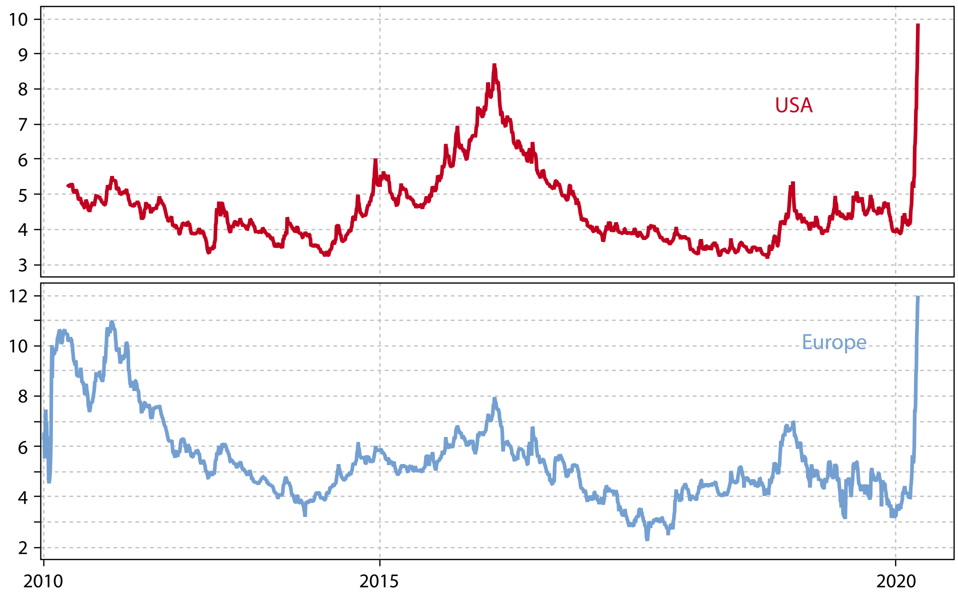
Dorval Asset Management: market note Covid-19

Setting the stage for an economic and financial stabilization

Health measures to manage the coronavirus crisis are currently creating the most serious and financial turmoil since 2008. The world economy is being stifled by lockdown and panic, while the world stock-markets have plummeted more than 30% in the space of five weeks, and yields on corporate bonds have surged considerably on fears of bankruptcies (cf. chart 1). As we write, **most countries are successively implementing massive lockdown measures that are set to last several weeks.** A transition period of several months should then follow.

Severe surge in risk premium on high yield bonds

Differential between high yield corporate bond yields and risk-free rates



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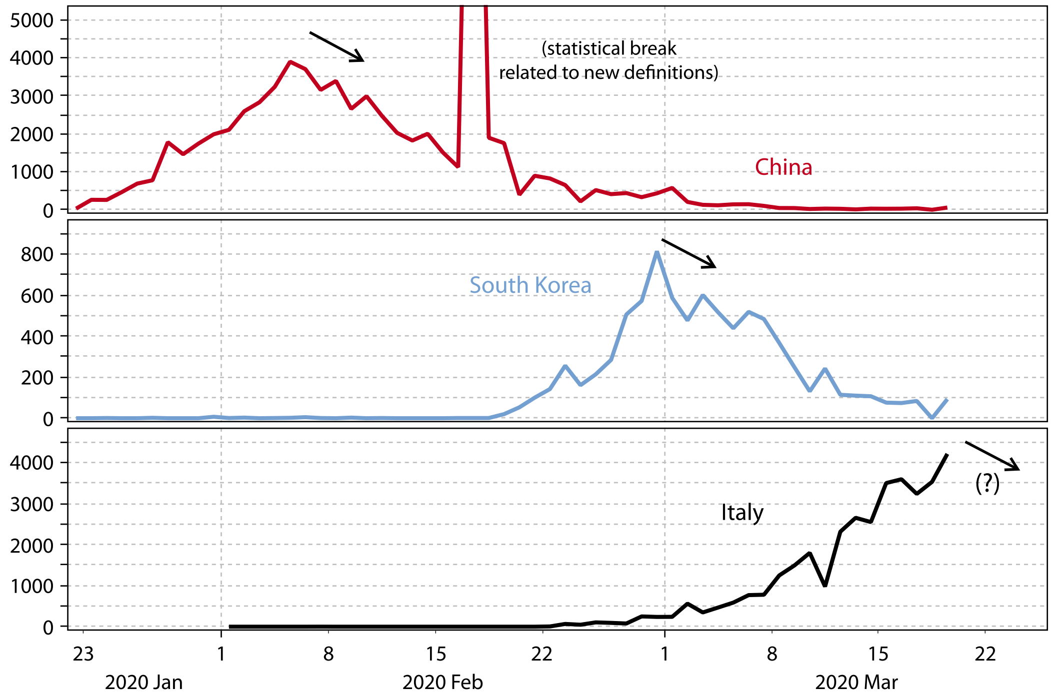
Against this backdrop, economic and financial stabilization and a subsequent recovery will hinge on two factors:

- Firstly, the health situation. The epidemic is only beginning in the US and Europe (apart from Italy), and there is still a great deal of uncertainty on its severity and length, which will be dictated by several factors: number of available hospital beds, varying degrees of infectiousness, differing mortality rates, political choices, reactions from various populations, scope for cure, etc. So the world economic impact will depend on all these unpredictable factors. However, **the number of new coronavirus cases has peaked in China, Korea and it would seem part of Lombardy** (cf. chart 2). Additionally, the gradual reopening of the Chinese economy – between 60% and 95% depending on the sector – is not for now triggering a second wave of new cases.

Number of new confirmed coronavirus cases



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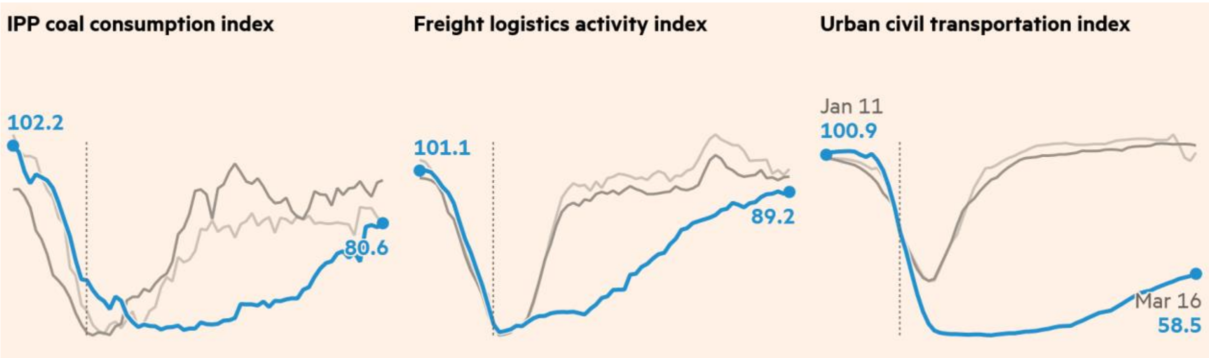
- Secondly, the fiscal and monetary bazookas. **Fiscal and monetary support is being rolled out on an unprecedented scale to put countries in a position to reverse the shock**: safeguarding income, guaranteeing loans, temporarily nationalizing struggling sectors, massive support on cashflow and on temporary layoffs, rescues for banks and massive asset purchases from the central banks. Central banks will have to ensure that this sharp surge in public debt – equivalent to around 10-20% of GDP – does not prompt a rise in interest rates. As shown by the Japanese example, where gross public debt is more than double ours, this does not raise any problems in theory. There will then be the slew of standard stimulus measures to come once lockdown is over i.e. car scrapping bonus, infrastructure plan, etc. China has started rolling out these measures now that work is increasingly resuming (cf. chart 3).

