REFLEXIONS

Q2 20

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BERGOS BERENBERG

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Executive Summary

MAXIMILIAN HEFELE, CFA
Head of Asset Management

Dear Investors,

which were again the dominant capital market topics of 2019? Against the background of the current health and economic crisis, the answer does not really seem relevant. With the new type of coronavirus, SARS-CoV-2, we are being struck by a global shock that not only paralyses our social life but also causes the global supply chains to freeze. The longest economic upswing since the beginning of recording ended with a bang. Despite enormous efforts in monetary and fiscal policy, a global recession cannot be avoided.

In this environment, short-term forecasts are obsolete and it is precisely this lack of orientation that causes extreme price-caprices on the capital markets. From their highs to lows, global stock markets have lost more than 30% in value. Historically, this is already the average price decline in a recession. The risks associated with a recession are thus already reflected to a large extent. This is by no means a signal of relief. The reporting on the damage to the economy is only just beginning, so we must continue to expect high price swings.

But how should an investor behave in such an environment? Panic is certainly not a good advisor. Today, it is more important than ever to stick to a sound investment philosophy. Let me take this opportunity to reflect on the three most important aspects of the investment philosophy in Bergos Berenberg's core strategies:

Global diversification

With a global orientation, our core strategies are geared to global value creation. In doing so, we broadly diversify into different asset classes, regions, sectors, market segments and even individual issuers. An unfounded "home bias" is deliberately avoided. In the equity sector, the US equity market in particular is of great strategic importance. A market that not only has a stabilizing effect in times of crisis, but also offers structural growth advantages over other developed countries. The technology and communications sector in particular is unparalleled. This strategic orientation was also advantageous this year.

Counter-cyclical investment patterns

In a balanced strategy, tactical liquidity, conservative fixed income securities and, to a certain extent, physical gold are essential in addition to equities. Due to their balancing effects, especially in times of crisis, these portfolio components help to avoid pro-cyclical errors. On the contrary, in our approach we use the investment mix to act counter-cyclically. In times of crisis, we shift the allocation from stable portfolio parts to promising equities that have excessively lost value in exaggerating markets. In this way, the portfolio is "rebalanced" counter-cyclically in order to benefit optimally from an upcoming recovery phase. The shift from liquidity to stocks in the communications sector in the USA is a current example of the implementation of our investment philosophy. In late March, we raised the general equity allocation back to a neutral level and sharpened our positive house view for US equities. In addition, we made counter-cyclical investments in the communications sector, which is not only profiting from the crisis but also offers structural opportunities for the future.

Long-term orientation

The basic requirement for the successful implementation of our investment philosophy is a long-term investment horizon. This is easier said than done when the portfolio values are melting away in the short term. With a stiff focus on the extreme developments of recent weeks, the fact of the enormous price gains in 2019 quickly fades into the background. If these price gains are included in the analysis, the current price caprices are already put into perspective.

A longer-term perspective is also worthwhile when looking at the future. We use this to formulate realistic future scenarios that go beyond the description of the current situation. For this, it is not necessary to predict the exact turning point in a crisis. However, it is crucial to have the imagination of how the world can develop from one crisis to the next upswing. We derive our investment policy on the basis of this scenario in order to benefit as much as possible from the future upswing.

In this issue, we discuss precisely this scenario and derive our capital market opinion on the various segments of the equity, bond and commodity markets accordingly. As usual, you will find our market opinion graphically summarized on the next page.

Even in this crisis, we remain true to our established investment philosophy and hope you enjoy reading this issue.

With our warmest wishes for good health and bright spirits,

MAXIMILIAN HEFELE, CFA
Head of Asset Management

Bergos Berenberg Hausmeinung

BANK VIEW

	--	-	0	+	++
Equities	○	○	●	○	○
North America	○	○	○	●	○
Consumer Discretionary	○	○	●	○	○
Consumer Staples	○	●	○	○	○
Energy	○	●	○	○	○
Financials	○	●	○	○	○
Health Care	○	○	○	●	○
Industrials	○	○	●	○	○
Information Technology	○	○	●	○	○
Materials	○	○	●	○	○
Real Estate	○	○	●	○	○
Communication Services	○	○	○	●	○
Utilities	○	●	○	○	○
Europe	○	○	●	○	○
Consumer Discretionary	○	○	○	●	○
Consumer Staples	○	○	●	○	○
Energy	○	●	○	○	○
Financials	○	○	●	○	○
Health Care	○	○	●	○	○
Industrials	○	○	●	○	○
Information Technology	○	○	○	●	○
Materials	○	●	○	○	○
Real Estate	○	○	●	○	○
Communication Services	○	○	●	○	○
Utilities	○	○	●	○	○

	--	-	0	+	++
Fixed Income	○	●	○	○	○
Denomination U.S. Dollar	○	○	○	●	○
Duration	○	○	○	●	○
Sovereigns	○	○	○	●	○
Corporates Non-Financial	○	○	○	●	○
Corporates Financial	○	○	●	○	○
Senior	○	○	●	○	○
Subordinated Debt	○	○	●	○	○
Corporate High Yield	○	●	○	○	○
Denomination Euro	○	●	○	○	○
Duration	○	●	○	○	○
Sovereigns	○	●	○	○	○
Core	○	●	○	○	○
Peripheral	○	○	●	○	○
Corporates Non-Financial	○	○	●	○	○
Corporates Financial	○	○	●	○	○
Senior	○	○	●	○	○
Subordinated Debt	○	○	●	○	○
Corporates High Yield	○	●	○	○	○
Emerging Markets	○	○	○	●	○
Hard Currency	○	○	○	●	○
Local Currency	○	○	○	●	○

	--	-	0	+	++
Alternative Investments	○	○	○	●	○
Commodities	○	○	○	●	○
Energy	○	○	●	○	○
Industrials Metals	○	○	●	○	○
Precious Metals	○	○	○	●	○
Hedge Fund Strategies	○	○	●	○	○
Long/Short	○	○	●	○	○
Relative Value	○	○	○	●	○
Macro	○	○	●	○	○
Event Driven	○	○	●	○	○
Convertibles	○	○	○	●	○
Real Estate	○	○	●	○	○

MACRO

Economics

APPROACHING THE BOTTOM

Dr HOLGER SCHMIEDING
Chief Economist, Berenberg

The virus pandemic and the lockdown to contain the spread of the virus are taking a heavy toll on the global economy. All major advanced economies have fallen into a significant recession. However, the harsh containment measures which major parts of Europe started to impose in mid-March are apparently starting to work. The rate of increase of confirmed coronavirus infections slowed down visibly in Europe in late March. While the US has turned into the third epicentre of the pandemic after China and Europe, some of the most recent data also points to a slower spread of the disease.

