

## Which asset class has got it right?

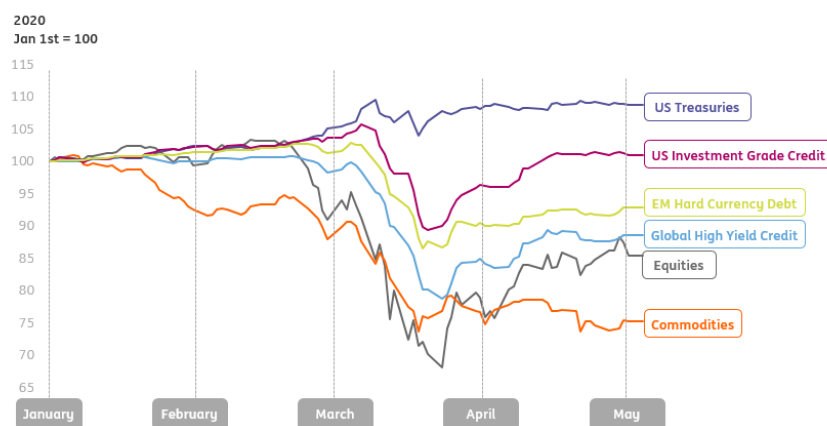
Equity markets have retraced around 50% of their Q120 sell-off and are focusing on the recovery. Credit markets are also performing well. However, sovereign debt, commodities and to some degree FX markets are still pricing recessionary levels. Which asset class has got it right? **This article is from our [Monthly Economic Update](#)**



People wearing medical masks in front of the Wall Street stock exchange in the financial district of New York City

Source: Shutterstock

## Total Return Indices by Asset Class: US Treasuries bid, Commodities offered, Equities and Credit recover



Source: ING, Equities: MSCI World (USD)

### Equity markets: powerful recovery, but questions still need to be answered

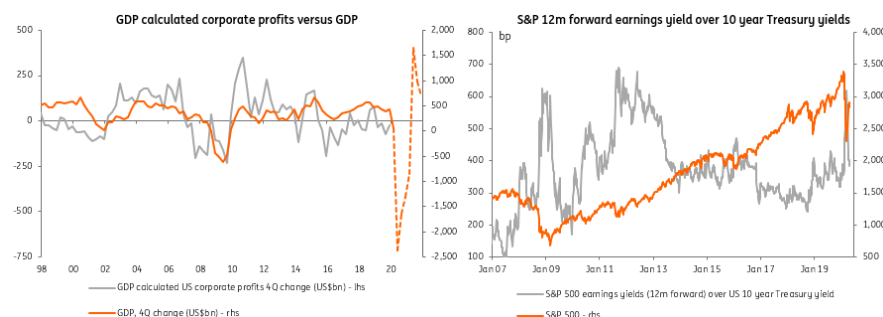
The MSCI World Equity Index has recovered more than half the losses it suffered between February and March. The quicker reaction from central bankers and especially politicians compared to events in 2008/2009 has certainly been appreciated by investors. That 2008/2009 playbook of aggressive liquidity provisions has again been seen as a move by central bankers to push investors out along the credit curve and into equity markets. So far, so good.

The narrative in equity markets seems to be that: i) given the prospect of another Fed-fuelled rally in financial asset prices and ii) such a paltry risk-free rate that iii) investors are prepared to look through the 2020 slowdown and attach more weight to the 2021 recovery. For reference, investors currently price a 20% fall in S&P 500 earnings in 2020, followed by a 25% recovery next year.

Our concern here is that the consensus 20% decline in 2020 US corporate earnings is too optimistic. James Knightley's 2020 US GDP forecast for a contraction of 7% is well below the consensus of -4%. If he is right, the 2020 drop in US corporate profits looks set to dwarf the US\$200-230 billion rolling four quarter losses seen during the GFC crisis.

Equally, the poor transparency for corporate profits – where even Amazon and Apple are struggling for guidance – suggests investors will need some strong compensation for holding equities. Given the recent 35% rally off the lows and the expansion in P/E multiples, the 12-month forward earnings yield on the S&P 500 now offers less than a 400 basis point pick-up over the long end of the US Treasury market. In uncertain times like these, higher earnings expectations or lower valuations may be needed to keep equity markets supported. We err towards the latter.

