MONTHLY HOUSE VIEW

MARKETS, INVESTMENT & STRUCTURING – APRIL 2020

MARKETING MATERIAL

FOCUS

OIL PRICE FREE FALL: A DISRUPTING FACTOR IN A TROUBLED WORLD ECONOMY

EQUITIES

ONE OF THE MOST VIOLENT CORRECTIONS IN HISTORY

This is an excerpt of our Monthly House View. Should you wish to receive the full version, please contact us.

EDITORIAL

VINCENT MANUEL

Global Chief Investment Officer,
Indosuez Wealth Management

FOR A FEW DOLLARS MORE?

Dear Reader,

Most investors are scratching their heads when they contemplate the magnitude of the equity correction that has occurred in just four weeks: a straight and breath taking 40% drop in European equities synchronised with the acceleration of new COVID-19 cases in the old continent, and a massive repricing of most assets in the world.

What is surprising asset allocators as well is to see that safe havens no longer play the role of shock absorbers in portfolios.

Is this correction excessive? Is there some rationality behind this? Why should gold start to lose its shine in a bear market with a return of the zero interest rate policy (ZIRP) at the Fed? Why do the markets not react positively to the significant rates cuts decided by the Fed?

The obvious answer is that markets are pricing in a more severe economic scenario and significant disruption in earnings: this is a global reality check on growth and risks, with some excess due to contagious fear. In this context, the significant monetary and fiscal support was not able to calm markets down.

A second answer can be found in investors' positioning and leverage which generally exacerbates volatility. Over the past years, central banks have compressed yield curves and pushed investors outside their natural hunting zone, to chase yields in new territories with more risk and less liquidity. This has led to a significant compression of credit spreads, whilst lower interest rates justify higher equilibrium price/earnings ratios in equity markets. Moreover, cheap money has encouraged the democratisation of leverage as a standard investor way of life, based on QE infinity and the belief that less cyclical economies should mean less cyclical markets. This is now being blown away by a pandemic with far-reaching macro-economic effects.

After a terrible December 2018, and a bull recovery in 2019, 2020 was not starting on high hopes of performance but at least with a relatively calm environment, which encouraged investors to chase after a few more dollars. This pandemic seems to be the catalyst of the reversal of the carry trade, and comes as a reality test for most investors. It tests our nerves, our capacity to bear risk, to cope with unprecedented volatility and a new form of uncertainty; it is a reality test on the sustainability of investment strategies based on the accumulation of leveraged risk premiums. It reminds us that leverage not only increases risk, it also shortens the time horizon of investors and affects their psychology.

There is a lot of rationality in the correction given the negative macro-economic effects of preventive measures and bearish psychologies, and subsequent impact on corporate earnings and default rates. But the magnitude and the speed of this correction are probably explained by the unwinding of this accumulation of leveraged strategies, and this unwinding probably accelerates when volatility and negative returns become unbearable. This is what is called the “Minsky moment”. This unwinding may also explain why not only are equities and corporate bonds losing ground, but also safe havens. So we should not blame it all on the COVID-19. There is certainly some overshooting in this correction, and the explosive cocktail of viral fear and margin calls can only amplify that before markets rebound and find a new equilibrium.

If this pandemic peaks in the next months and if the unwinding does not create more permanent effects on corporates and banks, we are probably not far from that stabilisation point. History tells us that most market corrections take place in a few weeks, followed by a few months of volatility and a sharp rebound thereafter. We can also expect that the European Central Bank's (ECB) announcement of a EUR 750 billion emergency purchase programme should help to anchor anticipations, ease the sovereign spreads and stabilise the yield curve.

FOCUS

OIL PRICE IN FREE FALL: A DISRUPTING FACTOR IN A TROUBLED WORLD ECONOMY

A SIGNIFICANT IMBALANCE

In the midst of dislocated financial markets, oil stands out as one of the most hit commodities. It has lost two thirds of its value since the beginning of the year, not only due to the slowdown of the global economy in the context of the coronavirus (COVID-19) but also to a new war on market shares, opened by the decision of the OPEC countries not to lengthen the agreement on production cuts.

The coronavirus had already hit hard the world's main consumer of oil, China. The country, which was also showing the fastest growth of marginal demand, nearly halted its imports at some point. This effect on demand is now propagating throughout the rest of the world. The unexpected disruption came from the supply side with the disagreement in late February between Russia and Saudi Arabia on cuts of production that were necessary to compensate for the slowdown of demand, in the context of increased US shale production.

