ACF EQUITY RESEARCH

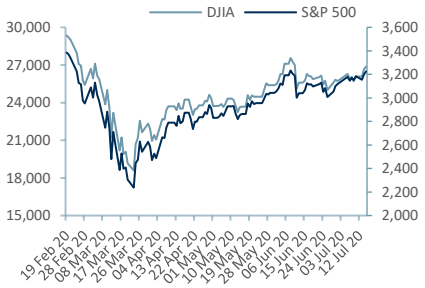
SPOTLIGHT

UPDATE

Friday, 17 July 2020

Covid–19 & Capital Markets

DJIA/S&P↓>8%



DJIA vs. S&P 500 (dark line))

WTI↓>24%

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Global Markets Future Developments

Global capital markets have recovered much of their losses far quicker than anticipated by many, and ahead of any economic revival. On the 10th of March 2020 we began briefing corporates on the impact of Covid-19 on capital markets. In this update we extend the data to support our original analysis, which you can find in this note. Covid-19's effect on the global stock markets was unexpected and unforeseen causing a market reaction that had not been experienced since the 2008 financial crisis. However, a cursory review of history shows us markets always overshoot and undershoot and that even liquid markets can be highly volatile. All markets exhibit a 'boom and bust' trend as part of their stock market lifecycle. With government monetary policy intervention and the introduction of fiscal stimuli, we forecasted a V-shaped recovery in US, UK and Asian capital markets since the end of March/beginning of April. What we have seen over the years since the great depression is that the actual time it takes for markets to recover to a new all-time high has been contracting.

- With global stocks recovering as of mid-April, now down less than 20%, we have emerged from a bear market in a V-shape;
- Aggressive government intervention, monetary and fiscal, has helped the capital markets bounce back;
- Chinese Covid growth rates (new cases) continue to flat line following the first 5 weeks of exponential growth;
- WTI Crude oil prices have improved - currently at $40.7/bbl up from -$2.72/bbl on 20 April 2020;
- Fear of a second wave has not had a significant impact on markets highlighted by the ongoing V-shaped recovery.

Covid-19

Covid-19 has had an unprecedented effect on global stock markets, not seen since the 2008 financial crisis, but its effect on markets has proven to be short lived.

By Friday 20 March 2020 the world entered a bear market with major indices recording decreases of over 30%.

By 20 March 2020 we had entered a bear market with stocks falling more than 20% since the start of this pandemic. The most notable summary of these stock falls is the US Dow Jones index (representing the US's largest industrial companies), which had recorded a 35% drop since 19 February 2020 (when Italy's Covid outbreak became market news and made Covid a 'brand name').

Over the same period the US's S&P 500 fell 32%; Nasdaq, the US technology index, and the UK's leading index the FTSE 100 both contracted by 30%. As of 15 July 2020 compared to 19 Feb 2020 the Nasdaq is up 7% above its Italy pre-virus high, the S&P is 5% below its all-time high, Dow Jones -8%, FTSE 100 -16% and FTSE AIM -10%.

Aggressive government intervention, monetary and fiscal, has been essential in helping the markets bounce back.

However, **this is not the first time** that markets have been hit this dramatically and **nor will it be the last**. With aggressive government intervention (i.e. both fiscal and monetary policy) capital markets always bounce back. Markets overshoot and undershoot their responses to dramatic, indeed any, news.

Below we describe with charts the progression of China's Covid-19 pandemic in conjunction with the declines in US and UK major indices since the beginning of the outbreak, as well as total infection rates from select major economies. We also describe the behaviour of stock markets in the current crisis and the behaviour of stock markets after the 2008 Financial Crisis and the Great Depression.

Growth rates of cases in China are flat lining with rates of almost 0%.

Based on the recent Covid infection statistics, the rate of outbreaks in China continues to decrease. Factories outside Wuhan province (the epicentre of the Chinese Covid-19 outbreak) came back on stream almost immediately after lockdown was eased in China – there was no shortage of demand based on our research in the Chinese market. When looking at the actual growth rates of outbreaks we can see that in China they have decreased significantly as of 14 Feb 2020 growing by only 6% compared to 25% growth rates prior to this date - the change was dramatic and sudden driven by China's isolation and shut down response to the pandemic.

