

Policy action at the next level, but markets still in search of a 'real' catalyst



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- Where we stand in the crisis and what to watch:** Investors have moved from underestimating the severity of the crisis (buoyant markets) to a full global escalation (with the US joining emergency measures) that has led to market disruption and over-reaction. We are still in this over-reaction phase and it will likely continue for some time as the news flow is heavy. **It is important to look at China and Italy as leading indicators of what countries can expect.** Macro data, unsurprisingly, will be very weak, as we have seen in China's retail sales and industrial production figures for January and February. What will be vital is that activity resumes after the containment measures. Again, China is our leading indicator. Italy will be crucial in assessing the impact and length of the crisis in Europe, followed by the US. We are still at too early a stage to see big improvements; **the next two weeks will be critical to see the effects of the containment measures and to estimate the potential length of the economic contraction.** Any positive (or negative) surprise in this sense will move market sentiment. Moreover the activity resumption in China will allow to size the risk of a second-round outbreak.
- Policy response:** For the first time since 2008 authorities are perceiving the need for coordinated global action, as evidenced by the G7 statement in which leaders said that they would "do whatever is necessary" to support the global economy. At the national level, policymakers are announcing backstops and fiscal packages to support their economies and healthcare spending, while major CBs have stepped in to provide liquidity facilities, QE programmes and interest rate cuts. The decision of the ECB to launch a new temporary PEPP (Pandemic Emergency Purchase Programme) worth €750Bln is just the latest in a series of measures to counter the risk for the Eurozone outlook posed by the coronavirus outbreak and to preserve financial stability in the Eurozone, avoiding the fragmentation in the EU financial system that characterised the Euro crisis. We are not at the end of this phase of Central Bank intervention yet: **we expect more to come from central banks and on the fiscal side.** The aim of the policy mix is to ensure that economies will survive to temporary national lockdowns and eventually preserve financial stability. Higher debt will ultimately be the end game of this crisis, and debt monetisation the likely solution. **QE infinity and zero rates are here to stay, if not forever at least for a very long time. Helicopter money has become a real possibility, but it will be another jump into uncharted waters.** There is also an opportunity for the Eurozone in this crisis. Unlike the Euro crisis, coronavirus is affecting all countries. The incentive to reinforce the institutional framework of the Eurozone and to move towards Eurozone debt issuance is higher than in the past: **we are now in a 'now or never' moment for the Eurozone.**
- Market outlook:** This is a time when it is too late to sell and too early to buy. Selling now could damage the ability of investors to reach their long-term objectives. Markets will remain volatile in search of a 'real' catalyst to trigger the bottom (a clear signal of containment in Europe at a time of coordinated fiscal and monetary push, or the discovery of a medical treatment). In this situation, **we maintain a cautious view on risk assets and a strong focus on liquidity. In credit markets, default rates are likely to surge** and a new wave of downgrades is likely, especially among BBB-rated US corporates, which could fall into HY territory. At the sector level, **energy** will be the hardest hit within the US HY issuers as at the same time oil prices are collapsing. Overall, there is still scope for spread widening, **but when the dust settles, there are opportunities for robust business models.** A focus on companies with good fundamentals will be critical to navigate this phase. In **equity markets**, the bear market may be an unusual one and probably of extreme magnitude, but it will not be as long-lasting as the one in 2008-09. **We maintain a constructive view on the final part of the year, expecting a strong recovery in market prices, along with an improvement in economic conditions.**

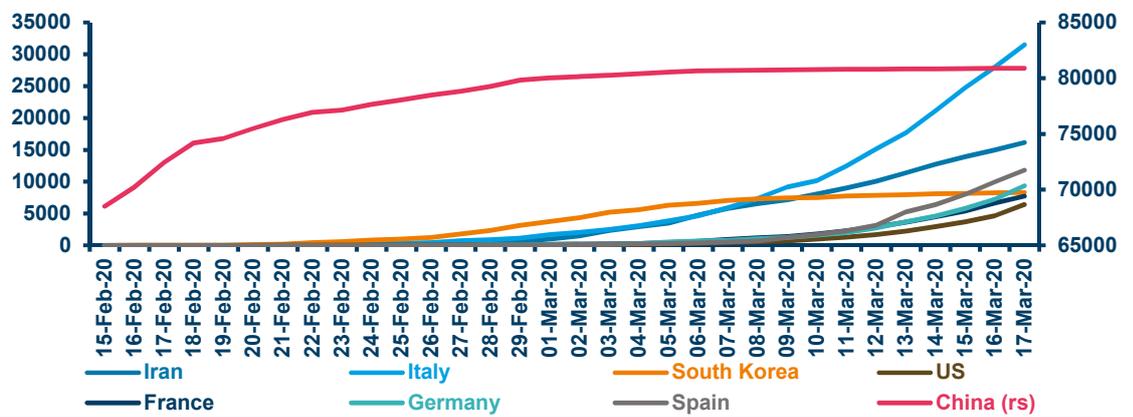
“The next couple of weeks are key to assess if containment measures are working in Italy and Europe, and to determine how low and for how long the economic contraction will last.”

