



Market update

It's time to heed the positive signals

- The market sell-off is rooted in major imbalances, built up over decades
- The good news is that governments are willing to take fiscal action
- Market valuations and technicals are turning positive

Robeco's fixed income teams gradually are shifting towards buying mode. As Victor Verberk, Deputy Head of Investments, says, it might not feel comfortable doing so in the middle of a crisis. But, having been positioned very conservatively going into this crisis, the portfolios are well placed to take advantage of market opportunities.

How did we get to this point?

"Understanding what got us here requires us to look back at the longer-term trend over recent decades – the secular trend. A number of major imbalances have developed in the global economy over the past 20 to 30 years. In my personal opinion, these were caused by central banks being very willing to avoid or soften recessions. Already in the Greenspan era we saw that, as soon as the economy slowed down, the Fed started cutting rates. In doing so, we created a debt supercycle."

"You'll see that this has been the common theme in our Credit Quarterly Outlooks of the past ten years. Corporates, households and countries all started to borrow. Overly active rate cuts pushed rates down, fueling this debt supercycle."

"Then the second phenomenon started, which is the carry trade. That means everybody living in yen or euroland, with

lower yields, started to invest in higher-yielding, faster-growing assets. The reality is, of course, much more complex than this. But, to simplify, in the end we all bought US shares and enabled US corporates to finance share buybacks – and everyone was happy. That is, until last year, when the S&P reached 30 times earnings."

"The consequence of all of this has been that it became more beneficial to invest in financial assets than it was to

Interview
For professional investors
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Victor Verberk
Deputy Head of Investments



borrow and build a new manufacturing plant or to be creative and innovative. As a result, the ratio of investments to GDP is now at lows last seen during the second world war.”

“This all means we are in a gigantic debt supercycle, with too low investments, too few defaults and no creative destruction, in the way that Schumpeter described.”

So, that’s the long history. How did that set the scene for what’s playing out now?

“Looking at this business cycle, I would use the metaphor of medicine given to a sick patient. If the medicine doesn't work, one would try something different. That hasn't been the approach of central banks. In this case, central banks just increased the dose: so, they generated more yield repression and hence QE. In my personal opinion, again, this is a policy error.”

‘This whole sell-off is not about the virus alone. It’s much more about these major imbalances’

“The problem with this economy fueled by rate repression, QE and share buybacks – a non-investment kind of economy – is that something has to give at some point. To quote my colleague Sander Bus, “always expect the unexpected”. The trigger could be anything. It could be a war, a recession, a virus. In this case, it was the coronavirus. The point is that this whole sell-off is not about the virus alone. It’s much more about these major imbalances that have caused, for example, the US to be in a net investment position or minus one times GDP. That means the US owes one times the value of its GDP to foreigners, on a net basis. And now the panic is here and GDP will shrink.”

Is this a recession?

“Yes. We are in the middle of a recession and a deep one at that.”

“So, with this trigger, trust evaporates and the whole cycle threatens to turn around. It means Asian investors are selling US assets, private individuals will not go back into money market pools out of equity and credit, and so on, as this whole cycle deflates.”

“We warned in the last Credit Quarterly Outlook that it’s dangerous to increase QE and to blow this bubble up even further. But policymakers did just that. The coronavirus is the sand thrown into the engine; the engine stops and panic results.”

“I call that three strikes, and the market is out. We had the Fed two weeks ago with a 50 basis point emergency rate cut. That was followed by some poor communication from the ECB. And then the completely unexpected developments with OPEC, which resulted in the oil price plummeting. Three major incidents in a couple of days. And just when we thought we’d seen it all, the Fed cut by another 100 basis points, which nobody had expected. The markets completely lost faith at that point, the selling started and liquidity disappeared.”

“That’s the difficult part of the story.”

Is there any good news in this?

“The good part is the fourth and the last step: the real answer to this situation is fiscal policy.”

“Compared with 2008, politicians this time are much quicker in understanding that this is a precarious situation. Particularly since corporates and SMEs and their own voters are hurting. In 2008, it was the banks and Wall Street – those who had already made a lot of money – that needed to be bailed out, and that wasn’t palatable. Right now, you see a much quicker reaction and it looks as though fiscal stimulus is coming. The proof of the pudding is in the eating of course, but nevertheless that is a little bit of positive news.”

“The second positive news is the speed of the sell-off. The sell-off in both the equity and the credit market has been unprecedented. The speed of the sell-off or the pace of spread widening has been much faster than in 2008. In equity markets, for example, we are down within a month what took us almost a year during the 2008 crisis. So the speed of the sell-off is very fast and that in itself is a good thing.”

“We are already in a recession but that is not the most important point. Equity and credit markets are relatively uncorrelated to GDP changes; you can easily have negative GDP growth coinciding with positive movement from the market, which is always forward looking.”

“Our view is that a V-shaped recovery is possible in the next few months, as we believe we will be successful in containing this virus. The global supply chain that came to a complete standstill will kick in again. Manufacturing plants in China are already back at 60 to 80% production levels. Europe and the US are behind in terms of the virus schedule, and will take a couple of weeks to recover. But it is likely that the contraction in GDP will reverse in the next few months. After that, let’s say in the second half of the year, we expect the fallout – and then the real damage will come through.”

What is your investment strategy at this point?

“When the dust settles, we will see that sovereign debt levels have risen, it will become evident that we are in the middle of a default cycle, a large portion of the energy sector will default, and – unless they get bailed out – airlines will default, and so on. But these are all lagging factors. So, if you wait for the default cycle to start, for rescue packages, you would be too late. Remember that the market is forward looking.”

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“In a recession like this, equities would need to go down by 30 to 40%. We are almost there. US high yield spreads are now at 850. The rule of thumb is to start buying when spreads are between 800 and 1000.”

“So, those are positive signals. Valuations now are positive, technicals are turning positive because of the political support, and the fundamentals are dismal.”

“Our fixed income teams are now slowly moving towards buying assets. It might not feel comfortable at all, because we are in the middle of the crisis, but it's always darkest before dawn. We were very cautious going into this crisis and, now that everybody is panicking, it's a great, great moment to start buying. It's still early days, but my advice is to become bullish now.”

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