China is reporting further progress. The official China PMI data for March came in well above expectations. Of course, official data out of China should always be treated with caution, and especially so at a time when China is trying to score points on the global scale for its handling of the crisis. In addition, the modest increase which the data now signals comes from a very depressed level of activity. This suggests that the rebound is modest and that, relative to the pre-corona level, activity remains quite depressed. Still, the improvement in the PMIs chimes with the measures of daily economic activity such as passenger traffic, coal consumption and the like which show that activity seems to be rebounding from the February lows.

A road map for Europe: As a rough guess, Europe is probably some 6 weeks behind China. While the trends will not be exactly the same, partly because the measures taken in Europe to contain the virus are somewhat less draconian, developments in China provide a glimpse into the possible future. Economic activity in Europe plunged in March according to the PMI data, with the falls almost in line with the drop in February in China. Europe will need to keep its strict containment measures in place for a few more weeks yet. But the evidence of the slowing virus spread in Europe supports the hope that at least some of the most restrictive containment measures may be lifted in May. With luck, the European economic trends will also follow the Chinese trends, although probably in a more muted form. If so, the inflection point in the coronavirus recession for Europe could be in late Q2. But it is far too early to assess this with any confidence.

Our core views on the Covid-19 recession have not changed much since mid-March.

The unprecedented monetary and fiscal policy response to the extreme health emergency will prevent a financial crisis that would otherwise exacerbate the severe recession. Markets should start to price in the post-corona rebound if and when we get some clarity about (i) the course of the pandemic, (ii) first steps to ease the lockdowns, and (iii) the extent of capital dilution risks for companies which may need an injection of public money. This will probably still take a while, though.

Worse than the post-Lehman slump: At least for the months March to May, economic data will show a contraction not seen before in peacetime. This year, all advanced economies will suffer a recession with yoy declines in annual GDP ranging from 3% in the US to c7.5% in Italy. Near-term, the risks remain heavily tilted to the downside.

Lockdown economics - a rule of thumb: For every month of a harsh lockdown, we would subtract at least 2.5% from annual 2020 GDP while adding at least 1.5% to 2021 GDP due to base effects and a post-lockdown rebound. We would also raise 2022 growth by up to 0.5ppt as the rebound continues, supported by the monetary and fiscal stimulus. Details vary with the specifics of each country and the assumptions about non-corona trends. Our current forecasts assume a severe lockdown of about eight weeks. The restrictions on daily life and economic activity are hitting most non-digital consumer-facing services more than manufacturing and construction.

Tickmark rebound: No letter of the alphabet, neither L nor U nor V, will do. Instead, we look for a tickmark-style profile, namely a sharp downturn followed by a slightly flatter upturn that goes beyond the pre-corona level of GDP, surpassing it roughly two years after the trough. Most – but not all - of the economic activities that now have to be switched off can be switched on again thereafter. However, the lockdowns will likely be eased much more gradually than they are being imposed now, possibly with some back-and-forth in

response to the shifting medical situation. Some activities such as long-distance travel will remain constrained for much longer.

For the rebound phase after the trough, risks are balanced. The rebound may be more muted because households and companies may hold back on spending as they are still scarred by the experience. But it may also be stronger. Most of the monetary and part of the unprecedented fiscal stimulus will still be in the pipeline if and when the shock to the real economy starts to ease. Pent-up demand may add to that for many goods and some services.

Mixed impact on trend growth: In manufacturing, companies will shorten and diversify supply chains and raise inventories. As they forego some of the earlier gains of globalisation, the sector will lose some momentum in line with a slowdown in global goods trade. The need for fiscal repair and more social and healthcare spending will also be a drag on gains in global supply. However, a crisis can be the mother of invention. The corona shock is likely to spur innovation in many fields ranging from a more efficient use of labour and communications technology to increased use of 3D printing. In the long run, the resulting jolt to productivity may be stronger than the drags unless economic policies turn away too much from market-based models.

After the selloff: Extreme uncertainty and self-reinforcing market dynamics can explain the recent market crash. However, we do not expect that, once the dust has settled, the productive capacity of the private economy in the Western world as measured by equity prices should be worth some 20-30% less than pre-corona. Near-term, this long-term fundamental view will probably not shape market dynamics yet.

A sea of red ink: Due to the fully justified "whatever it takes" policy responses, a significant part of the costs of the pandemic will turn into public debt over time. In the US, the UK, Italy and Spain, the fiscal deficits will probably be close to 12% of GDP in 2020 whereas Germany may get away with 8%.

Hello Japan: A major part of the extra debt will end up on central bank balance sheets. Policy rates will likely be lower for much longer after the corona recession. This will make the debt burden bearable in most cases. Expect a degree of "Japanification" in this particular sense.

The Corona Shock deals heavy blows to economies - but crisis can also be the mother of invention

EQUITIES

KEEP CALM IN TURBULENT TIMES

Exogenous shock drives the economy into a global recession, but not into a depression

Number of new Corona cases expected to peak in May at the latest; the worst could be behind us by mid-year

Central banks with extreme measures; massive fiscal packages to support the economy

Despite the risk of further setbacks, the current uncertainty could turn out to be an opportunity

TILL C. BUDELMANN
Equity Strategist

Exogenous shocks hit the capital markets from time to time – in the form of a virus, this type of shock is very difficult for us market observers to assess, however. The implications for the global economy are obviously enormous and can currently only be assessed in large bandwidths and with the greatest uncertainty. Next to the development of the virus itself, the main focus now obviously lies on the political response. The coronavirus (Covid-19) has struck twice at the same time, both the supply and demand side are severely affected. Production sites have been shut down, while consumption declines. The oil price shock following initially failed negotiations between OPEC and Russia has created further difficulties. Although cheap oil benefits consumers and transportation companies, we are viewing the sharp price drop in the currently weak situation as another net negative for global economic growth.

