Illumination: Equity strategy and market outlook

March 2020

Published by Edison Investment Research

Global perspectives: Too late to panic

- **The continued global spread of COVID-19 represents the worst worst-case scenario for the global economy.** Non-pharmaceutical intervention (NPI) methods, better known as lockdowns, are being employed in all major jurisdictions. As a result, there will be significant economic disruption in the very short term. However, in our view it is now too late to panic out of equity portfolios as valuations have fallen significantly. Investors should instead focus on the evolution of this healthcare crisis over coming quarters.
- **A significant contraction in global economic activity is now inevitable but will not be a surprise to investors.** We believe investors now fully expect a flood of adverse economic headlines and profit warnings. Yet the key investor sensitivity in our view is the ultimate duration of the lockdowns. Once social restrictions have been relaxed, economic activity can start to return to normal.
- **Market valuations have fallen to levels previously seen at times of financial distress.** We believe at the aggregate level much of the bad news is in the price of European and UK equities, even if US equities have not fallen as hard. If China's experience (to date at least) of successfully managing an outbreak can be replicated in other nations, the crisis will remain in the healthcare domain and some of the more bearish social and financial predictions currently popular may later prove wide of the mark.
- **We maintain a neutral position on equities, from cautious prior to the market declines.** We believe we are past the peak in terms of bad 'news' as all major nations are implementing lockdowns. Globally, central banks and fiscal authorities have come forward to support financial markets and the economy with programmes of unprecedented size for peacetime. Markets may remain volatile in the very short run but targeted NPIs could significantly ease the pressure on economic activity in coming weeks.

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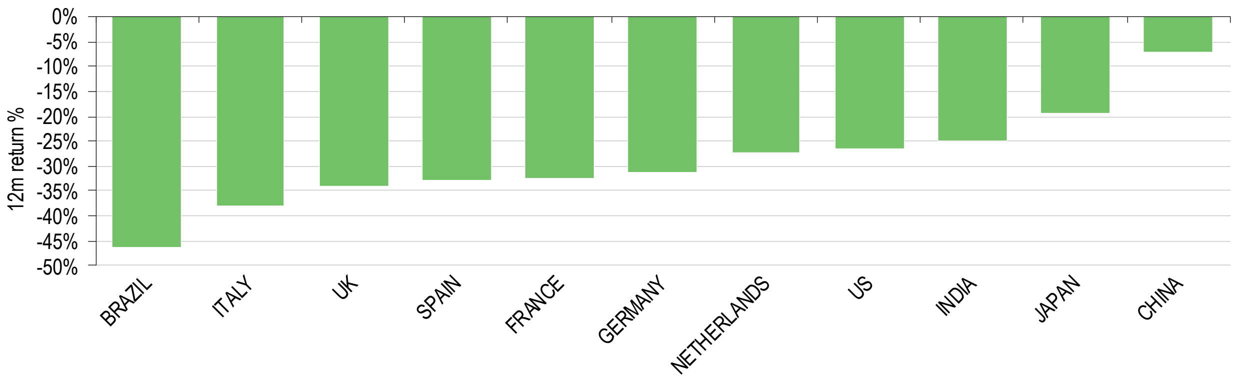
Too late to panic

Monetary and fiscal policy actions mean a financial crisis is not inevitable

The continued global spread of COVID-19 now represents the worst worst-case scenario. Non-pharmaceutical intervention (NPI) methods, better known as lockdowns, are being employed to supress the spread of the virus in all major jurisdictions. As a result, there will be significant economic disruption and earlier fears, initially dismissed in some quarters as fake news, have become a fact of life. However, in our view now is not the time to panic out of equity portfolios and investors should instead focus on the likely evolution of this healthcare crisis over the next 18 months and beyond.

Exhibit 1: Global market declines in 2020 will be recorded in stock market history



Source: Refinitiv, 17 January 2020 to 26 March 2020. Note: Declines shown in local currency.

If China's experience is a guide, NPIs can be effective but also severely impact the economy in the short run. During the first two months of this year, China's retail sales and fixed asset investment declined by more than 20%. Nevertheless, the continued low numbers of new infections in the country in recent weeks suggests that the COVID-19 impact may still be of relatively short duration. For now at least, China is reporting new infections only from returning travellers.

