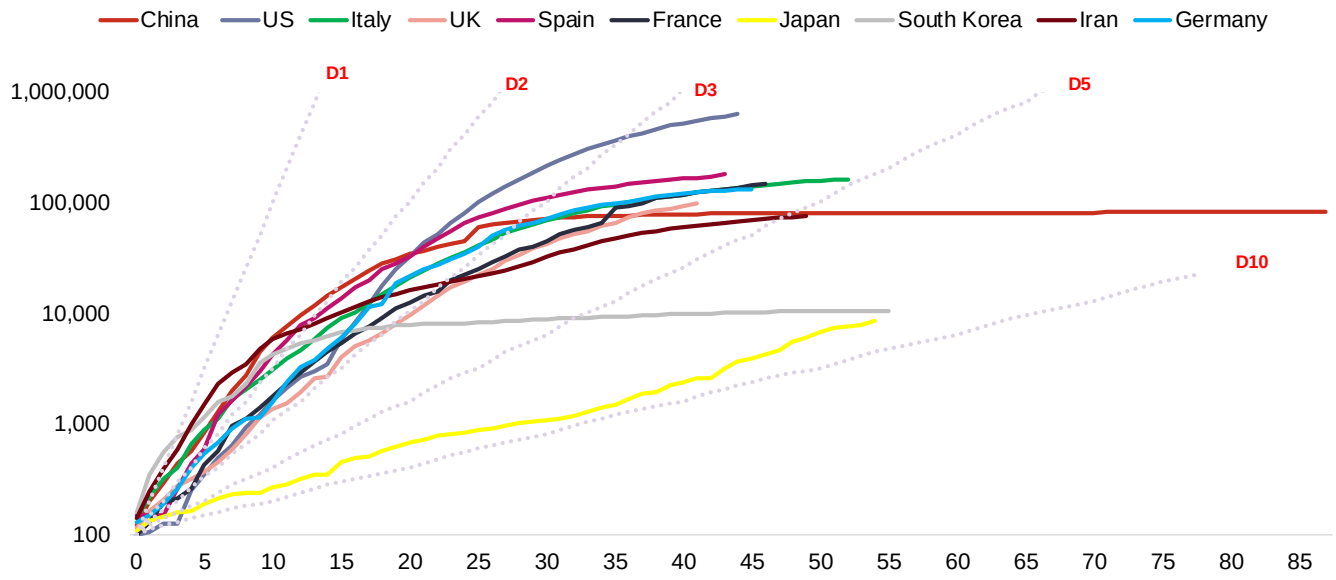
KHIC FLASH UPDATE

Coronavirus VI: The End of the Beginning

The dreaded contagion of the COVID-19 coronavirus is slowing. This "flattening of the curve" (see chart below) is exactly what policymakers had hoped to achieve by the severe lockdowns currently in place across the globe. It is a validation of the incredibly difficult decisions made by these policymakers to put our economies in collective stasis in an attempt to save lives. However, this nightmare is not over. Andrew Cuomo, the Governor of New York state, put it best when he recently quoted former British Prime Minister Winston Churchill: "Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning".

Confirmed Cases – Speed on increase in number of days post 100 cases, Log scale
Data up to 15th April 2020



Source: Bloomberg, WHO, Kleinwort Hambros. D denotes number of days to double cases e.g. D2 is cases doubling every 2 days; D3 is doubling every 3 days.

Nonetheless, over the last few weeks, global equities have recovered partially from the big falls in March, prompting some to call this a new "bull market" (it technically is, given a rise of more than 20% from a trough on 23 March). This is largely because of the "flattenings" which indicate the Coronavirus is coming under control, leading to a reset of "normal" life, but also because seismic levels of fiscal and monetary stimulus have shocked and awed some investors back into risk assets.

