BearBull
Global Investments Group

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Sell in May, reduce risk in anticipation of reality check

Beware the new wave of euphoria. Return of volatility in May. Liquidity driving the stock market recovery. Reduce risk after best month since 1987. Buy gold and silver.

Key points

- New wave of euphoria after wave of panic
- Beware the return of volatility in May
- Stock market recovery mainly driven by massive liquidity injections
- Low rate of participation on the upside is worrying
- Covid-19 creates new, lasting paradigm
- The monetisation of debt is an inevitable outcome with likely inflationary effects
- Gold and silver, an essential insurance policy
- Sharp contractions of GDPs in Q2
- Reduce risk in anticipation of the next reality check

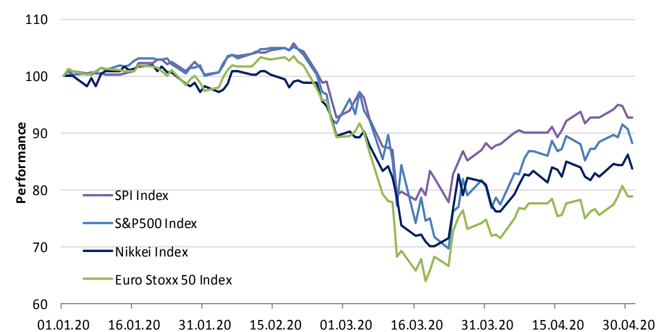
New wave of euphoria after wave of panic

April ended on a +12.8% increase of the S&P500 and the best overall monthly performance since 1987. Since the low point reached in the third week of March, the magnitude of the rebound was more significant still, reaching +35% for the S&P500 and 31% for the SPI index. Hence, the rise in Switzerland in the last six weeks completely offset the correction in March, with stocks back to just under -5% below their level at the end of 2019 (-9.9% for the S&P500).

In the US, Nasdaq stocks were particularly sought after by investors during this rebound, closing in positive territory in April year-to-date, against all expectations.

Nevertheless, all equity markets did not benefit equally from the renewed optimism of active investors looking for bargains, although we noticed, especially at the end of the month, widespread eagerness to try to partake in the stock market recovery. Small US stocks, for example, surged by +10% over three days between 26 and 29 April, before dropping as much over the two following days. Rebounds in stock indices in Europe, Japan and the UK were not as significant, and these three markets remain well below their highest levels of the year at -22.5%, -18% and -20%, respectively. While the S&P500 and SPI indices offset more than 60% and even 65% of their fall, respectively, the Nikkei made back only 50%, the SX5E less than 50%, and the FTSE 100 barely more than 40%.

YTD performance of equity indices



Sources: BearBull Global Investments Group Limited

After stock markets posted one of their sharpest drops in March, US stocks posted their best monthly performance since 1987. The rebound in the last weeks has thus offset a large part of the market losses generated in the four weeks of panic from February to March. Must we then consider that the bear market is over and that the situation is now once again almost normal?

Beware the return of volatility in May

The VIX index, an indicator of stress in the US stock market, could be pointing in that direction, since after surging from 15 to 85 during the stock market crash in March, it quickly fell back down to 31, above its 2019 average for sure but well below its peak in March, which was similar to the one recorded during the crisis in 2008. Volatility thus logically decreased in April with a new upwards trend in prices and a sharp decrease of investor concerns. However, after the extraordinary rebound of stock market indices in April, we reckon that volatility is likely to return in May, as often happens after such performance records.

Stock market recovery mainly driven by massive liquidity injections

Four weeks ago, we mentioned that the exceptional measures announced by central banks and governments to counter risks of a Covid-19-related economic collapse would temporarily reverse the risk perceptions of investors active in financial markets and would undoubtedly create the required conditions for a temporary recovery of stock markets. In that context, we then recommended that active investors again commit to tactical positions in equities and real estate, especially after the widespread collapse of valuations. At the same time, the very quick reconstitution of risk premiums attached to corporate bonds also created opportunities in the bond and high yield segments.