See Exhibit 1: below, which shows cases continue to increase but at a minimal rate of almost 0%. Therefore, even though the number of cases peaked within 4-5 weeks after infection rates turned exponential, infection rates stabilised within 2 weeks after the peak, which we attribute to China's policy response.

Rather than years, the trends and data suggest recovery of financial markets will take months and not years.

We have moved through the period of extreme market volatility associated with the first wave of the pandemic. Financial markets recovered very quickly by any measure in Europe, UK and the US once the exponential growth phase of the pandemic was passed. **Rather than years, the trends and data suggest recovery in financial markets is likely to take months.**

In our view economies will also exhibit a V-shaped recovery, though the downside is that the falls will continue to be steep until the nadir is reached and then accelerate rapidly creating a V-shaped recover.

The resilience in markets is further illustrated by the 2008 global financial crisis. Even though the crisis began on 15 September 2008 with the fall of Lehman Brothers, leading to very significant equity and debt market crashes around the world, US markets started regaining positive momentum towards the end of 2009 and the FTSE 100 recouped all its losses by mid-2010.

The current market crash is consumer led and recovery has occurred rapidly.

The Financial Crash of 2008 was complex and difficult to solve as, at points, it threatened the entire global capital markets system. The current crash is consumer lead and much of the recovery occurred rapidly due to the enormous effort by governments to stimulate growth and to support and re-build confidence in the economy and so the confidence and positivity of capital markets.

Exhibit 1: Selection of key commodities and financial markets

The Chinese growth rate in new cases of Covid-19 flattened out after just 5 weeks after entering the exponential growth phase.

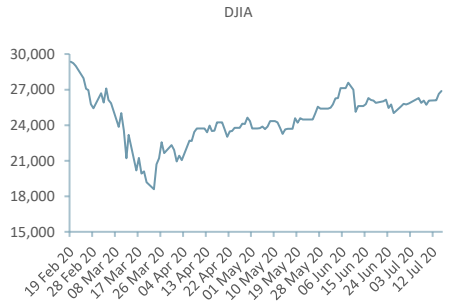
Global stock markets began their crash once the pandemic hit Italy around 19 February, the point at which the Chinese infection rate began to flatten. Italy was 4 weeks behind the peak infection rate at which point infection rate falls off dramatically.

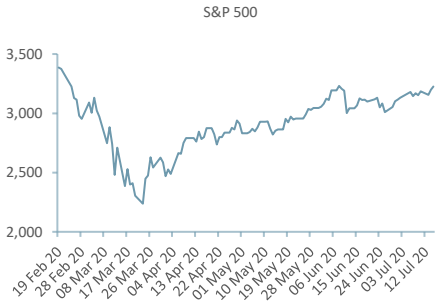
Platinum (Pt) vs. Palladium (Pd) price relative US $/Oz (Pd darker line)

2020 COVID crash – US's DJIA

2020 COVID crash – US's S&P 500

Global markets begin to dive 19th Feb just after Italy announces major infection incident. At the same point Chinese infection rates growth flattens to nearly zero. Our research suggests Chinese factories are already returning to full capacity outside of Wuhan province.

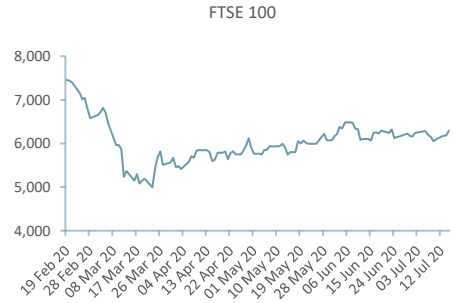


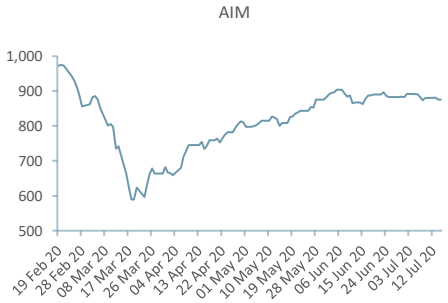


2020 COVID crash – UK's FTSE 100

2020 COVID crash – UK's AIM

The global wave of fiscal stimuli generated an uptick in markets.





