Searching for a bottom to deploy our long-term themes

- **Equity market decline of more than 30% has priced in some of the worst case scenarios regarding global growth prospects.**
- **At the same time policy makers are bending back over to minimise the damage that the spread of COVID-19 causes to the economy.**
- **In this context, searching for the bottom should be the next step for investors and here we provide a list of prerequisites for a market bottom, see exhibit 1 for summary.**

With all humility, we say that this COVID-19 outbreak and spread has been a true black swan event in our experience. However, we believe that the sharp fall in equity prices (exhibit 2) looks to be overdone. An equity analyst looking at the price chart of S&P 500 index 30 years from now will be left wondering what exactly caused such a sharp decline in the index value in such a short span of time. Indeed, it is the fastest 30% drop on record (exhibit 3) and is comparable to 1930s' experiences prompting some market participants to contemplate a potential global 'depression'. We stay in the camp that sees a short recession rather than in the one that sees a prolonged depression. Yet, given the unprecedented health crisis of COVID-19 with rising number of infected cases globally, flattening of infection curves would be a key prerequisite for the markets to find a well-defined bottom (exhibit 4). However, some of the panic associated with this sell-off seems to have peaked. Implied volatility in equities (exhibit 5) and S&P 500 Food retail relative to S&P 500 Hotels, Resorts & Cruise Lines (exhibit 6) have both reversed course in recent days. Yet, economic forecasters are struggling to identify the potential economic damage. As it stands, there is a huge dispersion within economic forecasts for Q2 2020 and full year 2020. Exhibit 7 shows the latest real GDP forecasts from The Institute of International Finance (IIF). We think markets are not fully taking into account the vast stimulus that is being put in place. As can be seen from exhibit 8, most developed markets have now in place, a strong fiscal stimulus that was never seen before. Bond yields seem to be reflecting the prospects of reflation with the long-end rates moving higher. This was one of the phenomenon observed around equity market bottom in 2009 too (exhibits 9 and 10). Equity valuations have been very attractive compared to bonds. Even compared to their own history, equity valuations have become a lot cheaper both on 12 month forward PE basis (exhibit 11) and on 12 month trailing PE basis (exhibit 12). Of course, valuations are not price catalysts but depressed valuations do improve the risk-return trade-off. When it comes to sentiment, whilst the current level of bearishness on equities is not off the charts, it is definitely at rare levels (exhibits 13 and 14).

In any sell-off, markets bottom out when tail risks recede. In the current context, there are three tail risks in our view – spread of the virus, impact on growth and policy reaction. Yet, we believe that the policy support this time around has been more proactive and that removes one tail risk leaving us with just two. But it might not be unrealistic to expect more than one trough in risk asset prices. However, looking at our checklist (exhibit 1), we tend to believe that we are closer to the trough than to the peak. As such investors need to start thinking about what they want to buy in the potential rebound than what they want to sell. Cyclicals are likely to bounce higher (compared to defensives) when equity markets find a bottom but equally could quickly turn if tail risks intensify at some stage. We tend to focus on our structural themes – 'new economy' and 'consumer facing tech' – that are more defensive and are likely to experience a more durable bounce once the dust settles. **Our equity strategy is to remain overweight the US (vs. rest of the world), large caps (vs. mid and small caps), quality and growth (vs. value).**

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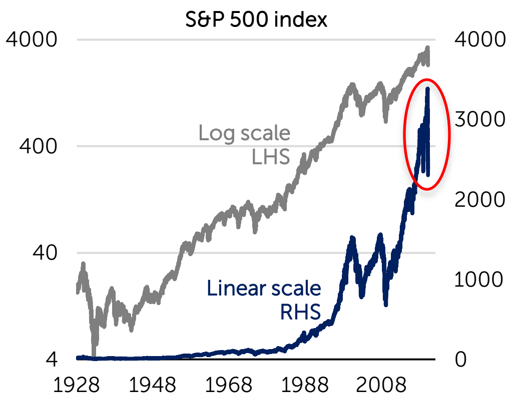
Exhibit 1: Equity market bottom check-list

S.No.	Item	Status
1	A massive price correction	
2	Flattening infection curves	
3	Peak panic	
4	Fading growth uncertainty	
5	Supportive policy	
6	Rising bond yields	
7	Cheap valuations	
8	High bearish sentiment	
9	A turn in the political economy	