MARKETS ALREADY PRICING IN TWO WEAK QUARTERS

Due to the difficulty in predicting the development of the virus, we laid out a few scenarios in February. Meanwhile, the focus is essentially on two of them. Equity markets are already pricing in a trend that roughly corresponds to our "escalation" scenario, which we currently believe to be the most likely despite all the uncertainty. According to this, the worst could be behind us by mid-year. Macroeconomic data was already very distressed in the second half of March and will continue to deteriorate significantly in April and May. Based on this scenario, we forecast a massive recession in the Eurozone for 2020. We expect the gross domestic product to decline in the mid single-digit percentage range, even under the assumption of a substantial recovery in the second half of the year. In the "massive escalation" scenario, the disruption continues at least until year end – markets have definitely not yet priced in such a development. The consequence would then of course be an even more severe GDP decline.

Figure 1: Performance of International Equity Markets

Indexed to 100
Note: Stoxx 50 Index includes blue-chip stocks from all across Europe; Euro Stoxx 50 focuses solely on the Eurozone.
Source: Bloomberg, Bergos Berenberg, Data as of 03/31/2020

MONETARY AND FISCAL STIMULUS TO SUPPORT THE ECONOMY

Never before has monetary and fiscal policy on both sides of the Atlantic reacted so quickly and extensively to an economic shock as in the past few weeks. At two unscheduled meetings in March, the US Federal Reserve has cut its key interest rate by a total of 150 basis points to a range of 0.00 - 0.25 percent and announced extensive liquidity measures. In addition, the US government has passed a fiscal package worth over USD 2 trillion. The European Central Bank also switched fully into "whatever it takes" mode and announced an additional programme to buy at least a further EUR 750 billion of assets. Despite all the supportive measures, economic output is likely to decline much faster in these months (during which the significant restrictions are in place) than during the last financial crisis. However, as soon as the restrictions can be gradually eased, a significant part of economic activity should also be able to recover.

EQUITIES PARTICULARLY ATTRACTIVE AFTER THE CRASH

The economic stress caused by the pandemic will obviously also have a strong impact on the development of corporate earnings. Almost certainly, there will be a global earnings decline in the double-digit percentage range in 2020 and the energy sector will suffer in particular. However, as equity prices have declined massively and bond yields already anticipated the steps taken by the central banks, the valuation of equities compared to bonds now appears to be even more attractive. The price-earnings ratio of the MSCI World is currently slightly below the long-term historical average. Compared to bonds, equities have a yield advantage far above the long-term average. The so-called "yield gap", i.e. the difference between the earnings yields of equities and government bond yields, remains noticeably above the historical average if one assumes a similar percentage decline in corporate profits for 2020 as during the 2008 financial crisis.

S&P 500 (closing price 03/31/2020)	2'584.59 Points
2020 EPS (assuming a 2008-like Decline in %)	125.32 USD
Earnings Yield	4.85%
10 Year Bond Yield	0.67%

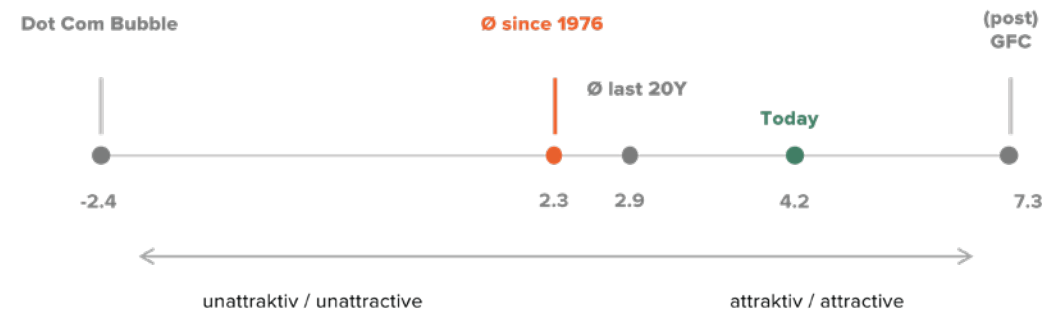

Figure 2: S&P 500 Earnings Yield Minus 10 Year Bond Yield from a Historical Perspective

Source: Bloomberg, Refinitiv, Bergos Berenberg, Data as of 03/31/2020

MODERATE DEMOCRAT AHEAD IN PRIMARY ELECTIONS

There has been some relief regarding another topic that until recently still appeared to constitute a major market risk for 2020. US primary results now indicate that it will be the more moderate candidate Joe Biden rather than the left-leaning and somewhat market-hostile Bernie Sanders who will go forward as the Democratic candidate to the US presidential elections. Either Republican Donald Trump or Democrat Biden would make for an acceptable president from the perspective of markets. While Trump wins points for his supply-side policies such as lower taxes and less regulation, his trade related policies provide a stress factor. There would likely be less trade related stress under Biden but he would probably try to reverse some of Trump's tax cuts. The likelihood for Trump to remain president or Biden to take office is at approx. 48 percent each, for Sanders on the other hand it is only in the low single-digit percentage range – all this provided that the candidates stay healthy.

UNCERTAINTY COULD TURN INTO A BUYING OPPORTUNITY

In this environment, we currently prefer a neutral positioning for equities because the different areas of our analysis balance each other out: The extremely poor macro- and technical picture is offset by attractive valuations and a cautious sentiment (as a contra indicator). And within the asset class, we continue to expect some relative strength of US equities compared to the rest of the world. Markets are likely to remain volatile for the foreseeable future and further setbacks cannot be ruled out during this phase of the pandemic. However, for long-term investors this may not be a bad time to start adding some equity risk. In times of market turmoil, it is important for investors not to panic but to keep calm. In retrospect, the high level of uncertainty could prove to be a good opportunity to position oneself rationally and at a reasonable price in long-term, future-oriented market areas. During these weeks one well-known quote from Warren Buffet comes to mind: „Four or five times during their lifetimes, investors will see incredible opportunities in equity markets and they have to have the mental fortitude to jump in when most are jumping out“.