In face of a slowing demand, the rise of production implied by the end of the OPEC's quotas is estimated to be as much as four million barrels per day, on a global consumption of around one hundred millions barrels per day. Even though Russia's fiscal balance implies an oil price at around USD 45, our experts anticipate that Russia will be able to withstand this shock and we should not bet too much on a renewed deal on supply cuts.

IMPLICATION FOR US SHALE PLAYERS

The consequences are significant for the entire sector from oil majors to shale oil producers. The general context is nevertheless very different from the 2014-2016 situation, where shale oil was on a strong rising trend with huge gains of productivity and large financial resources. The sector is rationalising, debt levels are in some cases unsustainable, and investors are no longer ready to back companies that keep on promising profitability without delivering.

On top of that, the hedging policy of shale producers only guarantee about 40% of their production at an average level of USD 50/barrel until the end of the year. As those players represent a significant share of the US high yield market, the risk of default is rising significantly and could lead not necessarily to a supply adjustment but to restructurings, consolidation and capital expenditure cuts affecting the entire chain. This partly explains the spread widening of US high yield segment this year that was also seen in 2014-2016.

Lastly, past correlations suggest that a lower oil price is generally associated with an earnings recession, as it happened in the US in the middle of this past decade-long bull market.

IMPACT ON OIL MAJORS

Indeed, the impact on oil companies is massive. Over the last few years, majors have been able to lower their breakeven, increase their profitability by rationalising their investment (relying for example on shared projects with guaranteed profitability such as liquefied natural gas (LNG), and lower their debt ratio to between 20 and 30%. A USD 50/barrel oil price offers most of them 15% Internal Rate Return (IRR) and allow them to cover capital expenditure and cash dividends. None of them can sustain a price under USD 30/barrel in the long term at this point.

Our internal analysts highlight that generally oil integrated majors do not hedge oil price as they generally offset the negative impact of lower price on their upstream business with higher refinery margins. Up to now, none has announced the intention to lower the dividend or to go to a scrip one, but with yields over 10% the market is discounting such an action on a short term. Services are even worse-off, as majors are already considering adjusting their capex for the coming months.

FOCUS

OIL PRICE IN FREE FALL: A DISRUPTING FACTOR IN A TROUBLED WORLD ECONOMY

MACRO-ECONOMIC IMPLICATIONS

From a macro-economic standpoint, a lower oil price should in the end have a positive impact on consumption in developed markets, even though it lowers inflation and therefore makes inflation targeting more complex for policy makers. This positive effect is generally witnessed the following year. On a shorter term view, the negative impact on PMIs and on fiscal balances of oil producing countries may also overcome the positive impact on available income. This is reflected in the significant drop of currencies of oil producing countries such as Russia with the ruble losing 25% of its value YTD whilst sovereign spreads have widened significantly. Oil prices movements are redistributing the cards among emerging markets, mostly in favour of Asian importers.

In the past, a lower oil price was often synonymous with a higher US dollar. This topic was notably one area of research of Paul Krugman 40 years ago, at the time when the United States were oil importers, and this relationship transited through oil inflation impact on the current deficit and subsequent inflation pressure on the currency. However, this inverted relationship has been troubled by a growing production in the US and growing demand from Asia, now meaning that a severe drop of oil price generally reflects slower global growth, implies industrial slowdown and results in more accommodative monetary policy. One could argue that in the past few days, this correlation has became true again; but we think that USD relative strength mostly reflects weaker currencies of oil producing countries, and rising sovereign risk affecting the euro these days.

IMPACT ON OUR 2020 SCENARIO

The oil market collapsed trading from 65 in early January to approximately USD 20-25/barrel (WTI) today with implied volatility trading at unseeing levels.

Our scenario for the rest of the year has been revised with an oil price (WTI) that should stay below USD 35/barrel in the coming months, and potentially some recuperation towards USD 45 only if the Chinese demand increases again in the second half, but this is increasingly unlikely given that demand from mature economies is weaker as well.

We do not expect Russia and Saudi Arabia to end this dispute any time soon, and we expect that confinement measures related to the COVID-19 virus will continue to weigh on demand which contracts for the first time since the 2008 financial crisis.

