revival in global growth, the US election and indeed most other issues have been set aside as that positive consensus has evaporated. We are once again facing a wall of worry, and as natural contrarians – and keen students of the ways in which media and markets interact – we find ourselves back on more familiar ground.

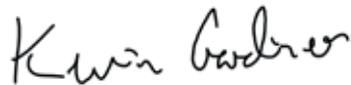
The humanitarian cost of the outbreak can hardly be exaggerated, sadly. But is the economic and financial mood an overreaction?

We cannot know exactly when global contagion will slow, or estimates of fatality rates converge. The disruption to business seems likely to be significant: having receded from view at the end of 2019, the prospect of recession has moved closer again.

Nor do we take much reassurance from the panicky response of central banks, which in this context seems as illogical as it is likely to be ineffectual.

Nonetheless, the World Health Organization (WHO) reports that contagion in China has been slowing for some weeks. The economic disruption may not last for long – but if it does, we suspect that a recession on this account might be less threatening than usual, not more. And from their admittedly lofty starting point, the falls in stock markets look bigger to us than the likely value of lost business.

Faced with this alarming bolt from the blue, our advice to patient investors is to sit tight and wait for more clarity – but to be looking for opportunities to add to long-term positions, not cut them.



Kevin Gardiner

Global Investment Strategist
Rothschild & Co Wealth Management



Cover:
A very public symbol of the heritage and values of the family business is the Rothschild shield positioned on the exterior wall of our New Court office in St Swithin's Lane, London. The five arrows combined with the family motto is the only advertisement for the business within.

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This too shall pass

Coronavirus: the economic questions

Could it cause a recession? It surely *could* – but we are far from sure that it will.

The economic damage is being done mainly by the understandable response to the virus, not the virus itself. Many more people are affected by cancellations and quarantines than are incapacitated by the illness. If controlling its spread means stopping people meeting, then it means stopping a lot of business.

This has been a deeply unpopular business cycle (despite – or perhaps because of – it having confounded so many pessimistic predictions). Pundits have not been slow to pounce on the virus as the latest reason for expecting its demise.

China's business surveys have fallen dramatically to lower levels even than in 2008 (figure 1). Admittedly, seasonal effects can be big around Chinese New Year, but we can easily imagine overall GDP there, and in some big Western economies, falling. If the WHO were to declare a pandemic, the impact would be even greater.

Having receded at the end of 2019, as trade tensions abated and data seemingly stabilised, the prospect of recession does seem to have moved closer again.

It is not yet clear though whether the pending fall in “hard” data – sales, output, employment – will be comparably large, and sustained for a full quarter, let alone the two consecutive quarters that conventionally define a recession.

Many transactions will be permanently lost. Some, however, may be simply postponed, while others, like the household goods being stockpiled and the additional government outlays on prevention and treatment, would otherwise not have happened.

There has been some discussion about the likely shape of the rebound, when it comes. It was arguable whether the revival from the two-year-old slowdown that seemed to be ending in late 2019 was going to be vigorous or not, but we think there is less uncertainty surrounding the profile of the rebound when the coronavirus controls are eased. We expect it to be almost as sharp as the downturn.

What happens to earnings if it does?

Earnings are likely to fall, and stock prices have already fallen in anticipation. As noted, we do not think that recession has to follow, but it is important to be aware that corporate earnings are literally geared into economic growth: a small change in the latter can have a big impact on the former, and an even bigger one on stock prices (see box ‘A bumpy ride: earnings and stock prices’).

The key investment point, however, is that growing economies and profits are the norm, not the exception: when growth resumes, profits – and stock prices – usually rebound. The volatility in stock prices usually significantly overstates any underlying changes in the net present value of businesses.

Would a virus-driven downturn be worse?

Recessions can hit employment and profitability hard, if temporarily. Is the risk posed by a virus-inspired downturn now worse than that posed by a “normal” one?

The initial downturn in output and sales will doubtless expose those businesses whose cashflow is thinnest and leverage highest, and their failures could hit overall liquidity hard. But there have been relatively few macro excesses in this cycle – banks and consumers have not been lending and borrowing recklessly – and these spillover effects may not be any larger than usual.

Figure 1: China seems set to be hit hard

Key business surveys: China's PMI and the US ISM index



Source: Bloomberg, Rothschild & Co
Past performance should not be taken as a guide to future performance.

