KHIC FLASH UPDATE

Coronavirus VIII: It's just a phase

In one of our first Coronavirus-related KHIC Flash Updates (9-March), we discussed a potential best case, "V"-shaped scenario where "fears are overblown, and the pathogen is quickly contained" and "economies and equity markets rebound… sharply." We also noted a potential worst case, where the "epidemic becomes a serious pandemic, and global economies enter recession… and we enter a bear market for risk assets." *With the benefit of hindsight, the worst-case scenario is what ensued.*

In either case, we outlined the likelihood of four distinct phases:

- **Phase 1 – economic and corporate shock.** This phase will see global growth slow and corporate margins narrow as sales fall, costs rise and supply chains are disrupted.
- **Phase 2 – financial disruptions.** This phase, which overlaps with phase 1, will be characterised by distressed selling and furious price discovery of assets.
- **Phase 3 – formation of a bottom.** Stabilisation will first happen in financial markets, and then in the real economy.
- **Phase 4 – fears ebb as the "new" becomes the "new normal".** In this phase, the Coronavirus either runs its course or other solutions are found. Eventually, animal spirits will be reignited.

The picture thus far has not fitted neatly into distinct phases. Phase 1 (economic and corporate shock) is ongoing. *Phase 2 (financial disruptions) was supposed to have coincided with Phase 1 – and until late March, it did.* Liquidity conditions were such that even US government bonds, considered "risk-free" assets, sold off aggressively and yields jumped. Then occurred the biggest monetary and fiscal stimulus programs in modern history, with policymakers straining every sinew of their collective ability to bring liquidity to financial markets and to backstop their respective economies (please see our last Flash Update for more details). Thus far – though still too early to say definitively – these policy interventions have had a more observable impact on financial markets than real economies, with a clear decoupling having occurred between the two.

Economic figures suggest a wasteland, with the expectation of even worse to come over the second quarter. On the other hand, global equities are technically in a new bull market. In April, the MSCI All-World index of global equities is up 10%. Also in April, the tech-heavy US equity market is up 13%, its best month since 1987; it is just a good day's performance away from regaining positive momentum (i.e. on the 10-month moving average basis that we look at closely). *In this topsy-turvy world, it is more than pertinent to ask if Phases 1 and 3 (formation of a bottom) are occurring simultaneously, with Phase 2 having somehow passed.*

In fairness, this is possible. However, also in fairness, it would be highly unusual. Bear markets tend to deflate over time; from 1872 to 2019, there have been 21 Bear markets, and they have lasted over two years on average (i.e. using monthly data from the US given its long history and reliability; see Figure 1). The shortest one lasted five months, straddling the famed 1987 "Black Monday" crash. Importantly, there was no recession at that time. History also suggests Phase 3 – the formation of a "true" bottom - occurs at much lower price-to-earnings multiples (i.e. using cyclically adjusted price-to-earnings; see Figure 1). Should the 23 March trough prove to be the true bottom, it would be from the highest valuation in history.

Bottom line

This year, we have seen a once-in-a-century tail risk event and unprecedented levels of policy intervention. Unusual events happen, and a new bull-market having been born, even from these valuations, is more than possible. As always, and particularly at times such as these, we must remain focused on our process.

Figure 1: Anatomy of a Bear – duration, returns and valuations (CAPE) in US equity bear markets from 1872 to 2020

Start	End	Duration (Months)	Annualized Return	Cumulative Return	Starting CAPE	Ending CAPE
May 1872	Jun 1877	62	-11.8%	-47.3%	N/A	N/A
Jun 1881	Jan 1885	44	-11.5%	-35.6%	19.0	13.1
May 1887	Dec 1890	44	-6.7%	-22.0%	18.1	14.4
Aug 1892	Aug 1896	49	-9.3%	-32.2%	19.2	15.7
Sep 1902	Oct 1903	14	-27.4%	-29.3%	22.9	15.3
Sep 1906	Nov 1907	15	-33.3%	-37.7%	19.2	10.6
Dec 1909	Dec 1914	61	-6.5%	-28.6%	14.8	10.2
Nov 1916	Dec 1917	14	-31.3%	-33.4%	12.1	6.4
Jul 1919	Aug 1921	26	-17.0%	-32.2%	7.1	5.2
Sep 1929	Jun 1932	34	-49.5%	-84.8%	32.6	5.6
Sep 1932	Mar 1933	7	-43.1%	-24.6%	9.8	7.9
Feb 1934	Mar 1935	14	-24.0%	-25.7%	13.9	10.4
Feb 1937	Apr 1938	15	-40.5%	-45.4%	22.2	11.8
Nov 1938	Apr 1942	42	-13.9%	-40.0%	16.1	8.5
May 1946	Jun 1949	38	-9.0%	-25.3%	16.0	9.1
Dec 1961	Jun 1962	7	-39.9%	-22.5%	22.0	16.8
Dec 1968	Jun 1970	19	-20.4%	-29.0%	22.3	13.8
Jan 1973	Dec 1974	24	-25.7%	-43.4%	18.7	8.3
Aug 1987	Dec 1987	5	-60.8%	-26.8%	18.3	13.4
Aug 2000	Feb 2003	31	-20.5%	-43.7%	42.9	21.2
Oct 2007	Mar 2009	18	-39.4%	-50.8%	27.3	13.3
Feb 2020	Apr 2020	3	NA	-24.6%	30.8	23.0
	Median:	**24**	**-24.0%**	**-32.2%**	**18.9**	**11.2**
	Average:	**28**	**-25.8%**	**-36.2%**	**19.7**	**11.5**

Source: Kleinwort Hambros, Shiller data US stock market 1871 – present, using start of month data. A bear market is defined as a fall in the market by -20% from its high, with start date set at that high point. Average and Median calculations do not include the current Bear market, only those that have ended."

This is how the various pillars look at present:

- **Economic regime:** We are in a global economic recession of historic proportions. *We know contractions are a poor state for risk assets.*
- **Valuations:** The value case for global equities is difficult to assess given enormous volatility in both price and earnings metrics. It will take some time before we are able to rely on valuation signals. However, with equity prices rebounding dramatically over April but earnings falling equally as dramatically, *current valuations are expensive*.
- **Momentum:** *The MSCI AC World index of global equities is below its ten-month moving average*. However, after a strong April, it is within touching distance of its 10-month moving average. Should it tip into positive momentum, we will be keenly watching for a confirmation of the trend.
- **Sentiment:** Sentiment for risk assets has oscillated wildly over the last few months. At present, it is well off the lows seen in March, *far from the pure, unadulterated pessimism that usually marks a bottom, and where we get more excited about risk-taking*.

We remain defensively positioned and there is plenty to warrant caution. Since March, we have reduced risk across our multi-asset strategies and bolstered our defensive allocations by purchasing more government bonds. We will maintain current positions or adjust our asset allocation as guided by our process.

CA26/MAR 2020

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