ISGAM

Manager's Report

QUARTER TO 31 MARCH 2020

ISGAM AG, Beethovenstrasse 48, CH-8002 Zurich. Switzerland
T: +41 44 286 6060 F: +41 44 286 6065 E: enquiry@isgam.ch

It has now been quite a number of weeks that most of us have been "self isolating", alone or in small groups, in a global concerted effort to "flatten the curve" of the corona virus epidemic, help prevent national health care systems from becoming completely overwhelmed, and save lives.

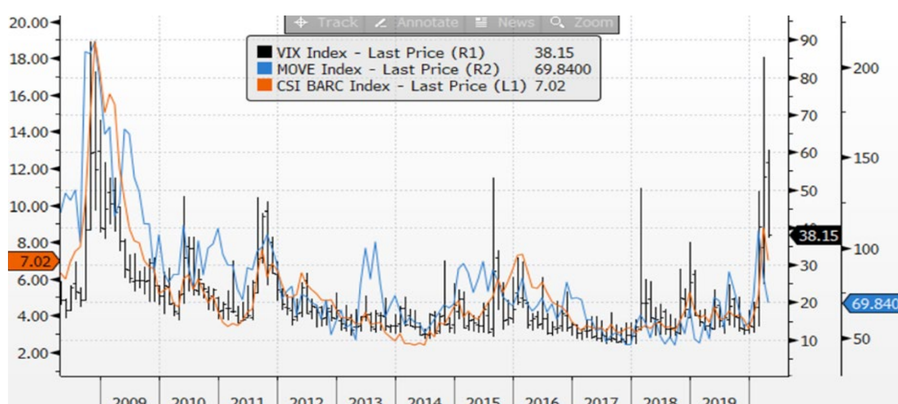
For the majority of people this has been a stressful and highly unusual period and we first and foremost express our hope that all of you, our clients and your loved ones, are safe, in good health, and coping.

In some of our countries infection rates have peaked, in others not quite yet; much is still unknown about the novel virus, whether those infected will obtain immunity, whether or not it will disappear over the summer months and then reappear in winter. Though many scientists are working on medicines and vaccines, a vaccine might not be available until early next year. One of our staff members, working from home while quarantined with her young teenage son, mused recently that if the medical establishment does not soon come up with a vaccine, mothers surely will.

In contrast to the 2008 "Great Financial Crisis", which originated in the financial sector and then spread to other parts of the economy, the current crisis is the first time in modern history that we witness a simultaneous supply shock (large parts of the productive economy have been shut down, disrupting complex global supply chains) and a demand shock, as people are forced to stay home.

This has been coupled with a dramatic decline in the oil price, due to an unfortunately timed power struggle between Saudi Arabia and Russia. A decline in the price of oil will eventually act as a support to consumer spending, but initially it depresses economic activity as production is curtailed. In addition, sovereign wealth funds (many of the largest ones are owned by oil producing countries) become forced sellers of assets as they need to raise cash, exacerbating market corrections. In short, the forced closing down of most of the global economy, coupled with a negative oil price shock, created a perfect storm for financial markets this past quarter. Volatility spiked and credit markets (the "oil" of the cogs of the global financial system) froze and became completely dysfunctional.

Chart 1) The VIX (Stock Volatility) MOVE (Bond volatility) and High Yield Spread (CSI Barc) indices spiked to levels last seen in 2008/9.



Source: Bloomberg Finance L.P.

As we mentioned in our most recent bulletin, your portfolio entered this crisis with an underweight position in equities; not because we were expecting this particular Black Swan to emerge but because we were cautious after a prolonged period of unusually low volatility and relatively rich asset prices, in the face of an ageing economic cycle.

We had also reduced some riskier positions (such as high yield bonds and high beta equity funds) in early February, rotating into higher quality assets.

This partly helped mitigate the shock to portfolios, but as no asset class remained unaffected there was no place to hide, and certainly no action to be taken in the highly volatile markets that followed.

The effects of the lockdowns on the global economy are enormous; estimates remain in flux but we consider Capital Economic's most recent projection of a 4% contraction in global GDP in 2020 to be very likely. The decline would be concentrated in Q1 and especially Q2, with a recovery beginning in Q3 as economic activity can hopefully gradually restart.

A 4% expected contraction is worse than the one experienced in 2008; at that time Asian economies were largely unaffected by the financial crisis and grew strongly, whereas currently most of the world is affected. There are differences in estimates between countries based on different spending patterns; the GDP decline in European economies, relatively dependent on tourism and with relatively high share of spending on luxury goods, is expected to be especially stark. Capital Economics estimates that second quarter GDP will decline by an annualized 18 to 20% in different EU economies, falling by a total of around 9% for the full year. For the UK their current estimate is -15% for the second quarter, -7% for the full year. For the US, where the unemployment rate is expected to rise to around 12% from recent all time lows, a decline of -12% is estimated for the current quarter, and -5% for the full year.

