Market Overview

Past pandemics—such as the Spanish Flu which infected 500 million people from 1918 to 1920—were followed by a strong economic recovery, rallying stock markets and a significant improvement in living standards. Of course, the world was different then and we shouldn't necessarily expect such dramatic leaps to materialise this time around. The fact is, we still don't know exactly how long the current lockdown will last and we can't be sure of the ultimate economic and social cost this pandemic will have. It does seem likely that this crisis will have a profound impact on how we do business, invest, travel and go about our lives for some time to come. So, what will the post COVID-19 world look like?

Many of the trends we write about below were already well underway before COVID-19, and we believe this pandemic has the potential to significantly accelerate some, if not all of them. As is the case with any disruptive change, this will create much pain, along with many opportunities for old and emerging industries. The noted economic philosopher, Rudiger Dornbusch, once said: "It takes a lot longer for things to happen than you think that it can, but then they happen much faster than you thought they would." This is how we should approach the crisis.

For example, the rise of populist politics, embodied by the election of Donald Trump in 2016, might have been the fuel for deglobalization and COVID-19 might provide the spark. Likewise, large fiscal stimuli announced around Europe and the US might be a catalyst for a wider discussion about the modern monetary theory (MMT), wealth redistribution and addressing the balance of trade issues for surplus economies like Germany. Many politicians elected on the populist platform now have very little choice but to deliver what they promised, which means an increase in government's share of GDP, the potential for higher taxes on businesses and tougher immigration controls.

In the wake of the Global Financial Crisis, the Fed and many other central banks faced a wave of criticism for embarking on Quantitative Easing (QE). The main argument was that expanding central banks' balance sheets will inevitably lead to runaway inflation. Twelve years on and most economies who engaged in QE programs are struggling to get inflation above 2%. So why should we be worried now? Relative to QE, fiscal stimulus is a very different animal. While the former is simply a balance sheet operation or buying assets from the banking system, the latter, especially in the form of MMT, has a real potential to be inflationary and, in some extreme cases, hyperinflationary. Add immigration control driving labour shortages and a recovering global demand to the mix and you may end up with more than you bargained for.

Another big shift in businesses' behavior we might expect from the post-COVID-19 world is somewhat subdued demand for commercial real estate as firms realise staff can be as efficient working from home as from an expensive prime-location office. This should also drive demand for remote access solutions and cybersecurity software. Most businesses which couldn't be bothered or never had a real need to use tools such as video conferencing, electronic signatures and remote desktop access will have to adapt or die.

And what will happen if China recovers ahead of the West? It will likely find itself heavy on supply and light on demand for its exports, which could easily accelerate its transition to a consumer economy. That in turn might well lead to a significant change in the architecture of global supply chains, which have been set up to support the Chinese export machine for over two decades. A powerful, Asia-focused supply cluster might emerge to support local and domestic economies. The region could become more self-sufficient which could promote the de-dollarization of certain Asian economies: a big geopolitical win for China, which has been trying for decades to expand its sphere of influence.

Of course, the lockdown gives us plenty of time to muse about what macro changes might lie ahead, but as this pandemic has illustrated so clearly, that exercise is full of uncertainty. While it's important to consider what accelerating trends might mean for economies, industries, and individual companies, nobody knows exactly what the future holds. We don't claim to have a crystal ball—we won't predict when the lockdown will end or the recovery will begin—but we will commit to building diversified, defensive portfolios, positioned to benefit wherever the trends take us post-pandemic.

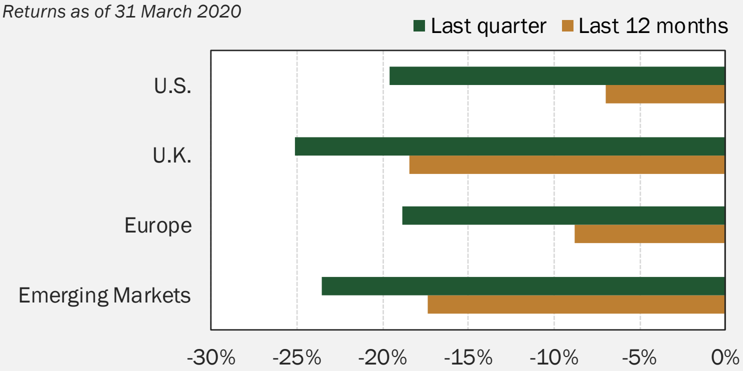
Asset Classes

Equities

In our last quarterly note, appraising global stocks at the end of 2019, we mentioned a number of risk factors looming over richly valued equities, including weak manufacturing data, a slump in corporate earnings, Brexit negotiations, and a trade war between the US and China. We didn't guess the ultimate undoing of an eleven-year bull market would turn out to be a bug measuring just 150 nanometers in diameter, which made the jump to human hosts and brought the world economy to its knees. The first quarter COVID-19 pandemic saw US stocks fall by –19.6%, European shares drop –18.8%, EM equities shed –23.6%, and UK stocks tumble –25.1% (see Figure 1). It's worth noting that, although the novel coronavirus first emerged in China, the nation's swift and extreme response led to effective containment and a muted decline in Chinese stocks of just around –10% for the quarter.

