Sanctum Wealth Management

THE BIG PICTURE OF GLOBAL ECONOMICS

WITH

GARY DUGAN
THE GLOBAL CIO OFFICE

April 20th, 2020

Major Challenges Ahead - Emerging Markets and Europe in Focus

- **US equities led by tech continue to climb higher**
- **It's only a matter of time before the scale of the drop in GDP overwhelms near-term positives for the equity markets**
- **Everything is happening slower in the emerging markets and major challenges are ahead**
- **Developed countries will have to be prepared to offer major concessions to emerging countries**
- **Italy is the bellwether of the degree of flexibility in the eurozone experiment to keep it cohesive**

It will be some months before we will fully comprehend the scale of the impact of COVID-19 on the global economy. We don't believe that anyone can currently get their head around the size of the downdraft in economic activity. The asset markets have taken a hit, but we doubt that it will be the last. The drip-feed of information is moving from the immediately available medical numbers, to economic data that with a significant lag is starting to describe the global picture. **The asset markets have taken a hit, we doubt that it will be their last.**

Equities should be lower but calling a top in the current recovery is challenging. Last week saw equities up 2-3% with the US Nasdaq 100 returning to a positive return for the year. The rally has been concentrated in tech-heavy mega-caps that have strong balance sheets and franchises. However, even with these attributes, it is difficult to believe that these stocks will be untouched by events. Amazon is up 28% year to date and Microsoft 13%. The US equity market is priced for a V-shaped recovery and a return to normal by year-end. The positives for the market include the hope of allowing people to return to work and secondly further spending programmes in support of the economy. There's also a sense that the US government will keep spending with the full support of the Federal Reserve. For the moment the positives hold sway.

Trouble brewing in the Emerging markets

Emerging countries aside from China have been hit later by the COVID-19, and hence the true scale of the challenge will not be known for some months. However, we fear that when the true extent of the hit to growth and consequent rise in bad debt problems the local financial markets will suffer. Some economists suggest that there is a need for a fresh approach to tackle the pending crisis. In a thoughtful article Carmen Reinhardt and Kenneth Rogoff focus on the need for countries to come together to provide a framework for the working out a debt rescheduling. They believe the developed world will need to create a controlled workout of debt in the emerging and frontier countries

Leaders of the world's largest economies must recognize that a return to "normal" in our globalized world is not possible so long as the pandemic continues its grim March. It is myopic for creditors, official and private, to expect debt repayments from countries where those resources would have to be diverted from combating COVID-19. (Reinhardt and Rogoff, Suspend Emerging and Developing Economies' Debt Payments April 2020)

We have warned in recent weeks that few developing country central banks have the tools that the Federal Reserve can call on to work through their country's monetary problems. The international community will have to cut them some slack. Unlike US corporates, emerging countries have not wantonly put themselves in harm's way in recent years. They have genuinely found themselves in trouble due to the unprecedented severity of the global economy. As Reinhardt and Rogoff argue developing countries at around 40% share of GDP, need supporting for the better good of the whole global economy.

According to a study by the BIS, a small number of creditor banking systems have tended to be the largest players across all emerging countries. Foreign banks' lending stands at around 15-20%.

The United States and the United Kingdom are among the three largest creditor banking systems in more of these EMEs than any other BIS reporting banking system, followed by Japan, Spain and France. However, the Spanish banking system is most often the top lender in an EME (BIS, Emerging markets' reliance on foreign bank credit, Match 2019).

The current spread for emerging market debt stands at 562bps down from 660bps in late March and the 890bps in late 2008. We have yet to see a headline-grabbing economic crisis in the emerging debt space; however, the fact that 90 countries have sought emergency

funding from the IMF must count as significant. Investors shouldn't be complacent.

Could Italy break the European Union?

Italy's economic challenges from COVID-19 are going to challenge the EU to its limits. No economic zone can be a static and the EU will need to evolve its monetary/economic and potentially political framework to maintain its cohesiveness.

The market's initial reaction to the dangers faced by Italy - from the virus and the strain it is bound to put on its fiscal resources - was to mark Italy's 10-year government bond debt to 280bps from 160bps. Although things started to subside, last week saw a further resurgence to 225bps.

There are two issues at play in Italy. The first is that the virus fell disproportionately on its industrial heart. Second, the crisis hit at a very inopportune time. Italy was in the middle of another attempt to get its budget deficit to conform to EU targets. It is now clear that the country will require emergency assistance to accommodate what will prove to be a massive stimulus effort.