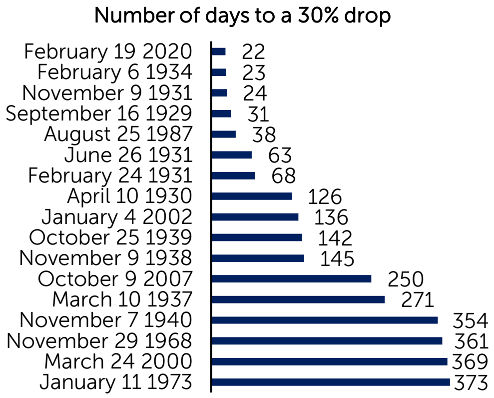
Source: ADCB Asset Management

Exhibit 2: A sharp sell-off ...



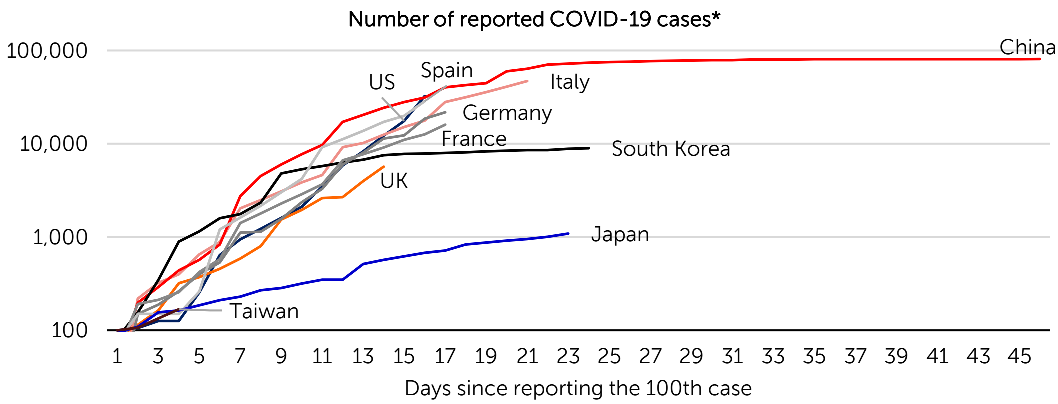
Source: S&P, Bloomberg and ADCB Asset Management

Exhibit 3: ... that is unprecedented



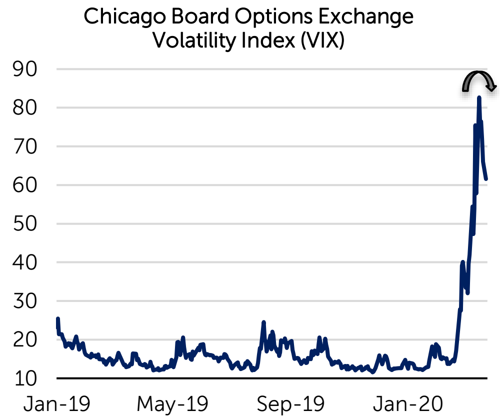
Source: Bank of America Global Research

Exhibit 4: Waiting for infection curves to flatten



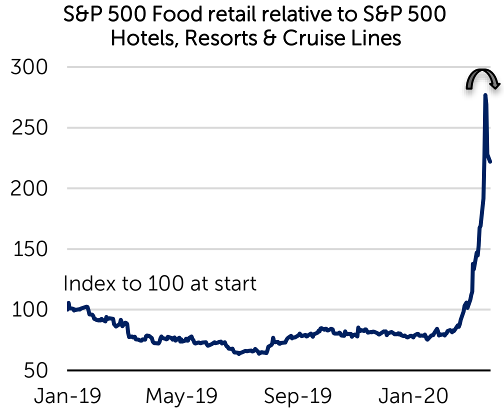
Source: Bloomberg and ADCB Asset Management | Notes: *data as of March 23 2020