Notwithstanding China's success in supressing the virus, in the absence of herd immunity NPI measures can only be lifted gradually and there remains the risk of repeated stop/start interventions until a vaccine or better treatment options are developed. One factor which investors should focus attention on is any increasing availability and prevalence of testing.

Testing for previous infection in addition to the disease itself will offer policymakers much better understanding of the actual infection rate and its geographic distribution. There remains a high degree of uncertainty as to whether there exists a much larger group of individuals compared to the officially reported infections who suffered only very minor symptoms and who are now immune to further infection. Confirmation of which mathematical model best describes the outbreak will be critical for informed public health policymaking. For investors this is the key factor in estimating the duration of the most severe lockdowns and the resulting economic damage.

Improved availability of testing should facilitate much more specific NPIs, such as tracing and isolation of only known patients and contacts rather than entire cities or nations. Testing could therefore dramatically reduce the economic cost of controlling the epidemic ahead of a new vaccine, which governments have indicated may be available by 2021.

We believe from a healthcare perspective the first focus will be on ensuring sufficient availability of fully equipped intensive care facilities to lower the fatality rate within the coming first wave of infections. At the same time, very recent studies and WHO guidelines highlight the benefits of much broader testing and rigorous contact tracing and isolation. The combination of expanded ICU capacity and targeted NPIs may allow policymakers to better balance the healthcare and economic objectives in coming months.

Progress in this regard will could enable the removal of the most intrusive and economically costly forms of social distancing. By increasing the specificity of the NPIs, it may be possible to hold down infection rates while allowing the economy to operate much closer to full capacity. A tolerable interim phase of NPIs ahead of a vaccine in 2021 would restore confidence in the economic outlook, reduce pressure on government balance sheets and calm financial markets, in our view.

Denial and panic phases are over

We believe the first two phases of this biological crisis were denial followed by panic. These phases were staggered in time – China first, global financial markets second but quickly followed by central banks, governments and finally the general population. Nobody is now in denial about the size of the task ahead but the time for panic has passed, in our view.

Investors are modelling the extent and duration of the necessary control measures to assess the impact on GDP and corporate profits. Central banks have shifted to implementing much looser monetary policy combined with a long list of operations aimed at ensuring the flow of credit within the economy and in particular to the corporate sector, as the plumbing of the financial system is stressed in a manner similar to 2008. The role of central banks at present is not to try to stimulate demand but to ensure that financial markets continue to function as normally as possible.

Governments have realised that substantial fiscal policy easing will be required to ensure that confidence in the economy and corporate sector will be retained during a period of lockdowns more akin to wartime conditions. We note there appears to have been broad political acceptance that such fiscal policies are necessary on a global basis to insulate both people and sectors most affected by the steps taken to control the epidemic. As a result, we believe markets should welcome the most recent initiatives offered by the US and UK administrations.

The actual economic impact of the NPIs is difficult to model as there is no modern precedent for a global lockdown. We view China's experience as instructive and the contraction of the private sector will therefore require substantial offsetting additional government spending during 2020 to merely mitigate both national and global recessions.

The recent initiative of dropping 'helicopter money' on the US population has headline appeal and is different from a tax cut as it represents immediate financial relief and would be particularly highly valued by lower income groups more exposed to the economic impact of the efforts to control COVID-19.

Market valuations close to 2008 levels in Europe

The impulse response of financial markets has been in part rational but has also exposed several weaknesses in financial markets which, in the absence of policy responses would risk propagating throughout the financial system. There has been significant stress in credit markets against an unhelpful backdrop of ever-increasing corporate debt levels globally and a well-documented easing of corporate credit standards in recent years. However, central banks' support for credit markets, exemplified by the US Fed's unlimited and wide-ranging QE, has slowed the dash for cash seen earlier in March.

In European markets, mid- and small-company shares have at times seen share price declines which appear to us in excess of those warranted by the viral outbreak. A lack of single-stock liquidity and unbalanced ETF flows have combined to form the perfect conditions for a downward price spiral. Poor liquidity within the smaller company space is a phenomenon we have highlighted in earlier notes. It is even more important now for companies to be transparent with investors about the impact of COVID-19 on their businesses, to facilitate a more orderly stock market response to what should remain a healthcare crisis. It is helpful for investors to understand how much impact COVID-19 is having on companies' underlying businesses, separately from any liquidity impact on share prices.