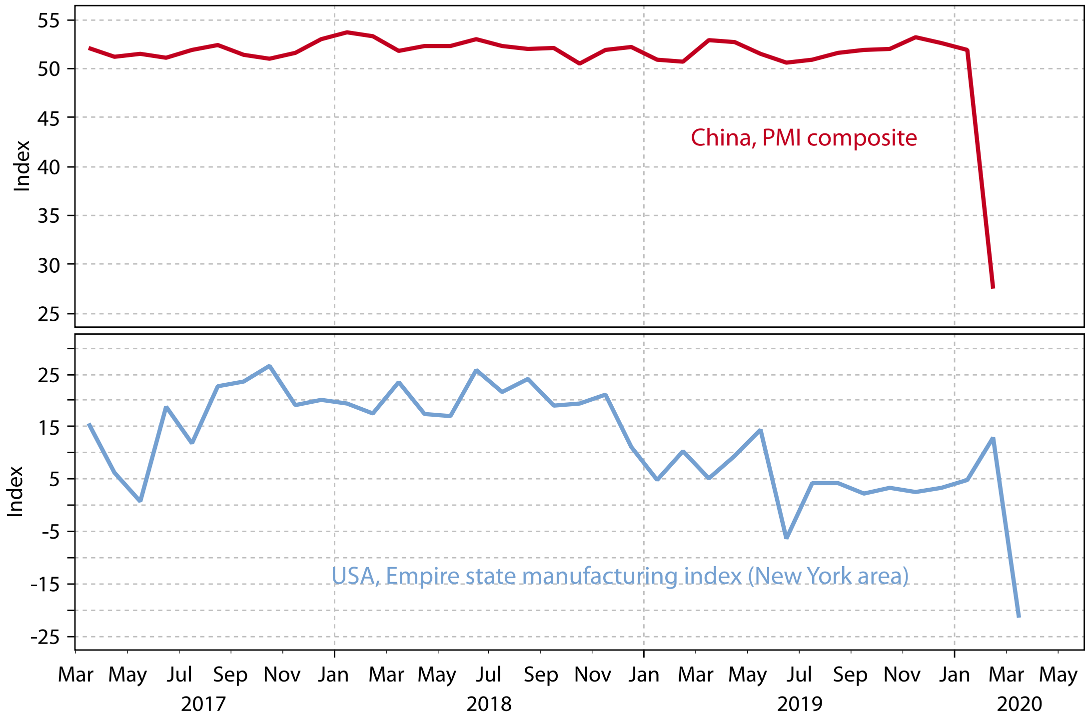
If all these factors come together swiftly, **then economic agents would be able to start envisaging a world where the virus is under control and economic activity is at least partly getting back to normal.** In the short term, successive lockdown measures – country after country and over several weeks – make a world economic recession inevitable. However, the shock is offset by the fact that modern economies display resilience features, whether as a result of digital technology (remote working and e-commerce) or the weighting of non-cyclical sectors (public and private administrations, subscription economy, etc.). Ultimately, we are obviously aware that there is no real credible estimate at this stage, but world growth in 2020 could come to between -1% and +1.5%, before a very strong rebound in 2021 (+4% or more). The recession is poised to be extraordinarily severe (cf. chart 4) but relatively short, bottoming out in 2Q or early 3Q 2020.

J-shaped curve for economic activity in China



Blue line for 2020, and grey lines for 2018 and 2019; source: Financial Times

Unprecedented economic shock, but inherently temporary



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In Europe, fiscal and public corporate aid restrictions have been suspended, with France and Germany alone rolling out a support package of close to €1bn. European solidarity will have to be taken a step further. Meanwhile, the US administration has announced a $1,200bn program. These various amounts will all be increased if necessary, and financing will be largely monetary. As we mentioned, this does not raise any problems in theory for most developed countries, but unfortunately the same does not apply for emerging countries (apart from China), which will sometimes need to rely on the IMF. Additionally, **the severe plunge in oil prices** (cf. chart 5) admittedly has disadvantages for some stakeholders, but it will make for more winners than losers once lockdown measures end, especially in Europe and Asia.

