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Similar, but different – 2020 compared to 2008

Market Comment, May 2020

The coronavirus crisis may appear to have peaked, but it is not over. Due to the longer-term consequences, a recovery phase could prove both weaker and shorter than after previous crises. After all, the cause of this crisis is obviously very different to that of other crises – such as in 2008, for example. This makes combating the crisis much more difficult this time, at least until a reliable vaccine is available in sufficient quantities. Defensive diversification remains the order of the day, as both bonds and gold are likely to be beneficiaries of the longer-term consequences of this unusual crisis.

Looking at the coronavirus crisis, it appears to be following – albeit at a much faster tempo – a pattern that we are familiar with from 2008. That pattern is essentially as follows: The risks to the economy are initially perceived only slowly, before then rapidly becoming obvious. Leading global organizations such as the OECD and the IMF reduce their economic forecasts in response, as do the banks. Asset classes that reflect economic growth, such as cyclical commodities and equity markets, initially barely react, but then go into freefall. On this occasion, the algorithmic trading programmes of hedge funds, which are much more widely used than in 2008, have the effect of accelerating market movements – and in both directions, both downwards and upwards.

As a result of these seismic movements, two things proved different this time compared to 2008. ETFs, which are much more numerous now, had enormous difficulty coping with the flood of incoming stock market orders: The underlying securities of these vehicles are often fairly illiquid, a problem compounded by the fact that the banks are no longer able to engage in proprietary trading as they once did. The result? Liquidity problems and forced selling. The authorities initially assessed the risk of recession as being low, but the liquidity bottlenecks apparent in the financial markets ultimately forced them to take dramatic action. Central banks are therefore essentially having to put free markets "out of action" for a long period of time in order to ward off the risk of a complete collapse of market systems. As a consequence, the markets could well be underestimating the ability of central banks to influence the economy, and may ultimately require several phases of excessive emotion in both directions – i.e. "hope" and "fear" – before the economic fundamentals provide proper clarity. This is because the key driver of today's global economy, consumer spending, is even more dependent on sentiment than the cause of previous crises, namely the production side of the economy and the financial sector.

> "The crisis is not yet over; defensive diversification involving bonds and gold remains important."
>
> Gérard Piasko, Chief Investment Officer

The cause of the current crisis is wholly different to that of 2008 or indeed previous crises, which always had major financial imbalances at their heart – e.g. insufficient capital buffers for banks or locally contained problems involving just a few countries or sectors. This time around, although imbalances such as historically high valuations or high levels of indebtedness have played a role, all countries and all sectors are affected, and the origins of the crisis do not lie in the financial system. The driving force of this crisis, the Covid-19 virus, has still been insufficiently researched: opinions vary widely, and each country adopts different counter-measures. However, this means that – unlike in 2008 – there is a clear lack of coordination within the G20 and within the European Union (EU). This in turn means that the coronavirus crisis has an additional component that is not without dangers of its own: it is strengthening a number of political problems that were already apparent prior to the crisis. A good example of this is the resurgence of political tensions within the EU, specifically between the countries of southern Europe, which are reliant on external assistance, and their wealthier neighbours to the north. Another example of political problems is the conflict over market share in oil production between Saudi Arabia, Russia and the US, which undoubtedly has the potential to extend and intensify this year's economic crisis. Not to mention the political tensions between China and the US, which are becoming acute again. In other words, nationalism is on the rise, and to the detriment of both global trade and the profitability of multinational companies.The authorities of various nations are pumping money into the system and granting cheap loans in an attempt to compensate for lost revenues and ensure that the liquidity crisis doesn't morph into a solvency crisis. While this liquidity is clearly an effective temporary assistance measure, it also creates more debt at both sovereign and private-sector level. Large amounts of electronic money are thus having to be printed for the bond purchase programmes in order to keep financing costs low for both governments and private entities. But as money will be needed to repay the enormous loans being granted, everything points to a lack of financial resources for the investment that is so crucial to future growth. Economic growth in the recovery phase will thus prove weaker than is typically the case after a crisis – which suggests bonds will enjoy an advantage over equities. The other beneficiary of the interventionist policy being pursued by central banks could be gold. After all, the (electronic) printing of money means that all major currencies – with the exception of the Swiss franc – are experiencing a dilution of their value. As an alternative currency, or indeed the ultimate currency, gold is now benefiting from the growing long-term trend of printing electronic money, and perhaps even more so than other real assets, which are likely to suffer from below-average demand for a longer period of time. The coronavirus crisis will have many consequences. Many things will never quite be the same as they were before the crisis, particularly our behaviour as consumers. The economic recovery is therefore likely to be dogged by greater uncertainty than in the past. In addition to gold, bonds look set to benefit given that the world's central banks have never been such strong buyers of fixed-income instruments as they are now.

Therefore, defensive diversification across all asset classes appears only logical. With regard to equities, we currently prefer US and Swiss stocks to those of the Eurozone and the emerging markets. The latter two regions are more cyclically sensitive (i.e. are less defensive), exhibit a higher beta (i.e. higher volatility) and are also more dependent on global trade, which could suffer against a backdrop of increasing Sino-US trade conflict.

Gérard Piasko

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