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Playing the possible sequence of market normalization gradually and selectively

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*As the Covid-19 virus spreads, investors can assess the potential **sequence of market opportunities that will emerge from the crisis**. The perceived features of the cycle of the coronavirus and the effectiveness measures taken locally to contain it are starting to drive allocations. A new market theme of **Covid-19 de-synchronisation is emerging,** a typical example being the long Asia.*

*The selloff has more or less eliminated deviations in equity returns (excessive vs. the long-term trend in earnings growth) and in credit spreads (too tight vs. implicit defaults), although not at the same pace everywhere (Europe and Emerging Markets at a discount vs. the US). Yet the selloff hasn't priced in a permanent loss of potential growth, hence the permanent shock to earnings expansion. **The margin for error for investors is therefore thin.***

*From an investment perspective, to detect the tipping point of the crisis, investors will need to look at the **corporate-bond asset class** where there is a race against time between liquidity and solvency. **The de-freezing of the credit curve – crucial at the short end – will be necessary for validation of a full recovery in markets.** Bounces in equity performance have masked this, but this is the indicator to watch.*

*Trying to time the bottom of the market is unrealistic. This is a time for **investors to consider adding gradually, and with discipline, opportunities to rebalance their long-term strategic allocation, whilst keeping a firm hand on liquidity and quality of assets in the knowledge that uncertainty will endure.***

The contagion wave is moving

As we also pointed out in our last update on the Covid-19 crisis, investors have to deal with three cycles concerning:

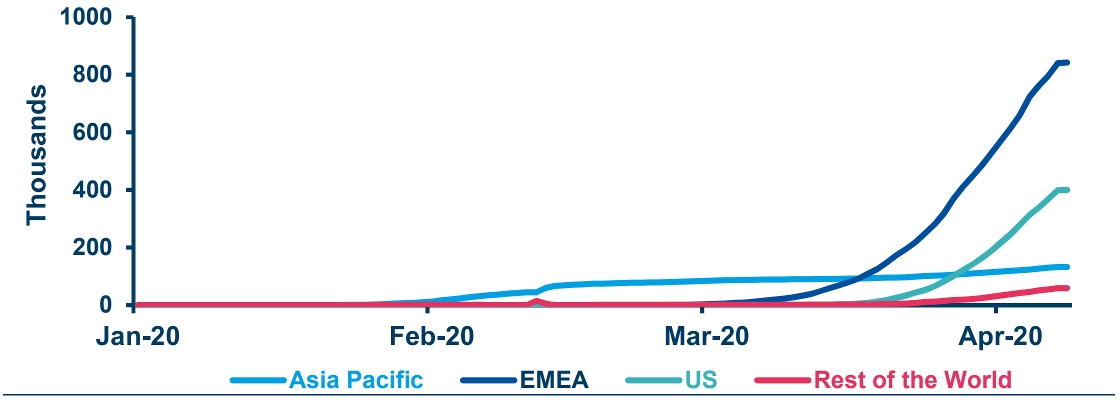
- the virus outbreak;
- financial markets;
- the real economy.

We know that the financial cycle leads the real cycle. Markets will bottom before the real cycle has completed its downward trajectory, and, based on history, their recovery will be ahead of and will drive the recovery in the real sphere by 3 to 6 months.

"The de-freezing of the credit curve - crucial at the short end - is the necessary condition to validate a full recovery in markets".

The acceleration in the global virus outbreak (the second derivative of the virus cycle) is, arguably, synchronised with the financial cycle. Detecting how the virus outbreak is moving is thus key, but isn't easy given significant uncertainty, with different regions affected at a different pace.
If we could visualize the spread of the virus, it would likely resemble a large wave. It started in China, affected some Asian countries that quite successfully contained it, it overwhelmed Europe (with some countries hit more severely than others and with a different timeframe), then hit the US and some emerging economies (African countries, Latam, India) that are still in the early stages but already feeling the pain. In the recent trading sessions, markets have started to react positively to the slowdown in contagion (new cases, fatalities) in Spain, France and, finally, to a declining trend in Italy. The containment measures introduced by these countries, with a total lockdown of economic activity and social distancing, have been effective in containing the spread of the virus.

Covid-19 cumulative number of confirmed cases by region



Source: Amundi on Bloomberg data, as of 7 April 2020.