Mostly beneficial effects from the oil shock

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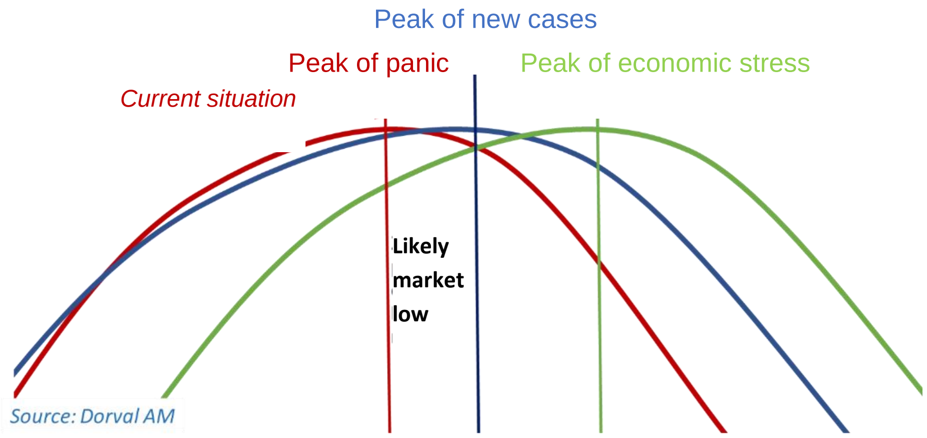
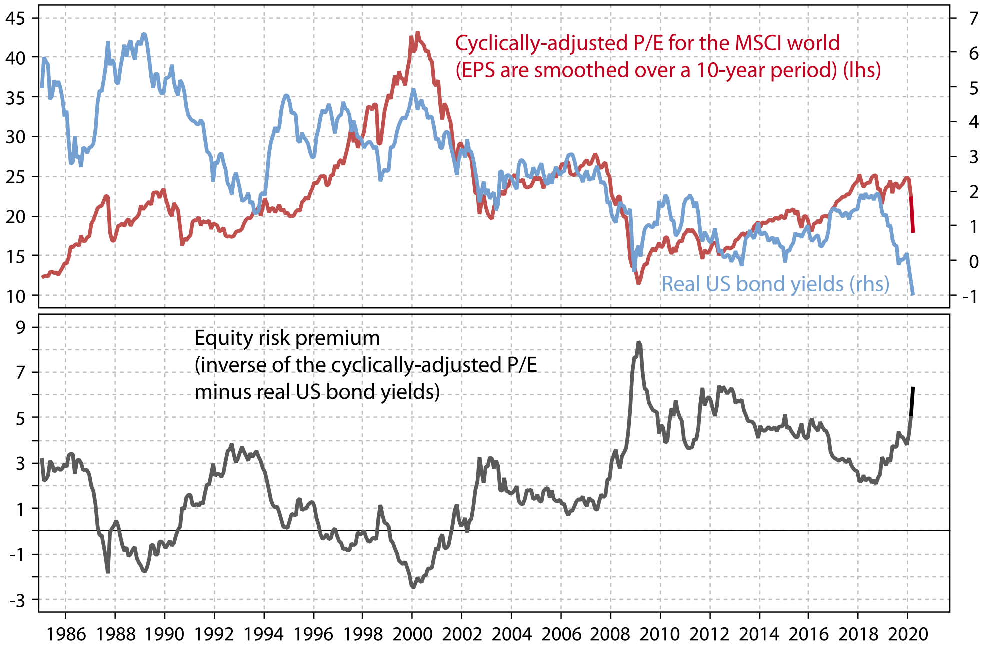
The most positive scenario would be a peak in the epidemic of new cases over the weeks ahead, and a J-shaped curve for the world economy, with a low point of unprecedented severity in the second quarter (or even the start of 3Q) before a gradual recovery. However, on the world stock-markets, **the low point should be sooner** (cf. chart 6), and in this scenario, **it is becoming difficult to drastically reduce portfolio positions as recent market changes have pushed valuations down to extreme levels.**



However, there are other more serious economic and financial stress scenarios for the short term that should not be ignored. Precautionary health measures are creating short-term economic chaos, so political and social objection reactions could further increase uncertainty. Authorities have brought out fiscal and monetary big guns, but these could turn out to be inadequate or overly complex for companies to use – particularly SMEs. Meanwhile, information on the health situation coming out of Asia is fairly reassuring at this stage, but could deteriorate again and indicate that the crisis is set to last longer than expected.

The financial markets will sway between the two scenarios depending on changes in the health situation that are impossible to predict over the weeks ahead, and market movements are poised to be even more severe as investors' timeframe has shortened considerably, and leveraged positions still need to be wound down. **But in the longer term, the prospects of a strong rebound in economic activity in 2021 and beyond, and very high risk premiums already hit on the financial markets create major opportunities for investors who have the patience to wait** (cf. chart 7)

Very high "cyclically-adjusted" risk premium for equities



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