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Monthly Monitor

April 2020

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Details below for CIO call, Thursday, 23rd April @ 10:00 am

Beyond The Virus: Lost Year not Lost Decade?

With half of the global population under some form of lockdown, we are experiencing unprecedented public health emergency action in response to the Covid-19 pandemic. The pandemic is a human crisis, and warrants a robust response to minimise its tragic results. The response is having a profound effect on the economy, but the key question for investors is whether the sudden shock to the economy results in a deflationary spiral and a lost decade similar to that which followed the financial crisis, or will the economic policy responses from governments and central banks succeed in containing most the damage to a year.

In assessing this there are numerous factors to be considered:

Part One – How does the world gets back to work?

The silver bullet to this virus is a vaccine. The consensus in the scientific community is that it will take approximately 12 months to test a vaccine and get it approved, even with regulators acting expeditiously. Given there are currently 41 different potential vaccines

being worked on and that vast resources are being invested in this, we may get lucky and one may get through approval a couple of months quicker than a year. Once approved, a vaccine can be rolled out worldwide very quickly, the virus effectively disappears after that, and the world returns to a place where we can work, socialise and travel without any material public health restrictions.

What happens before a vaccine is approved? In an ideal world everyone stays disciplined and every country adheres to mitigation measures for another few months – the measures work, the virus runs out of new hosts in several months and disappears. However, it is ambitious to expect such an outcome given that there are asymptomatic carriers, the extensive penetration of the global population that the virus has already achieved, and that some leaders and authorities are pursuing somewhat different health policy responses to the virus in their jurisdictions. In any event, the aim of the current mitigation phase is to flatten the curve, not stamp out the virus.

The more likely scenario is that after a couple of months of mitigation the curve has flattened and rolled over sufficiently to allow a gradual easing of restrictions and allow a return to work. The question then is whether the tail of the curve and the risk of a second wave (particularly when northern hemisphere temperatures drop again in the autumn) can be managed without the re-imposition of wholesale lockdowns until a vaccine arrives in the new year.

There are a number of grounds that support a view that this phase can be managed differently through a combination of strategies. Widescale testing will be the key element, particularly as capacity to test for the virus and analyse samples rapidly is being ramped up. This would allow subsequent cases to be diagnosed quickly and combined with properly resourced contact tracing and cluster identification could minimise the rate at which those pass on the infection. Immediate contacts get quarantined not the whole population. Antibody testing for those previously infected will also play a role, both in allowing those confirmed with antibodies to move freely and to inform health authorities how close countries are getting towards herd immunity.

Anti-viral medications could be a potential game changer in terms of managing a second wave. While vaccines may be a year away, anti-virals are much closer, possibly 1-3 months away as the candidates here have previously undergone safety trials. Anti-virals would reduce the pressure on health systems as many patients should recover more quickly and there should be a lower proportion becoming critically ill. Other strategies could include cocooning of vulnerable groups, widespread mask wearing, hygiene practices and continued social distancing. Self-isolation of those testing positive, their close contacts, and those travelling from other infected areas would also be likely.

Immunologists refer to this as a suppression strategy. With the above suppression strategies possibly mitigating the level of demand on health systems in a second wave, the capacity of hospitals (which has increased) may be better matched with demand without having to fully shutdown economies again. If a second wave emerges it is possible that a much greater level of economic activity can be sustained compared to the first wave – to what extent, there isn't enough data yet to judge that, but the world is trying to figure a way to live with the virus until a vaccine is ready. Simply put, initial containment strategies failed, mitigation is succeeding in flattening the curve, and suppression is likely to be the

strategy to manage the tail of the curve and the risk of a second wave..

Part Two - Will there be an economy that can be salvaged?

