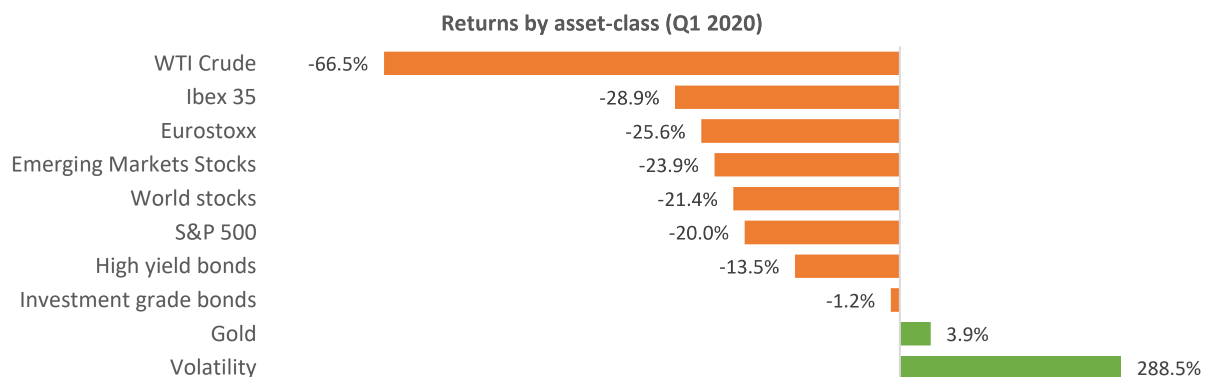
April 9th, 2020

Q1 2020

COVID-19, main player for the quarter

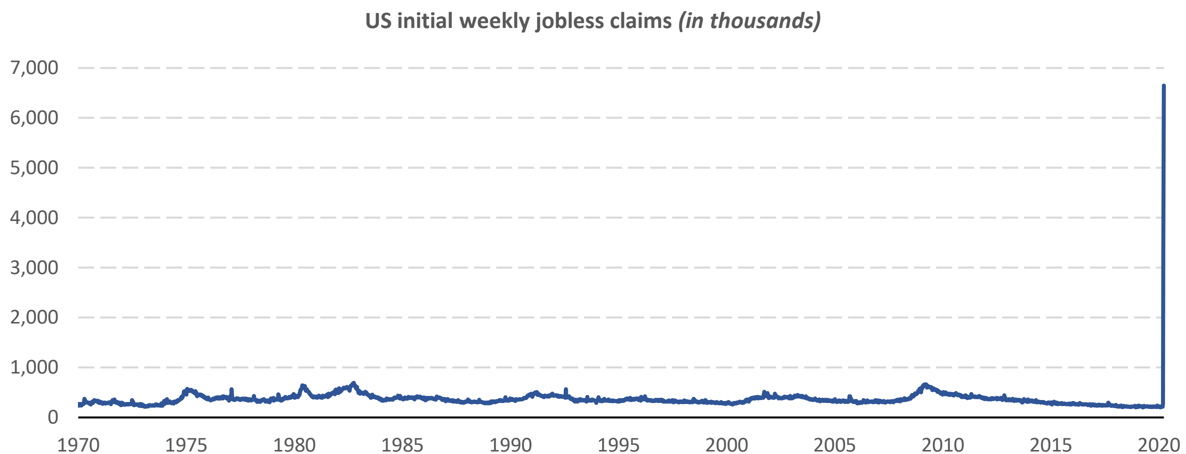
There's no doubt the beginning of 2020 will be a quarter that will go down in the history of financial markets. In just three months, the major stock indices have reverted to levels not seen since 2016, when Donald Trump's election heralded a time of business boom. The virus has been the trigger that has ended the complacency that existed in many financial assets, which continued to rise despite the risks that lurked in the global economy. Although our commitment to volatility originated precisely from this lack of perception of risk, no one expected that this crisis would be so sudden. If in 2008 the market took 273 days to enter a bear market (20% drop from the maximum), this time it has done so in a record time of 22 days. And as it is becoming more usual in recent market panics, no assets have been saved except for volatility.



The financial market finds its equilibrium through a constant negotiation between buyers and sellers. Facing the risk of a recession or correction, an intense debate opens between those who believe that it is imminent and those who believe that the cycle still has long to go. During 2019 the optimists won the debate and imposed their story. Even earlier in the year, when the Coronavirus stalked the entire Asian continent and closed in on the Chinese economy, optimists continued to win the argument. This is the only way to explain that at the beginning of February, equities hit record highs. However, when the virus landed in Italy, the entire world simultaneously understood that the measures that would be necessary to stop the spread of the pandemic would lead to an economic crisis. On February 20th, panic broke out and 22 days later, the longest bull market in US history had broken. Thus ended 11 years in a row without falls of more than 20%.

We are facing the worst humanitarian crisis since World War II, with more than 50% of the population confined in their homes. This is a sudden stop for the economy, a black swan that not only generates a shock in demand, but also in supply, disrupting global supply chains in a hyper-globalized world. Unlike what happened in 2008, this crisis has not been created in the financial and banking system to later jump into the real economy, but rather is the real economy itself that could end up infecting the banking system.