It is too soon to talk of another financial crisis. The fall in stock prices and the renewed “inversion” of the yield curve, as long-term US bond yields have dipped to new all-time lows, do not yet constitute one. The money market spreads that can signal growing systemic liquidity shortages have not yet widened alarmingly (figure 3). It is also too soon to talk of the end of “globalisation”, even as airports empty.

Set against this, there is less room than usual for interest rates to fall now because they are so low already (though central banks may be taking advantage of what room there is – see below). But even if rates could fall a long way, in the context of travel restrictions, contagion controls

and consumer fear, their impact would surely be less potent than usual.

Fiscal policy has more room to respond, but again, outside the immediate relief and control spending, it may not do much in the face of such constraints. As we note below, it is a moot point as to whether monetary and fiscal policy should be trying to do much now.

Nonetheless, we suspect that a recession – which as noted might yet be avoided – on this account might be less potent than one needed to correct consumer or inflation excesses. The very clear and non-economic cause of this downturn, and the absence of recent excess, arguably makes it less daunting than a more deep-seated economic or financial malaise.

A bumpy ride: earnings and stock prices

Stock prices track (albeit loosely) corporate profits, which in turn tend to track (again, loosely) the economy. If the response to the virus hits economic growth, what sort of profit and share price shock might we expect?

An outright fall in corporate earnings – as opposed to a slowing in the pace of growth – is relatively rare. But when it does happen, the retreat can be marked. It can also take some time to reverse: profits take 18 months on average to trough, before rebounding to their pre-crisis levels some 24 months later.

Cyclical threats to corporate profitability are obvious: recession, the burden of higher financing costs or some policy-induced mishap. But historically these episodes, while most frequent, have not done the most damage (figure 2). The most destructive episodes have instead been associated with financial accidents, such as the collapse of the TMT bubble and the Global Financial Crisis (GFC). Such episodes can still have cyclical consequences of course: during the GFC, liquidity seizures and a weak banking system sparked a deep recession as business and individuals simply stopped spending.

The looseness of the link between stock prices and earnings reflects sentiment and shifting market expectations, which often forces equity prices (and valuations) to depart from fundamentals. This was most recently visible at the end of 2018, where revived market volatility occurred during a period of stable, if unremarkable, earnings.

The magnitude of the fall in earnings can diverge sharply from the extent and duration of the market setback. In the early 1990s, US corporates faced a challenging backdrop: tight

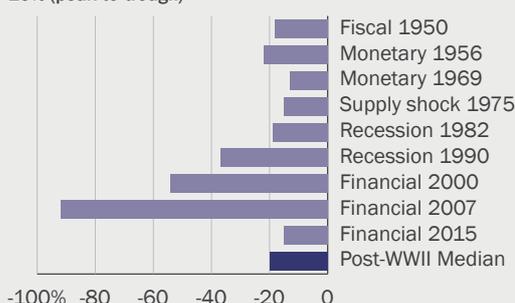
monetary policy and a domestic recession (alongside an oil price shock as Iraq invaded Kuwait). Earnings fell by over a third, but the market response was modest, down a sixth at its nadir. Conversely, market volatility often exceeds that in earnings.

Quantifying the virus-related threat is challenging. The risk of another recession has clearly revived, and we seem likely to see some fall in operating profits and earnings. As yet, however, we think that the decline may be small and short-lived.

In the middle of the media onslaught, it can be difficult to remember that the lasting damage being done to corporate net worth may be small. If Global Inc were to lose, permanently, one month's net income, a crude estimate suggests its present value might be cut by around one quarter of a percentage point. Even in recently low-volatility markets, this is well within the bounds of "normal" fluctuation. But sentiment can easily overshoot reality – in both directions.

Figure 2: Big falls in US corporate earnings

Post-WWII declines in earnings per share of greater than 10% (peak-to-trough)



Source: Shiller, Rothschild & Co
Past performance should not be taken as a guide to future performance.

Is it a supply or demand shock?

If the economy gets bigger because people decide to spend more, we talk of growth as being “demand led”. This is probably the default setting – it is certainly the establishment or Keynesian worldview. But growth can sometimes be driven by a resources or technological windfall, in which case we say it is “supply led”.

