BearBull
Global Investments Group

Alain Freymond
Partner & CIO

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What to do after three weeks of historic stock market panic?

Covid-19: a risk totally overlooked. Active management alone is able to counter a market shock. Is Covid-19 a lasting threat? Should we believe in a rapid rebound?

Key Points

- A real threat yet totally neglected for almost two months
- Active and rational management alone is able to protect against a market shock
- The Covid-19 reminds passive investors that this approach is by far not without risk
- Covid-19 and Saudi Arabia cause panic
- Is Covid-19 a lasting threat to the global economy?
- Falling financial markets will affect consumer sentiment
- The organization of world production will undergo significant adjustments
- Should we believe in a rapid stock market rebound?

A real threat yet totally neglected for almost two months

On February 21, 2020, during the stock market euphoria, the financial markets realized that despite the extraordinary actions undertaken in China to fight against the epidemic of Coronavirus, it was appearing in Europe and now directly affected Italy. It suddenly became apparent that the threat had been largely overlooked for several months by the majority of investors. The shock was then commensurate with the complacency that had prevailed for long weeks.

Insensitive to any threat and any form of risk, investors had only scarcely worried three or four days in January of the risks at a time when the gravity of the epidemic in China was no longer in doubt and was starting to make the headlines in the media.

Very quickly, the lure of gain took over, however, over the objective and rational analysis and assessment of risks, committing the majority of investors to regain enthusiasm and confidence in the future and in the economic outlook, which appeared to be unconscious for any measured and rational observer worried about the increase of risks in a context of extreme valuation of the financial markets.

Active and rational management alone can protect against a market shock

As an investor aware of the risks and the already particularly high valuation levels of the international financial markets as a whole, particularly after the last phase of stock market index growth at the end of the year, we warn of the real risks of a very significant return of volatility and risk factors which could cause very strong corrections in the financial markets in the coming months.

By recommending prudence and a decidedly more defensive asset allocation with regard to all "risky" assets, we were aware of adopting a tactical non-consensual position, the vast majority of the main players in the management of institutional or private assets were indeed still very largely optimistic and little aware of the risks. On the contrary, the major players almost unanimously recommended an overweight in equities in their investment policies intended for their clients, completely ignoring the risks of a pandemic and the increasing risks of falling markets.

Today these major players both in the U.A.E and internationally, who could not really act and reposition the asset allocations of their clients before this short crash
period, while it was still possible to do, in favor of a policy more suited to the situation will certainly argue that it was impossible to predict the evolution of the epidemic into a pandemic and that it was therefore not possible to guard against the possible effects of such a development or will simply argue that a rapid rebound will very quickly erase the losses in value recorded.

By thus trying to justify their inaction and their lack of vision or risk management, they demonstrate above all that their inability to act and react linked to various factors and particular interests is not adapted to the needs of investors who expect the unlike their partners and agents, a real capacity for analysis, assessment of risks and opportunities allowing them to manage in a rational and professional manner their personal wealth or that which has been entrusted to them (provident institutions, trustees, etc.).

This threat was, however, very predictable. In a world as interconnected as the one in which we now live, even the extreme measures taken by the Chinese authorities could not in fact guarantee that it would remain contained within Chinese borders. Therefore, this risk factor should not be overlooked and could only be de facto taken into account by active investment policies or management styles allowing tactical and rational management of opportunities but above all of risks.

Covid-19 reminds passive investors that this approach is not without risk by far

Investors who have adopted such organizational forms of wealth management by choosing active management approaches and techniques, also capable of taking into account specific imperatives such as absolute risk management for example, were certainly better prepared than those rather convinced of index management and therefore also convinced of the uselessness of managing market risks and capital loss risks in the medium term. Still it was necessary to be in real capacity for action and to want to protect the heritage so that these strategies can bring the expected benefits. Again, it is also a question of distinguishing among active management players those who do not hesitate to favor risk management and capital preservation when valuations become irrational and when the situation demands from those who claim to do so by ultimately adopting rather inactive approaches that do not conform to the style they claim to implement.