The evolution of the crisis

By nature, any epidemic is a containable and reversible shock. However, in the case of the current coronavirus spread it remains unclear how the virus can be contained and when the peak will come. **The centre of the pandemic has now shifted from the East to the West and it appears to be affecting more countries in the Northern Hemisphere.** China and South Korea seem to have controlled the spread of the virus and this appears to be more generally the case in Asia, where countries in most cases were better prepared to face epidemic diseases as they have experienced them in the recent past.

Europe is now moving towards a shutdown and for the first time is introducing border restrictions to contain the virus spreading (in a sort of Nationalist revamp). The US is also starting to face the crisis. The next couple of weeks will be key to assess if the containment measures are working in Europe, especially in Italy, which at the moment is facing the most critical situation having been the first Western country to face the pandemic. However, this will not necessarily mean a return to normality, but some partial relaxation of the most extreme measures, which could at least alleviate the pressure on some sectors of the economy. And then there will be a second round test as it is still unknown if the outbreak might run the second wave. **Research to find a vaccine and a medical treatment for the virus is advancing and this could be the real game changer to potentially lift market sentiment, but medical advances in that direction are limited at the time of writing.**

Covid-19 cumulative number of cases by country



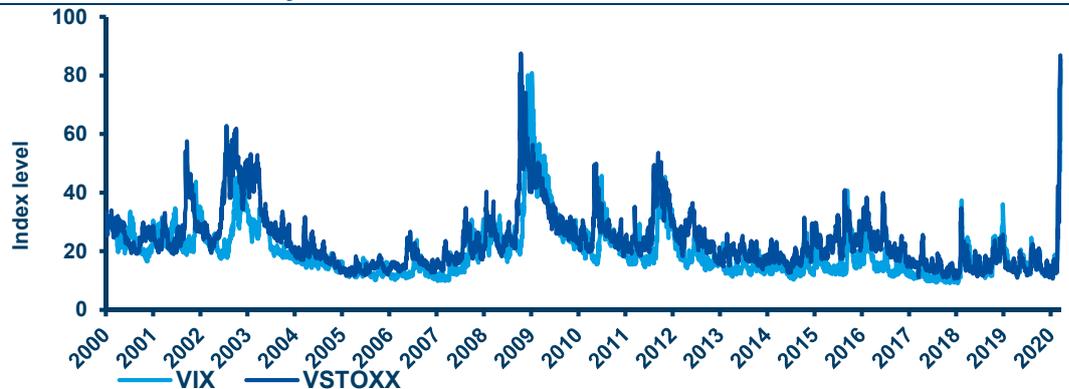
Source: Amundi on Bloomberg data, as of 17 March 2020.

Brutal market reaction: credit market is under watch

We have seen in recent weeks **extreme levels of volatility in equity markets**, similar to those experienced during the 2008 great financial crisis (GFC), even more in some cases.

“The dormant volatility finally woke up, hitting new records in a speed that had never been experienced before.”

VIX and VStoxx volatility indices back to levels not seen since 2008



Source: Amundi on Bloomberg data, as of 17 March 2020. VIX is an indicator of implied volatility in the S&P 500, VStoxx is a measure of implied volatility in the EuroStoxx 50.

“The mantra now seems a sort of “whatever we hope (will work)”, which is not fully reassuring for financial markets, despite the huge measures put in place.”

