

Don't panic: market overreactions may turn into opportunities for long term investors



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Key messages

- *At the time we are writing, major losses are occurring in risk assets, with equity indexes in Europe opening down today by around -6% to -8% and volatility spiking (VIX index above 58, a level not touched since the Great Financial Crisis in 2008). Demand for safe haven assets has surged to record levels, with the 10 Y US Treasury yield dropping to a new record level below 0.4% and gold touching a seven-year high above \$1,700. The recent reaction reflects fears of increased spreading of the coronavirus at European and global levels and increased uncertainty on the economic outlook, with the news on falling oil prices adding to this uncertainty.*
- **The oil price is crashing by around 20% amid a disagreement on oil production cuts between OPEC and allies. The energy sector is increasingly under pressure due to both demand shock from the coronavirus and supply concerns. We stay cautious on the sector both in the HY and IG credit, as we believe that it will be difficult to see an agreement in the short term.**
- **As of today, we believe that markets have gone from being overly complacent to overly pessimistic, discounting a prolonged period of stagnant growth. Our central case, instead, is the one of a temporary setback, although more prolonged compared to what we were expecting a month ago, followed by a recovery. It is uncertain when economic activity will resume in Europe. Monetary policy support is needed to mitigate the credit crunch risk, while fiscal push is required to support the shock on the supply side**
- *We could see a further leg down from the current level, if we were to move towards a global recession. But we believe that at the moment, this remains a tail risk. **We expect more central bank interventions, after last week's Fed cut, and more fiscal policy, on top on what has already been announced in various countries (Italy, the US, Australia, just to name a few). These measures could cause the economy to stabilise and avoid a global recession. Encouraging signals are coming from China, where activity is gradually resuming.***
- *Profit-taking, short-term market volatility, and investors' overreaction were on the cards already in the last couple of week, when the situation started to deteriorate in Europe. **This situation supported a tactical move towards a more cautious stance in risk exposure, and an increase in hedging to navigate this phase.***
- **Liquidity is a key priority at the moment and we remain watchful of liquidity conditions in the market.** As we have pointed out many times in recent months, market liquidity was one of our main concerns. Managing liquidity risk is an integral part of managing portfolios, alongside that of the risk/return balance. It is carried out via three levels: the first would relate to **carrying out fund-by-fund stress tests both in terms of their assets and their liabilities, and adapting the liquidity in the portfolios accordingly.** In the event of massive withdrawals, this would require putting in place measures designed to guarantee equal treatment of unit-holders, such as swing pricing. Finally, there would be the need to have a solid financial structure (equity, permanent resources) to possibly face extreme risks. At this stage, **we are at the first level and have increased the liquidity focus across the board.**
- **In conclusion, our main message today is that in these situations of indiscriminate selloff, fear is the enemy to fight.** Investors should stay vigilant, but not over-react to current market conditions. In these circumstances, opportunities arise for long-term investors that can add to fundamentally strong investment cases that pay off in the long term.

“We believe that the impact of the epidemic should prove short-lived and not harm potential long-term growth of economies”.

“In Europe, there is room of manoeuvre and we will likely see the ECB do whatever it takes with more fiscal policy intervention”.

“If fiscal monetary support coordination occurs, we expect a U-shaped scenario, with a significant rebound in GDP growth in the second half of the year”.

HOT QUESTIONS

How is the epidemic evolving and what could be its potential economic impact?

The epidemiological characteristics of this pandemic (low mortality rate, probably much less than the 2% reported for the whole population, and in any case less than 0.5% for the labour force) suggest that **the impact of the epidemic should prove “short-lived”** (first half of the year). An epidemic of this nature affects neither demography nor physical capital, provided that the policy mix is adequately calibrated, with a full mobilisation of fiscal tools.

In other words, **the medium-term potential growth of economies is intact as far as monetary and fiscal actions promptly materialise**. Once the epidemic has stabilised, economies will rebound (much more likely in H2) and catch up some of the lost ground: the supply shock disappears and "pent-up demand" materialises (except in some sectors where losses in activity are not recoverable, such as tourism and air transport).

At the moment, the "fear factor" is at full play because the whole population understands that the situation will likely worsen further in the coming weeks. That being said, **despite the panic that has gripped markets, we believe that investors should remain as calm as possible**.

What can we expect for Europe moving ahead?

