FINANCIAL MARKETS

FLASH

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The current stock market and financial crisis triggered by the Coronavirus is now of a magnitude and rapidity reminiscent of the biggest crashes in history. The drop in the main equity indices has now reached more than 30% in less than 3 weeks, credit spreads have widened by almost 100 bp on European Investment Grade, by 400 bp on the HY crossover, emerging currencies overall have lost more than 10% against the dollar, etc.

These movements raise questions and are of a worrying nature, going beyond the simple stock market correction of around 10% to 15% that we expected at the start of the year.

This crisis contains ingredients common to the 3 previous major crises, which we'll come back to, but it is also of a different nature. An epidemic of such magnitude is very uncommon. The health consequences are obviously impossible to predict and this uncertainty is adding to the surrounding negative psychology.

This epidemic also highlights several elements, which were already well known, and which have suddenly crystallized:

1. Debt is too high, everywhere! World economic growth is taking place "on credit" and the case of the United States is a good illustration: after the longest period of growth since the post-war period, the budget deficit has reached almost 5% of GDP and borrowing is now equal to 100% of GDP, which means that the period of prosperity was not used to restore public accounts. This observation is valid for many European countries, including France which is among the worst culprits. At the same time, corporate borrowing has also risen sharply (multiplied by 3 in the United States since 2009), as business leaders took advantage of the windfall of the cut in interest rates

2. International cooperation is currently very weak. The world is currently multipolar and very divided. Donald Trump's America has provided a good illustration of this in recent months with "the trade war", and measures taken in an attempt to respond to the Coronavirus show more than ever that it is "every man for himself"! The recent major disagreement between Russia and Saudi Arabia is a good illustration of this situation.

3. Europe is disunited. There is no common health policy strategy. We expect a significant budgetary response, Christine Lagarde has put the ball in the political court, but there appear to be major disagreements on this issue. This is the reason why sovereign spreads are widening in the Eurozone, particularly on Italian of course, but also on French risk: +30 bp spread with Germany this week!

4. Communication via social networks and the general precautionary principle (too extreme?) are resulting in uniform movements and promoting the spread of "fear".

5. The liquidity of the markets is raising questions. There are no more end buyers. Since the 2008 crisis and the increased solvency standards that regulators have put in place, Banks have no longer been taking positions, insurers are faced with the problem of interest rates at 0, etc.

The picture thus appears very bleak and there are ingredients in this stock market panic that point to 2000 (initial overvaluation of certain sectors), 2008 (liquidity crisis on the credit markets, start of suspicions between counterparties, etc.) and 2011 (euro crisis with widening of spreads between countries), etc.

In these conditions, what's to be done?

Historical observation of recent major crashes provides some pointers. In 2000, 2008 and 2011, the declines in the main equity indices were between 30% and 50%. With 30%, the current correction is therefore already significant. The same is true for widening credit spreads.

It is clear that the world is entering a recession. The major risk is that this economic slowdown will turn into a financial crisis with a wave of bankruptcies of companies and banks that are no longer lending to each other. The question is how quickly the health situation will improve. If we look at China (ahead of the West) it seems that the situation is gradually improving.

In addition, the conditions for a rapid recovery are there, with interest rates at almost zero and very cheap oil. Central Banks still have time to act. The US Federal Reserve will reduce interest rates to 0. And stock-buying policies are likely to resume and expand to lower-rated stocks.

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This time, it is mainly governments that are expected. Budgetary and targeted support measures (for the most affected sectors) are necessary and will have to be taken quickly and be of a significant scale given the challenges.

Expected corporate profits have been largely revised downwards by the first Top Down estimates. We are now expecting a 10-15% drop this year, followed by a 5% to 10% increase the following year. This therefore means that the P/E ratio for US equities is now close to 15, and 12.5 for European equities. These levels are historically reasonable, especially when compared to interest rates..

The context remains worrying and there will still be volatility. However, the market valuation levels are starting to look more attractive.

We therefore believe that it would be advisable to start to reinvest gradually:

- in HY bonds, short-term credits and emerging bonds
- In US and European equities.

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