These countries are ahead in the pandemic spread, after China, and could be a leading indicator of what investors may expect in the coming weeks as well the markets' trajectory thereafter. We now anticipate some positive signals in the coming weeks from the US, which is still in the deepest phase of the crisis, accumulating very significant contagion and a huge large number of fatalities. **Here, the wave has not yet lost its strength, and newsflow will likely continue to be heavy for the next 2-3 weeks.**

In the meantime, and unsurprisingly, economic data has been particularly weak at global level since the de facto freeze of a very large part of economic activity has no precedent in history. We don't expect any material improvement in this while containment measures remain in place, with a slow recovery once they are eased in the countries that exit the emergency lockdown first. This is already the case for China, where output went from 40-45% in mid-February to 85% at end-March, and where steel inventories are down 10% since March peak. The only positive from a macroeconomic standpoint is the perspective of an agreement for cuts in oil supply that could ease the pressures for some emerging markets whose fiscal balance breakeven price is much higher than 30 USD a barrel, the average WTI oil price in March.

The possible sequence ahead

"On the pandemic, the danger of a big wave is its backwash: the risk of a second wave is high, and will prevent a return to full normality."

Amid this gloomy economic picture, looking at recent equity performance, the temptation to see the crisis as already over is high.
We believe that there is little space for euphoria in this phase for at least two reasons. First, the strong equity rebound (S&P500 at +23% since the March 23 bottom) follows the fastest correction ever and significant market dislocations (S&P500 down 34% in the 19 February to 23 March period). For this trend to consolidate, higher visibility is needed on earnings normalization is (after a phase of zero visibility) and on the economic disruption that this unprecedented crisis brings. More clarity will come at end-April-/mid-May with the Q1 earnings season and guidance for the remainder of the year. Analysts have not yet materially adjusted earnings forecasts, but these will come down at least 20% for the S&P500, and further for Europe. There is not much space from here, and the risk of more volatility and a new leg-down is a strong possibility ahead of a firmer, more stable recovery.

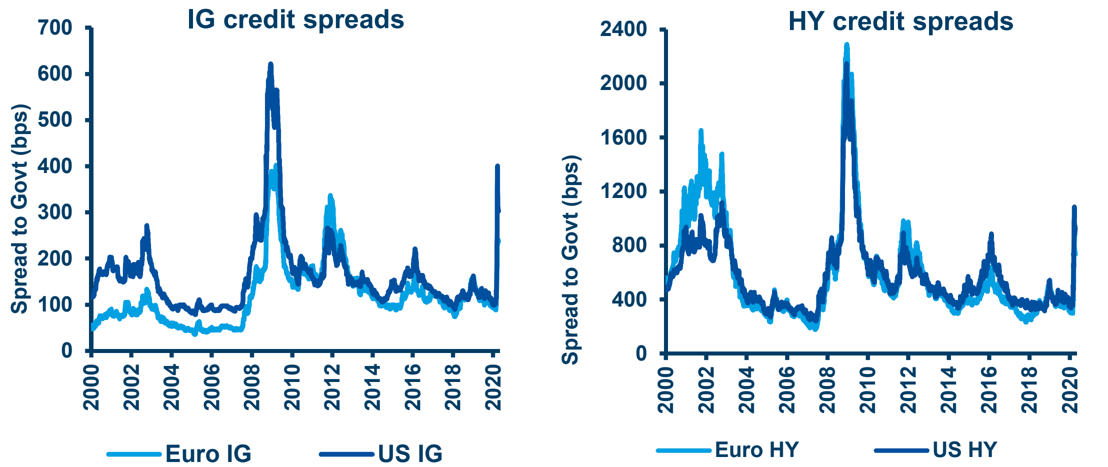
Second, **with the pandemic, the danger of a huge wave is its backwash**: we have already seen a fresh outbreak in Singapore, in other Chinese areas, and in Japan. Until a cure or vaccination is found, **the risk of a second wave is high, and will prevent a return to normality.** Some containment measures will remain in place (see the complex debate in Europe on how and when to start phase 2, with a gradual reopening of some industrial activities) putting a brake on an economic rebound. The adjustment phase will take time, and some "stop and go" in the pandemic's evolution can be expected. This could drive a sudden re-rating of expectations on the economic side (with recovery fast changing from U-shaped to W- or L-shaped) and on what's priced in the market (currently a U-shaped recovery, and very slow). In this process, volatility is expected to remain high, although it won't be as extreme as when the crisis first hit as many quant-driven portfolio adjustments have already taken place.

If it's not time to call a material and indiscriminate increase in risk-asset exposure, there is a space, we believe, to play a sequence of normalization in the markets and to build gradual positions that could pay off for long-term investors.

"Credit markets are the first in the sequence of investment opportunities that could materialise from the crisis, but the normalization of the credit curve is key."