Central Banks globally have now done "whatever it takes" to alleviate market stress and dislocation. Having learned from the recent 2008 crisis they have been much quicker to act and much more decisive, leaving no stone unturned and no potential tool unused.

What is more, both the US Fed and the European Central Bank have pledged they will not stop here if further action is needed. Their programs have been matched with unprecedented fiscal support packages by governments, who clearly want to prevent mass lay offs and bankruptcies. In most developed countries, large and small companies can receive aid packages and cheap loans to tide them over the coming period provided they keep paying their staff; unemployment benefits have been bolstered and also made available to independent and self employed workers, banks can receive cheap funding provided they keep credit lines open to businesses. In short, Central Banks and governments have this time truly thrown the kitchen sink at the unfolding financial and economic crisis. The table below shows a summary of monetary (ie Central Bank) and Fiscal (ie Government) measures announced until the end of March. Together they amount to roughly 11.1% of global GDP.

For comparison: the fiscal measures taken in the 2008 financial crisis amounted to roughly 1.7% of global GDP.

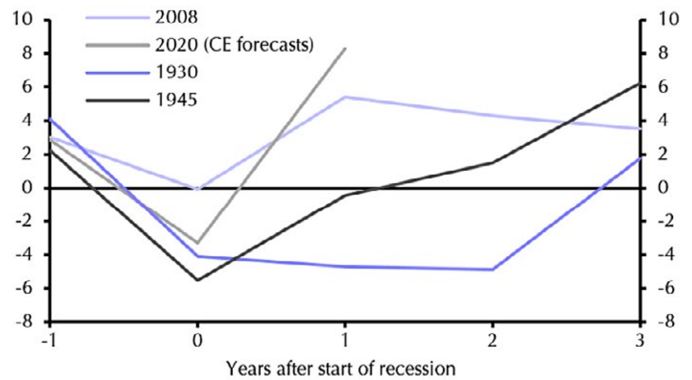
Global Monetary and Fiscal Stimulus to Fight COVID-19 Impact 2020 Feb to Mar

	Central Bank Liquidity Injection		Govt Fiscal Stimulus		Central Bank Liquidity Injectior and Govt Fiscal Stimulus	
	$ bns	**% GDP**	**$ bns**	**% GDP**	**$ bns**	**% GDP**
US	1500	7.0%	2756	12.9%	4256	19.8%
:urozone	1100	8.3%	480	3.6%	1580	11.9%
Japan	126	2.4%	184	3.6%	184	3.6%
UK	387	14.1%	38	1.4%	425	15.5%
China	1153	8.0%	111	0.8%	1264	8.9%
Others	406		1416		1948	
Total	**4572**	**5.4%**	**4984**	**5.8%**	**9655**	**11.1%**

Source: Blackrock

Many countries have now announced wage subsidy programs to prevent mass layoffs. These programs are modelled on Germany's "Kurzarbeit" program, which has been successful in enabling Germany to come through the Financial crisis of 2008 with a much below average unemployment rate. Also the US, which initially focussed on raising its Unemployment Insurance, has since started a Paycheck Protection Program which gives money to small firms provided they maintain payrolls. In spite of these efforts, most people's incomes will still be severely squeezed in coming months as wages are only partly subsidized, and inevitably some companies and many workers will fall through the cracks of the system. The support measures are meant to tide over consumers and most businesses until the economy can be opened up again, to prevent bankruptcies and lasting destruction of productive capacity; if these goals are met we can expect a strong bounce back in activity , hopefully starting in Q3 of this year. The chart below shows current estimates of the time line of global GDP contraction and recovery compared to previous recessions:

Chart 2) Probable shape of the current recession compared to previous ones: sharp but shorter

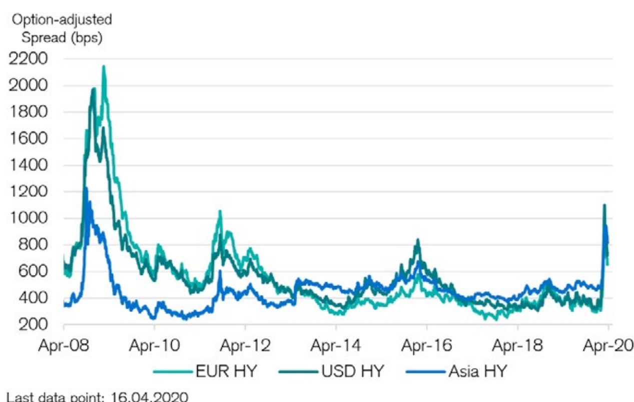


Sources: Maddison, Refinitiv, Capital Economics

Again, much remains uncertain and dependent on our ability to "conquer" a virus that is still not fully understood. The gradual re-opening of economies will certainly require the availability of accurate and widespread testing, so that those with immunity can go back to work while the vulnerable remain protected. As of yet there is little evidence of such tests being widely available in the near future.

