

Finding alpha in the age of Covid-19

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In the age of the lockdown restrictions, I'm reminded of the quote by Socrates, who said that "the only true wisdom is in knowing you know nothing." By embracing that notion, we can begin to accept that fundamental economic and investment theories no longer hold.



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Investment considerations go well beyond the traditional relative risk-adjusted returns comparisons in the age of Covid-19. Yet, unparalleled policy support provides opportunities to find alpha despite protracted risks.

Chief among these risks is that it will be years before GDP per capita (a measure of a country's standard of living) inches its way back to pre-Covid levels. The loss in productive capacity has been profound. So too, the corollary rise in joblessness and unemployment claims.

Economic recovery

The Covid-induced erosion of aggregate demand means that economic growth remains vulnerable, demanding concerted policy support to ensure that the lack of demand does not stifle the rebound in manufacturing activity. This narrative is applicable globally as countries gradually resume factory activity. Without the attendant lift in aggregate demand, a U-shaped recovery will struggle to materialise.

It's curious then that the S&P500 index, a proxy for global equities, suggests a V-shape recovery.

Optimism though is derived more from the unprecedented fiscal and monetary policy support demanded by the abruptness and intensity of lockdowns. The unmatched monetary policy accommodation extended by the Federal Reserve, both in terms of rate cuts and quantitative easing, has permeated across global markets, lifting both equity and non-government credit, and more importantly, setting a precedent for policy intervention.

Ordinarily, a US unemployment rate of 14% – last experienced during the Great Depression – would completely upend global markets. Yet recent labour reports have been largely overlooked, as markets consider the employment data a catalyst for further funding assistance beyond the already huge \$3trn in government support measures. The deteriorating credit quality of borrowers would be otherwise called into question. But, the Fed's purchase of vast quantity of higher-grade corporate debt obligations should embolden investment in companies that are resilient to the economic contraction. Opportunities lie in the purchase of quality instruments issued by healthy companies in healthy industries.

Emerging markets

What then of emerging markets (EMs)? In finding relative value among EMs that still offer higher real yields than their advanced counterparts, it is important to consider whether the sovereign has the requisite political will and necessary fiscal and monetary space to implement targeted economic support measures. There must be due consideration for the long-lasting effects of financial repression, especially in EMs where governments and corporates can borrow at lower, but not zero, rates.

Where the robustness of local capital markets continues to support corporate and government borrowing, but investors are sensitive to volatile pricing, alternative assets should be considered. Auxiliary debt issuance is also likely to offer opportunities as restructuring and reorganisations follow the potential wave of Covid-19 driven corporate failures.

The realisations outlined above are stark. Policy support is a necessary crutch but it's not a panacea for growth, which will be uneven at best as further waves of infections flows through the global economy. Asset class diversification provides stability in times of intense market volatility with much of the activity being driven by opportunistic buying rather than fundamental trades. In this environment, "uncertainty is the only certainty there is and knowing how to live with insecurity is the only security" (John Allen Paulos).

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