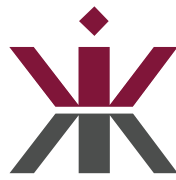


KINGSWOOD

PROTECT AND GROW YOUR WEALTH

COVID-19 & MARKETS

INVESTMENT OUTLOOK

SUMMARY

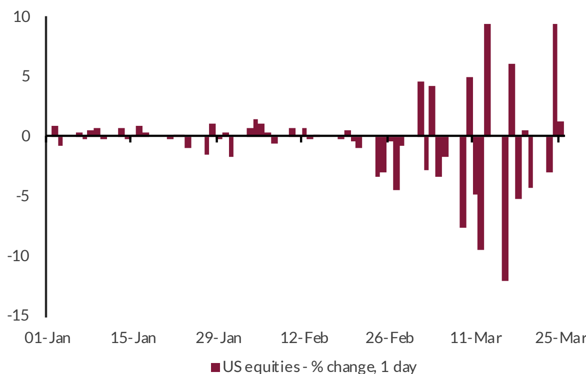
- The drastic containment measures in many countries mean the global economy is heading fast into recession
- The recession will be deep but hopefully short-lived with activity picking up again later in the year
- The massive monetary and fiscal stimulus now being implemented should help contain the economic fall-out
- Ultimately, however, a recovery will depend on a slowing in infections and easing of containment measures
- Equity markets have bounced in recent days but at their low were down over 30% from their highs
- A typical bear market sees equities fall 30% and at their low point much of the bad news was in the price
- Equities may well fall back again near term but we expect markets to be recovering later this year
- However, big uncertainties remain and we believe our neutral position on equities remains appropriate

A NEW WORLD

The world has changed out of all recognition in the space of a month. Containment measures of a scale never seen before have now been put in place by governments across much of the world. And the authorities have announced in record time an unprecedented range of monetary and fiscal stimulus measures.

As for equity markets, they have fallen over 30% in little more than 30 days – one of the sharpest declines ever. Equity volatility has surged, hitting levels not even seen in the global financial crisis, with daily moves of 5-10% becoming common. Credit markets have also come under major stress.

Equities have been exceptionally volatile



Source: Refinitiv

HOW DEEP AND LONG A RECESSION?

The containment measures now in place in a wide range of countries have brought activity to an almost standstill in many of these economies. The service sector, particularly leisure and travel, has been hit worst.

The global economy as a result is heading fast into recession. Global GDP could fall by as much as 5-10% over coming months, a bigger decline than seen in the Global Financial Crisis (GFC). **The key question now is how long this recession will last. There are two key factors at play here.**

First, the length of time the containment measures will need to remain in place.

This is very uncertain and will depend on how soon the growth in infections slows. The experts – the epidemiologists – are themselves quite divided on what course the pandemic will take.

The recent news from China, and also Korea, has been encouraging. There has been almost no growth in infections in China despite workers returning to work and economic activity picking up susbtantially - albeit remaining some way below normal. It will be critical to see in the next few weeks whether the return to normality triggers a secondary spike in infections.

Outside China, Europe is currently the epicentre of the pandemic although there are tentative signs that the lockdowns are starting to slow inflections in some countries such as Italy. Infections, however, are now rising rapidly in the US and other countries such as India.

It is far from clear at this stage whether the severe containment measures will continue for a few weeks or significantly longer. Certainly in the US, Trump's belief that everything will be back to normal by Easter looks highly improbable.

Second, the ability of the authorities to contain the economic damage.

Central banks have done almost everything they can over the last couple of weeks to limit the extent of the downturn. Interest rates have been slashed from 1.50%-1.75% to 0.0%-0.25% in the US and from 0.75% to a record low of 0.10% in the UK. Quantitative easing programs have also been restarted in the US and UK and increased in the eurozone. Even so, it's not yet clear how effective either rate cuts or quantitative easing will be in propping up activity.

*Global business confidence collapsed in March**

*Kingswood estimate for March based on US, Eurozone & UK data

Source: Refinitiv

Arguably, much more important has been the action taken in conjunction with governments to ensure that companies can gain access to credit either from the banks directly or government-backed lending schemes. This is essential to limit the wave of corporate bankruptcies that would otherwise have been triggered by the drying up of cashflows.