Exhibit 5: VIX has receded from its high



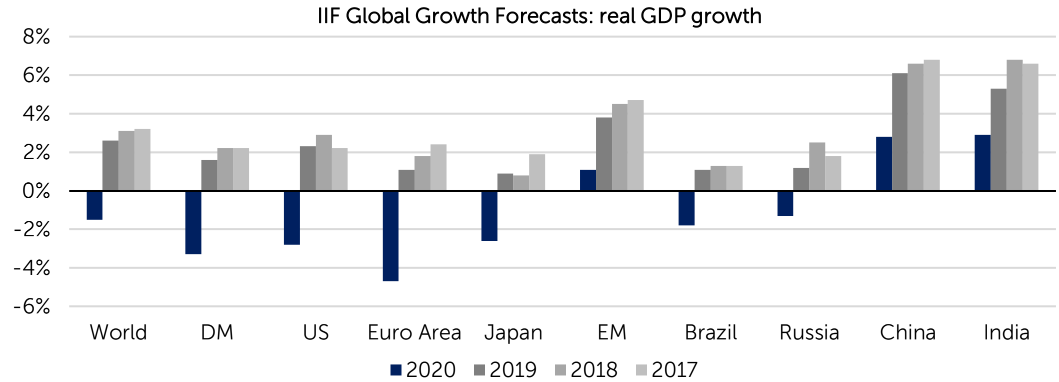
Source: Chicago Board Options Exchange, Bloomberg and ADCB Asset Management

Exhibit 6: COVID-19 panic trade is unwinding



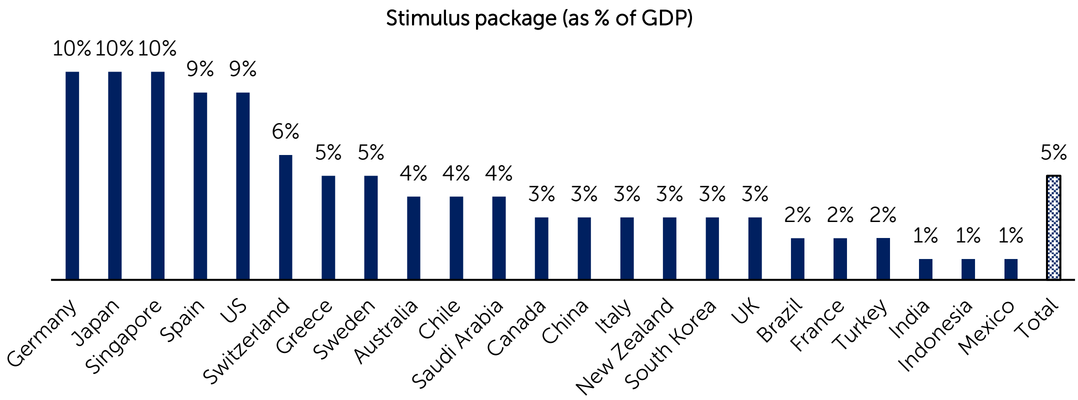
Source: S&P, Bloomberg and ADCB Asset Management

Exhibit 7: Economic output growth to fall across the board



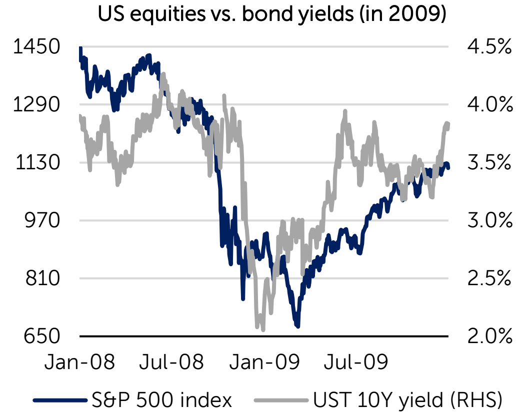
Source: The Institute of International Finance (GMV – Global Recession, 23 March 2020) and ADCB Asset Management

Exhibit 8: Governments have committed to unprecedented fiscal stimulus*



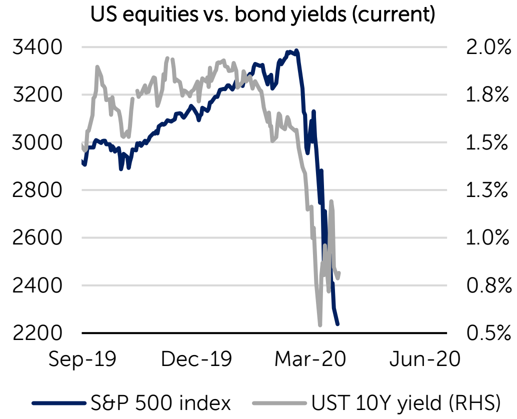
Source: BCA Research, Bloomberg and ADCB Asset Management | Notes: *data as of March 27 2020