These are important factors for optimism. However, we believe it wise to heed the Churchillian evocation made by Governor Cuomo and we are far from out of the woods. Consider the following:

- **The above "flattenings" have occurred due to the enormous sacrifices on normal economic activity and personal lives due to lockdowns. Once they are lifted, viral transmission may well rise again, making lockdowns necessary again.** While many are pointing to Wuhan as a proxy of "normalisation", there is also the case from Hokkaido in Japan. BBC News states: "In late February, Hokkaido became the first place in Japan to declare a state of emergency due to Covid-19… The local government pursued the virus with determination – aggressively tracing and isolating… But now, just 26 days after the state of emergency was lifted, a new one has had to be imposed… Hokkaido has recorded 135 new confirmed

cases." None of the new cases are foreigners, nor have any of those infected travelled outside Japan in the last month.

- Even if the Wuhan experience does prove more a proxy than Hokkaido, there is little doubt a "new normal" will emerge. Social distancing and social prudence are likely here to stay in some form or other: fewer tables in restaurants; fewer passengers on planes and trains; frequent medical testing. **Security protocols following the 9/11 attacks are a reasonable parallel.**
- In the US, about 21 million people have lost their jobs in the last month, taking the unemployment rate to about 17%. This already is well above the 10% hit at the height of the Great Financial Crisis and is expected to rise significantly further. Furthermore, some respected analysts expect US GDP will fall by 40% in the second quarter. Recovery does not occur at the flick of a switch, noted the economist Mohamed El-Erian. He urges investors to consider "lasting frugal behaviour on the…generation that experienced the Great Depression". **This surge in unemployment will likely push consumption patterns to caution.**
- The US budget deficit is expected to quadruple this year to a record $3.8 trillion according to the Washington-based Committee for a Responsible Federal Budget – this is a staggering 19% of gross domestic product. In the group's relatively rosy scenario of a strong recovery, the deficit would reach $2.1 trillion in 2021, and average $1.3 trillion through 2025. This would put overall debt at about 107% of GDP in 2025, exceeding levels following World War II. **This debt certainly leads to slowing of an already feeble trend growth rate in the years ahead.**
- Many companies have little clarity on what lies ahead and are suspending guidance on earnings. Furthermore, many have rushed to raise precautionary cash, by issuing more debt as their profits shrink and their credit profiles are adversely affected. **A Darwinian corporate landscape will likely emerge, where cash balances will be a critical determinant to survival.**

Further to the above, we know from history that bear markets last on average about 18 months – they also tend to be littered with interim rallies. These can be big: the S&P 500 dropped by 42% from the summer of 2008 to the autumn, but then rose by 24% by 2009. Of course, as we know with the benefit of hindsight, the US equity market fell another 28% before the true bottom was reached. History also suggests those that coincide with bear markets are strongly tied with their depth and length. During the financial crisis it took 17 quarters to recoup all lost earnings; it took eight years after the destruction of the Great Depression. **It would be highly historically unusual for the recent trough in global equities hit on 23 March to be the true bottom of this bear market.**

Bottom line

We fervently hope the recent flattenings are permanent, the pros of the vast fiscal and monetary stimulus outweigh the cons, and the trajectory of risk assets carry forward into a new bull market. However, as shown in this piece, **there is plenty to warrant caution – we must be prepared for the worst**. We reduced risk across our multi-asset strategies last month. This month we are bolstering our defensive allocations by purchasing more government bonds. As always, we were guided by our investment process as outlined below:

- **Economic regime:** We are entering a global economic recession. *We know contractions are a poor state for risk assets.*
- **Valuations:** The value case for global equities is difficult to assess given enormous volatility in both price and earnings metrics. It will take some time before we are able to rely on valuation signals.
- **Momentum:** The momentum case is clear and unambiguous with global equity markets across all regions trading well below their respective ten-month moving averages.
- **Sentiment:** This is the one part of our process which arguably would suggest increasing exposure to risk assets. However, sentiment may well continue to deteriorate.

It may well be the worst is already over and our risk reduction was unduly prudent. We would prefer this error as opposed to being overly exposed if the worst is yet to come.

CA26/MAR 2020

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