

THE COST OF FEAR

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HOW SHOULD WE INTERPRET MARKET REACTIONS TO CORONAVIRUS, AND HOW SHOULD WE RESPOND AS INVESTORS?

We have too little in the way of comparable precedents for the current crisis to be able to draw parallels. But though we don't know much about the virus, looking at the number of cases of infection provides a degree of insight into the epidemic's trajectory.



In China, the transition from an initial phase of exponential growth to a slowdown phase explains why financial markets fared well at first. From February onwards, however, other countries entered their phase of exponential increase in infection rates, and the spectre of epidemic began to loom large in the western world.

The emotions that tend to surface as such risks get closer to home are clearly powerful enough to generate major stress reactions in the public. Those reactions in turn exert considerable pressure on governments and businesses to introduce prevention and control policies that are undoubtedly helpful, but devastating for the economy.

Periods of panic are the mirror image of periods of exuberance: they take their start from concrete facts which are then escalated into extreme anticipations. So before going into the possible outcomes, we feel it is worth putting the recent sequence of events into perspective.

An essential point is that the current crisis constitutes an exogenous shock similar to 9/11 in 2001 and Fukushima in 2011, rather than an endogenous shock like the 2008 credit crisis which can't be corrected quickly or easily.

This suggests to us that, assuming the current health crisis doesn't spin out of control, we should view it as a temporary phenomenon (however damaging) and start thinking as of now about the economic panorama likely to come afterwards and how financial markets will be affected.

THE CORONAVIRUS OUTBREAK HAS OCCURRED AGAINST A VERY SPECIFIC ECONOMIC AND FINANCIAL BACKDROP

For the past five months, the Fed and other leading central banks were back to supporting financial markets (by slashing interest rates and expanding the money supply). The result was to drive markets up to historic heights.

The downside of this exceptional central-bank activism is that the Fed is now reluctant to shift those policies into overdrive. But in an economy in the throes of pandemic angst, markets plummeted dramatically from their previous heights.

From a macroeconomic standpoint, openness to China has hurt Europe more than the United States. Even if the public health issue gets resolved quickly, Europe's more open economy will be more at the mercy of China's success or failure at kick-starting its own growth engine than the US economy will.

HOW HIGH ARE THE CHANCES OF AN ECONOMIC UPSWING IN CHINA?

In opting for a drastic approach to Covid-19, the Beijing authorities resigned themselves to an economic slump in the first quarter. With no revenue coming in, many small companies will be facing a serious cash crunch.

So we can safely assume that providing those SMEs with emergency funding will be a key priority for the Chinese government. But considering the major external and internal constraints in China, we sense at this stage that any stimulus policies will prove rather disappointing, and much less effective than Beijing's response to the 2003 SARS epidemic.

AMERICAN EXCEPTIONALISM GETS A NEW LEASE OF LIFE

The United States enjoys two notable economic and financial advantages. Its economy is still relatively unexposed to China, and there have been large capital inflows into US government paper – viewed as the ultimate safe-haven investment.

This has led to a tumble in US Treasury yields that is also spilling over in part to mortgage rates. The effect will be easy access to financing for US consumers. The country's privileged position should enable leading US growth stocks to extend an outperformance streak, which over the past decade has been fuelled primarily by those companies' robust business models at a time of weak GDP growth and extremely low interest rates.

THE MARKET OUTLOOK

As previously mentioned, the Fed will be reluctant to ease monetary policy much further in the short run. What is more, if a lasting supply shock were to come on top of the demand shock, fiscal spending would be required anyway in addition to monetary policy intervention.

The market instability is likely to persist as long as the epidemic is still in the peak-anxiety acceleration phase outside of China, but this period should ultimately be followed by a period of relief when the public health situation gradually returns to normal. The key issue in short order will be implementing monetary and fiscal policies that are powerful enough to repair the damage to confidence, to supply chains and to investment.

Greater use of the fiscal spending weapon is still far from garnering consensus in Europe and seems constrained in China. But in the US it doesn't appear to spook any of the presidential candidates. This suggests that the United States might be the first country to take decisive fiscal action – and in tandem with renewed monetary policy easing. If that scenario were to materialise, it just might entail significant US dollar depreciation.

It's human nature to seek insurance after a storm breaks, while wishing that you'd done it sooner. But if the public health crisis turns out, as we expect, to be a relatively short-lived shock, the most suitable approach for investors will be:

- (1)** to maintain moderate exposure to stocks and bonds, while actively adjusting that exposure so as at least to cushion the impact of market instability;
- (2)** to make sure that earnings growth at companies in their portfolios remain high-quality and robust in any eventuality;
- (3)** to take advantage of arbitrage opportunities that arise from dislocations, most notably in the corporate credit space;
- (4)** to hold assets correlated to gold prices as a way to protect portfolios from a possible decline in the intrinsic value of the US dollar.

Source: Carmignac, Bloomberg, 29/02/2020

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