Market Perspective

We'll meet again | Longer-term uncertainties

Issue 118 | April 2020

Rothschild & Co
Wealth Management

Foreword

Market Perspective focuses on the narrow world of economics and finance. It can seem insensitive to talk of these matters at such a difficult time: it should go without saying that our thoughts are with those hurt by the illness, and our thanks go out to the dedicated healthcare workers supporting them.

We doubt the outlook has ever changed so abruptly. In a couple of short weeks in March, prospective growth turned unambiguously into a major reversal, as governments, with public support, closed part of the global economy to suppress COVID-19.

Data are now catching up, but may have lost some of their ability to alarm. A big decline, possibly the sharpest, was inevitable as soon as the scale of suppression became clear.

So not only is this the first deliberate downturn – if we stop meeting, we stop working and spending as usual – but it is also the first whose onset and scale are unanimously expected. This is not a contentious decline. Gloomy pundits who've waited a lifetime for such moves may feel somewhat cheated.

This doesn't mean it is not important, only that it is not now a big surprise. Some indicators will still move the markets, but to a greater extent than usual, perhaps, markets may regain some poise before the data does.

It is premature as well as tactless to be talking of this as another Depression. Contagion rates may slow, and the public mood soften, allowing economies to start to recover during the summer.

We also doubt that, as many suggest, "This changes everything". We'd advise long-term investors to keep an open mind: looking across the valley, the future may not be that different to the recent past.

Kevin Gardiner
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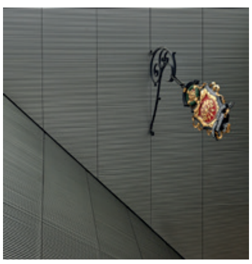
Rothschild & Co Wealth Management



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.

Publication date: April 2020.
Values: all data as at 31st March 2020.
Sources of charts and tables: Rothschild & Co or Bloomberg unless otherwise stated.

We'll meet again

A dramatic downturn, but how long will it last?

The superlatives are mounting. This downturn is already the fastest, the first to be deliberately engineered, and the least contentious (we all agree what is occurring and why).

We have seen a full cycle's US unemployment claims (22 million) compressed into four weeks' data. Looking ahead, double-digit declines – on a non-annualised basis – in GDP and corporate earnings (EPS) are plausible. Arithmetically, one saving grace may be that the lockdowns' centre of gravity straddles two quarters.

It is tempting to hope that monetary and fiscal support may avert it, but this might be to miss the point. The authorities have acted with unparalleled speed and scale, having learned from 2008 (and in turn from the 1930s), but they cannot – and are not trying to – stop economies shrinking. Instead, they want to reduce the long-term damage and suffering that closing much of the economy will cause. Some businesses inevitably will fall between the cracks. Sadly, the poorest families will suffer most, as always.

For now, we would not worry about the public cost of those measures. We don't know how much support will be taken up. Bond markets are telling governments that funds are available. The idea that we are borrowing from future generations is fallacious. There is also the possibility – and reality, as quantitative easing (QE) is revived and expanded, and day-to-day central bank financing rises – of money printing, though we see that as riskier. Systemic financial risks may also be manageable. Bank capital was rebuilt – more so in the US and UK than in the eurozone – and loan growth was subdued in this cycle. Interest rates are low in real as well as nominal terms.

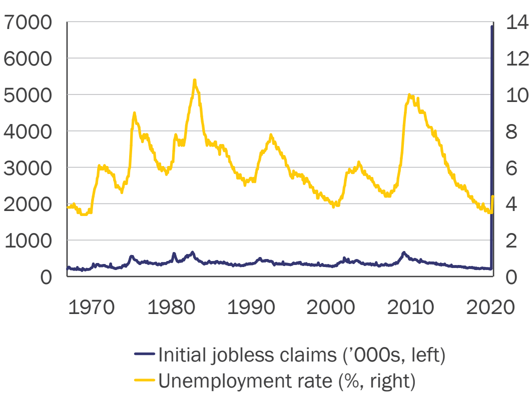
The downturn suddenly upon us is big, then. But to draw comparisons so quickly with the Depression – as many pundits are – is mistaken as well as tactless. The misery then – to which *The Grapes of Wrath* is a better guide than economics texts – lasted for years. Living standards now, even at their looming lows, and for the poorest, are much higher.