Once people are allowed to return to work the question is whether their jobs will be there? When looking at the surge in unemployment it is important to remember that unlike the Great Financial Crisis (GFC) 11 years ago, an unsustainable bubble has not burst. This time work has been suspended due to a public health crisis, these jobs have not disappeared because they are based on unsustainable economic policies or credit – this is the classic external shock to an economy, it is not the natural roll over of an economic cycle. Many of the jobs that have been furloughed for public health reasons can restart when restrictions end if there is sufficient policy response to mitigate the impact the health crisis on the economy.

Another key difference from the GFC is the scale and speed of the monetary policy and fiscal policy responses from central banks and governments. There has been a greater response in the eight weeks of this crisis than happened over eight months during the GFC. Cumulative support is now over $10 trillion. Central bankers are ensuring that there is more than sufficient liquidity in the financial system and that borrowing costs are lower. Fiscal policy is protecting individual incomes to some extent and supporting businesses through the shutdown. Support measures are significant, for example in the US they are equivalent to 10% of annual GDP, or 40% if it comes in one quarter. This should help individuals and businesses survive the shutdown – it is “fiscal relief” as it replaces some of economic activity lost due to the shutdown. Ramping back up will not be immediate, and will need fiscal stimulus to kick start economies. This is not lost on policy makers and attention has already switched to formulating post-shutdown stimulus measures. Unlike the GFC which saw government austerity to tackle unsustainable deficits, this time governments have the capacity to pursue truly countercyclical fiscal responses.

The other key difference with the GFC is that banks were at the epicentre of the problem that time. Now they have the capital and liquidity to be part of the solution. Rather than having to shrink their loan books, banks can now show forbearance to and extend credit for borrowers whose loans are sustainable post shutdown. Some would argue that this is an even opportunity for banks to start repairing their reputation by acting constructively.

Economies have the capacity to recover post the shutdown. Actions of policy makers will help. Unlocking the economy post shutdown will take time, particularly with residual restrictions in place to manage the risk of a second wave. Therefore, a “V- shaped” recovery is unlikely. The recovery is more likely to “U-shaped” or possibly even jagged given the unwinding of restrictions may be stop-start. In our view, a prolonged deflationary period is unlikely given the scale of the policy responses to date, although in the short term the shutdown will be a major deflationary force in the coming 12 months. However, 2021, particularly post a vaccine, should represent a year of strong economic recovery, with a return to 2019 levels of activity is possible by late 2021 or during 2022 if sufficient stimulus measures are pursued by governments. We see the probability quite weighted to this being a lost year rather than a lost decade.

Not All Plain Sailing

Our view on the potential recovery is not to dismiss the harsh realities and challenges that the shutdown will bring. A return to a normal level of economic activity does not imply the world returns to the way it was. And there is also the risk of a policy misstep along the way.

There will be businesses that will not survive. But many of these will be businesses that were already dealing with challenges such as having too much debt, or dealing with structural change (e.g. physical retailers or print media), or paying overly high rent. Some retail, restaurant, hospitality and travel models will also be under severe pressure from the crisis, but there will be winners among the survivors. The landlords of struggling businesses will also endure pain, particularly if they are carrying too much debt.

The current crisis is also likely to expose fragilities and structural problems that were in the world already. Eurozone cohesion will be tested by the response of the group particularly if insufficient solidarity is shown by the group to those members that have suffered most.

Credit will be re-priced over time, as many areas of the credit markets were mis-pricing credit risk. Longer-term this will be a challenge for those overly reliant on debt, particularly those overly reliant on cheap debt.

A key challenge will be how governments deal with the debt raised to manage their economies through the crisis. No obvious answer has emerged yet, but options include letting inflation erode the debt in real terms, austerity post the recovery, or monetising debt through loose central bank monetary policy (effectively just kicking the can down the road and letting reflating economies reduce the debt as a percent of GDP gradually over time). In time, although a long shot, some central bank write down of government is also possible.

What does this mean for financial markets?

At the lows during March equities were showing losses of c.35%, consistent with patterns during other external shocks. This fall reflected fears that an economic depression would follow this health crisis, a sudden tightening of liquidity and an oil price war breaking out during the middle of it.