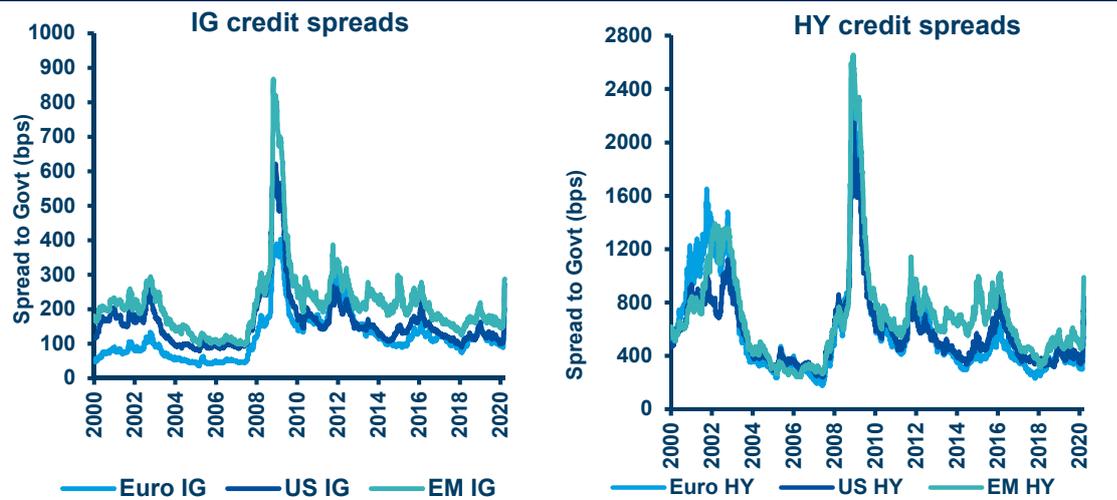
“Credit markets are the area to monitor, as an extreme deterioration of financial conditions could lead to a spiral of defaults, further harming the potential economic recovery in the future.”

“Policymakers will do whatever it takes to avoid a U-shaped recovery becoming an L-shaped prolonged contraction.”

The dormant volatility finally woke up and risk parity funds and automatic selling strategies led to a volatility spike. Investors sold off equity, the most liquid asset class, setting in motion an extremely fast downward move. Yet **this is not a financial crisis but an economic crisis**. After the GFC the banking system is now more solid and **policymakers are embracing a “whatever it takes” approach to avoid this also turning into a financial crisis**. The path may not be straightforward, and markets may have the feeling that this is more of a “whatever we hope (will work)” situation and therefore not feel reassured.

Credit is the area to monitor the most, to assess the potential spill-over of the crisis into a financial crisis, with possibly more profound implications. Spreads in credit markets have also widened significantly, but they remain at much more compressed levels in comparison with the extremes of the credit crunch of 2008 for the time being.

Credit spreads widening, but not a credit crunch



Source: Amundi on Bloomberg data, as of 17 March 2020. Data refers to ICE BofA indices by region.

While it is true that financial conditions have dramatically tightened (and this is what central banks are fighting at the moment), **we do not see right now the extreme market conditions in credit markets** that occurred during the 2008 crisis, when a financial crisis was the trigger of a profound global economic recession. This is key, as any liquidity and credit crunch could result in a rapid increase in the number of defaults, leading to a rise in unemployment and a further negative economic impact.

New frontiers for policymakers

We believe that the high uncertainty and the high level of volatility will continue for some time. **This is a time when it is too late to sell and too early to buy.** Markets will remain volatile in search of a catalyst to trigger the bottom (a clear signal of containment in Europe at a time of coordinated fiscal and monetary push, or the discovery of a medical treatment).

Policymakers will act to prevent the bottom being too profound and **will try to avoid the expected U-shaped recovery (with an extended contraction phase) transforming into an L-shaped downturn**. To do that, it is critical to avert a spiralling of the crisis from the real economy into a financial crisis and back into the real economy, as this could be profound and very prolonged.

- **Central banks (CB) are putting all their ammunitions to work:** CBs have done a lot so far and **we expect them to do even more.** Investors should not underestimate the firepower of CBs in terms of their ability to ease financial conditions and source liquidity for the corporate sector. The ECB, after something of a policy mistake last week, had to prove

