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After the Storm

by Jeroen Kakebeeke

Almost back to Strategic Asset Allocation

The Corona Pandemic is largely under control, although new clusters pop up.

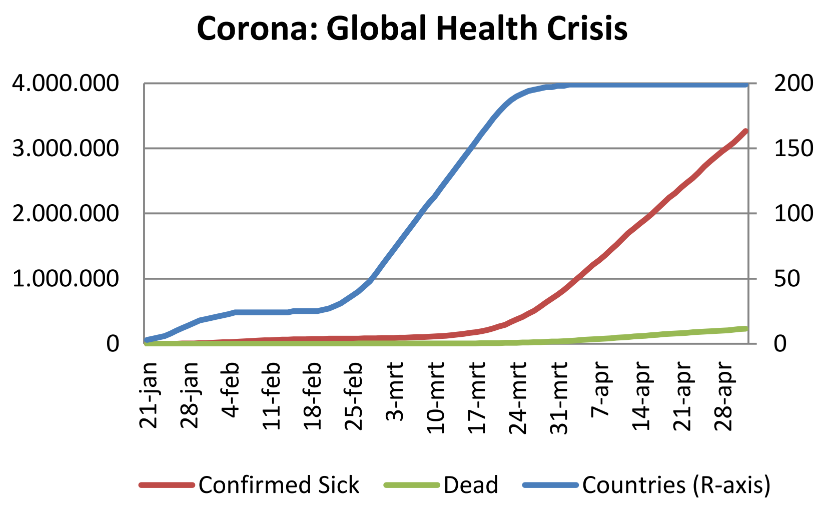
The Global Economy is largely opening up, although many restrictions stay in place.

Financial Markets have largely adapted to the recession and expected recovery.

Summary
At the end of January I strongly recommended to sell equities because of the Corona outbreak. Financial markets completely overlooked consequences for the economy and companies. Because of earlier scenarios and analyses I was prepared and partly protected. In my second investment letter of March I gave a roadmap to rebuild the investment portfolio. Hereby I share the latest insights to get almost back to Strategic Asset Allocation.

Crisis Management
The Corona pandemic is first of all a global health crisis. World leaders, often in close cooperation with government and epidemiologists, took bold action with lockdowns. Cities and companies had to close or keep their operations running with a minimum workforce and available cash. People and firms were focused on survival in the short term. The financial markets were taken by surprise and panicked. Big rotations took place in asset classes and sectors, all towards Risk Off. Many were trying to understand the situation by reflecting on history. Currently, *after the shock*, we start looking with ambition to the future again. We can plan and make investment decisions on qualitative arguments and facts.

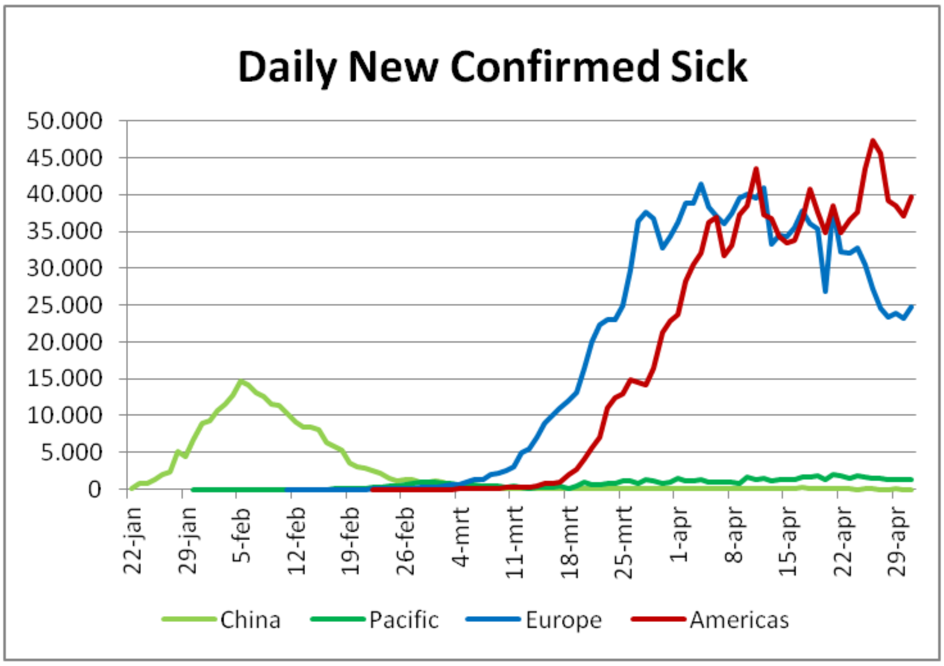
Corona
It is necessary to understand the Corona pandemic better to make any forward looking statements on the economy or financial markets. Although we know the numbers of infected and dead are incomplete (underreported), they give direction. Globally, all countries are infected. The growth in Corona infections is no longer exponential. The basis of sick people becomes larger, but the percentage of new confirmed sick is coming down. Society has adapted and we can cautiously conclude the Corona outbreak is not clogging the health care system. Still, the development of confirmed sick and dead looks grim, with no apex in sight.