DECELERATION
STAGNATION
RECESSION
DEPRESSION

HOW BAD WILL IT BE?

RENÉ BOLHAR, CAIA
Bond Strategist

After a volatile year 2019, with much headline news-flow around the US-China trade war, 2020 promised to be somewhat characterized by a new wave of solid and stable synchronized growth.

Even after what could have been considered a new long-lasting conflict in the Middle-East between the US and Iran in the beginning of the year, all seemed to be cleared for a new round of growth and prosperity for the rest of 2020. In hindsight, the situation back then appears to be marginal given what entered centerstage during the course of the first quarter.

TO SUMMARIZE:

First cases of Covid-19, caused by a new form of coronavirus in Wuhan, Hubei region of China, were already reported in December last year. Although the disease began spreading in South-East-Asia in January with its first case outside China being reported on January 13th from Thailand, it was considered a regional issue for several weeks, without any material impact. Until the end of February. The World Health Organization was actively monitoring the surge of new cases worldwide, but was hesitant to call it a pandemic until March 11th 2020. Until then, the virus already spread across the world with China being the starting point but Europe, namely Italy being the hot spot of new infections and casualties soon.

HOW IS THIS REFLECTED IN THE FINANCIAL MARKETS?

At the end of the month of February, the new disease started to catch increased attention by capital markets around the world. In addition, the WHO at that point called it according to their classification an Emergency of International concern, but not yet a pandemic.

With more and more single countries announcing unprecedented measures like lockdowns (Italy as the epicenter of this new disease reported the first case of Corona on January 28th, a lockdown was established in the most struck northern region on March 8th with more to follow), the economic impact of the situation – although not yet to be assessed in numbers – became more apparent in public perception with a so far unseen speed.

Over time, the situation got worse. Italy, Spain and other European countries reported more and more cases of Covid-19 during the month of March. As a consequence, major European countries announced lock- and shutdowns in order to mitigate the possible severe impact on economic output in a time span of only a couple of weeks.

Also not helpful was the open ideological conflict on global oil output between Russia and Saudi Arabia. In times of already heightened tensions due to the coronavirus, no agreement was reached to prolong the existing agreement on maximum oil output. A deteriorated risk sentiment hence was intensified by uncertainty around oil supply and consequently prices dropped.

Not only equity markets as the most sensitive risk asset class took a severe hit from souring investor sentiment and growth prospects. With almost the entire economic universe being in some way affected by the coronavirus fallout, fixed income markets reacted sharply to the new developments.

The first „canary bird in the mine" were the global benchmark rates on safe haven assets like US Treasuries and German Bunds, both hitting their all-time lows in yields on March 9th 2020. Bunds were touching an intraday low of -0.91% on 10yr maturities while its US pendant being low as 0.31% for the same maturity.

At the same time credit risk spreads of the entire corporate space rose with a speed last seen after the collapse of Lehman Brothers during the global financial crisis in 2008.

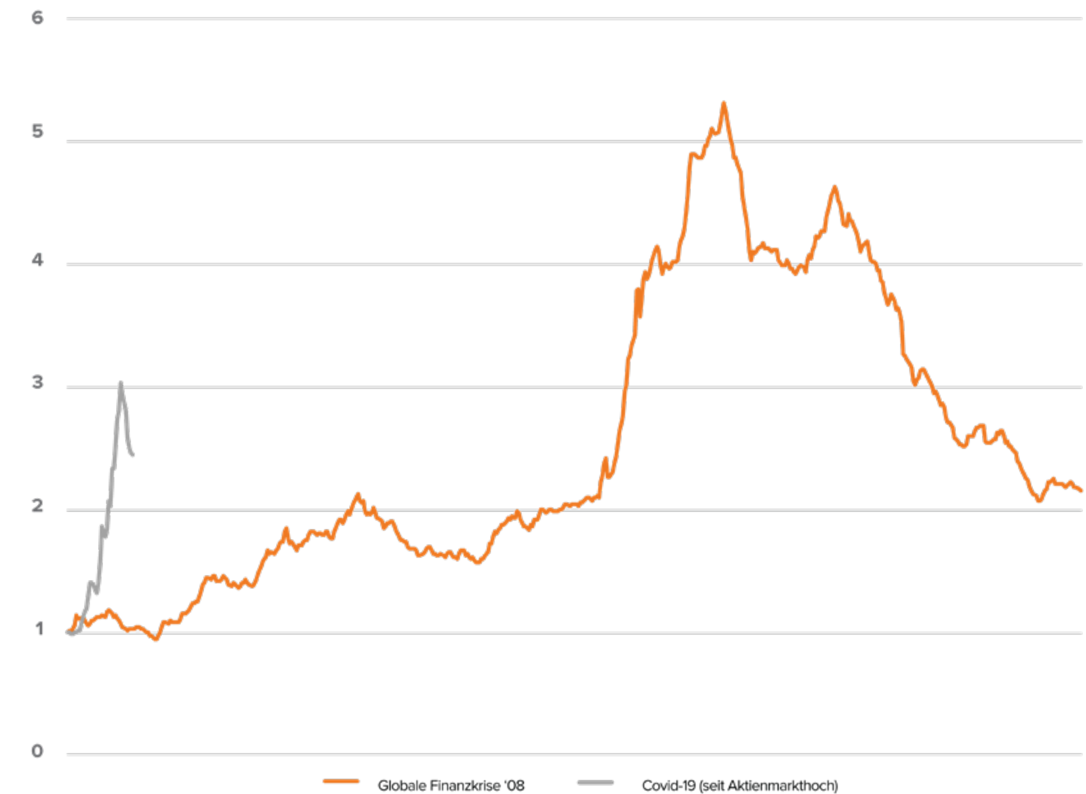

Figure 1: Development of Credit Risk Spreads since official start of the Global Financial Crisis (09 August 2007) and 2020 since equity market high on 12 February 2020

Period: 09 August 2007 to 09 September 2009 (GFC) and 12 February 2020 until 31 March 2020 (Covid-19)
Source: Bloomberg, Bergos Berenberg, Data as of 31 March 2020

Side Note.:

A Bid-Ask-Spread is the amount by which the ask price exceeds the bid price for an asset in the market. The Bid-Ask-Spread is essentially the difference between the highest price that a buyer is willing to pay for an asset and the lowest price that a seller is willing to accept. An individual looking to sell will receive the bid price while one looking to buy will pay the ask price.

