DIVAS ASSET MANAGEMENT AG

ANALOGY OF THE 2020 CRASH WITH PREVIOUS EPISODES

Marketing material for professional investors

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Within a matter of just three weeks, Eurozone equities crashed 40% between late February and early March. Looking at the last 100 years of financial history, we have to go all the way back to the great depression of the 1920's to find anything comparable, although the crash of October 1987 retains the record for the largest one day drop of 22.6%.

The seeds of the crash of 1998 were sewn during the Asian crisis of July 1997 and exacerbated by the Russian crisis which started in August 1998. This culminated in the first hedge-fund blow-up with LTCM going down under in October of that year. From peak to trough, Eurozone equites tumbled 34%.

The 2008/09 crash was triggered on 15 September 2008 by the bankruptcy of Lehman Brothers and troughed 6 March 2009, tanking 45% peak to trough.

Financials, typically at the epicentre of major market corrections, lost some 60-70% in the crashes of 1998 and 2008/09, only to double again within a matter of nine and two months respectively.

We basically don't know how bad the news flow will get, before it starts improving. However, what is key to understand, is that the market is merely a discounting mechanism, massively over- and undershooting its fair value, but always turning long before the negative news flow has peaked. In the months following the market trough of March 2009, the corporate news flow started to deteriorate with numerous profit warnings followed by relentless analyst downgrades. Such market rebounds tend to happen very fast, as could be seen in 2009, when our program, within 9 ½ months returned 177%, with 115 percentage points of this being attributable to Alpha generation.

In 2009, the Markit Eurozone Composite PMI troughed in late February at 36.2, only to recover back above 50 by August 2009 and to 54 by year end. Even though the market only learnt three weeks after the market trough that the March 2009 PMI was a slight improvement on February, it had already snapped back violently by that point.

The Markit Eurozone Composite PMI is likely to trough in May 2020 in the high thirties. The massive synchronous global fiscal and monetary stimulus is likely to see this leading indicator return to expansionary territory of above 50 within the next six months, which could be similar to what we experienced in 2009. The fact that the work resumption rate of the second largest global economy China is expected to return to some 75% by the end of March from the badly depressed 39% seen mid-February, will exercise a counterbalancing effect to the European and US economies which have yet to slow.

The key positive difference comparing the Eurozone of 2020 to 2008/09 is that back in 2008 the financial system at all levels was hugely leveraged, whereas today it is strongly deleveraged. Going into the great financial crisis of 2008, the banking system had the highest leverage in history, while a lot of its capital was low quality convertibles (which today no longer counts as core capital) with hundreds of billions of write downs of toxic paper yet to come. Today the banking system has the highest ever CET1 capital in history, with most banks holding 200-350 basis points of surplus capital above the level required by the regulator.

Corporates were leveraged to the maximum, following the M&A spree from 2004 to 2007 designed to conquer the markets of Asia and Latin America. Today, eurozone corporates have either record low net debt/EBITDA ratios or even net cash on their balance sheets.

Eurozone governments have, over the last couple of years, gradually reduced their debt levels. Even though some countries like Italy and Greece may still have elevated debt levels, their debt service is rapidly coming down, driven by the collapse in interest rates. Any debt issued by Italy over the course of the last 10-15 years which is coming up for renewal, can be refinanced 60% cheaper today. Debt service costs was, over course of the last couple of decades, the key driver for Italy in its struggles to sustainably lower debt levels.

Last but not least, the savings rate of some 13% in the Eurozone is close to historic highs, thus supporting consumer spending.

In the current crash, financials have lost some 50% to 65% of their value within just three weeks. One striking similarity to the trough of the great financial crisis in 2009 was that Banco Santander, at the intra-day low of 16 March 2020, was once again offering a dividend yield of 12.5%. The exact same level we had seen at the trough of 6 March 2009 (the stock was trading at EUR4) and which was subsequently duly paid over the course of 2009. By November 2009 the stock was trading close to EUR12.

Governments in Europe have already pledged more than 1 trillion euros in guarantees or loans to make sure businesses that face disruptions can keep operating and banks will keep lending. Regulators last week dropped capital requirement for Eurozone banks by more than a percentage point to give banks more flexibility to keep credit flowing. The EUR550bn program announced by the German government and funded through its state fund Kreditanstalt für Wiederaufbau (KfW) was set up to ensure unlimited funding for German corporates suffering from current dislocations. Consequently, and unlike that of previous crises, the brunt of the stress in loan markets is likely to be borne by the Eurozone governments, rather than the banks.

Once we see new infection rates in badly affected countries like Italy peaking (Yesterday Italy reported its slowest infection rate since virus first came to light in mid-February), as has happened in China and Korea, normalisation is likely to follow the same path as experienced in the preceding two major crises.

Currency Risk – Non-Base Currency Share Class: Non-based currency share classes may or may not be hedged to the base currency of the Fund. Changes in exchange rates will have an impact on the value of shares in the Fund which are not denominated in the base currency. Where hedging strategies are employed, they may not be fully effective.

Equity: Investments in equities may be subject to significant fluctuations in value.

Capital at risk: All financial investments involve an element of risk. Therefore, the value of the investment and the income thereof will vary and the initial investment amount cannot be guaranteed.