soundcapital

The coronavirus turns out to be a "black swan event"

March 2020

- Governments take massive fiscal measures
- Fixed-income trading heavily impacted by low liquidity
- Panic is bad investment advice
- More defensive investments and quality will prevail
- Unchanged asset allocation

Unprecedented monetary and fiscal policy responses

What we have experienced in recent days goes beyond most historical comparisons. The effects of the coronavirus pandemic cannot be compared with previous recessions. They are more like a natural disaster that suddenly unhinged the world. What is particularly remarkable is the speed with which investor sentiment has subsequently gone from greed to panic and ultimately to capitulation. The change of sentiment was accompanied by the highest equity market volatility since the global financial crisis of 2008. In addition, overvalued financial markets and careless investors became victims of this "black swan" event. Such events are indeed unpredictable, but their impact is clearly related to the excesses built up beforehand: "the wilder the party in financial markets, the greater the subsequent hangover". In contrast to the financial crisis already mentioned, today's banking system is, however, in much better financial shape. On the other hand, the large volume of bad debt, is a dangerous threat that is likely to deteriorate further due to the looming recession. A solidly financed economy can survive a recession unscathed, while overindebted economies can break apart in a severe recession. Being aware of this fragile situation, central banks have prevented the occurrence of a recession for years by generously supplying liquidity, thereby also ensuring the survival of so-called zombie companies. In other words, they were "kicking the can down the road". However, while this recession can no longer be prevented, governments and central banks are now primarily concerned with avoiding economic collateral damage. In this respect, central banks and governments are taking solid action: "whatever it takes" no longer only applies to monetary policy, but also to fiscal policy. The USA, for example, are considering so-called "helicopter money". Although the further development of the pandemic is not yet clear, massive monetary and fiscal measures are very likely to put a stop to the depressive tendencies and the financial markets will subsequently recover.

Sound Capital Investment Navigator

Valuation Bonds: -

	low		Yields		high
	- -	-	0	+	+ +
New	X				
Old	X				

	low		Spreads		high
	- -	-	0	+	+ +
New				X	
Old	X				

Valuation Equities: 0

	expensive		Shiller PE		cheap
	- -	-	0	+	+ +
New			X		
Old	X				

	low		Risk Premium		high
	- -	-	0	+	+ +
New					X
Old					X

	Contraction		Leading Indicators		Expansion
	- -	-	0	+	+ +
New	X				
Old			X		

	Euphoria		Risk-Index		Panic
	- -	-	0	+	+ +
New					X
Old			X		

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While wise foresight and quality will prevail in the medium to long term, these principles have enabled us to mitigate but not avoid losses for our clients year to date. In a countermovement, however, first-class investments are likely to recover quickly. For this reason, it is not advisable to temporarily take shelter in supposedly secure assets particularly when volatility is high.

It doesn't come as a surprise that some indicators of our navigator have shifted due to the turbulences:

In respect of fixed income securities: The sharp rise in risk spreads has led to an improved assessment to +. However, our overall assessment of fixed-income securities remains negative.