We should not conclude this article without a word on renewables. The need to decarbonise our energy production is still there, even if economics may for some time not be favourable to green capital expenditure with a lower price of fossil fuels. Better access to capital and a lower cost of capital associated with renewable projects should nevertheless allow them to gain their fair market share in the global offer of energy.

DISCLAIMER

CA Indosuez Wealth (Group) ("Indosuez Group"), incorporated under French law, the holding company for the Crédit Agricole group's Wealth Management business, and its related subsidiaries or Entities, namely CA Indosuez Wealth (France), CA Indosuez (Switzerland) SA, CA Indosuez Wealth (Europe), CFM Indosuez Wealth, their respective subsidiaries, branches and representative offices, whatever their location, CA Indosuez Wealth (Miami), CA Indosuez Wealth (Brazil) SA DTVM and CA Indosuez Wealth (Uruguay) Servicios & Representaciones SA operate under the single brand Indosuez Wealth Management. Each of the subsidiaries, its own subsidiaries, branches and representative offices as well as each of the other Indosuez Wealth Management Entities are referred to individually as the "Entity"and collectively the "Entities".

This document entitled "Monthly House View" (the "Brochure") is issued for information purposes only.

Generally, the Brochure is not intended for any particular reader.

The Brochure has been prepared by the Markets, Investment and Structuring Department of CA Indosuez (Switzerland) SA (the "Bank"). It is not considered being a financial analysis pursuant to the Swiss Bankers Association's directives aiming to guarantee the financial analysis independence. Thus, these directives do not apply to the Brochure.

The information contained in the Brochure is based on sources believed to be reliable, but it has not been independently verified. The Bank does not represent or warrant (expressly or implicitly) that such information is current, accurate or complete. The Bank does neither represent nor warrant (expressly or implicitly) any projection, estimation, objective or opinion contained herein and no one should rely on it. The relevant date for the information contained in this document is, unless otherwise specified, the one indicated on the first page. Any references to prices or performances are subject to change at any time. Past prices and performances are not necessarily a guide to future prices and performances. Foreign currency rates of exchange may adversely affect the value, price or income of the financial instruments mentioned in this document if the reference currency of one of these financial instruments is different than the investor's.

The Bank may have issued or may issue in the future other documents that are inconsistent with, and reach different conclusions than those presented in this document. The Bank is under no obligation to ensure that such other documents are brought to your attention. The Bank may at any time stop producing or updating this document.

The Brochure does not, in any way, constitute an offer or an invitation of any nature with a view to any transaction or a mandate. Similarly, it does not, in any way, constitute a strategy, personalised or general investment or disinvestment recommendation or advice, legal or tax advice, audit advice, or any other advice of a professional nature. The information published in the Brochure has not been reviewed and is not subject to the approval or authorisation of any regulatory or market authority whatsoever, in whatever jurisdiction.

The Brochure contains general information on the products and services that are described therein, which may generate some risk depending on the products and services. The risks include, amongst others, political risks, credit risks, foreign exchange risks, economic risks and market risks. For a comprehensive description of the products and services mentioned in the Brochure, it is important to refer to the related documents and brochures. You are advised to contact your usual advisers in order to make your decisions independently, in light of your particular financial situation and your financial knowledge and experience.

The Entities or their shareholders as well as its shareholders, subsidiaries, and more generally companies in the Crédit Agricole SA group (the "Group") and respectively their corporate officers, senior management or employees may, on a personal basis or in the name and on behalf of third parties, undertake transactions in the financial instruments described in the Brochure, hold other financial instruments in respect of the issuer or the guarantor of those financial instruments, or may provide or seek to provide securities services, financial services or any other type of service for or from these Entities. Where an Entity and/or a Crédit Agricole Group Entity acts as an investment adviser and/or manager, administrator, distributor or placement agent for certain products or services mentioned in the Brochure, or carries out other services in which an Entity or the Crédit Agricole Group has or is likely to have a direct or indirect interest, your Entity shall give priority to the investor's interest.

The products and services mentioned in the Brochure may be provided by the Entities under its contractual conditions and prices, in accordance with applicable laws and regulations and subject to the licences they have obtained. They may, however, not be available from all Entities. They may be modified or withdrawn at any time without any notification.