It is true that Europe is more exposed at the moment to the spread of the virus and that the fall in interest rates will not offset the negative shock on growth that is coming from the actions taken to contain the virus outbreak. **But, we think it is wrong to believe that the authorities have less room for manoeuvre than in the United States**. From our point of view, "conventional" monetary policy is relatively ineffective in the current circumstances. For example, there would be no point in lowering the deposit rate further into negative territory, but they will need to accelerate quantitative easing.

The pandemic is giving rise to both a supply shock (via the disruption of global value chains) and a demand shock because of all the preventive measures that are being taken. Given these conditions, the priority is to maintain access to credit. The ECB should show that it is prepared to do "whatever it takes" to maintain liquidity and stabilise financial conditions. The ECB has many tools at its disposal and will probably substantially increase its asset purchases (NB: The ECB 33% limit is not a legal constraint, but self-imposed. It can be increased up to 50%.)

But, this type of shock **more than ever requires fiscal policy intervention**. Governments have several levers at their disposal: giving wage compensation to those who are tied up at home; transfer spending to the most fragile; tax credits for those who cannot pay their debts, or to ensure the sustainability of sectors in serious difficulty (tourism sector, hotels, catering, air transport). **On the fiscal front, there are many options to counteract the shock. It is essential to avoid a cascade of corporate defaults amplifying the shock**.

This will have a budgetary cost, where the ECB can play a role by encouraging budget expansion via temporary fiscal measures. However, it should be mentioned that the Eurozone as a whole has a lower budget deficit than the United States and that public debt in the Eurozone is tending to fall while it continues to rise in the United States.

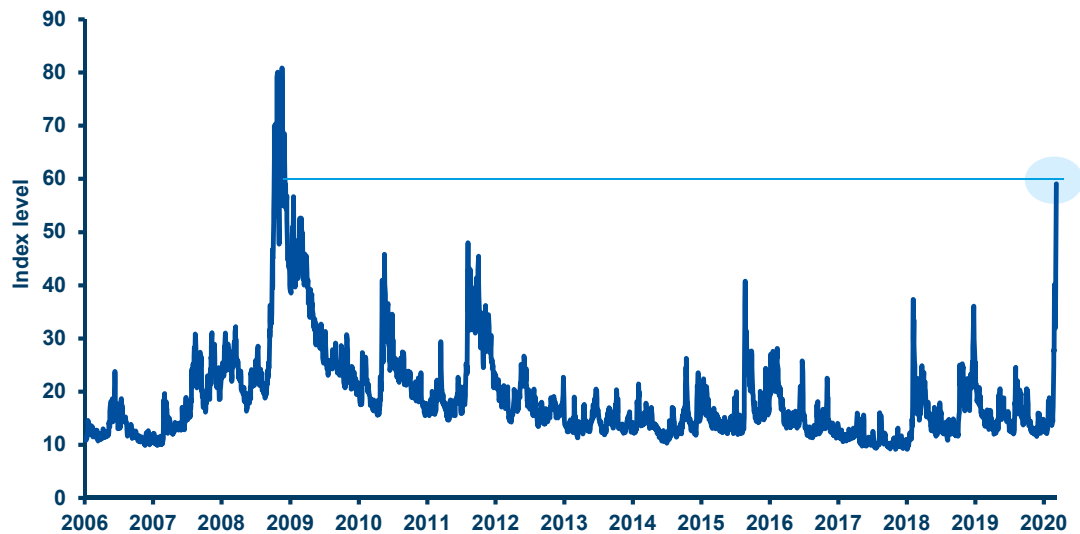
It means that there is room for manoeuvre in the Eurozone. But, the public finances of some countries are in a delicate state. That's why at the same time, the ECB's support must be secured. In exceptional circumstances, the European Commission has no reason to object to extraordinary measures, and given the scale of the shock, Germany, whose economy could easily fall into recession, may be one of the first countries to set an example. And, this already looks to be the case as Chancellor Merkel's coalition is loosening rules for short-term work compensation, making it easier for big companies affected by the virus to apply for aid. **Provided that governments and the ECB manage to act in concert and the health crisis stabilises, we still expect a recovery scenario, with a significant rebound in GDP growth in the second half of the year. This would open the door to a significant rebound in the equity markets**.

“Currently market expect a longer time to recover, but no global recession. We think that the worst could be contained to H1 as we already see some signs of recovery in China”.

What is the market pricing now and what could be the further evolution?