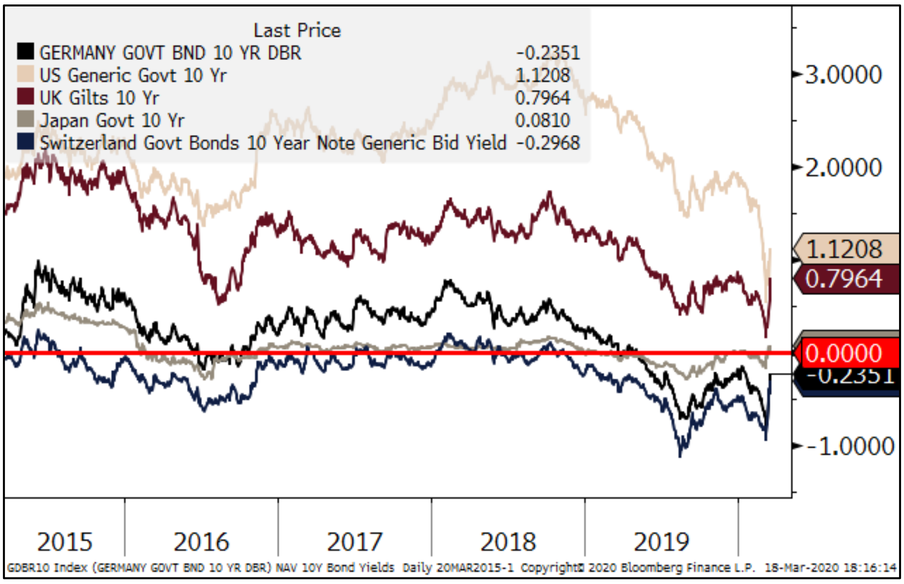
In respect of equities: The valuation measured by the "Shiller P/E ratio" has improved by two notches to neutral and the "Risk Index" increased to ++. However, these changes caused by the current price declines are neutralized by the deterioration in economic "leading indicators", which were lowered to --. Hence, we still assess equities neutrally. As a result, the asset classes change only slightly:

Liquidity remains overweight. Bonds are upgraded from heavily underweight to underweight. Equities continue to be rated neutral, although we are making purchases in order to rebalance the weighting after recent price declines. Alternative investments remain overweight.

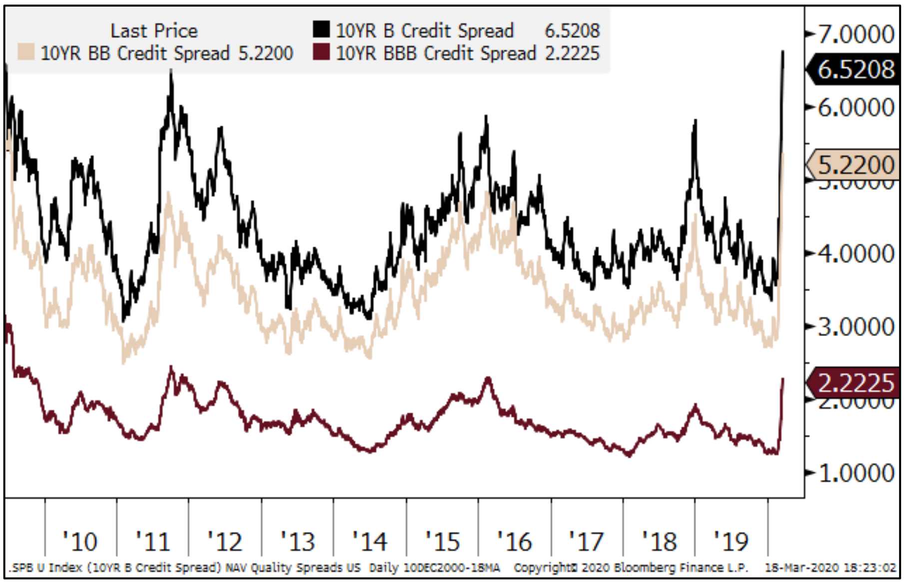
Interest rate level (indicator --) / Spreads (indicator +)

assessment unchanged / assessment increased to + from --

Since our last report, interest rates have fallen sharply, especially for US government bonds. In the course of subsequent sales, however, market volatility has also reached government bonds. A strong countermove caused yields to rise again in the last couple of days.