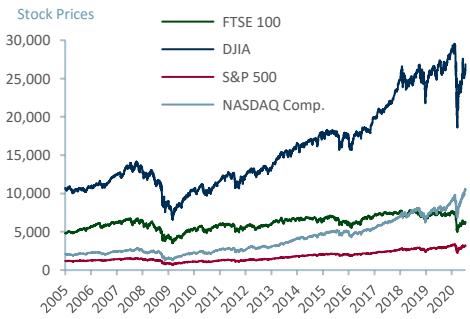
2008 Financial crash

1929 Great Depression

How long will markets take to regain the majority of their losses after the Covid-19 crash? We think it will be months rather than years.

5 years – financial markets recovery period post the 2008 Financial crash.

20 years – financial markets recovery period post the 1929 Great Depression crash



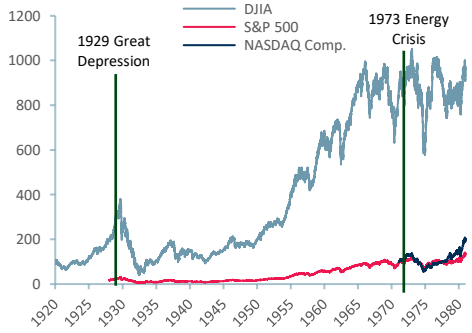
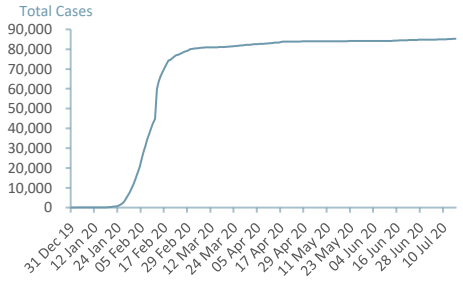


Exhibit 2: Selected regional infection rates

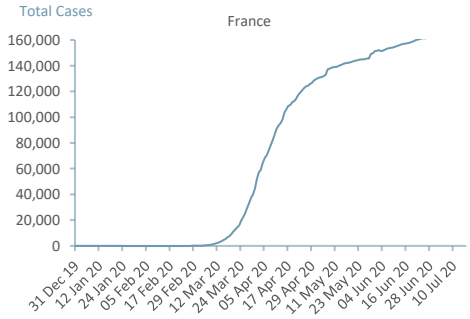
China



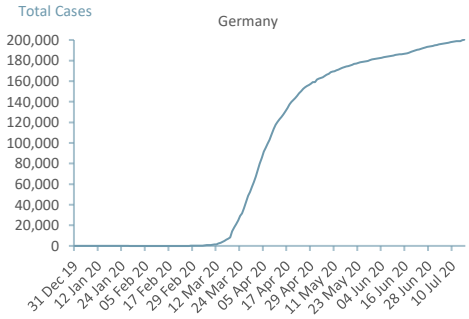
China infection rates (flatten to zero after 5 weeks)

Growth rates in total cases in Europe (France, Germany and Italy) began to level off two months after entering exponential growth.