But not only High Yield spreads, as a proxy for rather risky assets, reacted sharply. The whole credit space including presumably fundamentally weaker Sovereign issuers suffered in light of the new situation. Even within the Investment Grade bucket of the fixed income universe several names indicated a severe credit emergency, trading at levels more similar to a near default. Without trivializing the deep impact, the development seemed to be more than undue given the solid fundamental condition of the majority of the companies. The uncertainty on what was still to come simply led market participants to offload credit exposure at almost any price.

Especially passive products like ETFs and Index Funds, facing withdrawals from investors, were forced to sell, depressing the functioning of markets further and causing increased price differences between buy and sell order (Bid-Ask Spread).

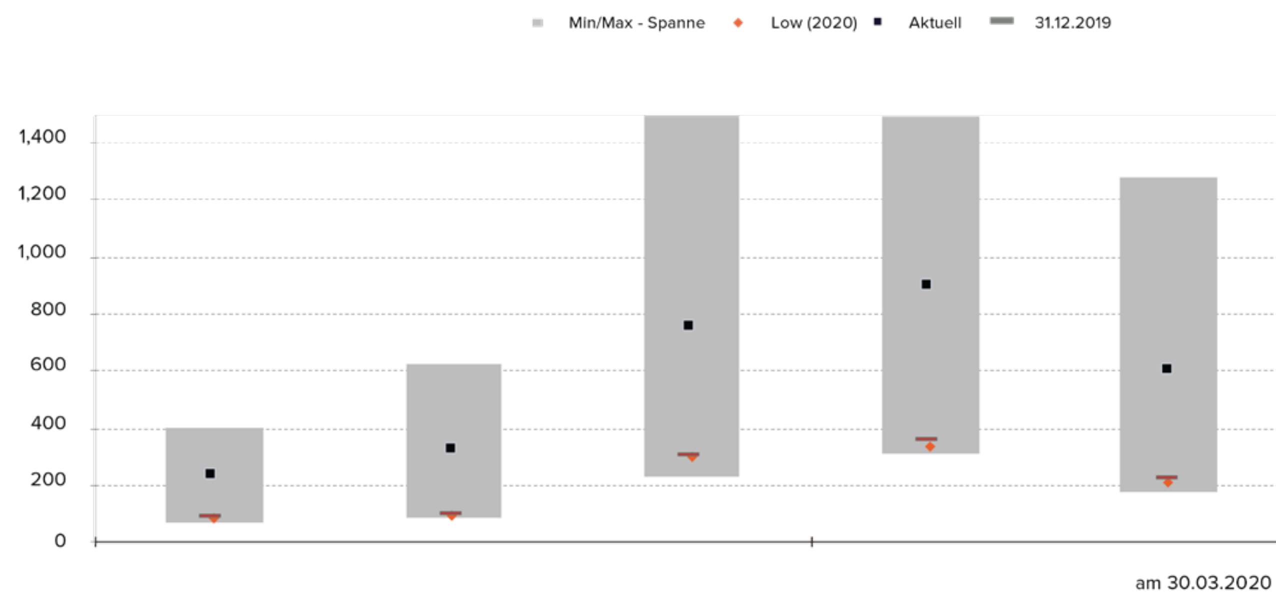

Figure 2: Risk premiums of investment grade, High Yield and emerging market bonds in EUR and USD
Period: 01 August 2007 - 31 March 2020

What followed was a major reaction by central banks and, with some time delay, governments worldwide (see for further information the wrap up on measures taken by global central banks and governments). Albeit the immediate effect on risk assets in almost all cases was not as positive as expected, it had some impact on the further development. Any unprecedented measure taken, whether from the European Central Bank ECB, the US Fed but also announced measures by individual governments was taken by markets by suspicion if it is going to be enough to prevent economic operation from collapse.

With some time delay, however, it was enough to restore some faith in the economic resilience. Credit spreads started tightening again, equity markets posted some very positive days and investors also got more convinced, the relevant actors will indeed do “whatever it takes”.

HOW DID THIS IN FACT IMPACT THE FIXED INCOME SPACE?

As mentioned before, the magnitude and speed in which credit spreads widened was reminiscent to what we have seen after the collapse of Lehmann Brothers in 2008. Risk premia on Investment Grade securities and even more so on High Yield, led by energy related names hit by the double-whammy of Corona and the Opec+- developments, skyrocketed.

After hovering close to their all-time lows until end of February at around Treasuries +100 for the broad US market for example, spreads quadrupled within only approximately three weeks. In light of the huge measures taken, spreads recovered somewhat to around +325. US High yield whose spreads went from +356 to +1087, slightly improved back to +899 (as of March 31st 2020).

The long-term effect on investor sentiment, however, remains to be seen.

DID INVESTMENTS IN SAFE HAVEN ASSETS PAY OUT AT LEAST?

Although markets remained more or less concerned since end of February, the announced large fiscal and monetary packages made investors to believe, that debt issuance will likely rise significantly. This in the meantime led to a rise in benchmark rates. Having rates on underlying sovereign debt rising while at the same time credit spreads continued to widen, led to a notable negative total return on credit instruments across the rating universe.

Looking at the yield curve, especially the short end of the Treasury curve came down, mainly due to the emergency cuts by the Fed amounting to -150bs to a range of 0 to 0.25% no.

Similar, although less pronounced it the situation with German sovereign debt. President Lagarde together with the ECB governing council so far abstained from cutting interest rates even more into negative territory. Hence the shorter end continues to show higher yields than the belly of the curve reflecting uncertainty on growth prospects and future central bank policy.

Towards the end of the quarter, benchmark yields in light of the significant central bank purchases, began to fall again with US Treasury yields on 10yr debt closing the quarter at 0.67% (as of March 31st 2020).

