Sanctum Wealth Management

THE BIG PICTURE OF GLOBAL ECONOMICS

WITH

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The Key Is Keeping People Employed

- **The markets will have to absorb poor economic data as unemployment rises sharply and activity collapses**
- **The depth of the economic slump dependent on people retaining their jobs and SMEs staying in business**
- **Selective bond exposure the first port of call for new investment**
- **Emerging Markets face big risks as the virus spreads and intervention fatigue sets in**
- **The IMF will have a pivotal role to play in helping the developing world**

First economic data points for the coronavirus-hit late March point to an unprecedented downturn in economic activity in the United States and Europe. US employment data points to 10 million unemployed with last week's predictions of potential future unemployment during the Covid19 crisis going as high as 32% or 47 million people. The St. Louis Federal Reserve suggests the unemployment rate could be anywhere from 10% to 42%, but that the compromised number was 32%.

The eurozone confidence surveys imply an exceptional drop in economic activity. Modelling the decline in confidence points into real activity implies a 15% annualised contraction in the eurozone activity in March.

For the markets not to go into a further tailspin needs some evidence that two things will happen. Firstly, the rise in unemployment will prove transitory, and, secondly that the small and medium-sized enterprises (SME) will be saved from widespread destruction. Prolonged high unemployment and considerable business failures would leave a considerable hole in the global economy and limit the scope of the subsequent recovery.

The SME sector is a crucial component of any economy, big or small, developed or emerging. In broad terms, it accounts for 35-50% of both employment and GDP of most countries. Even in the United States, the SME sector accounts for around 43% of GDP. SME companies are the most vulnerable to a cash flow crisis. JPMorgan recently found that 50% of US small businesses have less than 15 day's cash buffer.

To be fair, the importance of the SME sector has not been lost on most governments. Indeed, if there is one common theme of fiscal policy announcements in recent weeks, it has been a major program of support for the SME sector. Only time will tell if the policies are adequate and sufficient to maintain the continuity of the vast majority of these businesses. Germany has provided a “Hardship fund” with Euro1.5bn of funding for SMEs.

The scale of the challenge of unemployment is only just becoming evident, and it will be frightening policymakers. Economists have been substantially surprised at the sheer scale of the initial US job losses. However, some of this could’ve been expected considering that the US economy today has significantly more workers who are freelancers or are employed on an hourly basis. In February, there were nearly 50 million workers in industries affected by the early days of shutdowns, around 30% of the total workforce.

The increase in unemployment, particularly in the United States, does not bode well for the SME sector. US weekly claims numbers show that 10 million people have already lost their jobs. Many of these job losses will almost certainly be in small and medium-sized businesses that were running minimal cash balances.

The euro area has an opportunity to experience a shallower loss of jobs given the restrictions on job losses, but the service sector is seeing an unprecedented downturn. The latest Euro area PMI for services fell 26.2 points to 26.4. To give a sense of scale to the stop in the US economy, the first quarter auto sales are down 35% at an annualised pace in the final weeks of March sufficient to take a percentage point off US GDP growth.

Be patient investing in equities

There is for sure the temptation to jump in, but with so much uncertainty about the depth of the current crisis, it is a pure guessing game as to how much corporate profits and solvency of companies have been or will be hurt. Companies will struggle with trying to explain to the market the extent of the impact on their business and how extensive the problems could be. To date, only 45 companies from the S&P 500 have reneged on their sales or earnings projections.

As earnings forecasts tumble, we expect to see dividend pay-out cuts. Goldman Sachs estimates that the total pay-out from dividends from the S&P 500 will fall by 25%. Citigroup forecasts that dividends in Europe could be cut by half. Barclays forecasts a 40% cut in both earnings and dividends. Dividends will also be constrained by requirements in the United States that businesses that accept Federal bailouts will not be able to pay dividends for some time.

Given the likely scale of the markdown in profits forecasts, conventional P/E multiples don't provide much of an insight into whether a market or stock is cheap or expensive. Only when we have some insight into when a recovery starts and to what degree each industry can gain back turnover lost will we be able to use P/E multiples with any confidence.

For those entering the equity markets, the preferred metrics at present are quality earnings and strong balance sheets. Companies that have great franchises such as Microsoft have seen persistent support. Assuming the mitigating impact of the US fiscal intervention has the desired impact, many of the larger banks in the US look better capitalised than in 2008, have broad businesses and strong balance sheets.

Despite a surge in demand for its services, Amazon and it's CEO Jeff Bezos are facing higher risks than other FAANG stocks due in no small part of its business relying on distribution, a key differentiator from its Chinese counterpart Alibaba being a fully online marketplace with no warehousing costs. In the US, risks concerning Amazon's warehouse workers' health safety have arisen, and some of the largest labour unions could ultimately force the company to a temporary closure of its distribution centres across the country until the dangers of contracting the Coronavirus are mitigated.

Growth stocks continue to outperform value stocks now with that ratio at an extreme. It remains the case that if any 'value' industry has even a rumour of good news, investors are eager to jump back in. The Energy sector was a case in point last week with hopes that a deal could be done to support the oil price. President Trump sent the rumour round the market that Russia and Saudi were talking about a deal when, in reality, that was probably not the case.

Emerging markets have significant challenges

While the world's media focus on the infection and fatality curves in the USA and Europe for signs of stabilisation, not many emerging markets have been in the news. This situation may be about to change. There are some tentative signs that Italy, Spain and even New York are approaching the "apex" of their curves, most emerging markets are still at the beginning of this harrowing journey. The impact on the broader economy and financial assets will not be any milder than in the developed world.

To be sure, the past six weeks have been brutal for emerging market bonds and equities already. For a start, there has been the surge in the US dollar, which in itself is never the harbinger of good news for emerging markets. To follow was the unexpected oil price war between Saudi Arabia and Russia, catching several oil exporters in the crossfire. And then there was the devastating impact of the global "sudden stop" in economic activity.

Broadly speaking, the trouble brewing in EM can be split three ways. In the first bracket are the countries most severely affected by travel bans. These would be ones where tourist dollars are a big part of foreign exchange earnings. In the second are the ones that have a heavy dependence on oil export revenues for FX earnings. And then in the third bucket would be countries that have been sailing close to the wind in terms of debt sustainability in the first place. For these, the closure of capital markets for the refinancing of rolling debt will be the biggest problem.

JP Morgan reports that fully 80 countries have already approached the IMF for assistance. The IMF has a war chest of $1 trillion at its disposal. It is likely to want to disburse all of this as fast as possible. However, much as commercial banks have already raised credit quality issues when it comes to doling out new loans, the IMF is constrained by its own rules in how it can lend. The usual process is also known to be lengthy. For a speedy, effective response, some of the regulations around debt sustainability for new borrowers will have to be waived temporarily if the desired effect is to be achieved.

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