The global spread of the Coronavirus Disease 2019 (COVID-19) created a significant amount of market volatility and caused a steep sell-off in equity markets in March. While the situation remains incredibly fluid, and the full impact of the pandemic on companies’ valuations and earnings is not yet fully known, we believe companies that are able to weather this event-driven shock offer an extremely rare opportunity to invest in attractive businesses at historically low valuations. Companies with strong balance sheets, healthy margins, established and sustainable cash flows, and lower financial leverage should be better positioned relative to peers during and after this global health emergency.

The speed and scale of the global equity market sell-off in March was unprecedented, exceeding the pace of declines during the Great Depression. Although many stock markets in the developed world fell approximately 30% from their most recent peaks in less than a month before stabilising, we believe equity market declines appear to be consistent with an event-driven shock—compounded by developments in the oil market—rather than signalling a structural or cyclical bear market. We believe this market event should also be viewed in the context of the speed and scale of responses from central banks and governments around the world, which is unlike anything investors have witnessed in modern times.

Monetary policy measures—particularly those announced by the Federal Reserve and the European Central Bank—are welcome insofar as they should support markets in functioning effectively through this period of heightened uncertainty by adding fresh capital to the financial system and providing liquidity. However, monetary policy alone cannot counter the decline in economic activity in the way that fiscal policy measures can. Even in the months before COVID-19 became a global concern, central bankers, policymakers, and senior economists were becoming more vocal about the limits of monetary policy in supporting economic growth going forward and encouraging governments to pick up the mantle by deploying fiscal measures.

Many countries across the world—together accounting for 70%1 of global GDP—have announced fiscal measures to protect their economies from the social and economic fallout of the global outbreak. So far, these fiscal measures amount to approximately 2% of global GDP,2 with some countries having approved fiscal stimulus measures comparable in scale to those deployed in response to the global financial crisis (Exhibit 1).

Unlike central banks, national governments can directly limit the economic costs to the private sector and reduce job losses. An economic shock is not preventable, but its duration can be contained, and a systemic shock potentially avoided, if governments use the right fiscal tools and targeted relief package to support businesses and households. Whether the measures adopted in Europe and the rest of the world are extensive enough to stave off the most damaging effects to the economy from the current crisis—particularly in terms of the labour market, small- to medium-sized enterprises, and other highly exposed areas of the private sector, including the travel, retail, and leisure industries—remains to be seen.
However, if fiscal measures are substantial enough—and the outbreak of the virus is relatively short-lived—then the conditions for a strong economic rebound could be in place once the immediate threat of COVID-19 has dissipated and production and spending come back online, therefore avoiding more permanent damage to investment and consumption levels. In addition, the European economy has become broadly more resilient since the global financial crisis just over a decade ago, placing it on a steadier footing to weather the economic fallout from the current crisis, if it proves short-lived. The financial sector is more stable, better capitalised, and less vulnerable to contagion, while economic growth has been steadier and expanding at moderate levels. The unemployment rate was at its lowest level since May 2008 prior to the pandemic (Exhibit 2) and labour market conditions had improved. Household debt had also been steadily falling.

Equity markets have largely had a muted response to the monetary and fiscal measures put in place so far. Crisis policies have helped to stem the losses, but in order for a more meaningful rebound to take place, we believe investors will need more clarity on the virus’ infection and mortality rates, the success of measures to contain the outbreak globally, and the likely economic and corporate impact before they can assess whether the policy response has been adequate.

Navigating the current market environment is challenging, and while European stock valuations are now well below historical averages on a 12-month forward price-to-earnings basis, we would still urge caution. We believe investors should consider stocks based on their risk/return profile, alongside valuations, and consider reducing exposure to sectors where the COVID-19 outbreak could have a material impact on a company’s earnings, such as the airlines industry and the insurance sector.

We have become more concerned about the insurance sector, as it is particularly sensitive to falling equity markets, widening credit spreads, and declining interest rates. Insurers typically hold a high proportion of corporate bonds in their portfolios, which could come under pressure if credit spreads widen further and defaults increase, as this would weaken their capital ratios. Widening credit spreads also raises the risk of defaults in the oil sector. The high yield energy market was already looking weak prior to the outbreak of the pandemic, but concerns have spread more broadly following Saudi Arabia’s recent decision to raise oil production after a breakdown in Russia-OPEC talks. We believe this could particularly weigh on exploration companies and, more broadly, on oil companies with weaker balance sheets.

We also believe the market sell-off has created an opportunity to scale up exposure to quality stocks, given that some companies had sold off in line with the broader market and become overly discounted despite having strong balance sheets, healthy margins, sustainable cash flows, and lower levels of financial leverage both in absolute terms and relative to peers. We continue to believe that an active, bottom-up, fundamental stock selection approach is best suited to uncovering investment opportunities at attractive valuations and avoiding unintended risks, even during these unprecedented times.
European Fixed Income

The coronavirus pandemic and sharp drop in the oil price in March not only caused a rout in equity markets, it also triggered an aggressive sell-off in some fixed-income assets, including high yield corporate bonds, bank loans, and preferred securities, in moves reminiscent of previous recessionary episodes. Yields on some sovereign bonds in the G7 fell to record lows amid heightened risk aversion and market volatility. However, sovereign bonds’ traditional role as a diversifier—owing to their negative correlation with equities—broke down towards the end of the first quarter as market dislocations and concerns over liquidity grew.

Yields on German (Exhibit 3) and US government bonds, and other high-grade bonds in the euro zone, backed up toward the end of March, as governments around the world announced fiscal measures to counter the financial impact of the virus. In contrast, high yield corporate bonds, bank bonds, and government bonds of the euro zone’s “periphery” continued to sell off over the course of the month. Credit spreads widened dramatically in March (Exhibit 4) as demand thinned for high yield bonds and assets of a lower credit quality.

Investors look to be pricing in an economic recession that lasts until the end of 2020. However, much will depend on the impact of monetary and fiscal responses, the duration of the pandemic, and the true economic fallout from this global health emergency.

The nature of current events is unique relative to previous market capitulations and economic recessions. Central banks and governments have introduced a decisive set of monetary and fiscal stimulus measures, and it is possible that pent-up demand could translate into a strong recovery in the medium term, once the worst of the pandemic is over. However, with the heightened uncertainty at the current juncture and developments changing by the day, even the near-term outlook is clouded.
Outlook on Europe

Notes
1. As of 23 March 2020. Source: J.P. Morgan

Important Information
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