In view of the prospect of progressively more effective and less economically damaging control measures being implemented during the year, the enormous declines in UK and European equity markets to date suggest that market valuations may have even overshot to the downside.

The median price/book multiple of UK large caps is currently just 1.5x – a level not seen since 2009. A UK large-cap dividend yield of over 6.5% would also suggest that unless there is a calamitous and permanent decrease in the dividend-paying capacity of UK stocks, there is a case for considering the market undervalued in the context of 10-year gilts yielding only 0.4%.

Within Europe, the valuation picture is similar following a decline of 38% from the market high recorded only in mid-February, which leaves the median price/book multiple at 1.5x and close to the lows seen only during the worst phase of the financial crisis of 2008.

Exhibit 2: Median price/book for UK large-caps

Source: Refinitiv, Edison calculations. Note: 12-month forward median price/book shown.

Many equity investors will still be spooked by the red-flashing warning signals from credit markets, which gained favour as measures of financial market stress during 2008. Our observation is that in a distressed market all assets become correlated. Rather than offering a separate negative signal for equities, credit markets merely show that risk premia across financial markets are broadly elevated, as investors indiscriminately try to raise cash.

Exhibit 3: Median price/book for Europe ex-UK

Source: Refinitiv, Edison calculations. Note: 12-month forward median price/book shown.

We believe a reduction in uncertainty will occur as investors become better able to outline the shape of the downturn and the consequent recovery, potentially as we have indicated. Furthermore, specific instances of credit market stress are being rapidly targeted by central bank policies around the globe as corporate credit risk becomes in part underwritten by the state.

We therefore shift to a neutral position (from cautious) on equity markets primarily on valuation grounds but also with the view that time will demonstrate both control and more importantly, increasingly economically efficient control through widespread testing. This should result in much more specific NPIs evolving during H120. This would mitigate the economic damage of the epidemic. Monetary and fiscal measures will have to continue to provide sufficient support during this interim phase of the crisis and ultimately investors will look towards a vaccine becoming available by 2021.

Nevertheless, we must also respect that many investors will struggle with the concept of adding any risk to portfolios with such uncertainty and market volatility still ahead.

Conclusion

COVID-19 is now a global healthcare crisis and in the short term will create enormous income and revenue distribution changes across different sectors of the economy. Nevertheless, a financial or economic crisis does not necessarily need to follow in our view, even if the short-term recession impact will be as severe as indicated by recent PMI indices.

Policymakers have already quickly taken extraordinary fiscal and monetary steps to avoid a sub-optimal trajectory of GDP after COVID-19. For example, US and UK fiscal measures are of an appropriate magnitude – of the order of 10% of GDP – to support the economy in the short-term.

We believe the key uncertainty remains the likelihood or otherwise of cycles of lockdowns and travel restrictions on a global basis over coming quarters. There are few challenging the likely availability of a vaccine by 2021, but there is currently an academic debate on the prevalence of sub-clinical cases and the extent of herd immunity.

The first nation to test the effectiveness of lockdown followed by relaxation is China. Provided the data are accurate, the result is encouraging as no new community cases have been reported in recent days, despite travel restrictions being lifted.

We also expect equity markets will be discounting the time to an approved vaccine, the availability of which could quickly shift public policy towards pharmaceutical countermeasures for COVID-19. This could eliminate the need for the economically costly quarantines, facilitating a return to normality.

Furthermore, the increased availability of testing, first for healthcare workers and secondly for the broader population will allow governments to target public health measures much more accurately over coming months. This would lead to a dramatic reduction in the economic costs of controlling the epidemic prior to any vaccination programme.

We suspect in recent weeks many investors have been obliged to focus on managing portfolio risk. However, long-term investment processes should not be suspended during this period of increased volatility as specific equity opportunities may arise as market valuations move lower and investors can selectively provide much-needed liquidity in over-sold names.

During March, we upgraded our outlook to a neutral position on equities, from cautious prior to the market declines. We believe we are past the peak in terms of bad ‘news’ as all major nations are implementing lockdowns. Central banks and fiscal authorities have come forward on a global basis to support financial markets and the economy with programmes of unprecedented size for peacetime. Markets may remain volatile in the very short-term but targeted NPIs could significantly ease the pressure on economic activity in coming weeks while low market valuations highlight the potential for the long-term investor.

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