Figure 1: Equity Market Performance

Returns as of 31 March 2020



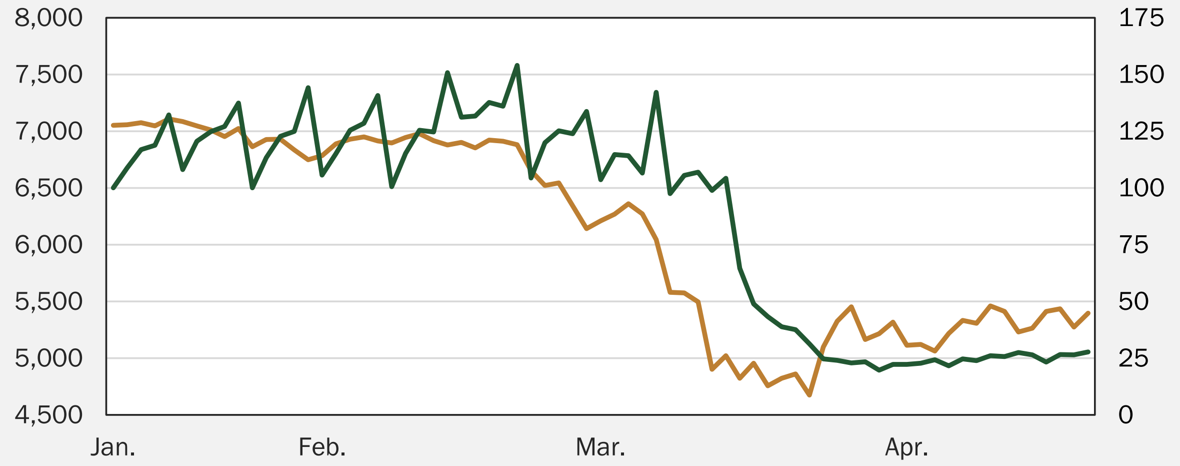
Source: S&P 500 (USD), FTSE All-Share (GBP), EURO STOXX 50 (EUR), and MSCI EM (USD) via Bloomberg

It wasn't until near the end of February, a month after China put the city of Wuhan under quarantine, that infections started mounting in other countries and global stocks began to price the inevitability of similar lockdowns throughout the rest of the world. The UK has been hit particularly hard by suspension of trade, with the March UK Services PMI posting an abysmal record low of 34.5 (anything below 50 indicates an economic contraction), and April's reading coming in at yet another all-time minimum of just 12.3. Big data give us an interesting perspective on the strong link between human activity, economic conditions, and stock market returns. London foot traffic recorded by users of the Apple Maps app neatly reflects the city's rapid descent into stay-at-home orders and business closures—events the market apparently saw coming at least a week in advance (see Figure 2 on Page 3). What investors worldwide seem not to have fully appreciated was the severity of the pandemic and its hit to economic activity, as forecasts for 2020 GDP became increasingly bleak throughout the month of March and into April (see Figure 3 on Page 3).

The same money managers have been hard at work (from the sofa at this point, no doubt) predicting what an economic recovery might look like. Despite horrific economic readings at the end of Q1, nearly 75% of professional investors polled in Bank of America's April *Global Fund Manager Survey* expected either a U- or W-shaped recovery, with 15% calling for a sharp V-shaped rebound, and only 7% predicting the dreaded L-shaped recession (see Figure 4 on Page 4). Of course, for most investors in the markets through the start of 2020, it seems hard to imagine a recovery in the midst of volatility surpassing that witnessed during the Global Financial Crisis, when

Figure 2: FTSE Index a Step Ahead in Clocking COVID-19 Impact on Economy

As cities locked down in March, consumers' mobility plunged. Markets fell in late-February reflecting the expected hit to economic activity. Alternative data—like foot traffic recorded by the Apple Maps app—help measure a connection between the real economy and financial market trends during a crisis.