Equities have posted a partial recovery and are now roughly 20% off peak. Central bank actions have provided liquidity, some level of supply discipline has returned to the oil market, and stimulus policies have eased fears of a potential depression.

History shows that following an event shock, equity markets recover quickly. In a “lost year scenario” financial theory tells us there should be a circa 10% adjustment to equity fair values, so there is more recovery potential short term, particularly as valuation levels are attractive, especially relative to bonds. As visibility improves regarding a return to trend economic activity levels in 2021 / 2022, the equity markets should be capable of returning to previous peak levels. While our view on equities is positive we do note that the recovery in values is likely to follow a volatile pattern.

As mentioned earlier, the effects on the crisis will be deflationary in the short term. However, we expect the scale of the policy responses will create inflationary pressures as

economies recover. Investors should be positioned in assets that can beat inflation and give a return in real terms. A likely Inflationary scenario reinforces our positive view on equities, particularly those that have strong balance sheets, pricing power, and valuations that are sensible. Markets are forward looking and as expectations of a recovery grow, we expect markets will look beyond the near-term deflationary news flow.

Other real assets such as forestry, infrastructure, gold and property should also be preferred in a likely inflationary scenario.

Fixed interest will struggle to protect investors in real terms if inflationary forces emerge medium term, particularly given that bonds yields are at extreme lows. Indeed, bond yields are likely to rise (and bond prices fall) in such a scenario. Those pockets of the equity markets that are expensive will also face headwinds as the extremely high valuation of these "long-duration" stocks are partly underpinned by extremely low bond yields.

Some sectors will be clear beneficiaries – construction and mining will benefit from infrastructure stimulus spending, and healthcare is likely to receive higher funding longer term. Other themes will emerge, but it is not as visible yet how some of these will play out, or where the attractively valued assets are to participate in these. We will revisit sectors and stocks in later commentaries.

What has Appian Done?

Entering 2020 we had trimmed the equity weighting in our multi asset funds to 40% from 45%. As equities sold off we first returned to a 45% weighting and as very attractive levels emerged in late March we increased our weighting to 50% (within the upper end of our 30-60% range).

We retain our positions in other real assets such as forestry, infrastructure, gold and property. We continue to avoid assets that we believe are intrinsically overvalued such as long-term bonds, growth equities, and private equity.

Our asset allocation has been active during the turbulence of the first quarter, and will continue to be so as the opportunities and risks in the post virus world evolve.

"*Note: stats referenced in the article sourced from: Eikon, Gavekal Research, Macro Strategy, and Exane BNP*"

Appian Monitor - Market Update Conference Call

Please join Chief Investment Officer Niall Dineen and Senior Relationship Manager John Flavin by telephone **Thursday morning, April 23rd at 10:00am** for a discussion on

Beyond The Virus: Lost Year not Lost Decade?

Dial in details

To listen in to the conference please use the dial in details below.

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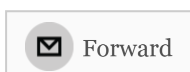
Submit questions

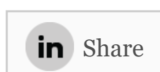
If you would like to submit a question for the team
Please forward it by email to john.flavin@appianasset.ie

Email in Questions

About the call

You can 'dial in' and listen to the call live on the date scheduled. Alternatively, a recording will be available on the Appian website which you can access at any time. Please note that this is not an interactive call. If you have a question you would like addressed, please submit it prior to the call.





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Appian AM NAV's Fund Prices 31-03-2020 (Citi)

NAV		YTD	SI	Q1
		%	%	%
AMAF	135.2223	-15.04%	35.22%	-15.04%
AGDGF	150.7153	-29.70%	50.72%	-29.70%
AGSCOF	121.6327	-35.04%	21.63%	-35.04%
AIF	93.2481	-15.81%	-6.75%	-15.81%
AELF	103.2226	-0.48%	3.22%	-

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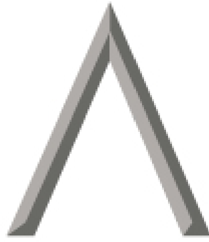

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