Exhibit 9: Back in 2009, bond yields bottomed ahead of equities…



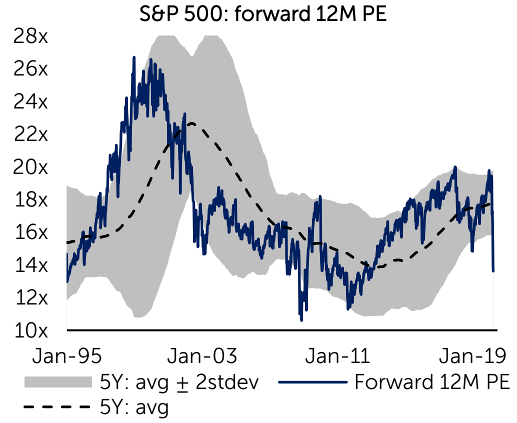
Source: S&P, Bloomberg and ADCB Asset Management

Exhibit 10: … bond yields are rising again



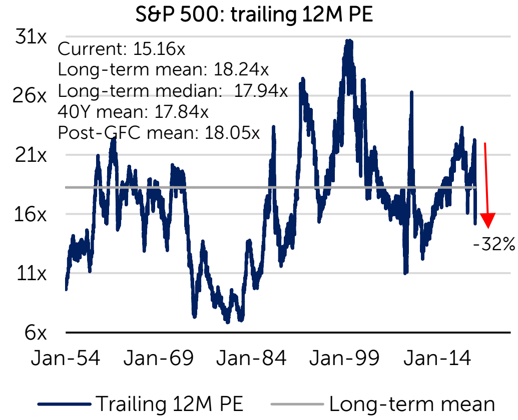
Source: S&P, Bloomberg and ADCB Asset Management

Exhibit 11: Forward valuations have fallen out of the band …



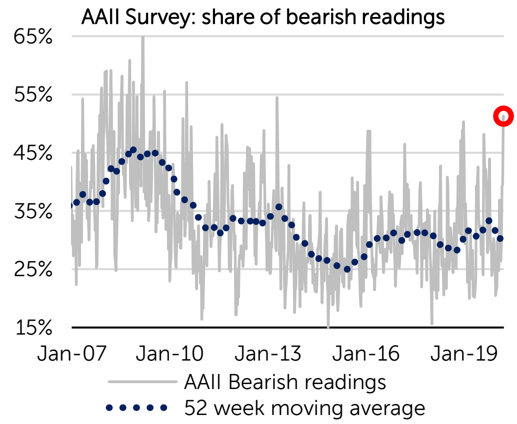
Source: S&P, Bloomberg and ADCB Asset Management

Exhibit 12: … trailing valuation metrics have fallen below their historical averages



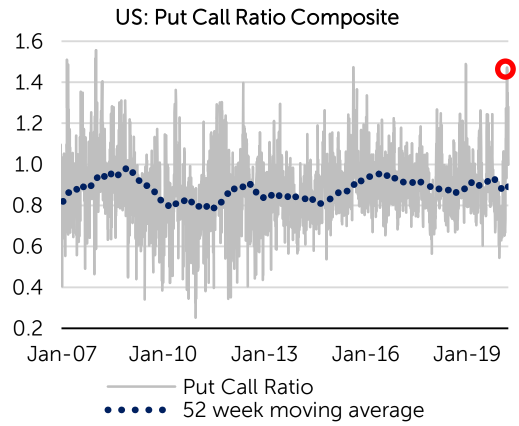
Source: S&P, Bloomberg and ADCB Asset Management

Exhibit 13: Whilst bearishness is not extreme …



Source: The American Association of Individual Investors, Bloomberg and ADCB Asset Management

Exhibit 14: … it is at levels rarely seen



Source: Bloomberg and ADCB Asset Management

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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