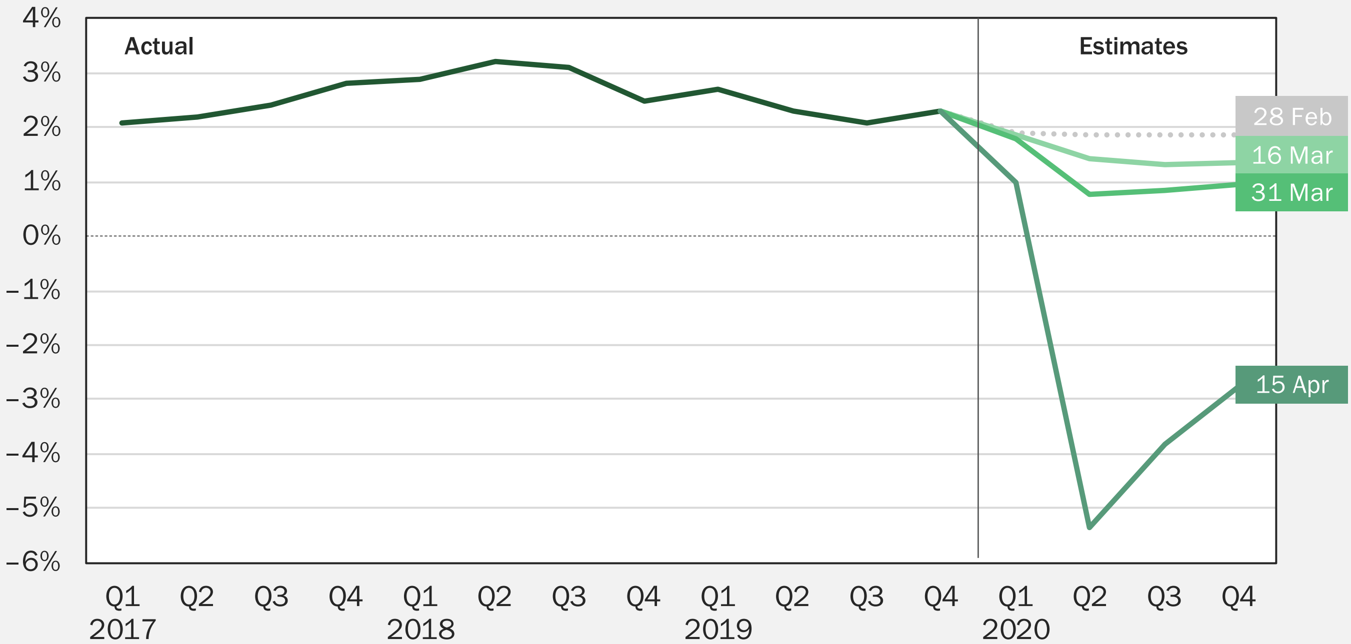


Source: Bloomberg, Apple Mobility Trends

Figure 3: Economists Continue Making Downward Revisions in 2020 GDP Forecasts

Prior to the global outbreak of COVID-19, analyst expectations for economic growth painted a rather average picture. But, with each successive report of the virus' spread and greater recognition of the economic toll mitigation will take, forecasters have become increasingly dismal on the path of GDP growth through this year.

Actual and average forecasts of year-over-year GDP growth for the U.S. economy, various dates

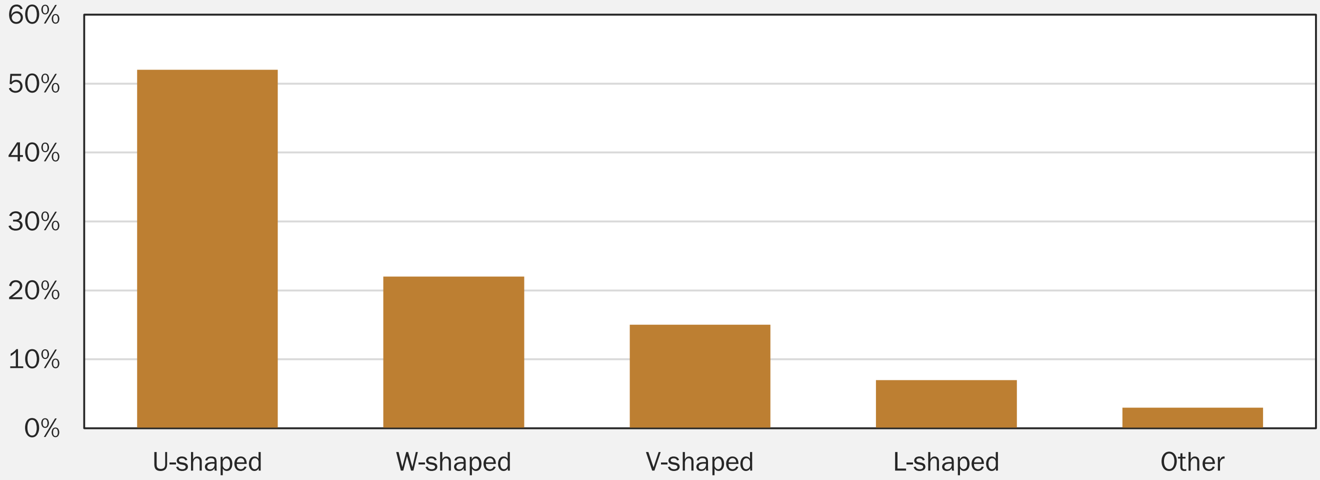


Source: Bloomberg

Figure 4: Fund Managers Expect the Economy to Shape Up—But Not Immediately

Over half of those professional investors polled in Bank of America's Global Fund Manager Survey in April expected the next recession to follow a U-shaped path to recovery. That's not as optimistic as the V-shaped rebound being touted by pundits earlier in March, but also not as dismal as the L-shaped variety, which would cause more pain for investors.