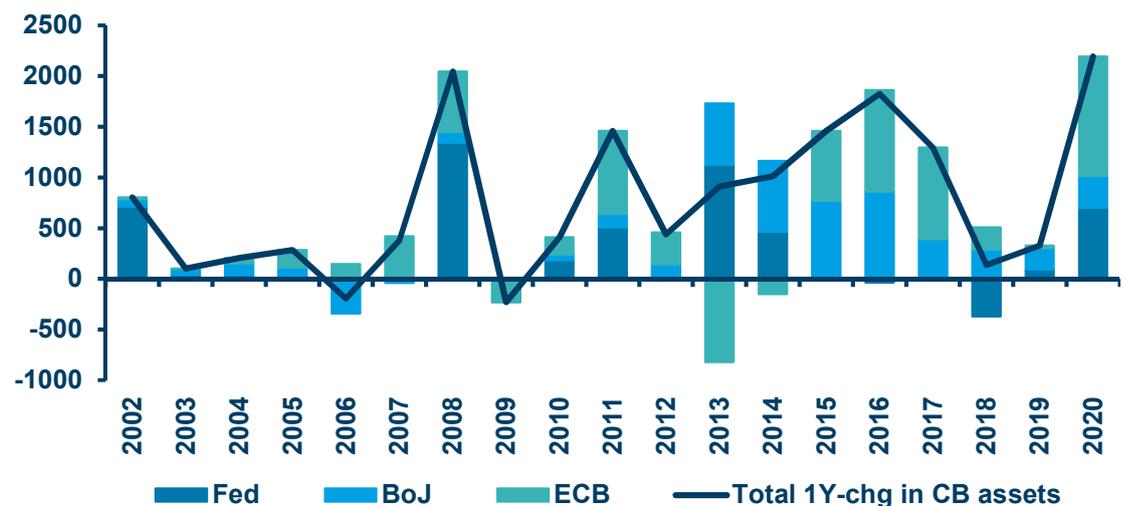
its commitment to preserving financial stability in the Eurozone and made a bold move on 18 March with the new temporary Pandemic Emergency Purchase Programme (PEPP), the asset purchasing programme of corporate and government bonds, bringing the overall quantitative easing amount above €1 trillion for 2020. In the new programme there are also important news: the extension to Greek Government bonds and the extension to non-financial commercial paper with sufficient credit quality, together with the ease of collateral standards, in line with what announced by the Fed the day before. The programme is highly flexible, allowing “fluctuations in the distribution of purchase flows over time, across asset classes and among jurisdictions and the purchases will not be constrained by the self-imposed 33% issuer/issuance limit. The ECB will consider revising (such limits) to the extent necessary”. The message that the ECB launched to the markets is clear: the fire power of the ECB, in a way, is unlimited if needed. The Fed, on top of an aggressive cutting of interest rates to zero, has restarted a massive QE programme and the commercial paper funding facility, a measure not used since the GFC. In the emerging world, central banks have also cut rates. **Therefore, rates are set to remain extraordinarily low: the end of the crisis will mean significantly higher debt. Financial repression will continue, to maintain the sustainability of this debt bubble.**

Main DM central banks and banking supervision actions to fight the crisis

Central bank	Rate cuted (bp)	QE additional	Banking supervision	Other measures
Federal Reserve	150	\$700bn	Full capital usage	Restarting of the commercial paper funding facility
ECB	Nil	€120bn +€750bn PEPP	Capital buffer usage	LTROs improvements
BoJ	Nil	¥6,000bn increase for ETF purchases and ¥2bn increase in corporate bonds and commercial payment		
BoE	25	Unlimited for large company financing	Use countercyclical buffer up to £200bn	

Source: Amundi Research, data as of 19 March 2020.

QE time: 1Y change in CB assets in \$bln (with forecast)



Source: Amundi Research, Datastream, as of 19 March 2020.

“CB expansionary mood will continue as QE is now a must-have, together with a big fiscal push.”

- **Fiscal policy – time to go big, very big:** many fiscal measures have already been put in place in almost all countries and more are to come. All of these measures, however, are still somewhat uncertain and not very coordinated. This, at the moment, highlights the vulnerability of the Eurozone. Europe’s reaction so far has been mostly at the national level, and the closure of borders is, in a way, an additional move in this direction. The severity of the crisis will prove if the time has arrived for more coordination. The most recent big announcement comes from the US, with the possible injection of \$1.2tn to support the economy, including measures of direct support to consumers, loans for small businesses and possible tax measures.

Strong interconnection between fiscal and monetary policy is a “must-have” at the moment

Pressure is starting to rise in the government space as well. Markets are starting to question how large, debt-financed fiscal pushes will be repaid, and this is what is driving the spread widening in peripheral bonds and also the rising yields in US Treasuries just after the huge fiscal push announcement (and despite weak equity markets) and some profit taking in the most liquid assets. **The answer will have to be even more aggressive QE, coordinated with a fiscal push. This is the idea materialising and helicopter money could be the next frontier,** something that is much closer now after the idea from President Trump of putting money directly in the pockets of citizens.

