Appian
Asset Management

The "Coronavirus" Bear Market

The coronavirus is set to impact the lives of all across the globe. Nobody knows the full extent of the pandemic and therefore the amount of cases that will materialise. The world today is living through a period of extreme real fear. The virus presents a unique set of challenges for financial markets. The greatest challenge is the uncertainty as to the scale of economic damage that will be caused and what the world will look like in 12 to 18 months' time. It is this uncertainty that has precipitated a bear market in equities over the last few weeks.

At times like this it can be difficult to focus on the long-term ramifications of a crisis. Shorter term it looks likely that the extreme containment measures employed in Europe and the US are going to result in a recessionary environment. Markets have priced in this and a lot of the economically sensitive areas of the market are pricing in an environment worse than the global financial crisis. However, it is not yet possible to say whether equity values have fallen enough.

The question many are asking is why has this drop been so violent and to a large extent indiscriminate. This isn't an easy question to answer but there are a few contributing factors. There is huge uncertainty as to the extent of the economic damage that is to follow but also as to the policy response that has to come from governments and central banks. A different response is necessitated than what came during the financial crisis. This is a human crisis so the question that has to be answered is how to get cash into people's hands quickly. The monetary response to the crisis of 2008 was to save Wall Street, the response today has to focus on Main Street and on how to protect people's incomes.

Now is that chance for Europe and the US to prove they have learnt from the mistakes of Japan and understand the need for swift action to prevent another lost decade of growth. The policy responses we need to see are threefold. Firstly, policies that are aimed at easing the economic pain the containment measures will place on populations over the next 3-6 months. We don't know the shape of these as of yet but the decision by Hong Kong to hand all citizens a cheque of US$1,200 means helicopter money is not off the table. Secondly, central banks will have to act to ensure corporates are supported through this, particularly SMEs in exposed sectors like hospitality. Thirdly, governments will have to enact fiscal spending plans to solidify the recovery for whenever societies start to come back to normal.

Equities are the headline casualty at the moment and are likely to remain volatile until some type of clarity emerges. Apart from equity market volatility, the likelihood is that this crisis will lead to a re-pricing of credit globally. This has already started with the re-pricing of corporate debt in the US. This re-pricing is likely to get worse and holders of low-quality corporate debt are set to take significant losses. In the medium term, it means the abundance of free money that has allowed loss making companies to exist is set to dry up. Longer term, our view is that the policy responses enacted over the coming months will have significant changes on financial markets for years to come, with the likelihood being that a more inflationary environment emerges.

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What should investors do in this environment? We foresee equity markets recovering but we can't put a timeline on when. We also can't say when the pain will end as calling the bottom of these type of events is not possible. For long-term investors we think it is a time for calmness as eventually the policy response will be enough to reboot economies. For shorter-term investors, who are unprepared to tolerate the volatility, there will be bear market rallies and people should take advantage of these if they have a very bearish long-term view.

Our view is that longer-term markets will recover so we are staying calm and waiting for the right opportunities to take our equity weighting up. We don't think it is the time for panic selling. The equity weighting of our multi-asset funds peaked at just above 50% during 2019. We took profits as equities gained during 2019 resulting in a equity content of 40% in early January 2020. This gave us capacity to gradually add more to our equities as stock prices fell over recent weeks and our weighting now is close to 45%. We are prepared to add to this further should we see credible and sufficient policy responses to economic threats arising from the pandemic as in that context current equity valuations will look very attractive.

We believe our equities will weather the storm due to their balance sheet strength and their quality as measured by their ability to generate earnings and turn those earnings into cash. The equity portfolio in our multi-asset fund today generates a cash flow return on capital of 9.4%. Valuations today look extremely attractive on a price earnings multiple of 9.2x and offering a dividend yield of 6.7%. Whilst these are attractive, we understand the outlook for earnings is now completely uncertain and the focus is on getting through the coming period.

We appreciate these are difficult times and aim to keep investors informed. We are setting up weekly information updates focused on market movements, the responses coming from policy makers and any change in our thinking.

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