No one can foresee exactly where we are going to land since there are few precedents for such an economic halt, although the variable that will most influence will be the duration of the lockdown on a global scale and its progressive rise. That is why we will abstain from making any macroeconomic forecasts, but we can comment on the first data that is beginning to emerge. Initial weekly jobless claims in the US have skyrocketed to 10 million people in two weeks, figures never seen in history. There are economists who point out that unemployment in the US could already be at the worst levels of the 2008 crisis. In Catalonia, the temporary layoffs already affect 630,000 people, which added to the more than 400,000 who were already unemployed before the virus, that places the current unemployment above the 900,000 people that were unemployed in the worst record during the previous crisis.



All this is happening with the greatest global indebtedness in history, both in nominal and relative terms. Despite the fact that financial institutions and families have deleveraged as a result of the previous crisis, corporations and states are in an unprecedented situation. As we explained in previous reports, in the US many companies have fallen into the perversion of taking advantage of the low interest rate environment to issue debt and initiate share buyback programs with a single objective: raise their share prices. On the other hand, and with the exception of very few cases such as the German or the Dutch, few states in the world have taken advantage of the tailwind from recent years to close their deficits and start reducing debt to be better off for the next slump. This will greatly limit the action of countries that will be forced to continue issuing debt indefinitely to calm the social unrest that will be generated.

On a positive note, it should be noted that institutions (central banks and governments) have acted quickly compared to 2008. The Federal Reserve has mobilized $4tn and lowered interest rates to 0%, while the European Central Bank has also stepped up its asset buyback program and started a new program worth €750bn. For the moment, they have managed to avoid the collapse of the debt markets by injecting liquidity and preventing risk premiums from skyrocketing.

In turn, governments have mobilized unprecedented fiscal packages to try to build a credit bridge for companies and workers between the abyss that has been opened by the fall in income derived from complete lockdown. The American government has announced up to $2tn in aid, including a free $1,200 check to every American citizen earning less than $75,000 a year and an additional $500 per kid.

All these measures will accelerate a debate that was beginning to creep into some circles of politicians and economists, Modern Monetary Theory. In our opinion, this theory is not very modern, since its

precepts have been applied previously: in the Weimar Republic of the 1930s, in the American Civil War and even in Ancient Rome. It is about putting money more directly in the hands of consumers to stimulate demand, either through public spending financed by central banks without having to return it as debt, depositing money directly into the citizens' accounts, or even with big debt write-downs. The long-term effect can lead to uncontrolled inflation and a depreciation of the currency compared to other assets such as gold.

What now? Outlook for the remaining of the year

In a simplified way, we are faced with two possible scenarios with multiple ramifications:

Favorable scenario

As we mentioned previously, there are no precedents for such an economic slowdown. It is not even comparable to the World Wars during which, part of the population was mobilized for the defense industry and the maintenance of local supply chains. The state of the economy is extremely fragile, but a balance could be achieved by avoiding breaking the chain of trust on which our entire economic system rests. For this, two premises are necessary: confinement must last as little as possible as a result of rapid control of the virus (such as in South Korea or Taiwan), and institutions are able to build the bridge loan needed to cross this trance. With the following measures well formulated and implemented, the much-desired recovery in "V-shape", or at least in "U-shape" could be achieved:

- Banks guaranteed by the State grant loans at very attractive terms to companies avoiding bankruptcies due to lack of liquidity
- The State pays workers and self-employed workers a living during these months, in the form of unemployment benefits
- Landlords avoid charging rent to those companies or workers affected by the crisis
- For those homeowners who rely on the rent to pay mortgages, the bank does not execute the mortgage during the crisis
- Collective effort, mainly by the *Haves*, with greater solidarity and understanding for liquidity problems of the *Have Nots*
- The State finances all this effort with debt. In a normal market, it would be very difficult for investors to lend this money to Spain at attractive terms
- However, the ECB has expressed its intention to prevent risk premiums from soaring by intervening in the secondary market with massive purchases of debt, and its ability to do so is theoretically unlimited.

All these measures cannot be applied without side effects and collateral damage, to which great attention must be paid from an investment point of view.

Negative scenario

Given the fragility of the economic situation, the above measures are not a guarantee of success and any mistake can derail the situation. If confidence is broken, a chain of disastrous events will begin that would lead us to a crisis much worse than that of 2008, with greater similarities to the Great Depression. This confidence can be broken in several ways condemning us to a recovery in "L-shape":

- The effort of the State is not enough and companies without liquidity go bankrupt, destroying jobs for Good

- Landlords and banks demand the collection of their rents and mortgage payments without flexibility, generating unbearable social tension and a wave of evictions
- The ECB loses control of the market and despite its massive purchases, risk premiums skyrocket, blocking the possibility of states to issue debt

Hanway Capital is ready to navigate both scenarios. Despite the fact that our wishes are placed in the favorable scenario, many indicators point out a difficult situation. As always, we hope for the best, but expect the worst.

The extreme market rally of the past few days may lead to the false perception that the worst is over, but we remain skeptical at the moment. Nobody can predict with certainty when the market will hit the bottom, so the most cautious thing to do is entering the market in stages. However, above all this, we wish that you, your family and friends are in good health and living the lockdown in the best possible spirit.

"Certainty is nothing more than the inability to see the alternative. Certainty, when widely accepted, tends towards uncertainty."

- Ludwig Wittgenstein

Warm regards,
Hanway Capital

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