Source: WHO, JK

Around the globe governments implemented lockdowns in accordance with their countries' culture, habitat and earlier experiences with a virus outbreak. Asia had most limitations. There, society is more valued than the individual, and Asia has the most multi-million cities, moreover with highest population density. The (relative) freedom in the West gave Corona more room to infect people and it takes longer to contain the virus.

The longer duration has to do with the nature of the Corona virus, and was confirmed by:
a) **US Centers for Disease Control** said on April 21st that the next wave in winter 2020-21 could be worse than we have experienced this spring.
b) **WHO** Director-General Dr. Tedros, cautioned on April 23rd that "we have a long way to go. This virus will be with us for a long time".
c) **German Chancellor Angela Merkel** has said on April 23rd her country must remain "clever and cautious" in handling the Corona crisis, as it is "not the end phase but still just the beginning. We'll have to live with this virus for a long time."



Source: WHO, The Lancet April 21st , JK

The deaths are a tragedy, the confirmed sick are a bellwether for economic damage. Looking at the four waves, the confirmed sick in China were concentrated in the city Wuhan, in the province Hubei. The Pacific does not show in the graph as a curve, it has a remarkable low number of infections, but still smoldering. South-Korea has the most successful combination of extensive testing, patient isolation, and an open economy. Europe and the USA are longer on a plateau, it takes them considerable more time to bring the number of infections down.

Emerging Markets are so diversified, literally the rest of the world. Generally, they lack test material, education, hospital beds, and relief funding. Some developing countries had already worries in food shortage, refugee camps, migrant workers without income and no way out. Some countries are even plagued by (religious) leaders who downplay the Corona threat.

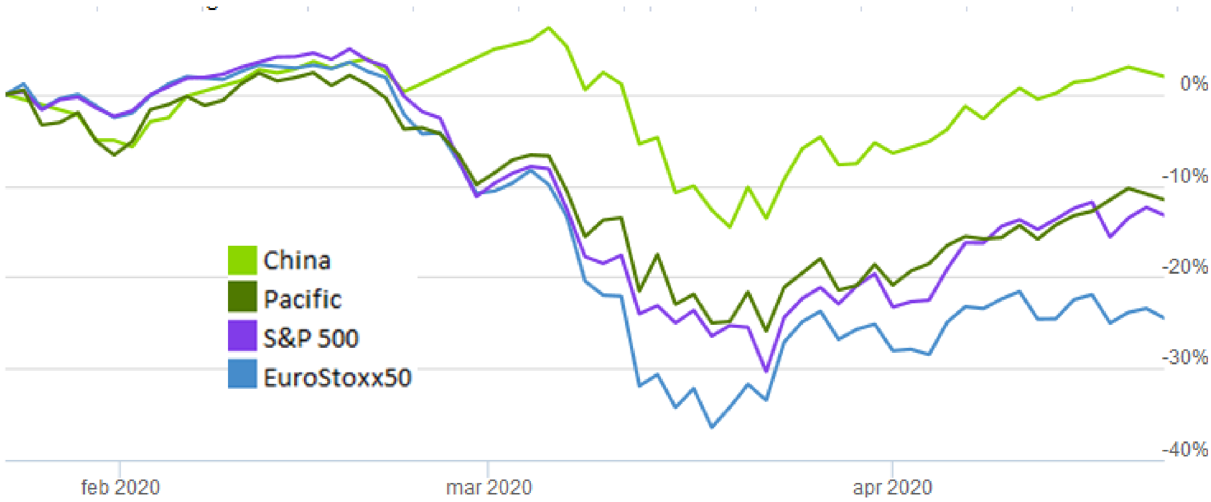
My calculations for the Corona deaths have not changed since January and March:
- minimum of 2.500 for the Netherlands and maximum of 30.000, probable in the middle;
- minimum of 42.500 for the USA and maximum of 500.000, probable in the middle.