With the current development one may give an inert "yes". With uncertainty prevailing, higher quality sovereign debt serves as protection in case times get rough again. But this is only a snap-shot of the current reality.

the severity of the current medical and economic threat. With large sums being deployed in the near future, they already made the first step to encounter the challenging new environment.

With our base case scenario of a peak being reached soon and the worst to be over until H2, we are confident that the measures taken will be sufficient to restore faith in financial markets.

As central banks seem to act like a backstop in case of market disfunctioning, the worst in spread widening should be over by now. With huge amounts of liquidity being sidelined and waiting to be put to work, the technical picture is supportive though. Over the course of the second quarter and with a relief in the current medical emergency situation, we expect credit spreads to continue their recently started tightening. A complete return towards their all-time lows is nonetheless rather unlikely.

WHAT IS OUR TAKE ON THE CURRENT SITUATION - WHAT CAN WE EXPECT IN THE COMING MONTHS?

The future development of corporate credit in particular but also fixed income securities as a whole highly depends on how the situation around the coronavirus evolves. Central Banks and Governments worldwide showed already, that they see

The situation, however, can change quickly to both directions. In case the pandemic will remain for longer, we believe, there will be more actions coming from fiscal and monetary side, namely participating even more in the fixed income markets through asset purchases and, as a later step, also as investors in the equity markets. But before that happens, we need to see a severe intensification of the current medical and economic conditions.

As the economic impact of the lockdowns and foregone consumption will be only seen over time, the likelihood of rating downgrades due to the recent developments went up notably. Even defaults especially but not only of High Yield issuers cannot be ruled out. We still remain cautiously constructive on Investment Grade Credits.

We feel comfortable with our slight overweight in US Duration and sovereign debt exposure as it acts as insurance in case of a further deterioration. Given the extraordinary central bank support we deem a rapid and sustainable rise in benchmark yields as rather unlikely. With, in parts, already substantially negative yields on European Sovereign Debt, the situation is a bit different on this side of the pond. From a relative value perspective we feel comfortable with our slight underweight for the time being. Increasing the Duration on those securities offers due to the flat shape of the yield almost no benefit.

The newly announced immense asset purchases (see section on central bank measures below) will to our understanding support and eventually benefit peripheral issuers from Europe. Hence we see, an attractive opportunity of recovery in this part of the universe.

Reducing our High Yield exposure already earlier this year, US as well as European, to slight underweight proved to be the right decision. Until more clarity on default numbers and economic prospects, we remain sidelined.

Notwithstanding the uncertainties going forward, we continue to favour Emerging Market debt, Hard as well as Local Currency, as a long-term strategic investment case. The valuations are compelling from a relative value perspective. In addition setbacks in the past proved to be good entry points going forward. In accordance to our base case that the worst should be over soon, we stick to our slight overweight.

WRAP-UP: OVERVIEW ON MAJOR CENTRAL BANK MEASURES TAKEN

US FED

The US central bank cut its main refinancing rate twice by several steps shortly before their regular scheduled policy meeting on March 18th. The first cur amounting to -50bps occurred on March 2nd, a step that was already expected by some market participants at that time. The second rate cut came only two days before their regular meeting on March 16th with additional -100bps in Cuts bringing the main refinancing rate to close to zero. To maintain the functioning of the credit flow to households and businesses, additional measures like the Commercial Paper Funding Facility and Primary Dealer Credit Facility have been established and additional swap lines with the major global central banks have been opened up to secure USD funding. The most exceptional measure taken was the extension of the Fed's asset purchase program by at least additional 700bln USD which now also incorporates purchases of Corporate Debt issues.

WHICH EFFECT DID IT HAVE?

Especially due to the significant rate cuts but also the increased purchases of government debt, the short end of the curve came down significantly. US Treasuries up to 6 months maturity yield only slightly above zero. The large actions taken in the repo and commercial paper markets, restored their functioning in those after a short period of obvious distortions.

ECB

During their regular meeting on March 12th the European Central Bank announced new temporary LTROs (long term refinancing operations) for European banks to bridge possible funding gaps until June and more favourable terms for the LTRO III from June onwards with an expanded eligibility and funding rates as low as 25bps below the deposits rate. In addition the asset purchases would be increased by 120 bln EUR until end of 2020. Not even a week later the ECB announced the creation of a Pandemic Emergency Asset Program PEPP comprising of 750bln EUR. In addition to those assets eligible already under the existing Asset Purchase Program APP, Greek debt will be included.

WHICH EFFECTS DID IT HAVE?

Lagarde's comment the ECB "is not here to close the spread" were not helpful to calm markets. Over time, however, the extraordinary amount seemed to calm investor hysteria in fixed income markets. New issuance activity went nuts with new weekly all time issuance numbers being reached afterwards. It may not yet be a "whatever it takes" moment for president Lagarde but it was enough to show the willingness to support European debt issuers.

OTHER MAJOR CENTRAL BANKS

The Bank of England followed the US example by cutting interest rates by 50bps, the countercyclical capital buffer for financial institutions to zero and launched a new Term Funding Scheme TFS. In addition a Covid Corporate Financing Facility CCFF has been established on March 17th to provide additional help for UK companies. The program will provide funding by purchasing commercial paper of up to one year maturity issued by companies making a material contribution to the UK economy.

In Asia, the Bank of Japan announced more proactive purchases of corporate bonds J-REITs (Yen 180bln) and equities (Yen 12trn).
In China a variety of rates like the Loan Prime rate, Open Market Operations and the Medium-Term Lending facility have been cut to incentivize loan creation and cushion the negative impact of Covid-19 on business activity.

COMMODITIES

CRUDE OIL – DUAL SHOCK SETS UP PREDATORY COMPETITION

Dual shock triggers historical price losses for crude oil

Coronavirus and large-scale shutdown of daily life lead to demand collapse

Failure of OPEC negotiations unleashes additional flood of oil

Quick market shakeout seems very doubtful due to political complexity

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Crude oil and energy markets have taken centre stage in the last few weeks as oil prices have paced the decline of financial markets. In retrospect, the price of oil has served as the perfect gauge of the ongoing development of the coronavirus crisis because it entered a bear market much earlier than all other markets. The price of oil has proved to be extremely sensitive to the news flow related to the worsening coronavirus crisis, having gradually begun to price in the possible effects of the advancing spread and therefore a possible economic slowdown already in January – long before the equity markets. That being said, the acceleration of the sell-off in March was unprecedented, surpassing even the erratic corrections that occurred during the Second Gulf War in 1991/92, as crude oil futures plunged by more than 40% at times during a single trading day. In the first quarter of 2020, North American prices of WTI (West Texas Intermediate) crude oil quoted on the New York Stock Exchange declined by 66%.