The reaction to COVID-19 has been so much more dramatic than we'd thought, but we still think the worst disruption might not last long. China's timeline – and there has not yet been a big second wave – may still be appropriate. Italy and Spain may be following a similar path, for example.

Moreover, public resolve may weaken, and lockdowns loosen, even if contagion doesn't slow sharply. The loudest dissenting voices so far have said that governments should have done more, sooner. There is now more public discussion of:

Figure 1: A full cycle in a fortnight?

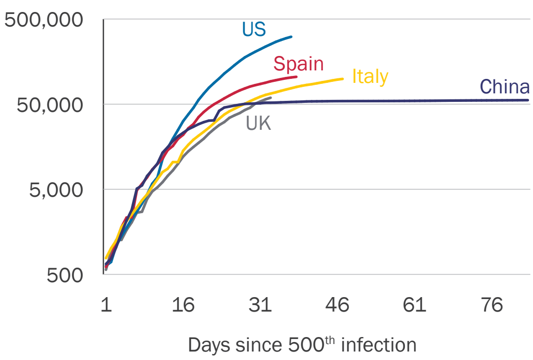
Weekly new US jobless claims and monthly unemployment rate



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

Figure 2: Global contagion poised to slow?

Cumulative COVID-19 cases in Asia, Europe and US (log scale)



Source: WHO/Johns Hopkins, Rothschild & Co
Past performance should not be taken as a guide to future performance.

- The distinction between science, and the mathematical modelling of complex systems (in which small changes in key variables deliver very different outcomes).
- The intergenerational and societal fairness of tackling the illness in this way (the young and poor bear the biggest costs).
- The big, certain, and possibly unsustainable, costs of suppression.
- The fact that society routinely faces difficult life-changing decisions, including those involving healthcare.
- Whether Sweden's alternative approach – supported by a population that favours bigger government – is sustainable (internationally, as well as domestically).
- Possible exit routes.

What sort of economic revival?

Usually the constraints are confidence and spending power. Now, the immediate constraint is dictat. When controls are relaxed, much business will resume.

Precision now – in either direction – is spurious. We think the precipitous drop may be followed immediately by some rebound. If policy stays expansionary, a return not just to the starting point, but eventually to the trendline we might otherwise have followed is feasible. We do not think long-term growth rates need be lower. Overall, a lop-sided V or "swoosh" profile seems likely: the rebound will take longer than the fall, as some businesses will fail.

Even when/if economies return to their earlier trajectory, some lasting damage to aggregate incomes will have been done: the area between recovery and the trendline in figure 3 will be painfully positive (more so for balance sheets, as bankruptcies and stranded assets drive a wedge between the path of GDP and capital).

Capital markets will however likely focus first on the direction of travel, not distance or speed.

Where does this leave stock markets?

Stock markets' response looks more understandable given the scale of suppression. That said, we thought they overestimated the long-term loss of business, and still do, even after their partial rebound. Losing even a full year's earnings would destroy only a few percentage points of market value.

We've seen the fastest-ever bear and bull markets. On 23rd March the MSCI all-countries index in dollar terms had fallen by 34% since mid-February's high. It has subsequently rallied by 22%, to stand "only" 19% below the peak.

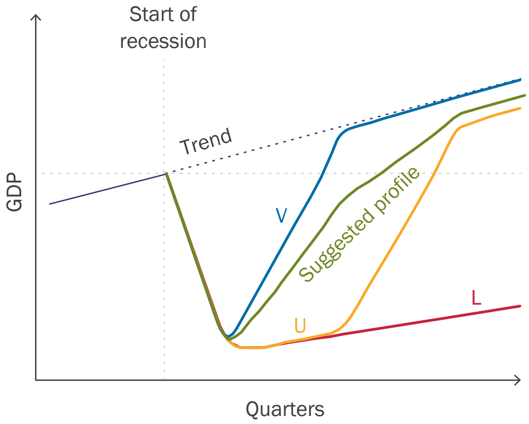
We may yet see a new low. But the idea that "lows" are always revisited before recovery" is as fallible as other market lore. Arguably the 23rd March low was itself part of a "revisiting" process.

Corporate earnings are set to slump for a while, and dividends have already been cut, making it (even) more difficult to value stocks. We'd focus on cyclically adjusted PE ratios and maybe price/book ratios. They suggest stocks were more expensive than usual in January, but having fallen back below it are now at trend (that is, they are not clearly "cheap"). Metrics that take interest rates into account – such as discounted cashflow – do make stocks look cheap, but are more contentious.