What has changed though, is the expected duration of the pandemic:

End of Corona	April estimates	January estimates
Spring 2020	X	X
Summer 2020	**10%**	50%
Spring 2021	**70%**	30%
Never	**20%**	10%

Economy
The Corona led recession has already unprecedented consequences. Developed markets' unemployment is skyrocketing towards 20%, and GDP numbers for the whole year become negative. From a macro view, it seems like governments do fill the output gap by massive relief packages, which are about 10% of GDP. Central Banks support with lower interest rates and more liquidity in the financial system. For sure we get a huge redistribution of wealth.

World leaders walk a tightrope to save lives and save the economy. In the US, the trade-off between epidemic control and economic development seems to favor the latter. Trump hurries to reopen the economy and claims victory with his USD 1.200 pay check. Secretary Steven Mnuchin seeks praise for his Coronavirus Aid, Relief, and Economic Security (CARES) Act of USD 2 trillion. However, according to CNN it is the elderly who pay with their lives.



See above the four stock markets, and compare with the earlier graph 'daily new confirmed sick'. There is a correlation between infections and stock market performance. Emerging Markets equity has performed worst, in line with a depressed outlook for their Corona epidemics. Year-To-Date returns: Brazil -48%, Mexico -40%, Russia -30%, India -26%.

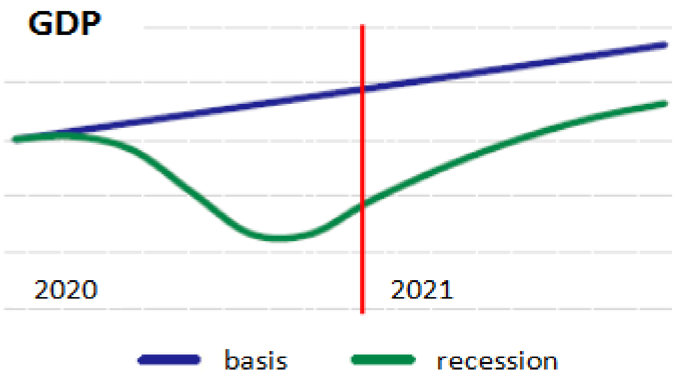
China was first to reopen their economy, but the hoped V-shape recovery is absent. It takes longer to restart factories, global trade stands still, people fear contagion, and consumers spend less money because of uncertainties and the need to rebuild a financial buffer. Call it the multiplier effect, or second order effect.

European consumers too are tightening their belts as they brace for the corona pandemic to hit both their income and savings, a global McKinsey survey has shown. Moreover, governments are announcing an extension of restrictions, albeit with some loosening. Physical distancing will be the norm for as long as a vaccine is unavailable. Probably, restrictions remain in 2020.

This is longer than the market currently expects. It will have devastating effects on consumer spending, hitting certain sectors hard, and especially small- and medium enterprises. Shops, sport centers, transport, restaurants, hotels, bars and movie theaters will likely reopen at half the capacity, with only half the workforce and hopefully some profits. In sectors like aviation, automobiles, energy and tourism, production is lost forever, simply impossible to catch up. Leading research from **IMF** *World Economic Outlook* of April projects a global GDP of -3% in 2020. Advanced economies are doing worse, and worse than I expected.