WHAT LED TO THIS PRICE SHOCK AND WHAT FACTORS WERE BEHIND IT?

The exponential spread of the coronavirus was doubtlessly the main factor behind the current correction. The control measures and shutdowns initiated across the globe have impacted nearly all areas of social and economic life. Although the duration of the crisis cannot yet be estimated, it already seems clear that the decline of short-term economic output will be even more drastic than during the global financial crisis in 2008. Accordingly, analysts and agencies abruptly downgraded their forecasts of crude oil demand from modest growth originally to a massive drop in demand tantamount to a temporary collapse of forecast demand.

At the present time, decisive and united countermeasures on the supply side in the form of further internationally agreed production cuts to balance the supply-and-demand equation and support prices would have seemed to be the obvious response, especially considering that the willingness of member countries to cooperate was demonstrated by very high discipline in complying with previously agreed production cuts. But the shock followed immediately when Russia, in a complete surprise, spoke out against further cuts in the OPEC+ negotiations in early March. The negotiations failed. Consequently, producing countries can produce without any restrictions at all beginning on 1 April. Saudi Arabia responded immediately with massive price discounts and announced that it would ramp up production close to its capacity limit, igniting the price war. Market participants reacted quickly to the failure of negotiations. The dual shock on both the supply side and the demand side that resulted from the failure of negotiations struck the market practically overnight, leading to trading losses of historical proportions when markets opened in the calendar week of 6 March, from which the market has not yet been able to recover.

WHAT ARE THE POLITICAL CONSEQUENCES?

The oil market has been largely defined and controlled by political influences at the latest since the oil crisis in the 1970s. But given the current economic pressures, geopolitical developments, structural changes in the oil market itself, and technological and ecological developments, the situation appears to be more inscrutable and fragile than at any time in the last 40 years.

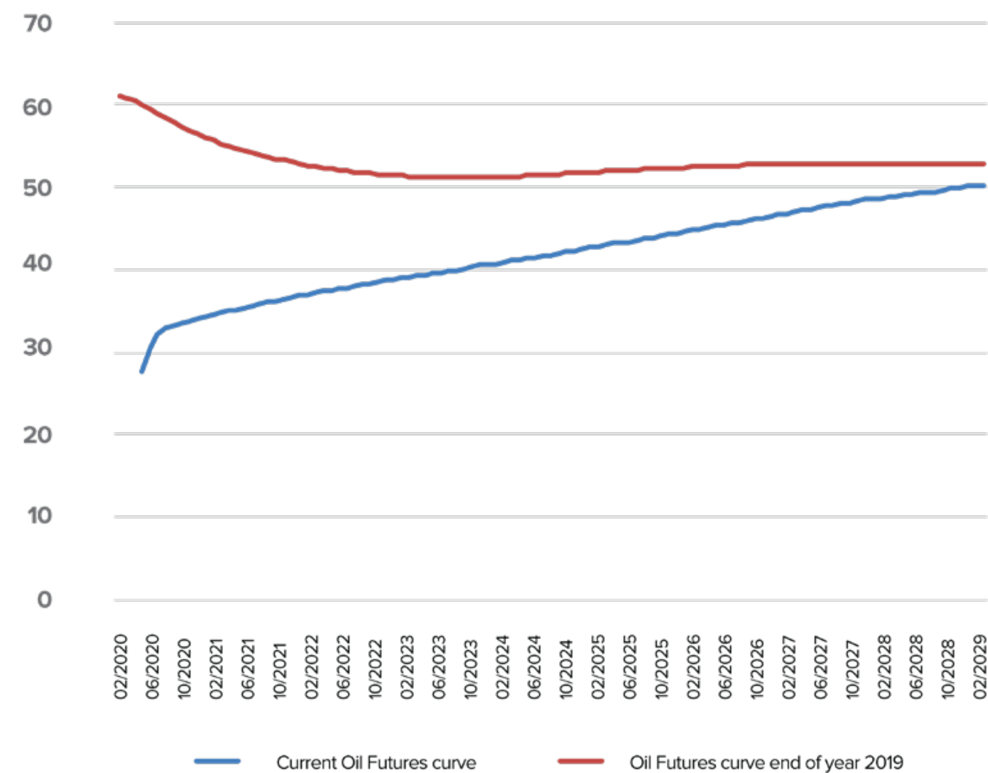
The failure of cooperation among OPEC members could therefore actually lead to brutal predatory competition that could well claim some victims. At first glance, the conflict would appear to be limited to Saudi Arabia and Russia. However, the United States, which has overtaken Saudi Arabia (12.7 mm bbl) to become the world's biggest producer of crude oil (13 mm bbl/day) in the last 10 years thanks to shale oil technology and has even gone from being a net consumer to a net exporter of crude oil, also plays a key role. In particular, the US fracking industry, much of which is financed with debt, can be expected to suffer at the current low oil prices, especially because many of these companies already needed to raise large sums of money over the next 12-18 months. Although a prolonged price war would be painful for all market participants in the short term, it is a price that some countries may be willing to pay to strengthen their long-term positions of power and achieve strategic political objectives. Producers in all three countries may have considerable staying power. Russia has a targeted fund of several hundred billions that can help it get through such times. Saudi Arabia is the lowest-cost producer and the US oil industry can expect sufficient political support within the United States.

WHAT ECONOMIC CONSEQUENCES CAN BE EXPECTED?

Aside from the question of OPEC's reason for being, many producing nations could suffer an existential crisis. For most other producing countries, an exhausting power struggle and predatory competition could not have come at a worse time. For countries like Venezuela and Nigeria, crude oil revenues are absolutely essential especially in the current economic crisis and given their already strained finances. In the case of Iraq and Iran, which is also being hit hard by the coronavirus crisis, the loss of oil revenue also presents a heightened geopolitical risk.