In this sequence, credit markets may come first. Unlike in 2008, this is not a financial crisis but an economic one, and this is reflected in the increase in credit spreads that is far more contained than in 2008 in both the IG and HY space. The corporate-bond asset class will be the first to react, and is the asset class investors should focus on. Here, there's a race against time between liquidity and solvency. **The de-freezing of the credit curve – most importantly at the short end – will be necessary to validate a full recovery in the markets.**

Credit spreads widening, but no a credit crunch



Source: Amundi on Bloomberg data, as of 6 April 2020. Data refers to ICE BofA indices by region.

The financial system is on a stronger footing and credit availability should not be materially impaired once economic activity resumes. Monetary and fiscal stimulus are unprecedented, exceeding that of 2009, and, implemented at the early stage of the crisis, should help the liquidity side and delay solvency issues while the curve of the virus advances.

"We expect further discrimination between liquid, eligible and good quality assets, and weakening and eventually defaulting securities."

Markets have started to react to the stimulus: issuance in the investment grade segment has been huge in recent weeks after the Central Bank's aggressive policies, and this provided opportunities to add good-quality assets at a substantial premium. Primary activity is also slowly resuming in the high yield space after the March freeze. There's still room for a normalization of market conditions, particularly at the short end of the credit curve in both the EU and the US, which remains out of balance. This will be critical.

The HY market appears to have already discounted most of the bad news. A further deterioration is unlikely unless we enter a deep depression. Considering the current spread level of the US HY market and a recovery rate of around 40% in the event of default, the market prices in a default rate of some 10-11% (and much more in some parts of the energy sector, such as exploration and production or equipment and services), in line with our estimates applying a -2% US GDP growth scenario. **Again, it's not a matter of being overly optimistic, but we do see that certain segments already price in much of the bad news.**

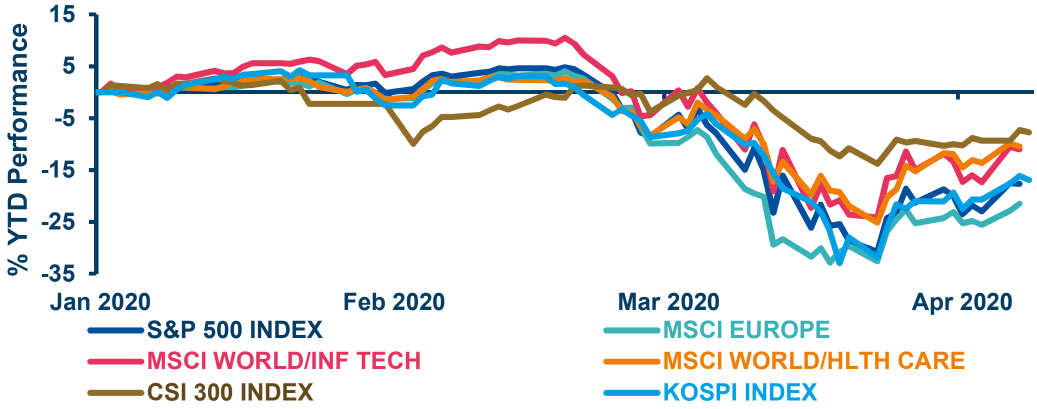
"What it was weak before the crisis, will likely be destroyed after it: a robust credit selection is critical".

However, **a robust credit selection will be critical.** We expect further discrimination between liquid, eligible and good-quality assets, and weakening and eventually defaulting securities. **What was weak before the crisis, will likely be destroyed after it.**
Therefore, it will be important to look at: a) areas set to deteriorate in the credit space (lots of rating downgrades are expected and the number of fallen angels will likely exceed that of the 2008-2009 crisis); and b) what can withstand the current crisis or even be upgraded.

Diversified and flexible approaches in credit may help to better exploit the opportunities in this sequence of repricing, rating migrations and market discrimination across sectors and geographies.

Equities could come later in the sequence, when we have further visibility on the damage to earnings. Again this will likely not be linear, both in terms of geographies and sectors.