Percentage of respondents with expectations of each recession type

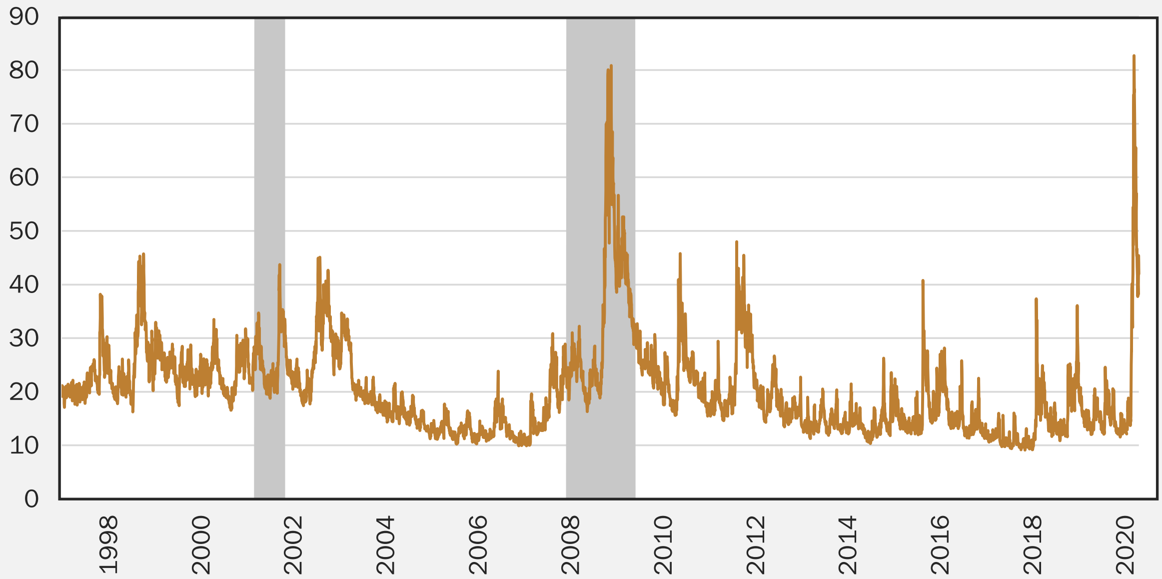


Source: Bank of America

Figure 5: Stock Market Volatility Hits a Crescendo in March, Signals Investors' Stress

The Chicago Board Options Exchange VIX Index—often referred to as the "fear index"—measures investors' expectations for volatility. The index, which has been running since the early 1990s, notched a record high in March, surpassing levels seen during the Global Financial Crisis, as equity investors panicked over the global spread of COVID-19.

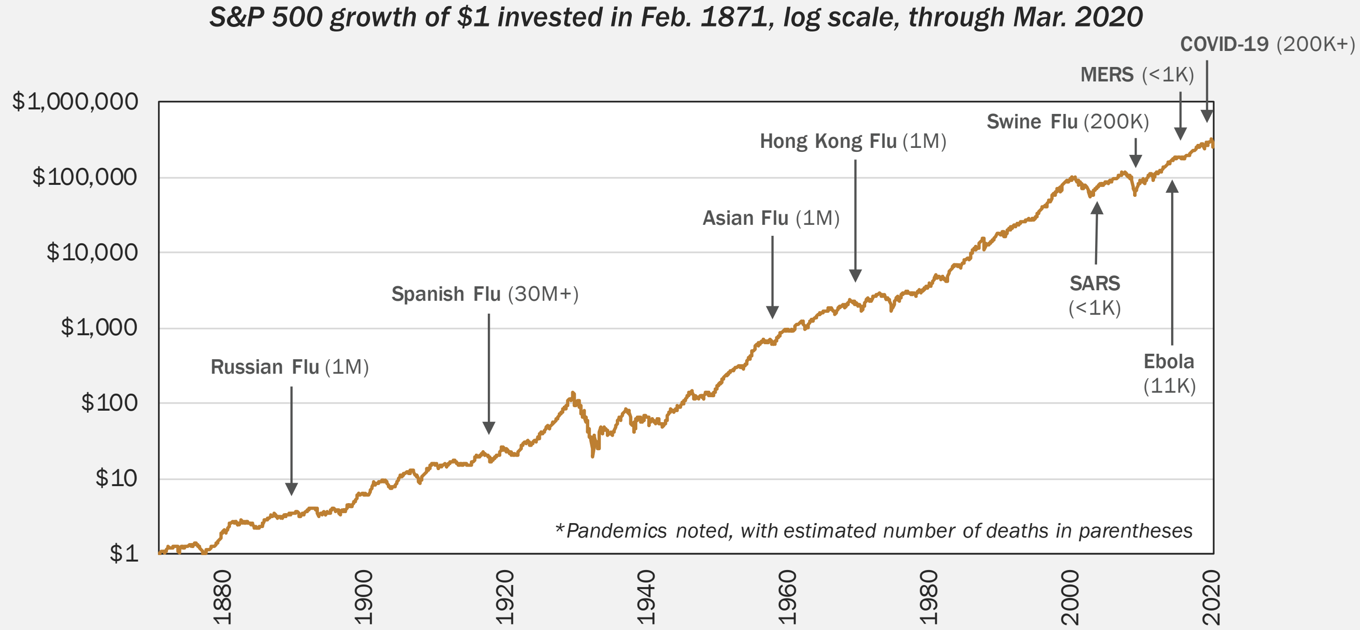
Daily closing level of the CBOE VIX Index, Jan. 1997 – Apr. 2020



Source: US Federal Reserve, NBER recessions shaded

Figure 6: Through 150 Years, Pandemics Barely Touch Market's Growth

For millennia, mankind has endured a long list of infectious diseases, including pandemics like the Spanish Flu, which infected one-third of the world's population and killed an estimated 30 million from 1918 to 1920. Over nearly 150 years, the effects of even the worst cases are hard to spot against the relentless growth of stocks through the decades.