Why might it matter? A sudden reduction in demand would likely result in a weakening in prices (deflation) alongside the fall in activity, as suppliers entice more hesitant customers to keep buying. But a sudden reduction in supply would likely result in rising prices (inflation) alongside the fall in activity, as customers compete for scarcer products. Profit margins might also be affected differently depending on exactly where the downward impetus comes from.

The financial crisis was largely driven by a collapse in demand, and was deflationary. Industrial unrest in the 1970s resulted in a fall in supply, and was inflationary.

The response to the coronavirus, however, is surely hitting both demand and supply. Travel restrictions and panic are preventing people from spending as they usually would – but they are also preventing them from going to work and producing stuff.

Oil prices have fallen sharply because oil supply has been less affected than demand, and the net impact does look deflationary. As figure 4 shows, the breakeven inflation expectations priced into bond markets have fallen a little. But the fall in activity, not the impact on consumer prices, is the main effect.

Who is most exposed?

An interruption to business combined with fear is as clear a case for weaker stock prices

and stronger safe-haven assets as you could want. On the front lines are oil (where the shock is entirely demand-driven), travel, hotels, distribution services and financials affected by lower interest rates (see below) – but also riskier stocks (and speculative grade bonds) in general, which suffer from the flight to safety. Geographically, the sell-off rolled from Asia to the West.

High-quality government bonds have performed predictably – predictably, that is, if you’d known there was going to be a scare – and surged in value. So did gold, and the newly fashionable (but to us uninvestable) cryptocurrencies, before falling back sharply. The response of currencies also failed to match the usual pattern: the dollar, yen and franc have firmed as usual – but more recently so too has the euro, which is not usually seen as a safe port in a storm.

We think that the impact may be brief, and that markets are overreacting, and so would be more inclined to buy some of the losers (not the energy sector, which increasingly faces more structural headwinds) and sell some of the winners.

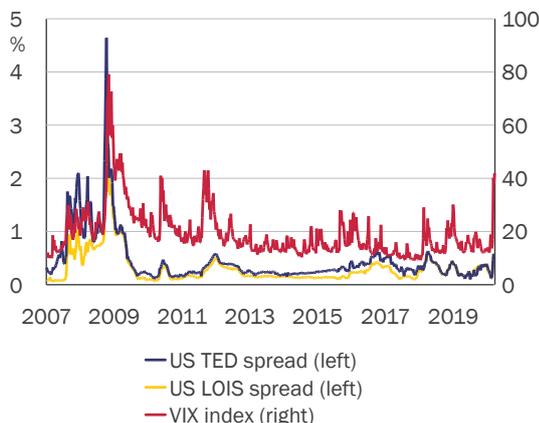
What should/can policymakers do?

Should policymakers even try to arrest a looming downturn on this account? As noted, on one hand the powers that be have decided that some economic dislocation is a necessary firebreak for contagion. If, with the other hand, they try to resist that dislocation, then why bother to begin with?

Of course, central banks are independent, and will do what they think is best in pursuit of their mandates. In early March, the US Federal Reserve (Fed) unexpectedly cut its main policy rate – the Fed funds rate – by 50bp, taking the targeted range to 1–1.25%. It usually moves in smaller increments, and the FOMC's next

Figure 3: Systemic risk may not have risen far

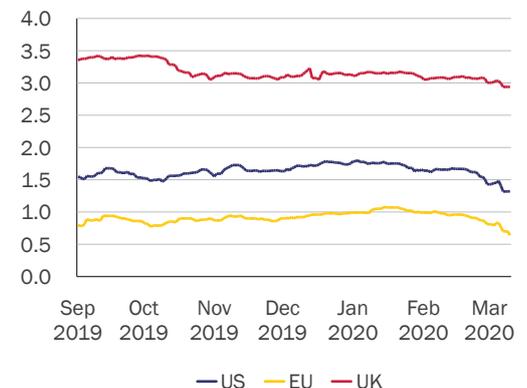
Spreads between policy and short-term money market rates



Source: Datastream, Rothschild & Co
Past performance should not be taken as a guide to future performance.

Figure 4: Expected inflation is a little lower

Implied inflation: 10-year breakeven rates



Source: Bloomberg, Rothschild & Co
Past performance should not be taken as a guide to future performance.

scheduled meeting was still two weeks away at the time.

The Fed has cut interest rates by larger than usual amounts, and between meetings, before – most recently in 2008, 2007 and 2001, which were times of significant market turbulence. It would seem that the central bank thinks things now are comparably serious.