As of the beginning of May, the exceptional rebounds in financial markets have indeed been driven mainly by the massive injections of liquidity promised by central banks and governments. Indeed, the major central banks, starting with the Fed, reacted quickly, promising to do whatever was necessary to avoid a collapse in economic activity by lowering their key rates and announcing massive liquidity injections through increasingly extensive asset purchase programmes.

The measures taken by governments to counter the negative economic effects of the lockdowns implemented to fight the spread of the Covid-19 pandemic have also been exceptional, although very different depending on the countries. The total injections of liquidities announced in industrialised countries are believed to amount to approximately 10 trillion dollars.

Low rate of participation on the upside is worrying

There is no doubt that these announcements radically modified the risk perceptions of certain market participants. Indeed, the commitment of central banks and governments seemed to show that a strategy could be quickly designed and implemented to ensure a recovery from the crisis that would be less chaotic than initially anticipated. While these investors drove the rise in the last few weeks with their reinvestments, we believe that they are few in number and that their time horizon is rather short. Moreover, transaction volumes during this rebound were lower, which points to limited participation in the rally. Most investors who sold on the downside have not returned to markets to "benefit" from opportunities, judging by the very high level of liquidities held in money market funds at the end of April. Even within stock market indices, the rebound of the S&P500 for example was mainly due to the rise in large caps such as Apple, Google, Amazon, Microsoft and Facebook. Small cap indices are still noticeably lagging.

Covid-19 creates new, lasting paradigm

In the last few weeks, a new paradigm seems to have taken shape, whose consequences for financial markets may be extremely significant in the next few years. The Covid-19 pandemic will have taken by surprise most governments, which have often had to take drastic measures to protect their populations at the risk of a possible collapse of whole segments of their economies. Initially, the scope of the health crisis left little choice to decision-makers, who had to reassure their populations of the fact that their primary objective was to guarantee their safety.

The economic risks induced by the lockdown were set aside, since weighing up interests was out of the question when human lives were at stake. We are now better able to assess the immediate economic impact of these lockdown measures, even when partial and short-lived, with the first effects on unemployment and GDP growth in Q1.

The financial cost of managing this health crisis is already turning out to be very high and will undoubtedly exceed the $10 trillion estimate corresponding to the measures already announced by central banks and governments.

Budget deficits will grow dramatically in 2020 and 2021 at the very least, while sovereign debt levels will increase further still. It will be difficult for governments not to be tempted by the necessity of increasing deficits further to support their populations made more vulnerable by a likely drop in employment and purchasing power. For central banks, a recovery of key rates clearly seems unlikely for a few years, even if inflation rises. Covid-19 will also have slowed the unrestrained globalisation of the last few decades. The reorganisation of production chains is likely to suffer some significant changes to help ensure that industrialised countries are less dependent on China. This reorganisation may have an inflationary impact in 2021.

The monetisation of debt is an inevitable outcome with likely inflationary effects

The increase in government debt and public deficits will prevent any normalisation, even gradual, of monetary policies, which will remain expansionary for a long time. Central banks' latest statements leave no room for doubt: monetary creation will serve to fund the public deficits necessary for curing the economic impact of the health crisis. Central banks will buy ever more government debt, but that is not all: they are now prepared to accept low quality bonds as collateral and in fact willing to purchase or accept as collateral almost any type of asset. In a few quarters, we will see if the estimate of $10 trillion of currently expended funds does not increase significantly.

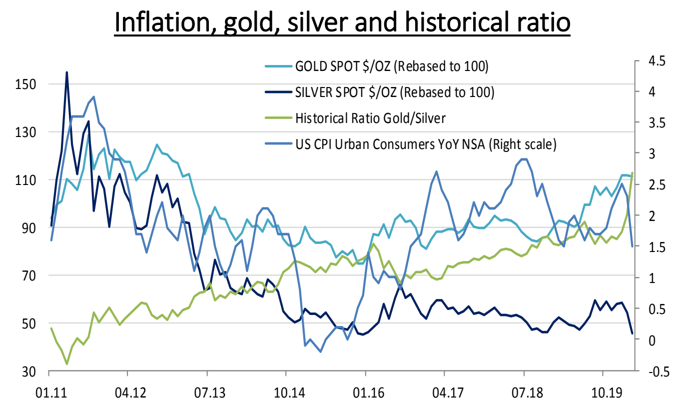
Although most experts now seem to think that the ongoing growth shock is clearly deflationary, we are already considering the possibility that the new post-Covid-19 crisis paradigm and the monetisation of debt will actually have tangible inflationary effects in the near future.