Advanced Economies	**1Q 20**	**2Q 20**	**3Q 20**	**4Q 20**	**2020**	**2021**
GDP QoQ estimates	-6%	-20%	+ 10%	+ 12%	**-6%**	+4%
EPS YoY estimates	-15%	-100%	-20%	+ 20%	**-25%**	+25%

IMF estimates a cumulative loss of USD 9 trillion GDP over both years, while global GDP is USD 90 trillion. In the graph the area between the blue (basis) and green (recession) line.



Source: PGGM, JK

Other conclusions for the global economy:

- inequality within *and* between countries becomes larger and visible. This might favor a movement towards solidarity, towards more left-wing politicians within countries, while between Northern and Southern Europe the division becomes larger;
- the environment and especially the air is much cleaner, with less CO_2 and related emissions. This might favor a faster energy transition, away from fossil fuels. To start with the abolition of tax exemption on kerosene of the outdated 1944 convention;
- The Corona crisis makes human society more humble towards nature, possibly high lighten the climate crisis and underlying cause in overpopulation. Governments, companies and investors might be forced to implement the UN SDGs faster;
- government debt rises on average by 15%. Probable repay via higher taxes, with a harmonized tax-system across developed markets to reverse the race to the bottom;
- supply chain disruption for critical or strategic products may be rerouted, from China closer to home. When reshaping the supply chain, other Asian exporters get hurt also;
- economic growth is expected to remain slow, a continuation of secular stagnation;
- inflation and interest rates remain lower for longer.

Financial Markets - Equity

In four weeks' time the stock market lost about 33% in value, and volatility quadrupled! For the time being, the market reached a bottom at March 23rd. Thereafter the market rose 20% and volatility halved. Equity markets made the following judgements on Sectors and Factors:

Sector	YTD%	P/E	10YR%		Factor	YTD%	P/E	10YR%
Health Care	-1	27	13		Momentum	-7	25	12
Infotech	-6	25	14		MinVol	-8	21	11
Cons.staples	-8	20	9		Quality	-9	19	10
Communication	-10	21	6		**ACWI World**	**-14**	**17**	**7**
Utilities	-12	16	6		DMF	-15	12	9
Cons.discretion	-13	16	10		Dividend	-16	12	7
Materials	-18	19	1		Equal Weight	-18	14	5
Real Estate	-21	16	6		Risk Weight	-19	14	6
Industrials	-22	16	6		Emerging Markets	-19	13	2
Financials	-27	9	4		Value	-22	9	4
Energy	-28	11	-4					

Source: MSCI, returns in USD ending 28 April 2020

Year-to-date sector performance is understandable, since the trend towards digitalization is accelerating. Online shopping, home cinema or working from home benefits **technology stocks**, enhancing their lead. The five biggest US companies by market cap – all of them technology – make up more than 20% of the S&P 500. Facebook, Amazon, Apple, Netflix, Google and Microsoft were already dominant players. These megacaps have established almost a natural monopoly, are cash rich, not expensive, and have a scalable business model.

Brick and mortar retail lose, together with real estate firms for shops and offices. I like sector neutral dividend strategies, without overweight to financials or energy. The jump in volatility makes option writing more rewarding. It was part of my strategy anyway, and after the crash *selling covered calls* gained importance. I stay away from cyclical value. In a world of *secular stagnation* overcapacity will be the norm, thus holding a lid on inflation and cyclical profits.

