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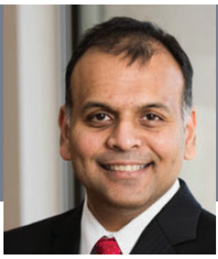

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Equity markets – more questions than answers!

The ongoing mayhem in equity markets worldwide reminds me of a famous quote from boxer Mike Tyson: 'Everyone has a plan until they get punched in the mouth.' I think OPEC just gave that punch to financial markets.

In my last note, 'History does not repeat, but does it rhyme?', dated 18 February 2020, I made the point:

> 'Markets are as complex as airplanes. They rarely, if ever, crash because of one big error; generally, it is cumulative small errors which compound to create the big problem. It would seem that we have quite a few things adding up, though markets for now continue to climb the proverbial wall of worry.'

My anticipation after the 10% correction post-COVID-19 outbreak was that I thought we would sort things out within the next two months once summer hits and go back to business as usual.

I think the oil markets crash (it's down c. 30%) changes everything for me. This is a lot of wealth destruction, and while a lot of the asset allocators are underweight energy, most have some exposure to the chain.

Global investing requires a bit of a macro framework. Mine has been akin to describing it as the Mexican standoff between oil, China, the Federal Reserve and US dollar and, more recently, trade.

- **Currencies:** How currencies move will be incredibly important, as this is the most liquid market, especially when all other markets are closed (watch YEN, CAD, NOK, RUB, INR, PESO). As things stand, we are getting three SD (standard deviations) moves in all currency markets which are open! This bodes pretty poorly for equity/fixed income markets as people are selling/hedging what they can – not what they want to.
- **Oil:** There is never any sure thing, but the breakdown in OPEC/Russia relationships would rank among the top three worst geopolitical, mutually assured self-destruction outcomes I have seen in my career. Our macro work around the energy sector makes it clear that neither Russia nor the Saudis break even their budgets below US$50 per barrel. This shock will be worse than the 2016 shock as we have both demand destruction (due to COVID-19) and oversupply (due to OPEC's actions) at the same time. In a world of uncertainty with COVID-19 etc, selling oil is the closest perfect no-brainer trade that you can get today, and everyone will execute it! The knock-on impacts on the high-yield market will be significant, and no one is going to be tempted to buy the dip (yet!).
- **Geopolitics/China:** More than the immediate financial impacts, there are some other geopolitical impacts that we need to consider (Iran, which has been weakened by COVID-19, now has to deal with lower oil prices which can be destabilising for the regime. The same holds true for Saudi Arabia, which explains all the news of the Royal Princes being put into detention). As long as we don't have a second spike on COVID-19, things seem to be returning back to normal. The bigger question for China will be how it will weather the downturn that the rest of the world will no doubt witness due to the COVID-19 outbreak, the extent of the stimulus that they have to do, and the target sectors. Undoubtedly, given that China is an importer of oil and any stimulus would have been oil price inflationary, having a lower starting point is better for the Chinese, so this OPEC debacle in some way does benefit the Chinese (as also India and Turkey). Venezeula, Rosneft, Putin and Trump relationships also deserve some thought, as also does the impact of all this on US elections.
- **Interest rates:** An observation that the US 10-year yield hit an intraday level of 0.666 on 6 March 2020. Eleven years ago to this day, the S&P 500 Index (SPX) hit an intraday level of 666 on 6 March 2009.[1] Things felt truly awful and then the markets turned. I guess the open question is what all the prospects of helicopter money and fiscal stimulus that everyone believes will come, will do to the fixed income markets and the 10-year yields. It might be the oddest thing to say, but maybe we should be brushing up on our inflation versus deflation playbooks.
- **Trade:** Nothing to be said there, things are poor!

- **COVID-19:** I think it is clear that the virus has come to our doorstep and hence the Western markets are taking cognisance. Our Fidelity Global Health Care Fund Co-Portfolio Manager Judith Finegold has done some great work recently on dimensioning the issue. Added to the note I read on LinkedIn, which does a good job of linking weather and humidity to the spread of the disease, my key takeaways on this issue are:

  (a) Italy is the base case for UK/Europe/US.

  (b) Unfortunately, we are yet to see a response in the West of the scale we have seen in Korea/China/Singapore, which means our peak will be worse.

  (c) Limited propagation in the Southern hemisphere with temperatures greater than 20 degrees Celsius gives us hope that this will sort itself by the summer.

  (d) Any question you have on healthcare facilities – the simple answer is: not enough! My local hospital in London has an ICU bed capacity of 11 (with 90% current utilisation).

So, in summary, the indicators I am watching are:

Negatives:

- Credit and bond markets started cracking last Thursday and Friday. This will get worse post the oil debacle.
- Oil markets are now breaking currency markets, creating a contagion effect.
- COVID-19 propagation in the UK/US is still ahead of us, with the next three weeks being critical.
- Oil is going to cause significant wealth destruction in a short span.
- Trying to read sense in fundamental prices is not going to help here. People sell what they can, not what they want to and – worse, at these levels – margin clerks are in charge! Also, where you have the most profits, you have the most selling pressure!

Positives:

- Low oil prices are positive for the US consumer and oil importers like China/India (these are the key engines of current growth).
- The Europeans have told Italy to spend without fear of budgetary retribution (given Italy will surely be in a deep recession by the end of next week).
- The US Federal Reserve is talking about the range of financial assets that it might need to buy (remember, the Bank of Japan owns a fair chunk of Japanese exchange-traded funds [ETFs] on the stock market).
- Quantitative easing infinity is coming; we just don't know what the strike price is!

Open questions to ponder:

- Central Bank response.
- Government response to COVID-19.
- Why isn't gold higher?
- How will credit liquidity behave?
- When do we see outflows?
- Where do we see outflows?
- How long is the hit to oil?
- Dimensioning the hit to US GDP and, more importantly, US consumer/jobs.

Potential answers (unrelated to the above):

- Continuously test the portfolios for liquidity risk.
- Keep a flexible mind, prepared to change when the facts change. (Did you know that the best-performing sector in the SPX in 2008 was airlines, as oil went from US$140 per barrel to US$30 per barrel?)
- Earnings drive the E, sentiment drives the P. We are now unclear on both, which means P goes down before E.
- This is nothing like 2008 – yet.
- **Have your buy list ready as the market is going to get dislocated pretty quickly, but dislocations always pass.**

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Reference: 1. Fidelity International, Bloomberg.