Gold and silver, essential insurance policy

Despite the recent increase in gold prices, investment demand for physical gold in particular is likely to grow further still in the persistently uncertain context we are experiencing. Gold prices are likely to progress and exceed their 2011 high of $1,921 per ounce. Negative real yields are favourable to gold, and a rebound in inflationary prospects will reinforce demand for gold as a store of value.

The gold/silver ratio is at its highest historical level and points to a normalisation phase probably based on a broadening of demand for silver as a store of value. Prospects for silver therefore seem superior in our minds.

Inflation, gold, silver and historical ratio



Sources: BearBull Global Investments Group Limited

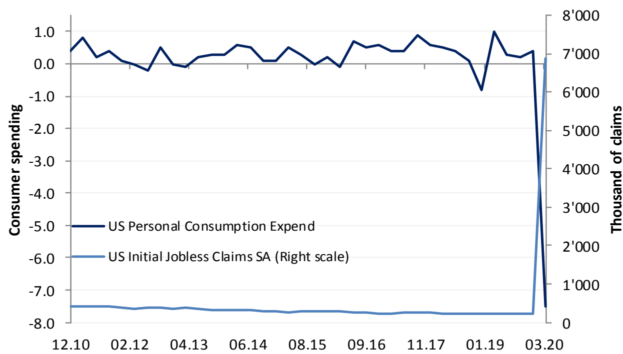
Sharp contractions of GDPs in Q2

Reported US GDP growth shows a -4.8% contraction in Q1, even though the economy was only subjected to a limited two-week-long lockdown. This is a major surprise, which raises fears of a much more significant collapse in Q2. In Europe, the statistics are also worrying but much more consistent with the duration of the lockdowns implemented in Italy (-4.7%), Spain (-5.2%), France (-5.8%) and China (-6.8%).

In the US, the number of first-time unemployment benefits claims surged to approximately 30 million in four weeks only. The unemployment rate, which had reached a historical low in January, is likely to exceed the worst number it reached after the economic crisis in 2008, above +10%. More than most other economies, the US economy is dependent on the health of its consumers. Household consumption represents close to 70% of US GDP compared with only 52% in Germany, Japan, Switzerland or France.

This unprecedented explosion of unemployment is certainly not over, since the Covid-19 crisis has created a shock in demand and supply despite the absence of an economic crisis, a completely unique situation. The US economy reacted violently to the lockdown measures with a significant number of layoffs in the absence of support measures similar to those implemented in Europe especially.

Employment & household consumption



Sources: BearBull Global Investments Group Limited

A negative spiral has been initiated, whose effects will last well beyond the deconfinement process. The downsizing carried out to deal with the drop in consumer demand will reinforce the trend and provoke further potential layoffs before any stabilisation can take hold.

Q2 could well be more difficult in the US than in other developed countries due to the superior resilience of consumers outside the US and their GDP's lower dependency on household consumption.

Reduce risk in anticipation of a reality check

The change in risk perceptions in April affected all asset classes. Rebounds were also significant in real estate, corporate bonds, high yield and private equity, to such an extent that valuation levels are once again "generous". P/E ratios in the US are once again at 19.6x current earnings and 22.5x 2020 earnings, which we reckon is already excessive given the prevailing uncertain context. Q1 reporting and earnings outlook season is ongoing but has not provided any reassuring indication of any potential improvement at this stage. More and more companies are admitting to a glaring lack of visibility for the next few quarters. Reductions in dividends and earnings prospects are inevitable and will not spare tech companies either.

We noticed a very sharp rise in our risk assessment ratios after the significant increase in stock indices in the last few weeks. A historical monthly performance record in the US since 1987 is likely to be followed by a decline in the current context. The once-again very generous valuations logically suggest a reduction and underweight exposure to equities. After recommending making the most of the opportunities in March, we now suggest a further reduction in equity exposure.

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