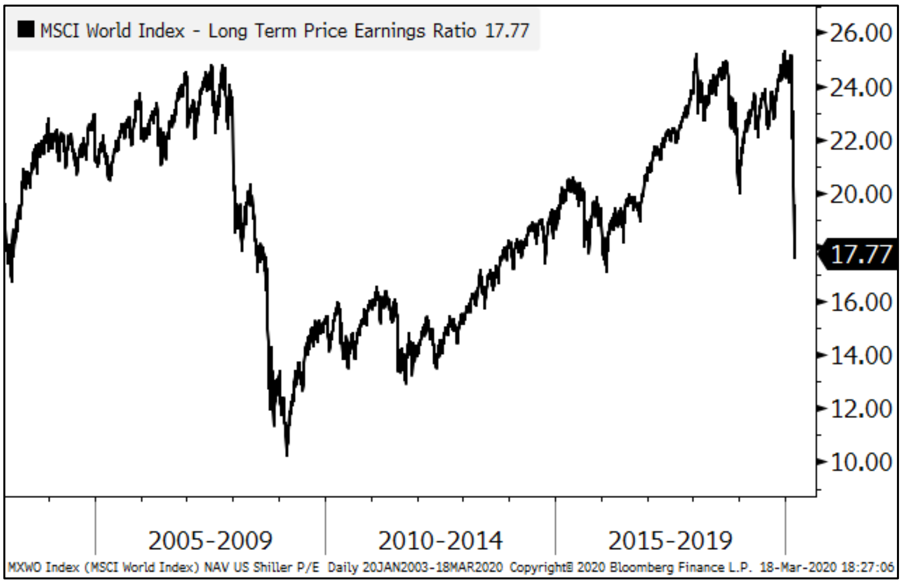
At the same time, spreads of high-yield corporate bonds spiked. The widening of spreads affects high-yield corporate bonds as well as investment-grade bonds. Moreover, trading these bonds has become very illiquid. Thus, we think that unnecessary transactions in the fixed income space should be avoided. We believe that the measures taken by the central banks should lead to a return of liquidity soon.



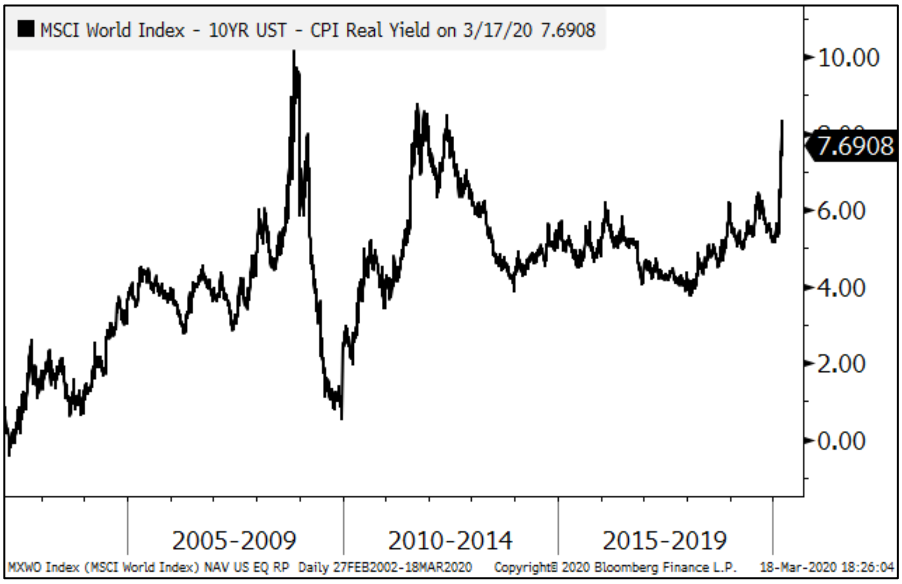
Shiller P/E ratio (indicator 0) / Risk premium (indicator ++)

assessment increased to 0 from -- / assessment unchanged

The sharp drop in prices has brought valuations back into neutral territory as measured by the Shiller P/E ratio.