Source: Monthly data from Bloomberg, supplemented with data from Prof. Robert Shiller prior to 1928, all in USD; list of outbreaks and death tolls from World Economic Forum visual history of pandemics

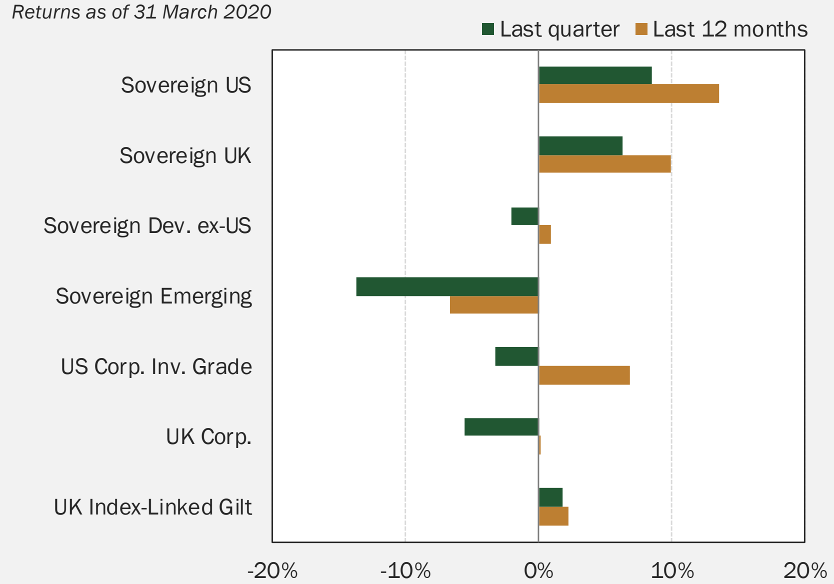
the world's economy seemed on the brink of collapse (see Figure 5 on Page 4). Nevertheless, zooming out for a much wider view on the market's progress through nearly 150 years of pandemics, it's hard not to see entrepreneurship and human ingenuity— which ultimately drive long-term market growth—winning out sooner than later, even if the short run holds further dips down in prices (see Figure 6 above).

Fixed Income

In the midst of a pandemic, bond investors' flight to quality left the usual safe haven sovereign issues higher, while fear over the effect a

Figure 7: Fixed Income Market Performance

Returns as of 31 March 2020

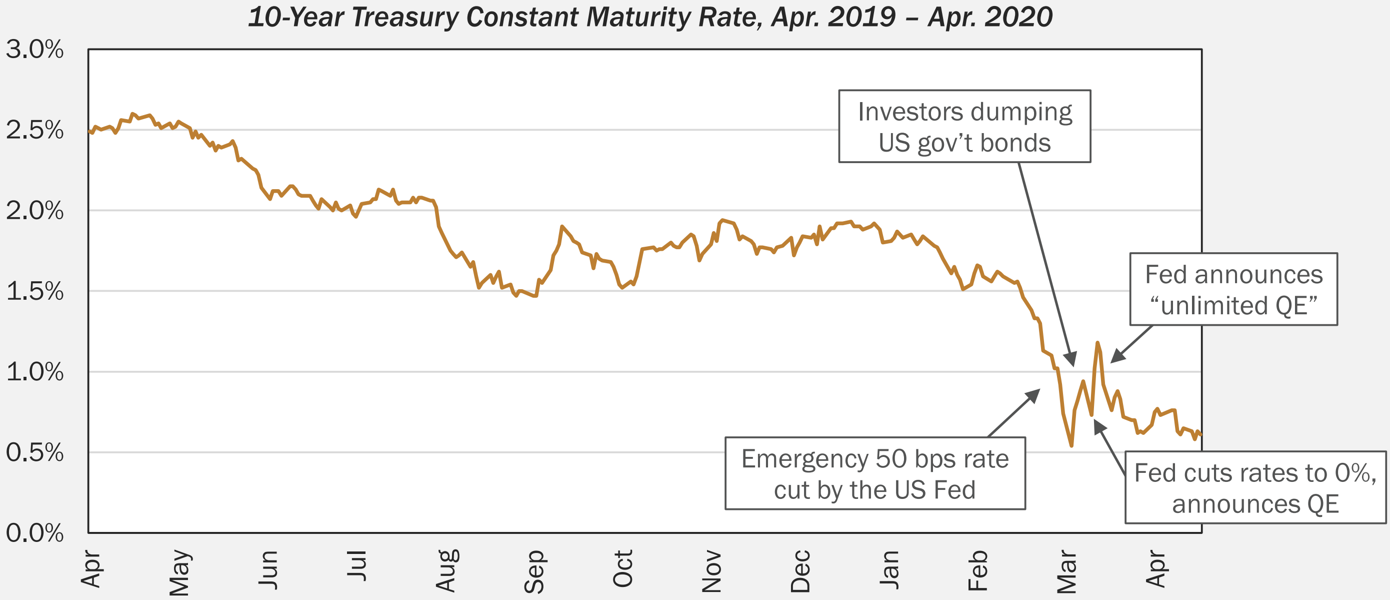


Source: Bloomberg, expressed in USD except for UK Gilts and UK Corporate in GBP deep recession might have on credit markets prompted losses in riskier debt (see Figure 7 on Page 5). While governments around the world enacted fiscal stimulus in an effort to fight the economic fallout of COVID-19, central banks did what they do best, pumping trillions of dollars of liquidity into the global financial system. The US Federal Reserve made an emergency 50 bps rate cut on 3rd March, slashed by another 100 bps on the 15th—bringing the fed funds rate to near zero—before announcing on 23rd March a policy of "unlimited" quantitative easing that by the end of March had seen record purchases by the Fed of Treasuries and mortgage-backed securities at a clip of $75 billion *per day* (compared to $120 billion *per month* in the most perilous days of the Global Financial Crisis). Between monetary stimulus and the usual flight to quality, Treasuries leapt in price and yields plunged, albeit with a brief and troubling spike in the rate on 10-year notes as panicking investors liquidated everything, including longer-term government bonds, in favor of cash (see Figure 8 below).