The second issue is that **there was an expectation in Italy (and likely Spain and Greece) that the eurozone would step up and issue debt – the so-called 'Coronabonds'** - to finance the spending that will be required to support the European economy through the crisis. That level of commitment to issuance of debt has not been forthcoming. As always, the bickering between the fiscally stronger North and the weaker South is holding back comprehensive action to support the South.

Time is short for the eurozone to resolve the issues. Some things have been done. Eurozone finance ministers suspended public budget borrowing targets, using an emergency' escape clause'. The critical question at the time was whether members such as Italy with already high outstanding debt could afford to avail themselves of this freedom. Thankfully, in parallel, the ECB Governing Council as an emergency move expanded its quantitative easing programme by €750 billion. Aspirationally it could help cap any spike in government bond yields. However, it puts the ECB in an awkward legal and political position as it positions them to cap any rise in bond yields, but to what degree?

There is an emerging new of defence to hold order in the eurozone. There is a financial rescue framework that emerged from the sovereign debt crisis of 2010-13, now principally housed in the seven-year-old European Stability Mechanism (ESM). In essence, its role is to support states when they can no longer access private funding markets at an acceptable price. This is not the case as of today, but already the Italian Prime Minister has called for its resources (up to €500 billion) to be deployed. In particular, the focus is on the use of an Enhanced Conditions Credit line facility. According to the founding principles …' it aims to help ESM Members whose economic conditions are sound to maintain continuous access to market financing by strengthening the credibility of their macroeconomic performance'. Specifically, it targets those members who currently do not meet the various conditions for budgetary stability. It, therefore, carries a stigma for applicants which Rome and Madrid are desperate to avoid.

Sanctum Wealth Management

The boldest move for the eurozone, that of issuing corona-bonds is still seen as unpalatable by the so-called 'frugal four' (German, Austria, Finland and Holland). Ten countries support the idea. The political fall-out arising from the deadlock is highly destructive. The (Italian) public sees the EU policy response so far as lagging. Even if something substantial does emerge eventually, the impact may be largely lost, leaving an impression of a lack of solidarity and cohesion. The window is closing quickly. **The spread of Italian government bonds over German bunds will be a crucial signal of whether the European dream is alive and well or flat broken.**

Gary Dugan
Johan Jooste
Bill O'Neill (Consultant)

Disclaimer & Important Notice

FOR THE INTENDED RECIPIENT'S USE ONLY

The Global CIO Office operates under Purple Asset Management. This document has been prepared by Purple Asset Management Limited ("PAM" or the "Company").

The document has been prepared on the basis of accounting and non-accounting grade information extracted from within the Company and its affiliates; and of publicly available economic and market data sources. This information has not been verified by an independent third party and should be treated accordingly. It is furnished to you solely for your information, should not be treated as giving investment advice and is to be kept confidential and may not be copied, reproduced, distributed, published, in whole or in part, or otherwise made available to any other person by any recipient.

The facts and information contained herein are as up to date as is reasonably possible and are subject to revision in the future. Neither PAM nor any of its directors, officers, employees or advisors nor any other person makes any representation or warranty, express or implied, as to the accuracy or completeness of the information contained in this document or undertakes any obligation to provide recipients with any additional information. Neither PAM nor any of its directors, officers, employees and advisors nor any other person shall have any liability whatsoever for losses howsoever arising, directly or indirectly, from any use of this document.

Whilst all reasonable care has been taken to ensure that the facts stated herein are accurate and that the opinions contained herein are fair and reasonable, this document is selective in nature and is intended to provide an introduction to, and overview of, the business of PAM. Any opinions expressed in this document are subject to change without notice and neither PAM nor any other person is under any obligation to update or keep current the information contained herein.

Such information contains "forward-looking statements" which are not historical facts and include expressions about management's confidence and strategies and management's expectations about future revenues, new and existing clients, business opportunities, economic and market conditions. These statements are made on the basis of current knowledge and assumptions. Various factors could cause actual future results, performance or events to differ materially from those described in these statements. These statements may not be regarded as a representation that anticipated events will occur or that expected objectives will be achieved. The forward-looking statements in this document are only valid until the date of this document and ISI does not undertake to update any forward-looking statement to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. This document is not an offer to sell securities or the solicitation of an offer to buy securities, nor shall there be any offer or sale of securities in any jurisdiction in which such offer or sale would be unlawful prior to registration or qualification under the securities laws of such jurisdiction