Other central banks have cut rates – including the People’s Bank of China, and the Reserve Bank of Australia. The European Central Bank and the Bank of England have indicated they are also considering easing.

We are in two minds about these monetary responses. Even if some action is desirable, if US manufacturers’ supply chains (for example) are missing components from China, lower US rates are hardly going to magic them into being.

Maybe the Fed sees some companies facing financial distress – but if so, the more logical response might have been the direct provision of liquidity, not a cut in borrowing costs (from levels which were low, and widely fixed, to begin with). Credit spreads have certainly widened, but not yet to extreme levels, and as noted, money market spreads have not yet surged alarmingly.

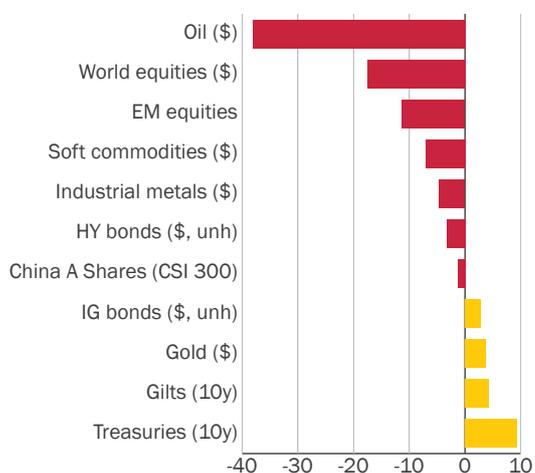
But apart from encouraging investors psychologically to rely on central banks’ support even more than they already were, the moves may not do much damage.

What should we be watching?

Talk of the downturn being confined within a single calendar quarter, or of an eventual rebound, may sound optimistic now. But

Figure 5: Losers and winners from equity market peak

Changes in selected asset prices: 19th February to 9th March (intraday), %



Source: Bloomberg, Rothschild & Co
Past performance should not be taken as a guide to future performance.

epidemiologists (real ones) suggest that epidemics often follow distinct profiles, influenced by “reproduction rates”, the mathematics of contagion and immunity. Typical curves follow a “sigmoid” or S-shaped profile.

We are watching figure 6, which shows that China – if we believe its data – may now have passed the inflection point that marks the slowing of contagion. The rest of the world is still some way behind – note the drastically lower scale – but if the timescale is echoed, we could indeed be talking about weeks rather than months before global contagion slows too.

Existentially, the emergence of a new virus is unsettling, and the apparent fatality rate of around 3% is worse than many others. But at some stage, people (and their governments) will accept (or feel able publicly to accept) that the threat of pandemic is always with us, and get back to business. And that fatality rate may be overstated, as the number of cases almost certainly understates overall infection levels.

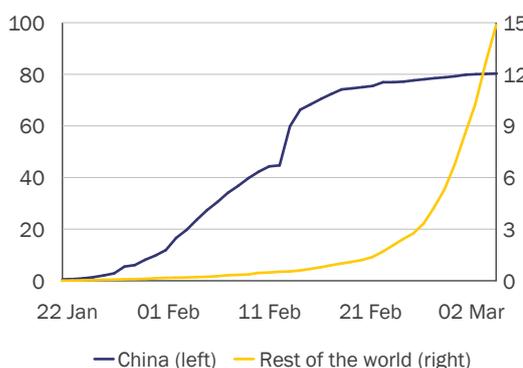
Investment conclusion

The collective response to the virus is understandable: in a world that has never been safer from violence or pestilence, any revival in danger is alarming. Our thoughts are with the affected families. Nonetheless, we suspect it may not last for long. The declines in stock market values look to us to be much larger than the likely damage done by that response to the net present value of lost business.

Stock prices had risen a long way beforehand: we’d suggested in February that they may have been tactically a little ahead of themselves. But the scale of the correction looks overdone. We do not advise chasing the markets lower, but instead think that long-term investors should be looking for opportunities.