Corporates generally suffered in the first quarter, with US investment-grade bonds giving up a year's worth of gains in a span of two weeks in mid-March, although stimulus near the end of the quarter saw corporate debt pare its losses. Indeed, credit spreads spiked in the first quarter, suggesting investors momentarily priced a heightened risk that the potential for prolonged economic pain from COVID-19 might eventually propagate to credit markets and do real damage to the financial system. At the same time, it's worth noting that the high-yield spread, while elevated, didn't come close to levels observed during the Global Financial Crisis (see Figure 9 on next page). In an interesting analysis published by Julian Kozlowski, Miguel Faria-e-Castro, and Mahdi Ebsim at the St. Louis Federal Reserve, credit spreads calculated for bonds in high-contact-intensity industries—e.g., personal care services and air travel—jumped significantly more than those in low-contact sectors of the economy, demonstrating the nuanced effects public health measures like social distancing and travel restrictions are having on the real economy and financial markets in this pandemic.

Figure 8: Massive Monetary Stimulus, Flight to Quality Send Treasury Yields Lower

March and April of 2020 saw central banks taking dramatic action to stave off economic disaster in light of COVID-19, cutting interest rates dramatically and pumping trillions into global bond markets through quantitative easing. Even so, the usual flight to quality that sends investors worldwide into U.S. Treasuries occassionally lost out to panic selling.

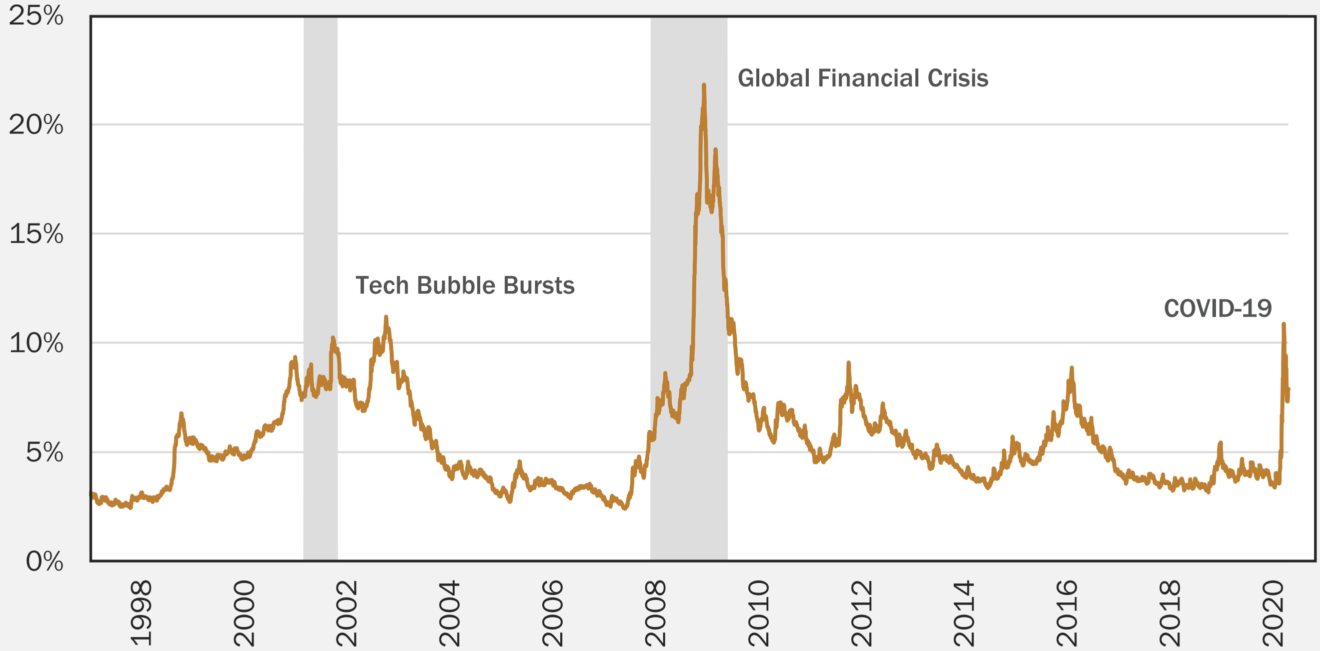


Source: US Federal Reserve

Figure 9: Spreads Spike, But Perceived Credit Risk Still Far Below Peak in '08-'09

Credits spreads—like the difference between U.S. high-yield corporate bonds and U.S. Treasuries, depicted below—help to visualize investors' perception of risk in the credit markets. While a spike in the high-yield spread suggests a greater chance of corporate defaults, risk of a full-blown credit crisis rates far less than during the Global Financial Crisis.