Valuations are less likely (at least, not unless they fall drastically further first) to trigger a rebound than news on contagion and lockdowns.

Figure 3: What sort of revival?

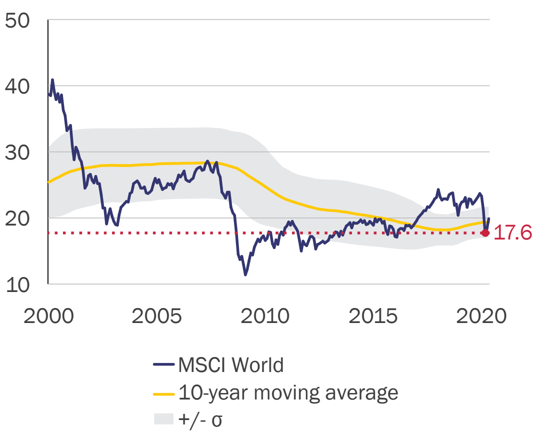
Stylised profiles of how the economic recovery could look



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

Figure 4: Stocks look better value

Cyclically adjusted PE ratio for developed markets



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

Where can investors hide?

What sort of assets can diversify equity risk, and how have they fared so far?

Most assets are less volatile than stocks. In balanced portfolios, we look for assets with complementary characteristics: uncorrelated (or negatively correlated) performance that might deliver positive returns – or at least loss-limiting stability – when stock markets fall.

Traditional diversifiers include bonds, gold, and cash (the latter is easily overlooked: it has no yield, but is stable). Newly popular, "alternative" assets include derivatives, structured products and (some) hedge funds, and private markets (equity and debt).

The turbulent first quarter exposed the inconstancy of some correlations. It also reminds us that the apparent stability of the private markets reflects their illiquidity – they do not trade often, and so we can't know how they did.

Figure 5 shows that while US Treasuries and UK gilts delivered positive returns, with their yields hitting new lows, eurozone government bonds fell (Italian bonds weakened, and gains in Germany and France were small). Performance generally has fallen short of that in other recent stock sell-offs. For each percentage point of stock market decline, bonds delivered less than "usual".

For investment-grade (IG) corporate bonds, the difference is big. They are never as safe as government bonds, but their fall in value here is pronounced, and their liquidity (not shown) has evaporated. Their extra yield has been costly in terms of mark-to-market volatility and illiquidity. Lower-grade, speculative – "junk" or "high yield" (HY) – bonds have also fared poorly, though these are always risk assets.

At first sight, the failure of bonds to do better is surprising. The stock sell-off is accompanied by major economic disruption and expanded bond-buying by central banks, and the low initial level of yields has increased their price sensitivity (their "duration").

However, in Europe in particular, those low starting yields may have proven a deterrent. If investors believe yields simply can't fall much further (remember they are already negative for the most creditworthy countries), they will be reluctant to bid even more for them. With policy rates staying even lower for even longer, little inflation (yet) and ongoing central bank buying, bonds may stay expensive. But they may at last be running out of headroom – which is why we've held few of them ourselves.

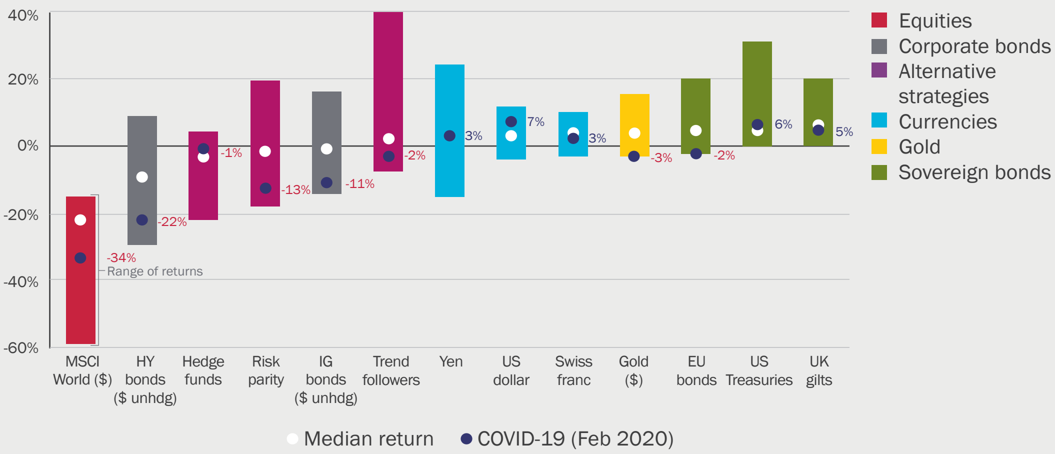
Other diversifying assets have also underwhelmed so far. Gold has not glittered as it might have; hedge funds remain lacklustre; and bitcoin (not shown) fell sharply. Safe-haven currencies have done well, but not compared to the scale of equity risk.

