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

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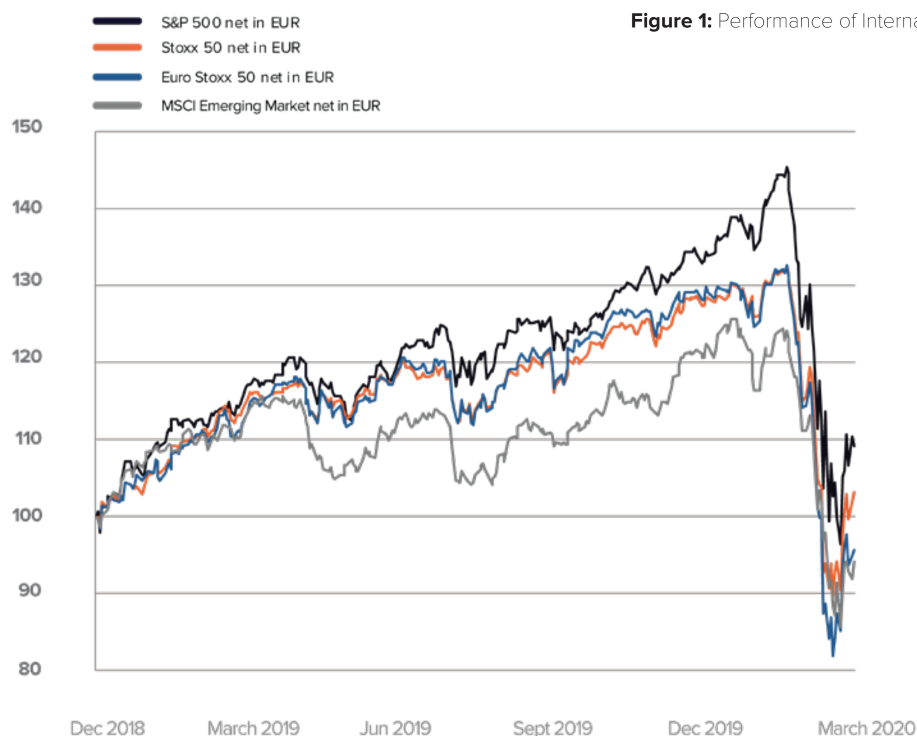
Exogenous shocks hit the capital markets from time to time – in the form of a virus, this type of shock is very difficult for us market observers to assess, however. The implications for the global economy are obviously enormous and can currently only be assessed in large bandwidths and with the greatest 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%

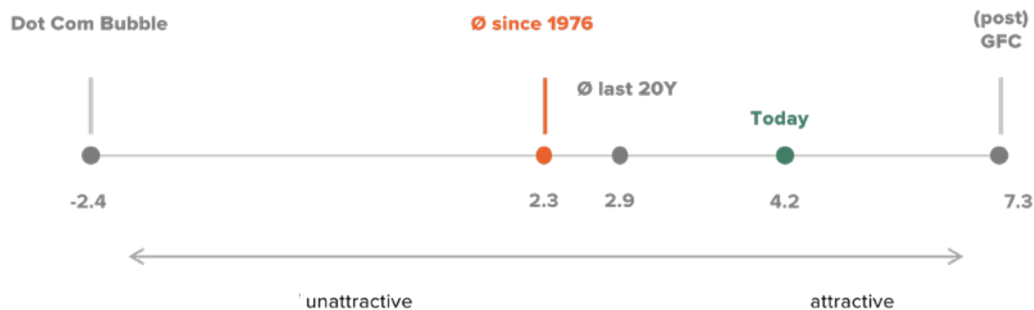


Figure 2: S&P 500 Earnings Yield Minus 10 Year Bond Yield from a Historical Perspective

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 Buffett 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“.