From the standpoint of net importers such as Germany, on the other hand, the lower price of oil provides welcome support in the medium term. If prices stay low, they could even serve as an economic stimulus programme. In view of the complexity of the situation, we consider it entirely possible that this battle for market shares could go on for some time. In the short term, the market is pricing in and expecting a veritable flood of additional oil that will very quickly push global storage facilities to the limit of their capacity. This is also reflected in the futures curve for crude oil that is currently in contango, meaning that contracts with short-term expiration dates are priced much lower than contracts with later expiration dates. Thus Trump's announcement that the United States will fill its strategic reserve as a form of short-term relief will probably only have a temporary effect.

Figure: Oil Futures Curve - from Backwardation to Contango
Source: Bloomberg



In the medium term, however, the increased supply will probably adjust to the lower demand as a result of market forces. Especially because the marginal production costs, particularly in the United States but also in other parts of the world, are well above the current price of oil in the world markets, some producers will probably be forced out of the market. Production should therefore decline, albeit after a delay. Given the heightened complexity of the situation, a political agreement and growing willingness to cooperate between the United States, Saudi Arabia and/or Russia are somewhat improbable, but still possible.

Beginning with the current level of prices, therefore, we take a neutral view of oil's potential because we see catch-up potential in the medium term after a possible consolidation on the production side, although the market will probably continue to suffer from over-production and high volatility in the near future.

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CORONA-CRISIS: NEW SET OF FACTORS IN THE CURRENCY MARKET

Worries about the economic consequences of the coronavirus have fundamentally changed the situation in the currency markets. When the disease was still limited to China, the US Dollar benefitted initially as a safe haven and continued to soar. But the unexpected wave of infections in Italy in late February suddenly changed everything. No longer limited to China or Asia, the virus now threatened to spread to the rest of the world.

At first, the European single currency rose sharply in parallel with the rapid increase in worries about the world economy and the drastic losses in equity markets. In this new situation, the Euro benefitted from the fact that the monetary policy of the European Central Bank (ECB) had been extremely lax for some time, meaning that unlike other central banks, it no longer had the option of reacting to the foreseeable economic risks by lowering interest rates. Due to the extremely low interest rates, moreover, the Euro was being used as a financing currency for carry trades, which could only be partially reversed amidst the market turmoil, driving up demand for Euros.

As a result, the Euro's exchange rate has been stable on the whole, also on a trade-weighted basis, thus compared to the currencies of the most important trading partner countries. Without these special effects, a stable Euro would have been something of a surprise because the export-oriented European economy is being especially hard hit by the international coronavirus crisis and two large Eurozone countries, Italy and Spain, have been devastated by the epidemic.

All things considered, the current exchange rate fluctuations only reflect the crisis-stricken state of the world economy to a limited degree. This is because the factors driving bilateral exchange rates offset each other to a considerable extent given that many economic zones are equally affected by the drop-off in economic activity and extremely lax monetary policy.

EUR/USD: TWO STEPS FORWARD, ONE AND A HALF BACK

The US Federal Reserve reacted quickly and extremely decisively to the economic threats posed by the coronavirus crisis. In two emergency meetings in March, it lowered the benchmark interest rate by a total of 150 basis points to 0.00–0.25%. In addition, it adopted liquidity measures and bond purchasing programmes of an unprecedented magnitude. The Fed therefore reacted much more aggressively to the economic collapse than at the time of the great financial crisis of 2009/2010. Market interest rates in the United States have also fallen drastically, even below 0.5% at times. The considerably changed landscape of interest rates temporarily put the Dollar under pressure compared to the Euro, with the Euro rising by more than 6 cents to more than 1.14 US Dollars per Euro in just 14 days. But then it quickly reversed course because even though the ECB did not touch its base interest rates, it did adopt extensive liquidity measures and bond purchases. The Euro has since lost most of the preceding exchange rate gains. In late March, the exchange rate was only at around 1.10 US Dollars per Euro. It could fluctuate more sharply again in the coming weeks. A modest rise in the Euro can only be expected in the second half of the year.

Fig1: EUR/US-Dollar

Source: Bloomberg

THE EURO HAS ALSO RISEN AGAINST THE POUND

The Euro's exchange rate against the British Pound exhibited a very similar development, albeit not as pronounced. Until the coronavirus crisis, the Pound's exchange rate had mainly been driven by Brexit-related developments. The Pound gained for months after a solution to the Brexit drama had begun to take shape. In mid-February, thus immediately before the coronavirus outbreak in Italy, one Euro only fetched around 0.83 Pounds. The Euro rose sharply against the Pound after the Bank of England likewise went into crisis mode and lowered its base interest rate in two steps to 0.10%. At the highest point, the exchange rate rose up to 0.95 Pounds per Euro. But just as it did against the US Dollar, the Euro reversed course and fell to a little more than 0.88 Pounds per Euro. For the time being, it can be expected to undergo a volatile sideways movement at this level.

Figure 2: EUR/GBP

Figure 3: EUR/CHF

Source: Bloomberg

SWISS FRANC STILL IN DEMAND AS A SAFE HAVEN CURRENCY

At almost 1.06 Francs per Euro, the Swiss currency is currently at its highest level since 2015. The Franc remains in demand as a safe haven even though Switzerland itself is also being hit hard by the coronavirus epidemic and is on the brink of a severe recession. The Swiss National Bank (SNB) is combating the strength of the Franc with apparently ever larger currency purchases – in addition to its already very expansive monetary policy. However, the SNB's measures will not be enough to do anything more than flatten the upward trend. The Franc will remain under appreciation pressure for as long as the further course of the coronavirus epidemic and the attendant economic consequences remain uncertain.

This pressure could ease and the exchange rate could gradually revert to a trend in the direction of 1.10 Francs per Euro in the second half of the year.

All in all, the future development of currency markets will depend in large part on the further course of the coronavirus epidemic. The timeline and pattern of economic damage will not proceed symmetrically in all countries. In the meantime, therefore, there could well be some surprising developments in the currency markets.

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