Humble cash at least has done what it usually does: maintained its nominal value. With inflation low, it is one diversifier whose real performance – despite lack of yield – may have improved. Another would be derivative-based strategies involving put options, particularly given how cheap they were, but such bespoke assets cannot be shown.

Mitigating stock market risk is getting harder. With interest rates so low, there may simply be fewer safe havens.

Figure 5: How assets have performed in previous times of crisis

Range of cross-asset returns during recent market setbacks



Source: Bloomberg, Rothschild & Co
Past performance should not be taken as a guide to future performance.
Returns have been calculated during peak-to-trough equity market drawdowns across a selection of setbacks since 1987.
Alternative strategies reflect composite indices (in USD); Currencies reflect 'real' trade-weighted indices.

Longer-term uncertainties

"Supposing a tree fell down, Pooh, when we were underneath it?"
"Supposing it didn't," said Pooh after careful thought.
— A. A. Milne

Contagion and isolation, recession, disrupted working and spending patterns – and the possibility of a second wave, and/or the arrival of a new virus. Doesn't this "change everything"?

Fellow panellists in a recent discussion suggested, among other things, that Western leaders will be dumped; China and Russia will become more powerful; globalisation is done for; inequality and low pay will no longer be tolerated; Brexit won't be completed; and we will all be nicer to each other.

We would keep Big Picture analyses at arm's length. We would also avoid the blame game: government is not easy, and sometimes the only choice is between two bad outcomes. Capital markets don't consider fault.

The longer-term outlook may not change much. My suggestion on that panel was that we will again prosper, but also that people will think and say we aren't.

The world is not necessarily any more dangerous. The arrival of the first pandemic since 2009, horrible though it is, does not reverse the long-term trend towards improved health and safety.

Another common view is that this is a crisis of capitalism. It is certainly a crisis in a capitalist context – more of the world is capitalist these days. But does it reflect a doomed system? We are sceptical.

Pundits talk as if there is a neatly labelled set of economic regimes on the policy shelf from which we can choose. But we can no more replace self-interest as an economic force than a physicist can replace gravity, and with as little need. This is not veneration – physicists don't venerate gravity – but acknowledgement.

For sure, capitalism will continue to be modified – to deal with environmental market failures, perceived unfairness and so forth – but there is no other "system" available.

Nor is it certain that taxes have to rise a lot: it depends on how much government support is taken up, and how the economy fares. To say big government has "won the argument" is a bit premature. Emergency powers may be just that.

We may reject travel, eating out, live entertainment and sport when they reopen. It is also possible – likely – that some of us won't see the daily commute in the same way again. But tastes may change less than the more fanciful essays suggest, and not everyone can work from home. Memories can be short. Just three weeks ago we were reading about the fragility of the food supply chain.

The future has always been profoundly uncertain. It is no more so now. Otherwise how could we have got here?

Rather than seek new directions, investors might do better to focus on existing trends given added impetus by the crisis. Sustainability, for example. Perhaps the encroaching end of the oil age, big banks and physical cash? More online distribution and distrust of established media?

The future has always been profoundly uncertain. It is no more so now. Otherwise how could we have got here?

Inflation

We do need to stay alert to one potential development. The last quarter-century has been characterised by low inflation. Contrary to what some economists and central bankers have been suggesting, this has been a Good Thing.

Now, with one hand governments are suppressing output, and with the other supporting demand – and doing so by creating liquidity, not just borrowing it. Are we at last about to see "too much money chasing few goods", and the revival of demand-pull inflation?