In this context, passive or index management approaches, indexed on "benchmarks", or "momentum" type approaches, which have been favoured in recent years by an increasing number of institutions will not fail to arouse reactions of stupor and dissatisfaction with the historic fall in prices and that of the value of the assets concerned. Indeed, after many years of "bull market" supported by active central banks, many investors had doubtless forgotten that exogenous factors could cause rapid financial crashes and reduce in a few days the capital gains gradually recorded during years. For example, European investors following an index approach have thus lost in a few days all the capital gains recorded since January 2013, that is to say almost sixteen quarters of patience reduced to nothing, but still justified today by the hope of a long-term return to the peaks reached in February 2020.

Covid-19 and Saudi Arabia cause panic

On February 21, the financial markets faced a first shock caused by the awareness of a possible transmission beyond the borders of China of the Coronavirus and the potential effects on the world populations. Gradually, the world also realized both the Middle Eastern and the Western economies were weakened by a now extreme interdependence between them and the Chinese economy.

The collapse of Chinese activity, which initially had little impact on the financial markets, has now emerged as a major threat that can affect supply and production chains in a very large number of industrial sectors in particular. The air, maritime and transport sectors in general have suffered massive effects which are sure to cause bankruptcy risks without government support in the coming weeks. At the same time, the risks of economic downturn thus appeared more serious, pushing interest rates, equity markets and commodity prices down.

The fall in the stock market was already significant, but it was then exacerbated also by the shock caused by Saudi Arabia on the oil market. On March 6, by decreeing a drop in its crude prices to its customers following the absence of an agreement on the reduction of quotas within OPEC+, Saudi Arabia was unintentionally throwing oil on the fire and caused a 40% drop in WTI prices in two days. In the days that followed, the Covid-19 and the fall in crude oil therefore pushed the equity markets -20% lower, causing a day of absolute panic (-9.5%), which will undoubtedly remain for a long time as the second largest decline. in the history of the S & P500 after the fall of Monday October 19, 1987 (-20.4%).

Is Covid-19 a lasting threat to the global economy?

After two months of health crisis and extreme measures taken by the Chinese government, it now appears according to official figures and published statistics (to be taken with usual precautions) that the peak of the epidemic in China is about to be achieved. Resumption of activity is still particularly timid, and we will have to wait to see clearer signs of a return to normal. In terms of health, the WHO has published to date (March 18, 2020) 216,304 confirmed cases of Covid-19 and 8,862 deaths, including 80,928 cases in China and 3,245 deaths, followed by Italy 35,713 and Iran 17,361 cases – we expect the US figures to grow dramatically over the course of next week.

The WHO therefore considers that it is indeed a pandemic, that it is controllable, but that this requires a higher commitment from many countries which still do not seem to have implemented all the required control measures, most important of which is the United States where the Covid-19 has exposed a lack anticipation on the political and the health system. The situation is therefore serious and should continue to undergo significant developments for several months.

Beyond the public health aspects dealt with by the competent authorities, our analysis of the situation in terms of cyclical impact leads us to believe that the potential effects on world economic growth will be significant. It has often been mentioned recently by certain governments in Europe that the effects on growth would be limited to -0.5% to -1.0% in 2020. Now, we must consider that the health precautionary measures taken this week by most European governments and today by the U.A.E government, aiming to limit contacts between citizens and between populations by closing borders, will have significant repercussions on world economic growth.

The declaration of a state of emergency in the United States and the abolition of flights from Europe are sure to increase the level of tension in an already particularly anxious climate. Many sectors will be hit hard as a result of travel, gathering, sporting and cultural gathering bans. The risks of rising unemployment rates and business bankruptcies will be increasing and directly linked to the duration of health measures affecting the economy. In most countries, the risk window appears to have been assessed at around two months, which is probably the minimum period during which activity will now be very significantly slowed down in most countries.

If China is perhaps today in a phase of slow normalization of its activity, it is possible to hope that the experience acquired and the precious time saved to finally adapt the organization of our health systems before the emergence of a wave of cases expected for the next few weeks, will allow countries that have taken the right measures to get through this coming crisis in better conditions. On the world economic front, the Chinese and Asian slowdown will very clearly affect world growth in the 1st quarter, while the economic downturn expected in Europe and the United States will adversely affect the 2nd quarter. This time lag in the pace of activity should lead the global economy into a potential recession in the first quarter and a strong decline in global GDP output in the second quarter of 2020, with a risk of recession in countries most affected by the virus.