YTD performance of regional and sector indices

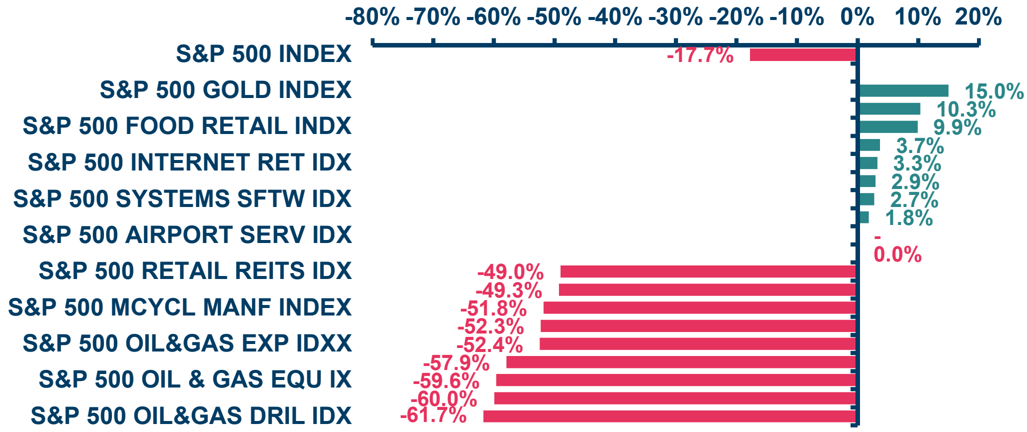


Source: Amundi on Bloomberg data, as of 7 April 2020. Performance of price indexes in local currency.

"Equity markets have already rebounded from the bottom. Further upside is possible, when there will be more visibility on the length of the crisis."

China and certain other Asian markets, such as Korea, could lead the rebound. US equities that entered the crisis on a stronger footing could exit the crisis in better shape, thanks to the prevalence of resilient, innovative companies whose business models have actually got stronger. The most damaged sectors (airlines, cruise lines, retailers already weak before the crisis, commercial real estate, and shale oil) could remain under pressure, with healthcare, tech, communications and financials likely faring better.

S&P500 Index YTD performance by sector



Source: Amundi on Bloomberg data, as of 7 April 2020.

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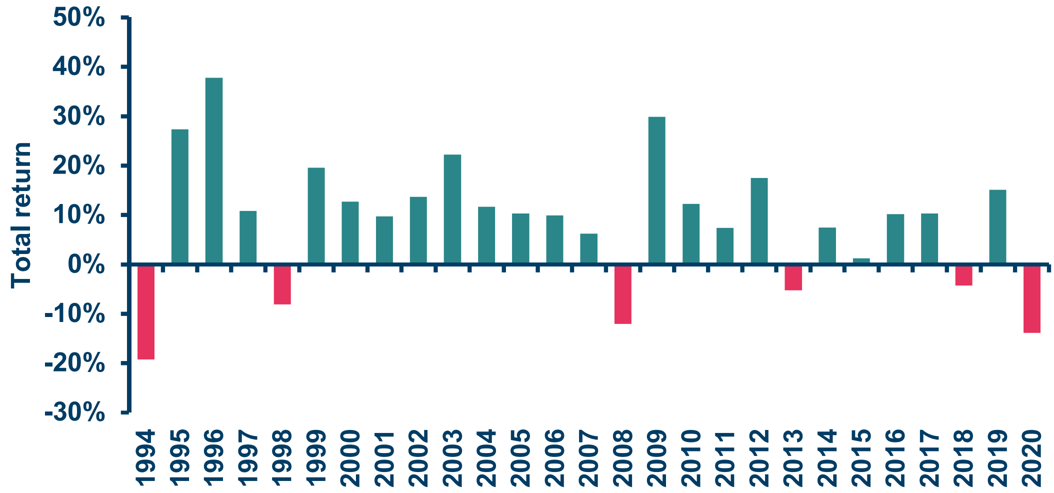
The European story will be one of good cyclicals with strong balance sheets trading at significant discounts. Their business models will be resilient and skewed toward quality and solid financial conditions. Health care, consumer staples and utilities are favoured, with energy, media and autos the least preferred.

"EM bonds will come probably at the end of the sequence: buying the capitalization of the markets for long-term investors has paid off during other times of crisis".

EM bonds will probably come at the end of the sequence, not only because most EM countries are at the early stage of pandemic but because they are dealing with multiple hurdles: limited fiscal capacity to face the crisis in many cases, the falling oil price and demand for commodities, dependence on foreign flows. We are already seeing a number of countries that need to restructure debt or support from the IMF or World Bank, and to a much higher degree than during the 2008 financial crisis. The road will remain bumpy for this asset class before it becomes popular among investors again. **On the positive side, valuations have become very attractive: buying the capitulation of the markets for long-term investors has paid off during other times of crisis.** Again, selectivity for country and corporate fundamentals will be crucial.

EM Hard Currencies Sovereign Debt Index



Source: Amundi on Bloomberg data, as of 2 April 2020.

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Definitions

- **Asset purchase programme:** A type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Credit spread:** Differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.
- **MBS, CMBS, ABS:** Mortgage-backed security (MBS), commercial mortgage-backed security (CMBS), asset-backed security (ABS).
- **Quantitative easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **Volatility:** A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

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