As stated above, markets have become over-pessimistic. In our view, markets are now likely expecting a global L-shaped recovery with economic growth damaged in Europe and China and a longer time to recovery (beyond H1 or Q3), but still no global recession. China is likely already past the virus peak and Europe may touch it in the first half of the year. It is true that measure taken to contain the epidemic will have a negative impact on growth, but based on what we believe will be the fiscal measures used and that central banks will step in to support liquidity and the recovery, **the global economy could avoid a recession**. Should a global recession materialise, we may see a further extended sell-off from current levels, but this is not in the fundamentals at the moment. That said, volatility will remain high and some further downward move could occur, and this is why we remain cautious. **But, entry points will also emerge as market reaction looks to be getting excessive.**

VIX volatility index back to levels not seen since 2008

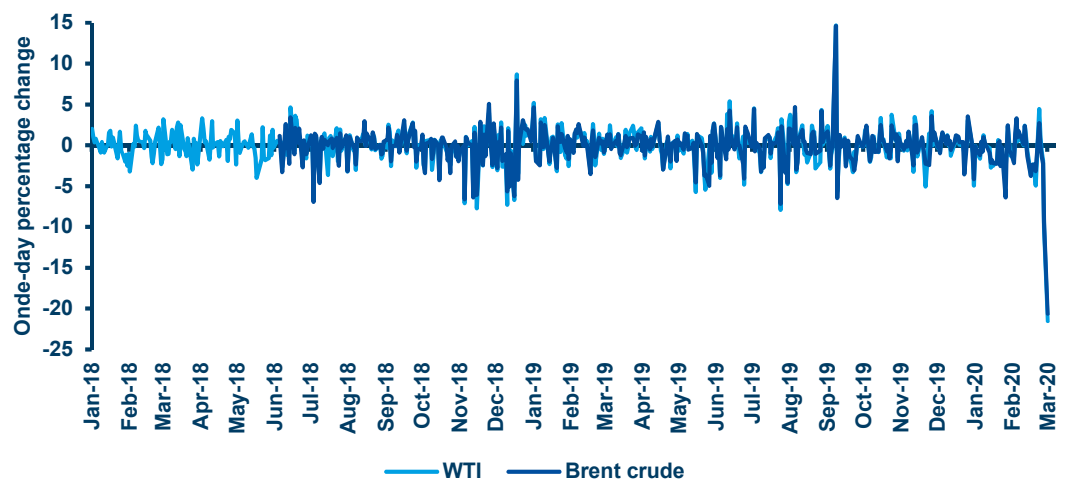


Source: Amundi on Bloomberg data, as at 9 March 2020.

What is happening to the oil and energy sector?

The oil price is crashing by around 20% amid a disagreement on oil production cuts between OPEC and allies.

Oil prices



Source: Amundi on Bloomberg data, as at 9 March 2020.

“The energy sector is increasingly under pressure due to both demand shock from the coronavirus and supply concerns. We stay cautious on the sector”.

On Saturday, Saudi Arabia announced it was slashing its official selling price (OSP) for April for all crude grades to all destinations following Friday’s failure to reach an agreement with Russia on additional supply cuts. In addition, several sources have said that Saudi will ramp production from its current 9.7mmbpd to closer to 11mmbpd in April in order to further pressure oil prices and put stress on Russia and the US. It’s notable that Saudi’s OSPs are also used by other Middle East producers, so the total impact is ~14mmbpd of crude. This is putting pressures on oil prices. **Until now, weakness in energy was entirely the result of the demand shock caused by the coronavirus with some hope that OPEC would continue to provide some support. With that hope now off the table, the sector is facing supply and demand concerns.**

We’ve already seen the lower-quality energy bonds hit hard and this could extend to the entire sector as well, **which is one of the largest HY sectors.** We were already cautious on the energy sector because we saw many of the shale oil companies having unsustainable capital structures. **Due to the recent evolution, we believe it is appropriate to take a more conservative approach to the energy sector overall in both IG and HY.**

How are you dealing with the current environment in your investment strategy?

Overall, in the short term, we remain cautious, as we expect volatility to persist. At the same time, we look for entry points to exploit in the areas of major price dislocations in various asset classes.