“It is a “now or never” moment for Europe.”

This will be the challenge that Europe faces in this **moment of truth for the European project.** So far, the European answer to the crisis (both sanitary and economic) has not been coordinated and markets are starting to test the debt path of the most indebted countries such as Italy, with yields surging across the board. The most relevant challenge but also the greatest opportunity will be for the European Union to follow a new, more coordinated approach to deal with this unprecedented crisis. There appears to be some opening up also from Germany (together with Italy and France) to move towards a European Union debt issuance, targeting the sanitary crisis on temporary and extraordinary measures, or to activate the European Stability Mechanism (ESM) to bring down borrowing costs for European countries¹. **It is a “now or never” moment for Europe.**

The perspective of higher debt is putting pressure on government bond yields



Source: Amundi on Bloomberg data, as of 19 March 2020.

¹ Source: Bloomberg, data as of 18 March 2020.

How to navigate the current market phase

Until we see some containment measures working in Italy, and subsequently in other countries, uncertainty will persist and the news flow will remain hectic. This is a time when it is essential not to be caught up in pessimism. Investors should **resist the temptation to sell in this market environment and be willing to tolerate higher volatility than anticipated**. Past crisis experience shows that the **emotional response is the biggest risk investors face** in such an exceptional environment and actions taken in this phase risk damaging their ability to reach their long-term goals in an irremediable way. It's worth pointing out that the disruptive GFC **losses were recovered by assets that did not encounter capital impairment and turned to provide opportunities for entry points in good quality assets at attractive valuations**.

We remain cautious on risk assets at the moment and focused on triggers in some oversold good quality assets or areas that could potentially be the first to bounce back (emerging markets, for example). **Monitoring liquidity is critical at the moment and a key priority for us**. In risk assets, equities and credit, we continue to be very selective.

Credit market

Credit is under pressure. Here **selection is crucial, especially in HY** to avoid more vulnerable/leveraged companies and areas of risk (some companies in the US shale industry).

CBs have stepped in to support the economy through different tools. However, they cannot support profit generation and the **corporate default rate is rising** (it is currently priced in by markets at 6-8% in the United States; for comparison, at the peak of great financial crisis it was 15%). A new wave of downgrades is likely, especially among BBB-rated US issuers, which could therefore fall into HY territory. At the sector level, **energy** will be the hardest hit within US HY issuers, where the default rate could peak at about 25%.

At the moment, credit markets appear to be functioning as last week new issues still met investor appetite despite the challenging market backdrop. If CBs manage to calm the markets with massive liquidity injections, and as we believe we will not enter a deep and profound global recession, we could see some attractive entry points from the current dislocation.

Equity market

Equity markets have already corrected meaningfully but current levels are not yet discounting a full-blown global recession.

The current bear market may be an unusual one and possibly of an extreme magnitude, but it will not be as long-lasting as the one in 2008. We maintain a constructive view on the final part of the year and the main support to markets is likely to be via policy responses.

In European equities we note that during the sell-off good quality stocks over-performed significantly, and this reaffirms further the **case for our focus on quality stocks with low leverage and healthy balance sheets**.

Portfolio construction

We note that position unwinding by investors such as hedge funds or risk parity funds that have to either face redemptions or reduce risks may also prompt some dysfunctional market reaction in the short term. Government bonds remain volatile and this undermines also the potential hedging quality of US Treasuries. Zero/negative yields on core govies and the search for yield will return as soon as the situation stabilises – this is certainly on the cards given the extremely accommodative monetary stance, but in the short run investors should be aware that some moves in the opposite direction could occur.

On a long-term perspective, we believe that while most businesses will return to normal operations, some areas will go through profound transformations. We will likely see a new wave of nationalisation in some sectors (i.e., airlines) and deglobalisation forces could be further reinforced (local production reinsourcing is already happening), which could increase the scope for country/regional diversification.

“The outlook for the credit market is more challenging, particularly in sectors that were already in trouble (i.e., US HY energy). There is still scope for spread widening, but when the dust settles, there are opportunities for robust business models.”

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Definitions

- **Asset purchase programme:** A type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Credit spread:** Differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.
- **MBS, CMBS, ABS:** Mortgage-backed security (MBS), commercial mortgage-backed security (CMBS), asset-backed security (ABS).
- **P/E ratio:** The price-to-earnings ratio (P/E ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings (EPS).
- **Quantitative easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **Volatility:** A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

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