Amplia Monthly Investment Letter

Return of the bear market

March witnessed the end of the 11-year old stock market bull market. Between 19th February and 18th March, Euro STOXX 50 index fell by 38,27% and its American counterpart, S&P 500, by 29,18%. The aged bull had been died at a pace last seen in the 1930's. The abrupt switch from greed to fear prompted many investors to re-think their strategy and scramble for cash. We have also spent the past weeks trying to analyse, how long will the disease keep spreading and when do economies return to normality again.

Closed societies – for how long?

Part of the slide in risky assets can be explained by the overwhelming uncertainty that investors are facing. The core issue is that there are no similar events in history that investors could draw comparisons with, and thus no playbook how to go about in a situation like this. The closest comparable event, the Spanish flu, dates back 100 years to a time when the economies and the world looked completely different.

The latest US jobless claims from 2nd April, with 6.65m claimants, highlight the breadth of the furloughs and lay-offs companies are resorting to. With service sectors such as tourism and leisure are grappling with the lockdowns of entire cities, central banks and governments on both sides of the Atlantic have announced support measures. These measures range from government-back loans and bond-buying programs to outright equity stake acquisitions, as done by the Germans.

We certainly welcome these extraordinary stimuli. For a society as a whole, it is beneficial to spend unlimited sums to rescue companies. Now is not the time to fret about moral hazard or other unintended consequences a state intervention usually brings about.

Irrespective of how long the lockdowns last, the economies will not be the same again. First, a government-issued guarantee for a bank loan to a company may lower the interest rate to zero but the loan will have to be repaid once nevertheless. Thus, the lockdowns boost the indebtedness of companies, consumers and states to levels not witnessed since the second world war. Many businesses will see their balance sheet ruined by the debt load, reducing the appetite for and capability to invest in growth. Many service sector companies will close their doors for good. In a grim way, the crisis accelerates the evolution of capitalism, hitting the low-productivity sectors the hardest.

Light at the end of the tunnel

There are however several factors that have made us become more optimistic in the recent days.

First, many high-productivity sector workers have been able to resume work from home, with minimal slippage in productivity. Some companies within utilities, consumer staples and pharmaceuticals sectors have reported an uptick in demand as people hoard goods. To the extent we can extrapolate the development from the cradle of the virus, the Hubei province in China to Western economies, the impact will be temporary and limited. The 60-million province was put to a full quarantine from 23rd January, now to be lifted on 8th April. Countrywide, the drop in the GDP will be sharp in the first quarter but the second quarter should see a strong bounce upwards. Chinese manufacturing PMIs that reflect month-on-month changes in business conditions in the producing sector, jumped from 35,7 (official) and 40,3 (Caixin) in February to 52 and 50,1 respectively, in March, signalling expansion.

Second, the deepest recessions of the past 100 years have been characterised by a banking crisis. In a banking crisis, problems inherent (endogenic) to the economy – usually excessive debt-levels – make the banking system implode, thereby reducing the banks' ability to lend to consumers and businesses. This vicious circle takes a long time to break and leaves deep wounds to the society. This time however, the policymakers, having learn the lessons from the previous financial crisis, seem to appreciate the role the banks play in allocating money to where it is needed the most. This is evident from the supportive messages from politicians and central bankers: banks' reserve ratios have been cut; all loan guarantees and other measures are funnelled to claimants via banks. Hence, when the smoke settles, banks will be well capitalised and equipped to resume lending for growth.

Third, there is a narrow chance that a joker element, a medicine (be it a vaccination or reactive therapy) will be approved for human use sooner than markets expect. Globally, there are numerous talented researchers working around the clock to discover a treatment. Whilst this may take time, should a medicine be approved for mass production, the entire contagion issue will vanish as quickly as it came.

Our markets positioning

We are turning more optimistic about equities, for the aforementioned reasons. On 6th March we cut the individual equity exposure in discretionary portfolios to 50%, which we raised back to 75% on 30st March. We have reduced also bond market exposure, to make cash available, which we intend to deploy soon. This is based on our belief that the equity market is close to bottoming. We rather take the risk of buying stocks in the coming weeks, even if the markets were to slide 10-15% further (adverse scenario). The present stock market decline has been historically deep and quick, and the recovery is also likely to be swift. A lot of bad news have been priced in. A study shows that those who missed the ten best days in stock markets in each decade since the 1930's, clocked a return of just 91%, whereas those who were constantly in the markets, made a gain of 14'962%. Less surprisingly, these 10 best days occurred in each decade at times of high fear and uncertainty. This is something we want to avoid.

In March, prices of almost all asset classes moved downwards, reducing the benefits of diversification. As to fixed income, both high-yield (HY) and investment-grade (IG) bonds have sold off massively. This seems to have been driven by forced-selling through fund managers. Whilst we see great value in selective names in both universes, we recommend increasing equities for now in portfolios where both asset classes are allowable due to the higher upside.

In Zurich on 3rd April 2020

Stay healthy and safe,
with kind regards

Juho Kivioja

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