Figure 6: Contagion

The spread of the virus: reported cases (thousands)



Source: John Hopkins University, Rothschild & Co
Note: Correct as of 5th March

Economy and markets: background

Growth: major economies

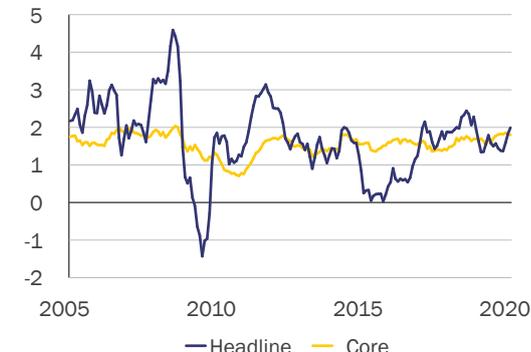
Business optimism: standard deviations from trend



Source: Bloomberg, Rothschild & Co
Composite of the forward-looking components of manufacturing surveys from China, Germany, Japan, UK and US loosely weighted by GDP

G7 inflation

%, year-on-year



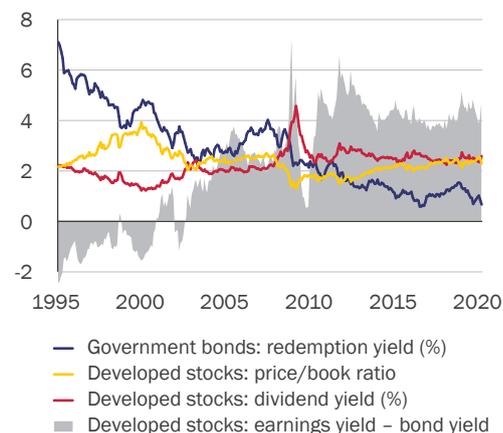
Source: OECD, Bloomberg, Rothschild & Co

Stocks/bonds – relative return index (%)



Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

Stocks/bonds – relative valuations



Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

Selected bonds

Current yields, recent local currency returns

	Yield (%)	1yr (%)	3yr (%)
10-yr US Treasury	1.1	15.1	18.7
10-yr UK Gilt	0.4	7.9	9.9
10-yr German bund	-0.6	5.7	7.7
10-yr Swiss Govt. bond	-0.8	3.8	4.8
10-yr Japanese Govt. bond	-0.2	1.2	2.7
Global credit: investment grade (USD)	1.1	10.2	16.4
Global credit: high yield (USD)	6.5	5.7	14.6
Emerging (USD)	4.8	10.2	17.5

Source: Bloomberg, Rothschild & Co

Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	2.6	4.9	22.6
Developed	2.6	5.3	22.7
Emerging	2.8	1.3	21.9
US	2.0	7.7	30.7
Eurozone	3.5	2.7	9.7
UK	4.9	-3.5	1.5
Switzerland	3.0	7.8	25.1
Japan	2.5	-2.1	6.4

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (2000 = 100)

	Level	1yr (%)	3yr (%)
US Dollar (USD)	111	3.3	1.2
Euro (EUR)	124	-0.2	6.5
Yen (JPY)	96	6.1	5.0
Pound Sterling (GBP)	79	-0.8	3.1
Swiss Franc (CHF)	165	6.3	3.1
Chinese Yuan (CNY)	131	-2.2	-0.5

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	159	-12.7	-16.4
Brent crude oil (\$/b)	50.5	-23.5	-9.1
Gold (\$/oz.)	1,586	20.6	26.2
Industrial metals (1991 = 100)	220	-13.6	-8.4
Implied stock volatility: VIX (%)	40.1	171.4	210.4
Implied bond volatility: MOVE (bps)	109.7	132.3	53.8

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 29th February 2020.

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Dusseldorf

Heinrich-Heine-Allee 12
40213 Dusseldorf
Germany
+49 211 8632 17-0

Frankfurt

Börsenstraße 2 – 4
60313 Frankfurt am Main
Germany
+49 69 40 80 260

Geneva

Rue de la Corraterie 6
1204 Geneva
Switzerland
+41 22 818 59 00

Guernsey

St. Julian's Court
St Julian's Avenue
St. Peter Port
Guernsey GY1 3BP
Channel Islands
+44 1481 705194

London

New Court
St Swithin's Lane
London EC4N 8AL
United Kingdom
+44 20 7280 5000

Manchester

82 King Street
Manchester M2 4WQ
United Kingdom
+44 161 827 3800

Milan

Via Agnello 5
20121 Milan
Italy
+39 02 7244 31

Zurich

Zollikerstrasse 181
8034 Zurich
Switzerland
+41 44 384 7111

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