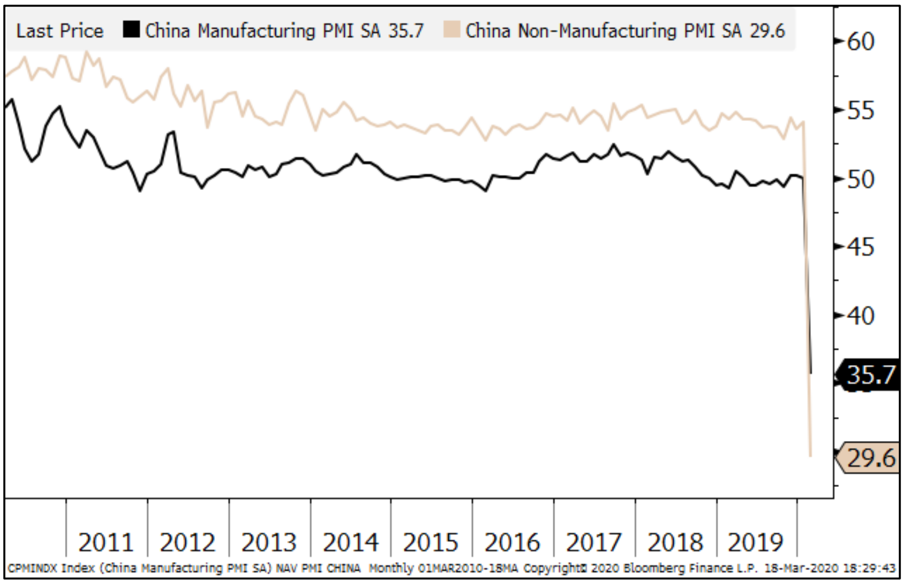
Equity risk premiums have risen even further due to the sharp decline in share prices. This key figure should remain very attractive, even when taking into account an expected sharp drop in profits.



Macro leading indicators (assessment of indicator --)

assessment reduced to -- from 0

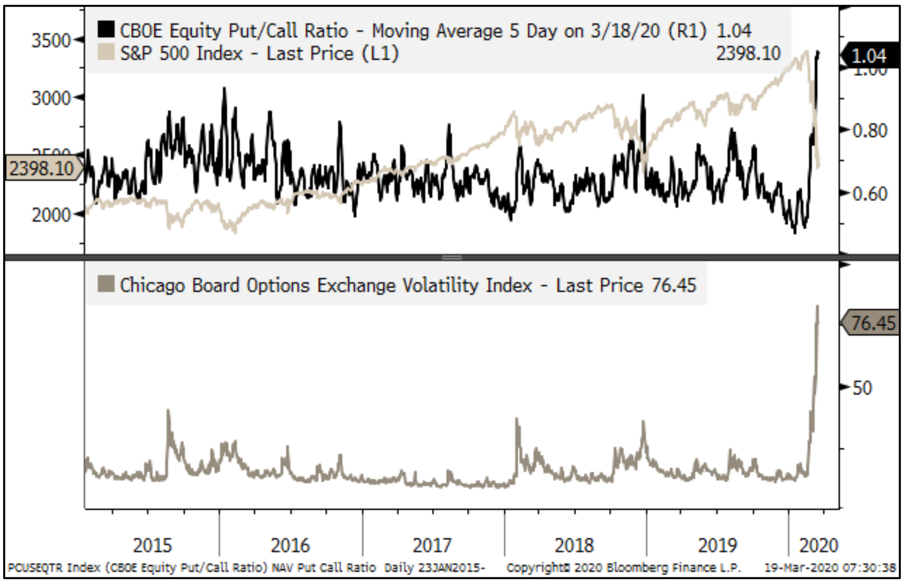
Data available shortly after the end of the first quarter will most likely confirm that the global economies are facing a recession. The success in combating the corona pandemic and the current economic crisis is likely to have a massive impact on the length and extent of the recession.



Risk index (indicator ++)

assessment increased to ++ from 0

In this area, we see values similar to those seen during the global financial crisis in 2008. The course of the put/call ratio and the VIX (volatility index) are showing the extent of the distortions. Accordingly, the countercyclical risk index gives a very positive signal of ++.



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