Falling financial markets will affect consumer sentiment

However, it should be noted that the drop in financial markets by more than 30% between February 21 and March 15 will have an impact on growth, in particular due to the very marked decrease in the feeling of wealth for households. We can estimate that these, already worried about health risks, will decrease their consumption and will certainly increase their precautionary savings.

The outlook for private consumption for the coming months should be strongly revised downwards, which is not a positive factor for the GDP of countries closely linked to household consumption. Public consumption should in this context be clearly a factor of economic support and could compensate for a drop in private demand. In terms of investment in capital goods, the current environment is clearly not a source of motivation, which should therefore slow down, particularly in the energy-related sectors. Finally, disruptions in value chains and production will not diminish quickly, even during the recovery of Chinese production. A return to normal is difficult to predict and will vary widely depending on the business sector. It will also depend on the interdependencies existing between countries or production areas and on the evolution of the constraints and regulatory limits imposed on the transfer of goods and products.

The organization of world production will undergo significant adjustments

The Covid-19 crisis highlights this interdependence, which is known to most of the economies linked to China, but whose negative effects were not perceived as acutely as they are today. It brutally underlines the fragility of these economies and the limitation of their capacity to react in the face of an external crisis, but it also highlights the very damaging lack of anticipation on the political and economic fronts.

When the world economy recovers from this crisis, the organization of world production will certainly undergo significant adjustments which will undoubtedly constitute particularly attractive positioning and long-term investment opportunities.

Finally, the Covid-19 crisis is in its infancy and the flow of economic news to be published in the coming months should not be optimistic. As a result, investor sentiment, which has gone from extreme optimism in the short term to probably exaggerated panic in the short term, is unlikely to improve quickly and sustainably. The first half of 2020 should therefore be marked by generally negative statistics which should support expectations of a cyclical slowdown.

However, we consider that the negative economic effects of the Covid-19 crisis should be limited to the first half of 2020.

Global demand is expected to be stronger in the second half, especially supported by central bank interventions in favour of rather aggressive stimulus policies. We also believe that fiscal policies will be significantly more expansive and favourable to growth very quickly in 2020, which will limit the next cyclical risks.

Should we believe in a rapid stock market rebound?

The market correction that has hit all the stock markets in recent weeks has, in our view, certainly already reached a level enough to arouse new interest from some investors focused on the shorter term.

Our risk and opportunity valuation measures applied to the various equity markets had reached extreme levels of risk in January 2020 according to most of our measured standards. From now on, the observed value corrections have reduced and sometimes almost normalized the risk parameters monitored.

After a massive correction of -40% in Europe, -35% in the United Kingdom, -32% in Japan, -30% in the United States and 26% in Switzerland, we estimate that the economic risks linked to Covid-19 have was already sufficiently taken into account on the basis of our current knowledge of the problem to justify a probable recovery of the stock market indices in the coming days which could prove to be rapid and of a significant amplitude.

However, a technical stock market recovery will necessarily have a negative impact on the level of valuation and risk of the markets. Such a rebound could then be likely to cause a new wave of falling prices before the situation really improves. Volatility is not about to decrease significantly over the next few weeks, it will be a question of remaining cautious in a generally very uncertain context to take advantage of the opportunities that already appear to present themselves.

As for crude oil prices, the fall in recent weeks is similar to that observed in 2015, which hit $ 26 a barrel before rebounding above $ 50 and then stabilizing for four years between $ 50 and $ 60. Saudi Arabia's initial strategy to cut OPEC production to keep supply and demand balanced against the backdrop of a weaker economic outlook for Covid-19 was not followed by the Russia. Saudi Arabia temporarily lowered prices with two goals. The first is certainly to bring Russia to the negotiating table and the second is undoubtedly aimed at penalizing American producers of shale oil with high production costs, who are solely responsible for the increase in the world supply of crude. Crude oil prices are not expected to remain low for a long time and to return to an equilibrium level of $ 50 in the coming months.

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BearBull Group
Gate Village 3, Level 1
Dubai International Financial Centre
PO. Box. 127676, Dubai
United Arab Emirates
T +971 4 4019160
F +971 4 4019992
M info@bearbull.ae

www.bearbull.ae