## US corporate profits look set to fall heavily, earnings yields may not be attractive enough



Source: ING calculations, Macrobond, Bloomberg

## Credit markets: Under-pricing default rates

Credit spreads have shown much the same picture as equity markets with about half of the spread widening being retraced from roughly a month ago. At that time, we had a look at these valuations and concluded that credit markets were pricing in potentially too much economic fallout and consequent rise in default rates. Looking at that same valuation now, by calculating expected default rates from the prevalent credit spreads in investment grade and high yield, we think that markets are taking a rather benign view of future default rates. Framing credit spreads at times of turmoil is never an easy exercise but looking back at default rate levels, the depth of the economic downturn and the accompanying spreads will give us some guidance where spreads could or should be trending from here. This is highlighted in the figure below and backed up by the theoretical compensation for these spreads based on loss, given default calculations assuming 40% recovery rates (i.e. how high should credit spreads be to compensate for certain cumulative or annual default rates).

The graph; the index and the accompanying 1yr default rate that is being priced into spreads (LHS axis) currently shows that after the sharp rally, we are now looking at a scenario where default rates are expected to approach levels seen during the recession in the early 2000s (dot-com bubble) and will stay below those seen during the global financial crisis some 10 years ago. However, the 7% GDP contraction for 2020 in the US indicates that close to GFC style default rates are far more likely.

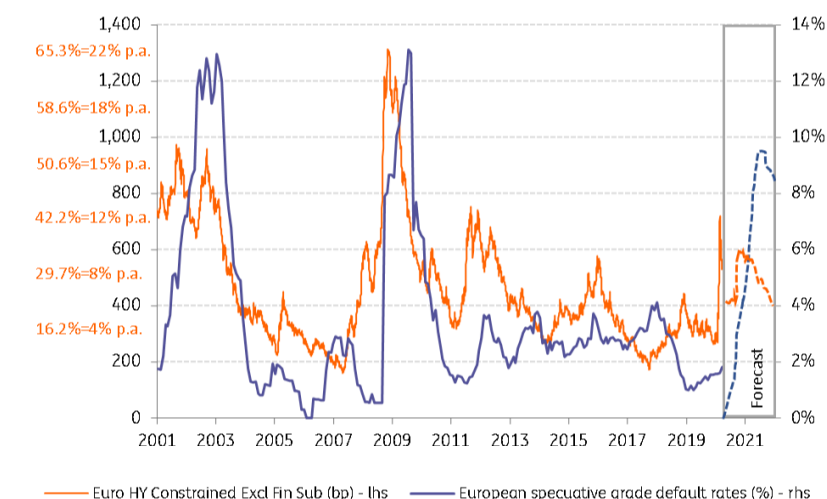
To back that up, Moody's said it expects a speculative-grade 6.8% default rate in 12 months for "a short, sharp downturn" and 16.1% for a "GFC-style" crisis (to compare, default rates peaked at 13.4% in 2008-2009). Hence it is clear that markets are expecting a V-shaped recovery.

Looking at ING scenarios and/or recessionary environments and accompanying default rates, it is safe to say that a 7% annual default rate is a given. The truth might well lie in between the elevated levels of the Global Financial Crisis and that most "optimistic" scenario. This, however, at least for the time being is not a systemic crisis but one that will lead to higher corporate leverage and pressure speculative-grade issuers, as such default rates might well hit 10%, but the GFC peak at c. 13% should be avoided, unless we see winter lockdowns.

Importantly, this crisis has one big difference in terms of financing - markets are not closed. Bank balance sheets too are stronger and will be able to absorb more, and let's not forget government

support measures (not just QE) are also different to the GFC and offer some bankruptcy protection. Hence as stated before, we feel comfortable with default rates approaching 10% but not reaching GFC levels. But that still means credit spreads could widen.

## European High Yield credit spreads versus speculative grade defaults



Source: ING Credit Strategy

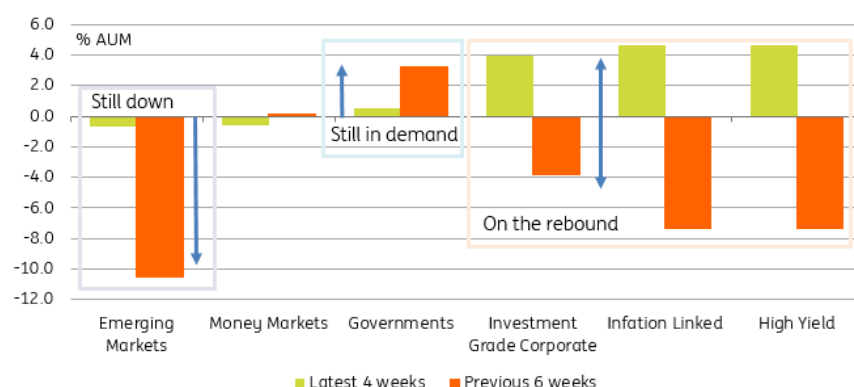
## Bond Markets: Follow the flows, as that is where the money goes to work

The Covid-induced lockdown saw significant outflows from risk assets, especially emerging markets and high yield, but also investment grade corporates. In more recent weeks, flows have gone back into corporates, including high yield. But despite the prior outsized outflow from emerging markets, there have not been marked reverse flows back in. Part of this reflects the contrast with big support put in place for developed market-based corporates through the various support facilities, but part also reflects a residual fear factor that a second wave of negativity has yet to hit emerging markets.