Daily level of Bank of America Merrill Lynch High Yield Option-Adjusted Spread, Jan. 1997 – Apr. 2020



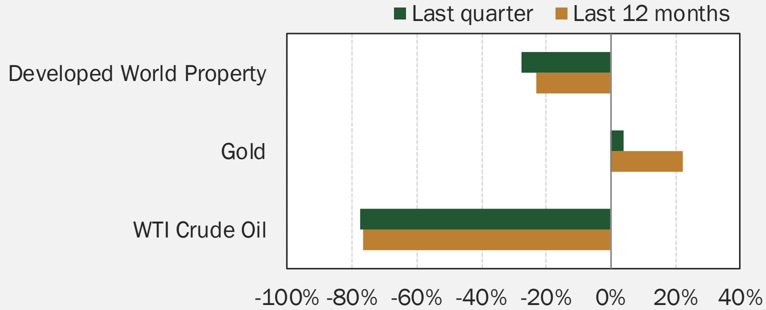
Source: US Federal Reserve, NBER recessions shaded

Alternatives

Oil was one of the biggest gainers among commodities in 2019, but suffered a dramatic decline in the first quarter, falling by –77.4% in the face of simultaneous demand and supply shocks (see Figure 10). With the world economy—including car traffic, air travel, and large swaths of manufacturing—effectively on hold for the foreseeable future, consumption of crude plunged with estimated global demand for oil lower by a record 9.3 million barrels per day (see Figure 11 on next page). Making matters much worse, Russia walked out of talks in early March between members of OPEC+ to decide on production cuts in response to the coronavirus-related drop in demand, triggering a price war with Saudi Arabia that had not been resolved by the quarter's end.

Figure 10: Alternatives Performance

Returns as of 31 March 2020

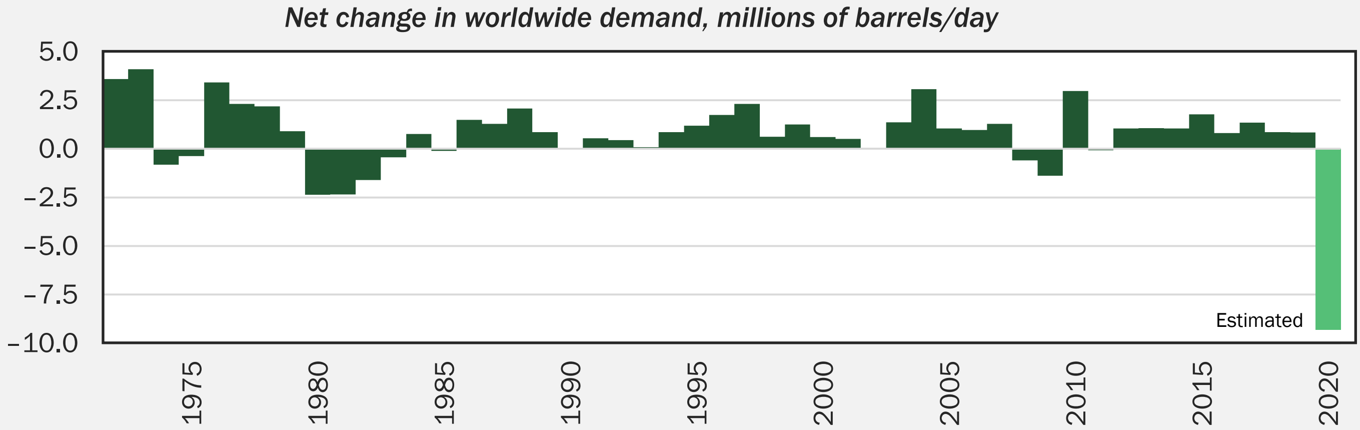


Source: iShares Int'l Dev. Real Estate ETF (USD), WTI Crude (USD), Gold Spot (USD) via Bloomberg

REITs had a wild ride during Q1, generally suffering as the effects of COVID-19 put the global economy on a clear path to recession, then rebounding somewhat

Figure 11: As the World Shuts Down, Oil Demand Forecast for Its Worst Year on Record

One casualty of the global spread of COVID-19 and corresponding slowdown in economic activity has been worldwide demand for oil, which is expected to experience its biggest decline ever by year end, with consumption falling by 9.3 million barrels per day. Coupled with an ill-timed price war among oil producers, this resulted in large losses for crude in the first quarter.