France

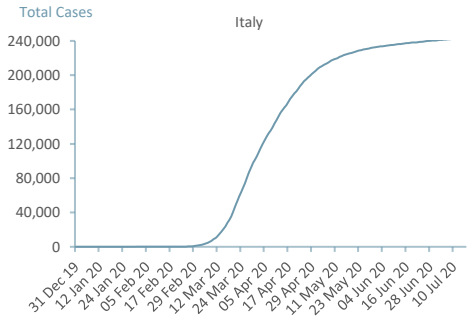


Germany

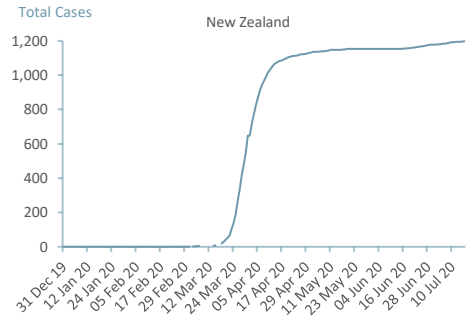


New Zealand began observing Covid-19 cases two weeks after Europe. Cases flat lined within two weeks of entering exponential growth.

Italy



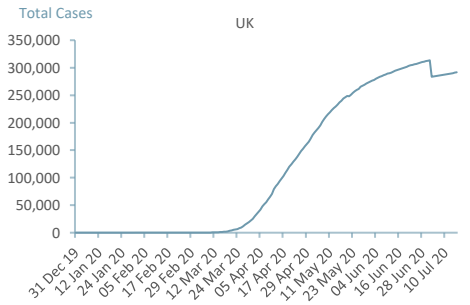
New Zealand



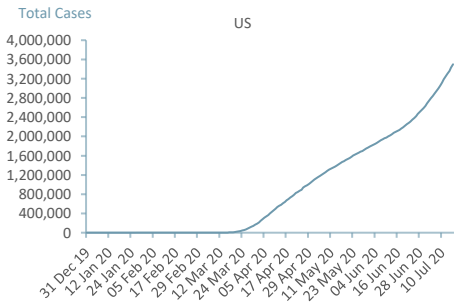
The UK and US also observed cases approximately two weeks after Europe. Both have yet to flatten out.

The US has observed a record number of cases. At the date of this note total number of cases reached 3.6m.

United Kingdom



United States



The US markets 'boom and bust' trend is a part of the stock market life cycle.

Over time, following the great depression, US markets have shown us that the 'boom and bust' trend is part of the stock market lifecycle as is highlighted in Figure 7. On 'Black Monday' 28 Oct. 1929 the Dow Jones experienced a decline of 12.8% and on 'Black Tuesday' a further decline of 12%. It took about 20 years for the market to recover from Black Tuesday however, we saw that during the 2008 financial crisis the FTSE took 2-3 years to recover.

We have observed that the time it takes markets to 'bounce back' or to revive from major catastrophic events diminishes significantly over time.

The speed and breadth at which global communication is growing is increasing the recovery rates of markets

This increase in the rate of recovery of global markets is in large part, in our view, due to global communications investments in the 1980s and the speed at which data is now processed and shared – crashes happen quicker and go deeper but the recovery period is also becoming quicker. We see the same trends in the business cycle, and largely for the same reasons, the cycle gets shorter and shorter and this appears linked to the greater and greater speed, depth, and breadth of global communications and the continued fall in the cost of computing.

Fiscal stimulus will increase disposable income and in turn feed into businesses.

Our team has worked through four global market crashes or corrections of depth and significance. Most of the market recovery has already happened earlier and faster than many market participants expected.

Exhibit 3: **China returns to growth June 2020**

China returns to economic growth during June 2020 as per July stats.

China Economic Data July Releases	Period	Actual	Previous	Consensus	Forecast
Balance of Trade ($bn)	Jun-20	46.43	62.93	58.6	60
Exports YoY	Jun-20	0.5%	-3.3%	-1.5%	-1.4%
Imports YoY	Jun-20	2.7%	-16.7%	-10.0%	-12.0%
House Price Index YoY	Jun-20	4.9%	4.9%		5.0%
GDP Growth Rate YoY	2Q	3.2%	-6.8%	2.5%	2.4%
Industrial Production YoY	Jun-20	4.8%	4.4%	4.7%	4.8%
Retail Sales YoY	Jun-20	-1.8%	-2.8%	0.3%	0.5%
Unemployment Rate	Jun-20	5.7%	5.9%		5.7%
FA Invstmnt (YTD) YoY	Jun-20	-3.1%	-6.3%	-3.3%	-3.3%
GDP Growth Rate QoQ	2Q	11.5%	-10.0%	9.6%	10.2%
Indstrl Capacity Utlztn	2Q	74.4%	67.3%		75.0%

- **Beat**
- Consensus
- Miss

Sources: ACF Equity Research; Chinese economic bureaus.