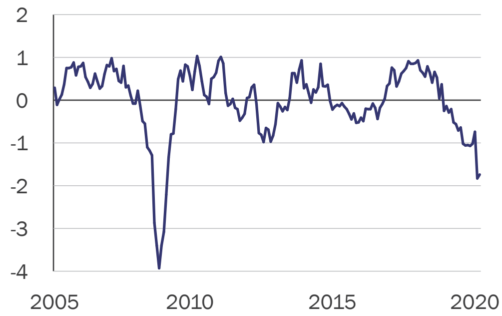
As yet, weaker oil prices are keeping a lid on inflation expectations. And when growth does resume, supply may prove more responsive than feared, as we've noted here before. As stale bears of bonds, we recognise that the underlying inflation/output mix has been better than we'd feared for some years.

And yet, and yet… we will revisit this topic: watch this space.

Economy and markets: background

Growth: major economies

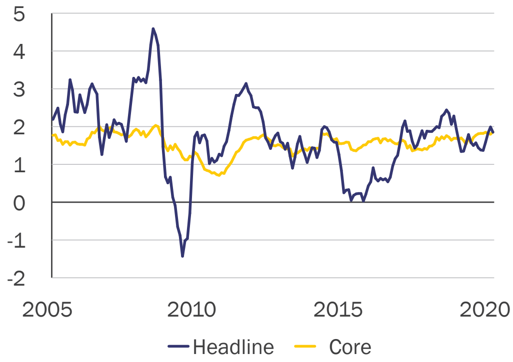
Business optimism: standard deviations from trend



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

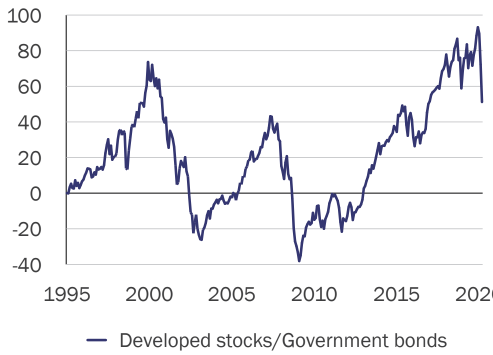
G7 inflation

%, year-on-year



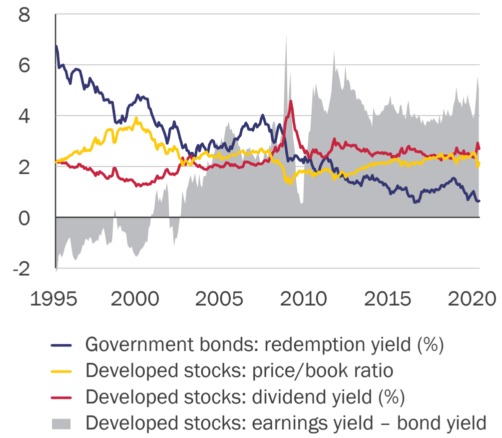
Source: OECD, Bloomberg, Rothschild & Co

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	0.8	17.1	20.5
10-yr UK Gilt	0.3	8.2	10.2
10-yr German bund	-0.4	2.9	5.8
10-yr Swiss Govt. bond	-0.3	0.1	1.7
10-yr Japanese Govt. bond	0.0	-0.4	0.8
Global credit: investment grade (USD)	1.2	7.7	14.5
Global credit: high yield (USD)	9.1	-5.2	3.8
Emerging (USD)	6.7	-0.7	6.2

Source: Bloomberg, Rothschild & Co

Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	2.7	-5.4	15.0
Developed	2.7	-4.8	15.7
Emerging	3.1	-10.5	9.6
US	2.1	-0.8	27.4
Eurozone	4.0	-14.8	-8.6
UK	5.5	-19.8	-12.2
Switzerland	3.2	2.9	19.3
Japan	2.6	-7.6	5.8

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (2000 = 100)

	Level	1yr (%)	3yr (%)
US Dollar (USD)	115	7.0	6.3
Euro (EUR)	127	2.0	9.2
Yen (JPY)	98	9.2	4.6
Pound Sterling (GBP)	79	0.3	2.5
Swiss Franc (CHF)	168	8.4	5.7
Chinese Yuan (CNY)	132	-1.4	1.4

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	126	-33.1	-32.9
Brent crude oil ($/b)	29.6	-58.6	-47.0
Gold ($/oz.)	1,734	34.4	34.9
Industrial metals (1991 = 100)	202	-20.9	-10.9
Implied stock volatility: VIX (%)	37.8	214.4	136.6
Implied bond volatility: MOVE (bps)	69.5	42.3	-6.7

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 14th April 2020.

Past performance should not be taken as a guide to future performance.

Notes

At Rothschild & Co Wealth Management we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.

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