The Brochure is not intended for or aimed at the persons of any country in particular. The languages in which it is drafted form part of the working languages of Indosuez Wealth Management. The Brochure is not intended for persons who are citizens, domiciled or resident in a country or jurisdiction in which its distribution, publication, availability or use would contravene applicable laws or regulations. The products and services may be subject to restrictions with regard to certain persons or in some countries. In particular, the products or services featured in the Brochure are not suitable for residents of the United States of America or Canada.

The Brochure is published by CA Indosuez (Switzerland) SA on behalf of Entities in the Indosuez Wealth Management Group, whose employees, experts in their respective field, contributing to the writing of the articles contained in the Brochure. Each of the Entities makes the Brochure available to its own clients in accordance with applicable regulations. We would draw your attention to the following specific points:

- in France: this Brochure is distributed by CA Indosuez Wealth (France), a public limited company with a capital of 82,949,490 euros, a credit institution and an insurance brokerage company registered with the French Register of Insurance Intermediaries under number 07 004 759 and with the Paris Trade and Companies Register under number 572 171 635, whose registered office is located at 17, rue du Docteur Lancereaux - 75008 Paris, and whose supervisory authorities are the Prudential Control and Resolution Authority and the Autorité des Marchés Financiers. The information in this Brochure does not constitute (i) investment research within the meaning of Article 36 of Commission Delegated Regulation (EU) 2017-565 of 25 April 2016 and Article 3, paragraph 1, points 34 and 35 of Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse, nor (ii) a personalized recommendation as referred to in Article D. 321-1 of the Monetary and Financial Code. Readers are advised to implement the information contained in this Brochure only after having exchanged with their usual contacts within CA Indosuez Wealth (France) and gathered, where appropriate, the opinion of their own specialised accounting, legal and tax advisers;
- in Luxembourg: the Brochure is distributed by CA Indosuez Wealth (Europe), a credit institution, 39 allée Scheffer L – 2520 Luxembourg, BP1104, L - 1011 Luxembourg, registered in the Luxembourg Trade and Companies Register under number B9198;
- in Belgium: the Brochure is distributed by CA Indosuez Wealth (Europe), Belgium Branch, Chaussée de la Hulpe 120 Terhulpsesteenweg, Bruxelles B-1000, Belgium, registered in the Trade Register BE 0534.752.288;
- in Spain: the Brochure is distributed by CA Indosuez Wealth (Europe), Spain Branch, Paseo de la Castellana 1, 28046 Madrid, Spain, registered in the Trade Register CIF W-0182904 C;
- in Italy: the Brochure is distributed by CA Indosuez Wealth (Italy) S.p.A., headquartered in Piazza Cavour 2, Milan, Italy, entered in the register of banks maintained by Banca di Italia under no. 5412, tax code and Milan trade companies register and VAT identification no. 09535880158, R.E.A no. MI-1301064;
- within the European Union: the Brochure may be distributed by Indosuez Wealth Management Entities authorised to do so under the Free Provision of Services;
- in Monaco: the Brochure is distributed by CFM Indosuez Wealth, 11, Boulevard Albert 1er - 98000 Monaco registered in the Monaco Trade and Industry Register under number 56S00341;
- in Switzerland: the Brochure is distributed by CA Indosuez (Switzerland) SA, Quai Général-Guisan 4, 1204 Geneva and by CA Indosuez Finanziaria SA, Via F. Pelli 3, 6900 Lugano. The Brochure constitutes marketing material and does not constitute the product of a financial analysis within the meaning of the directives of the Swiss Bankers Association (SBA) relating to the independence of financial analysis within the meaning of Swiss law. Consequently, these directives are not applicable to the Brochure;
- in Hong Kong SAR: the Brochure is distributed by CA Indosuez (Switzerland) SA, Hong Kong Branch, 29th floor Pacific Place, 88 Queensway. No information contained in the Brochure constitutes an investment recommendation. The Brochure has not been referred to the Securities and Futures Commission (SFC) or any other regulatory authority in Hong Kong. The Brochure and products it may mention have not been authorised by the SFC within the meaning of sections 103, 104, 104A or 105 of the Securities and Futures Ordinance (Cap. 571) (SFO). The Brochure may only be distributed to Professional Investors (as defined by the SFO and Securities and Futures (Professional Investor) Rules (Cap. 571D));
