Sanctum
Wealth Management

THE BIG PICTURE
OF GLOBAL ECONOMICS

WITH

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Broad Panic – But Finally Meaningful Policy Action

- **Market panic in full flow**
- **However, policymakers are well engaged and starting to deliver scale intervention**
- **Economists at a loss to understand the true scale of the likely recession**
- **Fear of massive deleveraging particularly amongst corporates**
- **Policymakers need to work hard to mitigate mass unemployment**
- **Bonds are better supported by central bank action than equities**
- **Hope will depend on evidence of a drug to mitigate the symptoms of COVID-19**
- **It remains risk off**

The last week witnessed panic as equity and bondholders ran for the exit. We will all remember the week that ended on the 20th of March, 2020, as one of the wildest and most unnerving experiences of our financial market careers. There is a real risk that it won't be the last one of its kind before Covis-19 is vanquished. Within the space of five trading sessions, entire industries have seen their very existence questioned by market. Liquidity conditions worsened in the core part of the market – treasuries and money markets – causing extreme gyrations in yields and bond valuations.

The equity market fell 15%, and bond spreads move aggressively higher. However, at least there were signs that policymakers are making efforts to catch up with challenges at hand. Central banks were easing policy from every direction and governments seemed to be trying to outbid each other on the scale of their intervention.

The panic is evident. For businesses, every counterparty is a potential failure in the network of supply and demand. Every bank is a potential source of a failed backer in a crisis.

We don't believe that it is the beginning of the end of financial markets as we knew them. However, we do think that we have now completed the end of the beginning stage of this crisis – we are finally clear of denial. Unfortunately, panic was always likely to follow.

It is now evident that there is not a corner of the world that doesn't believe there is a substantial medical and economic challenge ahead.

The good news is that policymakers are engaged in providing significant support for the global economy. Every major central bank has announced measures that provide urgent lines of credit for corporates and provide liquidity for the banking system. The cuts in interest rates have been modest only because they were low to start with and to cut drastically below zero might undermine the profitability of the banking system and cause more damage to confidence.

The next stage is waiting to see whether the scale of policymaker action will be enough. Will it be sufficient to offset the extent of the downdraft in the global economy? We know how much earth we have, but we don't know how deep the economic hole is.

Economists will, in particular, be nervously looking at the employment data. If there is mass unemployment, it will undermine hopes of a rapid economic recovery sometime in the second half of the year. At the peak of the

Global Financial Crisis (GFC), US unemployment rose by just over 800,000 in one month. We hear fears of numbers as high as two million in one month. It is becoming something of a consensus view that over the coming months the unemployment rate will rise above 6% from the current 3.4%. US Treasury Secretary Steven Munchin even suggested a temporary rise in US unemployment to 20% in the absence of help from the government. As we mentioned last week, compared to the GFC, there are more workers vulnerable to losing their jobs as many more jobs are on short term contracts or the worker is a freelancer with little job security.

Rising unemployment leads to deleveraging in the economy. US Auto loan originations hit an all-time high in 2018 and 2019 with an average balance of $22,232 compared to a $35,000 average price of a car. Some of those $584 billion of loans must now be in trouble – those loans were often by the auto companies themselves. To be fair in general US households are not as vulnerable as they were in the GFC as they have been repaying debt in recent years.

The most significant risk of deleveraging is in the corporate sector. For the first time since 1991, corporate debt has grown to a number larger than household debt. US high-yield debt amounts to $1.3 trillion compared to

$743 million in 2009. High-grade corporate debt is now $6 trillion compared to half that level a decade ago. At the global level, all forms of corporate debt today is at $75 trillion compared to $48 trillion in 2009.

Governments have no compunction about increasing indebtedness. For one their economies need it, and secondly, it has almost become a consensus that central banks have become the buyer of last resort. Modern Monetary Theory whereby central banks buy government debt to ensure that long term interest rates are well and truly suppressed will be in full flow.

Corporate debt markets are likely to receive good support from central bankers, although note that it is only likely to extend to higher quality credits. We doubt that central bankers have the appetite to continue their buying into the high yield market.

Beyond high yield, equity markets look even more vulnerable. Some strategists have ventured to suggest that equities are in cheap territory with V-shaped recoveries pending. We disagree. The world faces probably at least a year of trouble that will stretch the balance sheet of every company – remember bondholders come first, equity investors will be left to pick up the pieces.

The other factor that works against risk assets at the moment is the emotion and bond panic. We have argued for some years that investors were overexposed to equities, from some institutional investors through to the average private client. The low volatility of equities as an asset class created by crazily loose monetary policy led investors into a false sense of security.

From the medical side, there remains the hope of mitigants to the death rate, but the medical profession is mostly resigned to believing that it will take 12-18 months before they find a vaccine. As we detailed last week the main hope is that an existing drug will mitigate some of the worst effects of the virus and hence reduce drastically its deadliness.

Without a vaccine, you have got to expect that there will still be limitations on the freedom of movement for people. Given the devastation thus far to individual economies is any government going to re-open a border or indeed wholly allow their population to return to work.

The coming weeks will be a battle between the economic data and the policymakers. Policymakers are only just recognising the potential scale of the economic downturn. It still seems like it will be a long time off until we genuinely believe that the healthcare industry and policymakers have things under control. Until then, it is risk- off.

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