Finally, central banks, particularly the Fed, have stepped in to prevent the money markets and corporate credit markets seizing up through lack of liquidity.

Governments have also taken drastic action. In the UK, the government will pay 80% up to £2500 per month of the wages of workers who would otherwise have been laid off. Other additional measures include the deferral of VAT payments for companies and assistance with mortgage and rent payments for individuals. Action has also been announced to help the self-employed.

In the US, a $2 trillion stimulus package (9% of GDP) has just been annnounced. Even Germany which has until now been pathologically opposed to any fiscal stimulus, is planning a sizeable package.

Many of these support measures will take a bit of time to be implemented and can only do so much to boost spending while the containment measures are in place. But they will be crucial in limiting the longer term damage done to the economy.

The Government's focus in the UK is not so much to stimulate current demand as to alleviate a cash-flow squeeze on households and companies that would otherwise cause multiple failures and a surge in unemployment. The authorities are willing to endure a more severe short-term drop in GDP if this eases pressure on the NHS and improves the speed of the subsequent recovery.

Assuming - and this is a big asssumption - containment measures are relaxed in a number of weeks rather than months, **the global economy should be starting to pick up again by late-summer.**

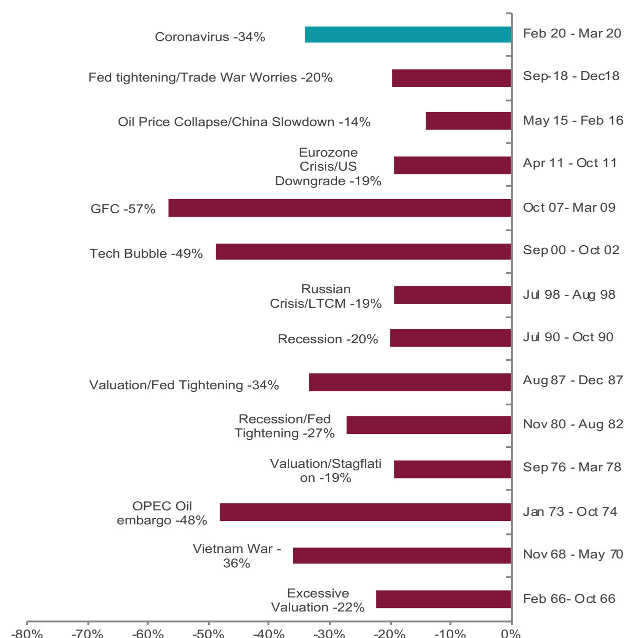
While a sharp V-shaped recovery looks unlikely, the prompt action by the authorities should mean this recession is much shorter than the downturn in 2008-09. Back then, GDP declined for a full year before starting to recover. This was a result both of considerably greater economic imbalances than now and less timely action by the authorities.

Even so, the peak-trough decline in UK GDP this time could be as much as 10%, compared with 6% in the GFC. There is also a significant risk that the rebound from recession is not as swift as people are currently assuming. This risk will intensify, the longer the social and economic shutdown goes on.

HOW DOES THIS BEAR MARKET COMPARE?

Global equities have bounced in the last few days but at their low-point were down over 30% from their mid-February high. This is similar to the fall seen in a typical bear market and would suggest that **at their low point equities were discounting much of the bad news.**

US equity bear markets compared



US equities - % peak to trough decline

Source: Kingswood, Refinitiv

The big proviso here is that we are not entering a re-run of the GFC, the bursting of the Technology Bubble in 2000 or the Great Depression of the 1930s. All three episodes saw equities decline as much as 50% and would imply markets have significantly further to fall.

Equity bear markets and subsequent recoveries

US/Global Bear Markets Compared

Date of Peak	Duration Days	% Peak to Trough (USD) US	% Peak to Trough (USD) World	US % Gain after Trough 3mths	6mths	1yr
19/02/2020 *	30	-34	-34	-	-	-
Average	455	-31	-	18	27	37
Median	482	-27	-	16	24	33
Avge since 1973	347	-30	-28	20	28	36
Avge exc. 3 biggest	215	-23	-21	18	27	32
Three Biggest **	557	-53	-	32	36	44

* As at Low on 23 March ** GFC, Tech Bubble & Great Depression

Source: Kingswood; Refinitiv

We do not believe we are looking at a re-run of any of these. The differences to the GFC were highlighted above. As for the Technology Bubble, equity valuations in January were nowhere near as excessive as in 2000. Meanwhile, ex-Fed Chairman Ben Bernanke yesterday likened the current coronavirus disruptions to a major snowstorm compared to the Great Depression.