- **Multi Asset:** Our focus is on **protection of client portfolios:** we increased **hedging on credit** at the beginning of last week, while we had already **moved to a more cautious stance on equity** at the end of February (EU equity and US equity).
- **Equity:** In **European equities, we are at a crossroads** now. There is a risk of a spill-over into the economy that could result in a recession in key economies, and if this were to occur, earnings will have to come down significantly and the equity selloff could extend further. In our **base scenario of stabilisation of the economy over the next few months** (as a combination of containment of the virus and the various monetary and fiscal stimulus kick in to support the economy), European equities will offer value for investors. In the meantime, investors will have to navigate a volatile environment that will **likely offer entry points** in which **we continue to favour high-quality names.** Our preference is for companies with solid and resilient business models and solid balance sheets. We are starting to selectively add what we consider **oversold consumer cyclicals / industrials,** with a focus on quality.

In US equities, we are overall cautious. The structural themes have not changed: specific consumer/retail, structural tech winners and healthcare. The tactical themes have changed because they were dependent on a nascent global economic recovery that at this point is postponed, leading to cyclicals underperforming vs defensive. **At some point, adding to cyclicals will be the most important decision of the year.** Investors should do that if they have another leg down or after one additional quarter of reporting so that we can assess the damage to the business sector. **Financials will continue to benefit from cheap valuations and strong capital positions, but they will see their earnings fall** because of lower interest rates and increased cost of risk. Utilities are still overvalued, but they continue to work when rates go down. **We prefer real estate.** We note that the relative attraction of US equities vs bond is at historical highs.

- **Fixed Income:** In the recent sell-off, volatility in corporate credit has disproportionately widened spreads in certain sectors and securities. We see that the **US credit market appears increasingly attractive, and we continue to prefer securitised bonds while we are cautious overall on the energy sector.** There are opportunities in companies that remain fundamentally strong, with reasonable leverage and liquidity, strong free cash flow, not capital-intensive or too dependent on oil prices. While we have a cautious stance on US duration, **30-year Treasuries look attractive relative to 10Ys.** We are contemplating further weakness in the USD due to potential interest rate convergence as the Fed eases, and with the increased likelihood of broad-based fiscal stimulus. **On EU credit,** for most of last year and since the beginning of this year, we have been positive. **The coronavirus crisis more recently led us to review our sector view,** reducing our positive bias to cyclicals and sectors directly exposed to this crisis (shipping, auto for instance) and

favoring financials, pharmaceuticals. We have overall increased the focus on liquidity. More importantly, we had, over the past few months, increased the preference for medium term maturities at the expense of long dated one. Finally, we have been more demanding regarding the quality of issuers. We believe it is too soon to increase risk: we would need to see some signs of stabilization. The ECB decisions will be crucial in this respect, and for sovereign credit as well (Italy 10y spread close to 230 bps, 100 bps above January levels). On duration, we have a positive bias, especially in the US.

- **EM:** We think the level of uncertainty is unusually high given the lack of clarity over the spread of the virus and the unprecedented nature in which businesses are reacting across the world. Higher uncertainty necessitates lower risk-taking, in our view.

In **Equities**, we see opportunities in China equity, while in other Asian countries, we remain cautious. There could be entry points in Korea (now neutral), once the situations stabilises. In **EM bonds**, while we maintain a preference for Hard Currency debt given cheapening valuations and a cushion from US Treasuries, we have reduced the risk stance and in particular we favour IG vs HY.

While **we continue to prefer rates to FX, we are mindful that the divergence may have gone too far too fast**. In particular, the slashing of rates in the US has significantly eroded the carry proposition for the USD. **Once risk sentiment stabilises, EM currencies could find their moment to shine**. But we think that in the absence of a global growth pickup (which we do not expect to occur soon), sharp rallies in EM currencies are likely to be short-lived.

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.
- **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.
- **Cyclical vs. defensive sectors:** Cyclical companies are companies whose profit and stock prices are highly correlated with economic fluctuations. Defensive stocks, on the contrary, are less correlated to economic cycles. MSCI GICS cyclical sectors are: consumer discretionary, financial, real estate, industrials, information technology and materials, while defensive sectors are consumer staples, energy, healthcare, telecommunications services and utilities.
- **FX:** FX markets refer to the foreign exchange markets where participants are able to buy and sell currencies.
- **Quality investing** aims to capture the performance of quality growth stocks by identifying stocks with: 1. high return on equity (ROE); 2. Stable year-over-year earnings growth; and 3. low financial leverage.
- **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.
- **VIX:** VIX is the CBOE volatility index. The VIX index is a measure of market expectations of near-term volatility on the S&P 500 (US equity).

Important Information

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