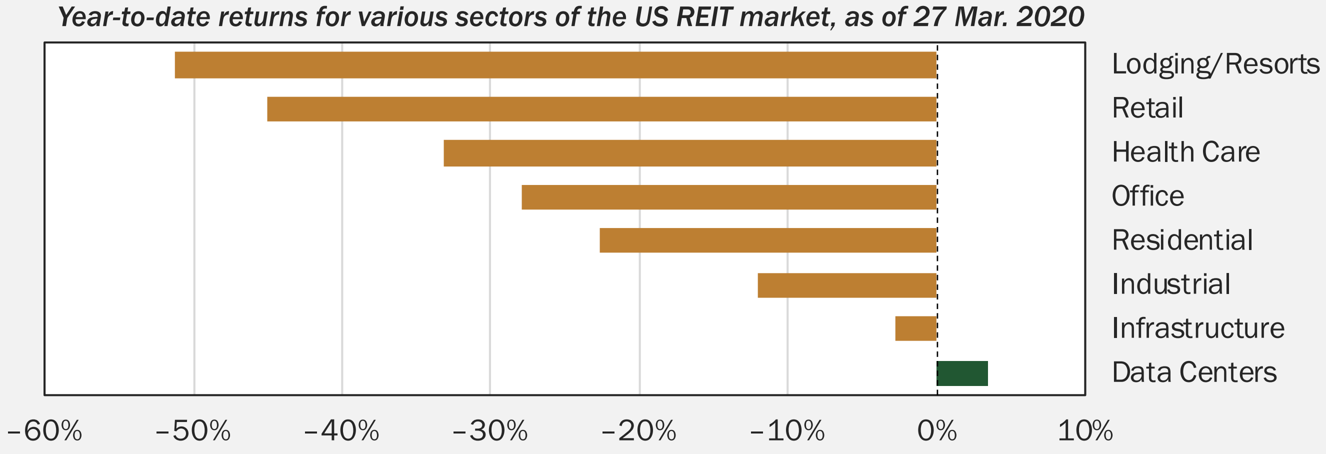


Source: International Energy Agency, Bloomberg

with the massive monetary stimulus enacted in the final weeks of March. Still, Developed World Property ended –27.7% lower through the end of the first quarter—especially disappointing in light of the popular view that REITs should offer diversified exposure relative to common stocks in periods of market stress. It's interesting to note that not every segment of the real estate market fared equally in the pandemic, with Lodging/Resort and Retail REITs experiencing the greatest declines, falling by –51% and –45%, respectively, while Infrastructure REITs only lost around –3%, and Data Centers (powering Netflix while the world sheltered in place) actually *added* 3% for the quarter (see Figure 12).

Figure 12: Real Estate Investments Differ in the Damage Done by COVID-19 Lockdown

The degree of diversification offered by real estate investments in the current crisis depended on a property's exposure to the economic disruption caused by COVID-19. With travel mostly suspended, hotels have suffered; with housebound consumers needing mobile phones and internet service more than ever, data centers have prospered.



Source: Nareit

Looking Ahead

With most markets down double digits since the end of last year, Q1 2020 will likely be remembered as one of the most brutal quarters since the Global Financial Crisis—perhaps even since the 1930s for some emerging markets. In the US, first-quarter earnings have been disastrous for the Financial and Basic Materials sectors. With most banks reporting sharp drops in revenues and taking 2008-like provisions for loan losses, Wall Street is clearly preparing for a serious slowdown. Meanwhile, oil and other commodities have been crushed by demand destruction due to COVID-19, which has already resulted in significant oversupply and stress for the industry.

Midway through the US earnings season, there is still less visibility than one might hope to have in terms of the actual impact of COVID-19 on the real economy (perhaps the number of companies pulling guidance tells us something). The Q2 earnings calendar might be more relevant, and most market commentators expect next quarter to be far worse than the last. Taking oil prices as a proxy for economic prospects, one sees a very bleak picture.

That said, some European economies are already beginning to lift lockdowns. Once the social distancing restrictions are lifted or eased, the global economy may start surprising on the upside. E-commerce and remote access technologies have just passed the most important test in terms of their ability to scale up capacity. There will be winners coming out of this crisis, and as usual, the market will take most investors by surprise. Q2 might have been written off by many, but we may see some light at the end of the tunnel very soon.

Key Economic Releases and Events for Q2 2020

UNITED KINGDOM

Bank of England Official Bank Rate Release:
7th May, 18th June

PMI Figures:
1st May, 5th May

EUROZONE

YoY GDP:
30th April, 29th May, 30th June

PMI Eurozone:
6th May, 4th June

Unemployment Report:
30th April

ECB Monetary Policy Meeting:
30th April

UNITED STATES

FOMC Rate Decision:
29th April, 10th June

GDP Figures:
29th April, 28th May, 25th June

PMI Figures:
1st May, 1st June

Closing Comments

We often take it for granted that markets operate with extreme efficiency. But there is substantial evidence that at least in the short term, prices are prone to overreact, overshooting on both the downside and the upside. Markets are made up of human beings, after all, buying and selling securities with one another. It should be no surprise, particularly during times of severe market stress when emotions run high, when we see behavioural bias dominating. As students of investor behaviour, we believe there are valuable lessons to be learned in such periods by a critical evaluation of the bias in investors' trades.

During a mid-April sell-off in the price of oil, for example, US retail brokers saw a surge in new accounts opening. Small mom and pop investors piled into the markets trying to trade oil, cheered by talking heads on TV. Unfortunately, many ended up buying the wrong products or took on too much leverage and failed to withstand short-term volatility, forced to liquidate with substantial losses. Often, those who had never invested before, motivated by fear of missing out, attempt to trade with no knowledge of the market, eschewing basic risk management and trading on gut instinct. Once burned, of course, they swear never to invest again. That is until they hear their neighbour made a killing trading some penny stock or a beaten-down commodity. And so, the vicious cycle of investor self-harm continues. Time and time again, volatile markets combined with fear and greed lead investors to shift their focus away from long-term investment goals in favour of short-term speculation.

These are precisely the times when an institutional approach shines. The institutional approach to investing does not register feelings of envy, does not act on a sudden onset of panic, is not motivated by a short-term urge to gamble and, most importantly, is disciplined enough to stay the course as opposed to deviating from a winning strategy when market conditions change. That's not to say the institutional approach isn't dynamic. Indeed, it sows seeds of outstanding performance in times of extreme fear; it takes profits and assumes a defensive position when greed prevails. Markets are made up of human beings, and that's what makes investing so difficult. COVID-19 has made for a more difficult market than most. At Henderson Rowe, we believe the institutional approach turns this challenge into a distinct opportunity.

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