Mild aggregate flows in the money market masks some massive movements. US corporates initially liquidated money market holdings significantly to get access to quick liquidity. But then, the Fed's Money Market Facility was fast-tracked into place as a viable backstop. In the meantime, primary markets had reopened, allowing corporates to have a more traditional route to liquidity and taking pressure of the money market funds.

Meanwhile, in government bonds there was an initial inflow, and that has been sustained, even as rates collapsed to new historic lows (or deeper into negative turf in many regimes).

## Bond flows as % of total assets under management



Bottom line, the support being provided by central banks and governments has calmed the pain in the corporate space. There it still some vulnerability attached to high yield though.

Bigger residual angst is in emerging markets (higher beta). Here, the support comes mostly in the guise of supra-national support, which comes with ratings and default risks as typical riders. Meanwhile, government bonds and money markets remain recipients of residual cash.

Worth also taking note of the cash going back into inflation-linked funds. This is supposed to be a dis-inflationary environment, but with some obvious upside risks to prices in an environment where scarcity does breed spikes in prices in some places.

Flows show the glass as being half full, with stressed scenarios waiting in the wings.

## FX Markets: More inclined towards a slowdown

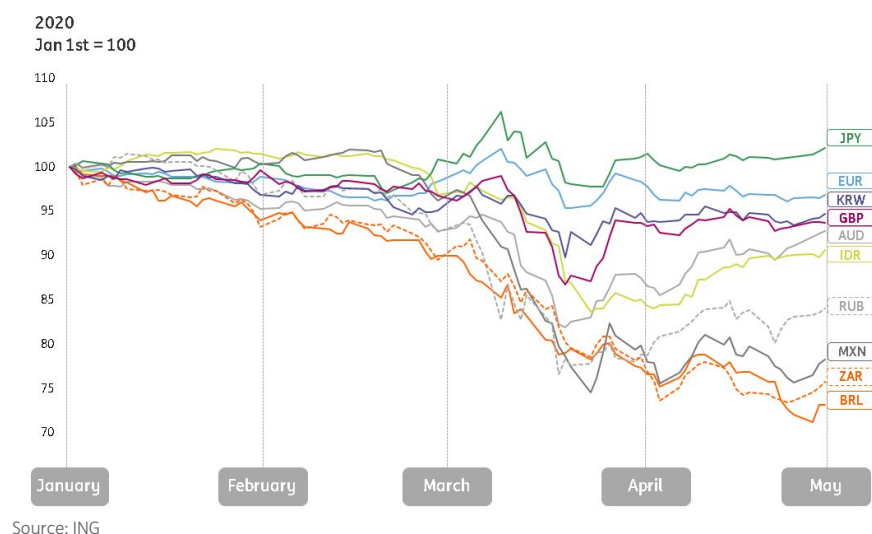
Our generally bearish view on the dollar, particularly in the second half of 2020, is premised on: a) broader signs of the recovery coming through, which will b) allow dollar liquidity to be put to work in higher-yielding and perhaps faster-growing economies.

The signs of that theme already emerging are patchy at best. High beta FX continues to trade not far from its lows and roughly 25% down on the dollar since the start of the year. And it is only the safe-haven Japanese yen, which is firmer against the dollar this year.

Until clearer and more confident signs of a recovery emerge, we think we will see a much more differentiated recovery coming through in FX markets. Based on our [FX scorecards](#), we tend to favour the Swedish krona and Australian dollar in the G10 space, and North Asia in the emerging market FX world (as long as a new trade US-China trade war does not erupt).

Our view of a gently higher EUR/USD this year, culminating in an end-year target of 1.20, again is premised on the global recovery story, but also eurozone fiscal premia being contained largely through ECB actions. Were the latter not the case, the global recovery story would also be challenged (as it was in 2012) and EUR/USD would be ending the year under 1.10.

## Year-to-date performance against the dollar of selected G20 currencies



### Authors

#### Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

[chris.turner@ing.com](mailto:chris.turner@ing.com)

#### Jeroen van den Broek

Global Head of Sector Research

[jeroen.van.den.broek@ing.com](mailto:jeroen.van.den.broek@ing.com)

#### Padhraic Garvey, CFA

Regional Head of Research, Americas

[padhraic.garvey@ing.com](mailto:padhraic.garvey@ing.com)

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