Are we there yet?

Not many children are saying that at the moment, but adults in the investment world are asking it a lot for very good reason. Has the relief rally this week marked the low?

Our answer is “probably not” but we could be close. That is based on the view that there are three things that we need to see in this multi-faceted crisis to have the ingredients for a sustainable market rally. Those are improvements in the health crisis, effective measures to alleviate the economic demand crisis and assets at attractive valuations.

The first remains the hardest for investors to calibrate. We can model the likely track of the virus based on what we have seen in China and Italy but we remain very unsure about exactly how it evolves given the variations in the quantity of tests being done to determine the number of cases and in the varying speed of the application of social distancing. Anyone investing bullishly today is willing to guess the speed with which the health crisis is resolved.

The second ingredient has seen some improvement in the last week because investors have seen a series of unprecedented policy responses announced on both sides of the Atlantic. The Fed and the Bank of England have cut rates to effectively zero, are doing more QE (unlimited QE in the case of the Fed) and have cooperated on measures to unglue the plumbing in the financial system. Those things have happened faster than in 2008, and in greater magnitude.

There has also been a fiscal response, unprecedented in size, with components within it that are simply unprecedented. The $2 trillion Federal government stimulus package that is in the process of being passed is 10% of 2019 GDP, and likely a bigger % of current GDP. It includes direct cash handouts to people.

The same ingredients have been put in place in the UK, again including the government paying people directly. This is not the same as paying someone a state pension or unemployment benefit. We have taxes and savings plans to, in theory, fund those. The only fund for these payments is the Treasury and Bank of England agreeing to create money. It fits the definition of “Helicopter Money” that we talked about in a recent report. That has gone from theory to practice in days.

As a palliative to the demand shock affecting the economy (corporates and individuals), it should, provided it can be administered effectively, be a genuine positive and it should mean that the extent of the collapse in the economy is less than it would have been. It may take another round of fiscal measures too, but there is clearly a willingness to do that if needed.

All that said, the third part of the puzzle presents a conundrum. We know significant industries such as travel, leisure, hospitality, and general retail have been decimated by the social distancing policy. We also know that demand in a lot of other areas is dramatically lower. But so far it has been difficult to quantify what that means, except in extremis, for corporate earnings.

<table>
<thead>
<tr>
<th>Region</th>
<th>PE NTM</th>
<th>Relative</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>11.9</td>
<td>(3.6%)</td>
<td>+1.1%</td>
<td>+12.6%</td>
<td>+8.4%</td>
<td></td>
</tr>
<tr>
<td>US</td>
<td>13.2</td>
<td>111%</td>
<td>(0.2%)</td>
<td>+3.4%</td>
<td>+12.7%</td>
<td>+9.5%</td>
</tr>
<tr>
<td>Europe ex UK</td>
<td>11.2</td>
<td>94%</td>
<td>(1.2%)</td>
<td>(0.3%)</td>
<td>+11.5%</td>
<td>+9.3%</td>
</tr>
<tr>
<td>UK</td>
<td>9.6</td>
<td>81%</td>
<td>(7.9%)</td>
<td>(13.7%)</td>
<td>+11.0%</td>
<td>+10.0%</td>
</tr>
<tr>
<td>Japan</td>
<td>11.1</td>
<td>93%</td>
<td>(11.5%)</td>
<td>+2.3%</td>
<td>+9.7%</td>
<td>+11.0%</td>
</tr>
<tr>
<td>Asia Pac ex Japan</td>
<td>10.6</td>
<td>89%</td>
<td>(11.3%)</td>
<td>+7.4%</td>
<td>+16.7%</td>
<td>+5.6%</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>10.2</td>
<td>86%</td>
<td>(6.4%)</td>
<td>+0.8%</td>
<td>+12.2%</td>
<td>+9.2%</td>
</tr>
</tbody>
</table>

Source: MSCI, Factset, Waverton
Indeed as the table above shows, the consensus bottom-up analysts’ estimate for global Earnings per Share (EPS) growth in 2020 is 1.1%. That is down from 10% at the beginning of the year - but we all know that the current number is still wildly optimistic.

But how optimistic is very difficult to judge. Normally we would be monitoring closely the earnings reporting season in two weeks’ time and we would be confident that we could then start to get a better quantification of the impact on companies. But some earnings announcements will be delayed and most managements will have no more visibility on how the health crisis unfolds than financial analysts and investors.

So these numbers may be slow to adjust.

We have looked back at 2008 and can see that the level of earnings estimates dropped around 1/3rd over a period of 4 months to their lows. Today that would imply that we have a further 25% drop at least in the US, and by extension global, EPS estimates. Given the extent of the demand collapse that sounds like it would be an optimistic outcome.

But if we think there is 25% more downside to estimates then the current price-earnings (PE) ratio on forward earnings is not 11.9 times for the world, 13.2 times for the US and 9.6 times for the UK.

Rather it is 15.9 for the world, 17.6 times for the US and 12.8 for the UK.

It’s worth reminding ourselves that the US went to just under 10x in the early part of 2009. The UK was at just 8x earnings.

If we get to those 2008 valuations, even using what are likely to be optimistic projections, that implies a downside of around 40% from here in the market.

However, the good news is that this is happening so fast, the policy response has been so vigorous and believable, that if we get some visibility on the health crisis we are unlikely to reach those sorts of trough valuations because there will be greater confidence in the recovery being swift and robust.

So, we are likely not far from being able to see a market bottom. But we need more visibility on the health crisis and on the damage done to earnings from the policy of social distancing.

Finally, when we do get through this we will be in a world where the interventions in the economy by governments will have altered how we think about the contract between citizen and state. That is a topic for a future paper. One where we will be able to tell the children that yes, we are there, but yes it does look different. We’re not in Kansas anymore.

William Dinning and Jeff Keen
26th March 2020

Risk Warnings

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