Whatever the eventual recovery turns out to be, "V shaped", "W shaped", or "U shaped", once this crisis has passed we can start pricing financial assets based on their longer term cash flow projections, coupled with what is likely to remain a low interest rate environment for a long time to come.

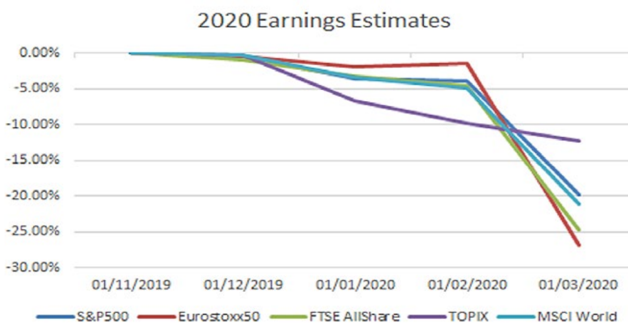
Chart 3) Corporate bond yields once again at very attractive levels



Source: Bloomberg, Credit Suisse

At the start of the year we struggled to find value in fixed income investments; government bond yields were very low and the "spread" (or yield difference) between high grade, lower grade and "junk" (or "High Yield") corporate bonds was narrow. This has changed dramatically in the recent sell off; it is once again possible to lock in attractive yields for medium and long term bond investors, though they have already come down somewhat from their "panic" peaks. It remains important to be selective as default rates always rise during a recession, but current yields probably over-estimate likely default rates. Both the US Federal Reserve and the European central bank have committed themselves to buying corporate debt in their new QE programs, in an effort to keep companies afloat and be able to refinance themselves. The US Fed's decision to include junk bonds in its buying program (for the first time ever) seems to have been triggered by the recent downgrade of Ford's bonds to "junk" status; having rescued their domestic automakers in 2008 the US is certainly not planning to let them go under in the current crisis.

Chart 4) Equity analysts have been relatively quick to cut their 2020 earnings estimates



In contrast to bond fund managers who are notoriously cautious, equity analysts tend to be an optimistic bunch who usually start a new year projecting overly hopeful earnings growth, which they then slowly and grudgingly downgrade as time goes by. Although the first quarter's earnings reporting has only just started, we are heartened to see that presently they have been quick off the mark to downgrade 2020 earnings estimates to more realistic levels, as per the chart above (compiled on 11 April). These are average estimates, aggregated for major stock indices.

Of course there is large dispersion depending on the sector. Hard hit sectors include part of the consumer cyclical as well as non-cyclical complex, especially companies exposed to travel, tourism, dining out. Also hard hit are the oil sector, the banks (most European and UK banks have been forced to suspend their dividend payments this year as they are receiving support from Central Banks and Governments) and many industrial companies. Healthcare companies are relatively uneffected, as are companies providing telecom, internet and cable services.

The tech sector is very mixed, with some companies (eg those that provide cloud based services and enable people to work from home) expected to do well this year, whereas those that are more exposed to the corporate investment cycle feeling the pinch. As much of this has already been rapidly discounted in relative share price peformance and valuation, it remains as important as ever to look past the immediate future and value companies based on their longer term expected cash flows; the current year's earnings should never feature heavily in a company's overall valuation anyway. A focus on durability and quality (strength of balance sheet, pricing power) remains as important as ever.

Considering the factors above, stock markets are more attractively valued than they were at the start of the year. They are still not downright "cheap", with the exception of Emerging markets. The latter are cheap but will also be relatively hard hit, by the health challenges of the virus, the global economic fallout, the reduction in tourism, the recent strength in the dollar, and the large outflows of investment dollars from their markets.

Developed markets are not particularly cheap but do offer an attractive "risk premium" over cash and government bonds, where yields are once again close to zero with a high chance of remaining there for the foreseeable future.

We have prepared for a move back to "neutral" equity levels from "underweight"; this entails a shift of 5% of the portfolio from low-risk bonds and alternatives back to equities. We will make this shift once we believe the time is right. Much remains uncertain, and dependent on the path of a virus we still know little about. But we think it is likely the floor in asset prices has been set, given the speed and strength of central bank and government actions.

As always, please do not hesitate to contact us if you have any questions or comments, about the contents of this report or your portfolio in general.

Stay safe.

Portfolio Management Team ISGAM AG

Marianne Rameau ASIP

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