- in Singapore: the Brochure is distributed by CA Indosuez (Switzerland) SA, Singapore Branch 168 Robinson Road #23-03 Capital Tower, Singapore 068912. In Singapore, the Brochure is only intended for persons considered to be high net worth individuals in accordance with the Monetary Authority of Singapore's Guideline No. FAA-G07, or accredited investors, institutional investors or expert investors as defined by the Securities and Futures Act, Chapter 289 of Singapore. For any questions concerning the Brochure, recipients in Singapore can contact CA Indosuez (Switzerland) SA, Singapore Branch;
- in Lebanon: the Brochure is distributed by CA Indosuez Switzerland (Lebanon) SAL, Borj Al Nahar bldg., 2nd floor, Martyrs' Square, 1107-2070 Beirut, Lebanon. The Brochure does not constitute an offer and does not represent marketing material within the meaning of applicable Lebanese regulations;
- in Dubai: the Brochure is distributed by CA Indosuez (Switzerland) SA, Dubai Representative Office, The Maze Tower – Level 13 Sheikh Zayed Road, P.O. Box 9423 United Arab Emirates. CA Indosuez (Switzerland) SA operates in the United Arab Emirates (UAE) via its representative office which comes under the supervisory authority of the UAE Central Bank. In accordance with the rules and regulations applicable in the UAE, CA Indosuez (Switzerland) SA representation office may not carry out any banking activity. The representative office may only market and promote CA Indosuez (Switzerland) SA's activities and products. The Brochure does not constitute an offer to a particular person or the general public, or an invitation to submit an offer. It is distributed on a private basis and has not been reviewed or approved by the UAE Central Bank or by another UAE regulatory authority;
- in Abu Dhabi: the Brochure is distributed by CA Indosuez (Switzerland) SA, Abu Dhabi Representative Office, Zayed - The 1st Street- Al Muhairy Center, Office Tower, 4th Floor, P.O. Box 44836 Abu Dhabi, United Arab Emirates. CA Indosuez (Switzerland) SA operates in the United Arab Emirates (UAE) via its representative office which comes under the supervisory authority of the UAE Central Bank. In accordance with the rules and regulations applicable in the UAE, CA Indosuez (Switzerland) SA representation office may not carry out any banking activity. The representative office may only market and promote CA Indosuez (Switzerland) SA's activities and products. The Brochure does not constitute an offer to a particular person or the general public, or an invitation to submit an offer. It is distributed on a private basis and has not been reviewed or approved by the UAE Central Bank or by another UAE regulatory authority;
- in Miami: the Brochure is distributed by CA Indosuez Wealth (Miami) - 600 Brickell Avenue, 37th Floor, Miami, FL 33131, USA. The Brochure is provided on a confidential basis to a limited number of persons for information purposes only. It does not constitute an offer of securities in the United States of America (or in any jurisdiction where this offer would be illegal). The offer of certain securities which may be mentioned in the Brochure may not have been subject to registration in accordance with the Securities Act of 1933. Some securities may not be freely transferable in the United States of America;
- in Brazil: the Brochure is distributed by CA Indosuez Wealth (Brazil) SA DTVM, Av. Brigadeiro Faria Lima, 4.440, 3rd floor, Itaim Bibi, São Paulo, SP-04538-132, registered in the CNPJ/MF under number n. 01.638.542/0001-57;
- in Uruguay: the Brochure is distributed by CA Indosuez Wealth (Uruguay) Servicios & Representaciones SA, Av. Luis A. de Herrera 1248 – World Trade Center Torre III – Piso 15 – Of. 1576, 11300 Montevideo, Uruguay. The Brochure does not constitute an offer to a particular person or the general public or an invitation to submit an offer. It is distributed on a private basis. The Brochure and the products it may mention have not been reviewed or approved by or registered with the Central Bank of Uruguay or any other Uruguayan regulatory authority.

We draw your attention to the fact that access to certain products and services presented in the Brochure may be restricted or forbidden by the law of your country of origin, your country of residence or any other country with which you may have ties.

Please contact your banker and/or your usual advisors for further information.

The Brochure may not be photocopied or reproduced or distributed, in full or in part, in any form without the prior agreement of your Bank.

© 2020, CA Indosuez (Switzerland) SA /All rights reserved.

Photo credits: iStock, pixabay.com

Edited as per 20.03.2020.