None of this is to say that equity markets have necessarily bottomed yet. In contrast to most bear markets, this one has so far lasted little more than a month whereas they generally last considerably longer. That said, the speed of the decline, as well as the likelihood that economic activity will recover relatively quickly, suggest this bear market should be considerably shorter than most.

Valuation levels are also a guide to how much further potential downside there is. The forward P/E ratio for global equities has fallen back substantially from a high of 17x in January to 11x at the low-point. The big problem is that these numbers do not yet incorporate the sharp cuts in corporate earnings estimates now underway. Consequently, valuations are not as low as they look.

Equity valuations are not yet compelling

Source: Refinitiv

Earnings now look set to fall significantly this year, although they should recover much of the decline in 2021. Dividend yields present a similar problem. The yield on UK equities is now as high as 5.9% but this is misleading as it does not factor in that dividends will be cut substantially or even passed as companies scramble to conserve cash.

Our conclusion is that **equity valuations are not yet sufficiently low to trigger a sustained market recovery** given the extreme uncertainty at the moment about the outlook.

WHEN ARE MARKETS LIKELY TO BOTTOM?

We are monitoring a range of indicators to assess how close we are to a market bottom as shown below.

Indicators of a bottoming in equity markets

Indicators of Equity Market Bottom	Score (1-10)
Size of Equity Market Fall	7
Equity Market Undervaluation	6
Market Volatility	9
Investor Capitulation	7
Authorities Policy Response	9
Virus Infections Peak - in China	6
Virus infections Peak - outside China	1
Global Economic Activity Bottoming	1
Average	**6**

The Higher the score, the closer to a Market Bottom & Buy Signal for equities

Source: Kingswood

Currently, the scale of the monetary and fiscal stimulus and the extreme market volatility are giving the strongest signals that we may be close to a bottom.

However, what will be more critical still will be signs both that infection rates have peaked outside China and that there is no resurgence of infections inside China. Both of these in turn will be key determinants of how soon global activity starts to recover. Overall, these indicators suggest **caution continues to be warranted for the time being.**

HOW ARE WE POSITIONED?

We went into this crisis neutral on equities i.e. the equity weighting in our discretionary portfolios was in line with the neutral weighting for each risk profile. We had believed the economic outlook was reasonably favourable but, with valuations somewhat on the high side, an equity overweight was not justified.

The speed and severity of the crisis has surprised almost everyone. This, along with the swiftness of the market reaction, made it impopssible to reduce our equity positions ahead of the market falls.

These declines reduced the value of our equity holdings and in turn left us underweight. This then prompted us in the last couple of weeks to **take advantage of the lower prices and marginally add to our equity positions, taking them back up to neutral which is where we remain**.

Near term, markets could well fall back again. While the marked 15% bounce in markets in the last few days is undoubtedly encouraging, it is not on its own a reliable sign that we have necessarily seen the bottom. The GFC saw a couple of rallies of similar magnitude following the collapse of Lehmans only for equities subsequently to hit new lows.

But, if economic activity does pick up again later this year, as is our central expectation, then markets should rebound. Past experience is that **equities usually see substantial gains in the early stages of a bull market.** Typical gains from the bottom have been 15-20% in the first three months and around 25% in the first six months.

UK equity performance since market high in 2007

Source: Refinitiv

It is also worth noting that even in the GFC when UK equity prices fell by close to 50%, they had regained all their losses within four years of the bottom. Including dividend payments, the losses were recaptured in only three years.

With our medium-to-long-term investment horizon, we believe it is appropriate to retain our neutral positioning. Although markets could well fall back again near term, we believe **equities should on a 12 month view be higher than current levels, quite possibly significantly so.**

Once the uncertainty has lessened and we are more confident we are close to the bottom, we intend to move overweight equities. In the meantime, we continue to monitor economic and market developments closely in this fast moving environment.

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