In addition, our assumption has been and remains that **the economic recovery is driven by the global wave of fiscal stimulus,** which has proven to be correct in both developed and developing countries. Any **fiscal stimulus will increase disposable income** for consumers, which feeds directly into businesses. This in turn will stimulate the rest of the global economy and **historically such changes of outlook have been recognised by wholesale market participants before they have been recognised by other investors.**

Glossary

AiM	Alternative Investment Market (AiM) is a sub-market of the London Stock Exchange and was launched on 19 June 1995 and specialising in smaller companies. The top half of the index is generally considered liquid. The bottom half of the market contains many illiquid stocks. There are currently 830 companies on AiM as of June 2020. At its peak in 2007 AiM was host to 1,694 companies though many of these were or questionable long-term quality.
BBL	bbl is the abbreviation for 'barrel of oil'. In the US and Canada, a barrel of oil is 42 US gallons or 159 litres.
COVID-19	Corona Virus Disease 2019 caused by the Sars-Cov2 virus, is the deadly disease that has caused more than 1m cases and 100,000 deaths world-wide.
DJIA	Dow Jones Industrial Average index tracks the stock performance of 30 largest companies by Market Capitalisation listed on US stock exchanges.
FTSE 100	Financial Times Stock Exchange 100 index tracks the stock performance of 100 companies, with the highest market capitalisation, listed on the London Stock Exchange.
Market Volatility	Volatility is a statistical risk measure of a market. It is measured by taking the dispersion of returns for a given security/stock or market index. Volatility is relative to the time. A fall or rise of greater than 1% over a stated time-period is characterised as a volatile market. A market could be volatile over certain shorter time periods but considered not volatile over a longer time-period.
NASDAQ Comp.	NASDAQ Composite index is comprised of common stocks and similar securities listed on the NASDAQ stock market dominated by so-called technology stocks.
Overshoot	Market overshoot refers to the observation that markets often climb higher than current or forecast fundamental suggest they should. The term overshooting was originally defined for foreign exchange markets responding to a change in monetary supply Dornbusch (1976) and was explained by the theory of price stickiness.

Palladium	Palladium (Pd) is one of the Platinum Group Metals (PGM) within the noble metals group of the periodic table. Its main use is in Platinum-Palladium-Rhodium catalytic converters in the auto-industry (80% of consumption). Another 15% of consumption is accounted for by varied other industrial uses and it has minor consumption uses in dentistry and jewellery.
Platinum	Platinum (Pt) is one of the Platinum Group Metals (PGM) within the noble metals group of the periodic table. Platinum's primary use is in autocatalysis. It is also used in the jewellery industry and is regarded as a store of value and inflation hedge in much the same way as gold as an asset class.
S&P 500	Standard & Poor's index tracks the stock performance of the 500 largest companies by market capitalisation listed on US stock exchanges.
Undershoot	Market undershoot is other side of the model that explains market overshoot. It summarises the idea that markets temporarily overreact when compared with the sticky prices of goods in the economy thereby creating a temporary equilibrium.
V Shaped Recovery	V shaped recovery is a popular visual image used to describe the steep fall and subsequent steep rise in a financial market or economy for goods and services. Variants are W shaped (double dip fall and rise); U shaped (longer period of stagnation or flat growth and: L shaped – long period of structurally lower economic activity.
WTI	West Texas Intermediate (WTI) refers to a particularly high grade, or a mix of, crude oils that are easy to refine and or its accompanying spot price. WTI is a global oil pricing benchmark along with Brent Blend (Brent crude) and Dubai Crude. WTI is produced and refined around Midland, Texas from the Permian Basin and stored at and distributed from Cushing, Oklahoma.

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