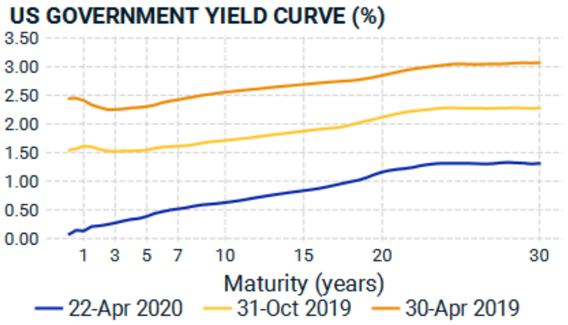
Headlines tracking the scope of the Corona pandemic have driven investor sentiment. In January I expected 40-45% downside for equities. Thus after the crash in March I had bought back most of my equity exposure, and expected a last 10% downside, when the virus would take over the US. Obviously that did not happen, since panic or a liquidity crisis were averted by Central Banks & Governments actions. FactSet analysts see US earnings over 1Q come down with 15% and 2Q will be much worse. Financial markets look further, into recovery.

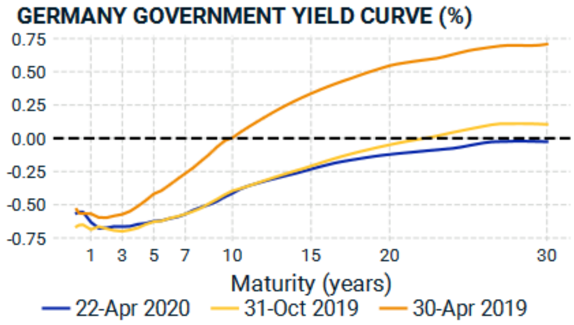
S&P 500	2017	2018	2019	2020E	2021E
EPS	115	136	140	105	130 – 140
Index	2.449	2.746	2.913	2.846	2.600 – 3.100
P/E-ratio	21,3	20,2	20,8	27	20 – 22

The March low will probably hold. EPS for the S&P500 might fall to 105 and come back to 130 or 140 in 2021. Profit growth per share will be smaller because of less buy backs and secular stagnation. Equity demand is driven by a lower interest rate. Medium term, attach a historic 20 to 22 times PE ratio and the S&P target is between 2.600 and 3.100 ultimo 2021. Indeed a bold prediction with such a narrow bandwidth, but my best estimate. It is also a mediocre return expectation, with small return for the risks, but *there is no alternative*.

Financial Markets – Fixed Income

With US interest rate almost zero and negative interest rates by the ECB, safe government bonds have reached their most expensive levels ever. Safe government bonds performed YTD around 10%. Expect negative returns for coming years, this asset class got less attractive.





High Yield, Contingent Convertibles, Emerging Market Debt (USD & Local) and EM Credit all fell around 10% year-to-date in EUR. These fixed income classes got more attractive, with higher carry that more than compensates for the slightly higher default risk.

Conclusion

Risk analyses and scenarios helped me to withstand the Corona storm. Based on new facts and insights adaptations were implemented. In principle, I followed my roadmap and advice: 'come back in the stock market after VIX has topped and signals that the virus outbreak is peaking'. Thus, I missed the largest crash, and am currently almost back at Strategic Asset Allocation. Only a small deviation with less Govvies versus more other fixed income, and less EM Equity versus more DM Equity. Long term, the portfolio has the same risk and same return expectation.

Short term, the Corona pandemic remains the largest risk. The virus has a longer duration, and economic consequences are not precisely known, thus weighing on financial markets. How will upcoming economic activity spark new Corona infections? Do countries then take the sick for granted, or will they impose new lockdowns?

Besides the Corona crisis, do not forget other major economic risks: Brexit, US-China trade war, oil war, cyber security, debt mountain, and climate crisis. International cooperation is much needed, **anti-globalization is most worrisome**. The cold war between the US and China is partly a result of 'America First'. And since my 2011 publication of emerging 'Superpower China', the CPC went from assertive towards aggression. Internally via censor-ship and human right violations, with Hong Kong, Tibet and the Uyghurs. Abroad it is power play in the South China Sea, against Malaysia, Philippines, Taiwan, Vietnam and the United Nations Convention for the Law of the Sea, or the 'debt-trap diplomacy' in Africa.

drs Jeroen Kakebeeke RBA is an Advisory Board member of Institutional Investor, working as Investment Risk Manager for a large pension fund. The views expressed in this paper are his own. The author thanks Kiemthin Tjong Tjin Joe for his valuable ideas.