Coronavirus and all that

Uncertainties dominate, and the stock market sell-off will continue. Sell equities and high yield bonds. Be careful to separate known facts from hopes and guesswork.

When trying to get our heads around the impacts of the corona virus we need to carefully analyse the facts and not the emotions. The reports of the growth in the number of cases and the casualties are far from reassuring, but we are as of yet far away from the impact of a completely normal wave of the seasonal winter flu.

Our conclusion is that the market sell-off in risk assets is very likely to deepen and we recommend to considerably reduce exposure to stock markets and high-yield bonds. Our preferred holding of equities is 0, zero, nothing.

As an insurance against the uncertainties, safe-haven assets as precious metals will continue to shine. It may also be time to reduce holdings in long bonds, which have gained considerably. Despite negative rates, cash will be king for a time.

Facts first

The corona virus is highly contagious, kills about two per cent of the infected while 81% have only mild symptoms. China appears to have contained the outbreak in the sense that fewer and fewer new cases are detected per day.

The virus was first detected in China mid-December 2019, has spread to approximately 50 other countries with Italy, Spain and Iran being the new critical locations. In each of these countries the contagion seems to be sufficient to keep itself going and WHO may soon call a pandemic, an action which triggers coordinated mitigating actions.

The incubation period is 14 days and the patients are contagious during this period, even if they have no symptoms. In several countries, the health authorities appear to have been taken by surprise by this element.

In the US, the central organisation put in place by the previous administration has for political reasons been dismantled in 2018. It means that the authorities now are scrambling to establish procedures to contain the virus.

The known unknowns

Are the authorities able to contain the spreading of the virus outside of China? The campaign to contain the virus to the Hubei province has been described as draconian, and it is not clear that the authorities in more democratic countries will have the possibility of taking such strong action. Add that Iran appears to have chosen a notably less strict policy towards quarantining infected individuals.

In many cases, virus attacks beginning in mid-winter have weakened as spring arrived on the northern hemisphere, due to the population spending far more time outside of their homes. It is currently unknown if this virus will follow the same pattern.

The Trump administration has decided to restrict communications from the health authorities, apparently for political purposes. This points to a wider problem: we do not know if we receive correct data.

A few things we can hope for

The creation of a vaccine would draw a sigh of relief. Some companies have requested permission to perform tests on humans. Those familiar with this matter say that if standard testing protocol is followed, it can take 12 to 18 months before a vaccine would be ready for mass distribution.

A treatment based on a combination of already existing antivirus medications may arrive much faster. It would not stop the epidemic but might bring the casualties down to fatality levels corresponding to those usual for "standard" winter flu viruses of around 0.10%. Another sigh of relief, but not as resounding as what would happen in the case of a vaccine.

Finally, it would be taken up very positively if it appears that Italian, Spanish, Iranian and indeed all other health authorities have effective plans to contain the virus in a meaningful way, causing WHO to back down from the declaration of a pandemic.

The epidemic is likely to continue until one of the possible mitigating factors gains ground.

Economic impact

So far, no sober analysis has been made of the potential impact on the global economy – mainly because the unknown factors above are still dominant.

However, there is a general consensus that a tangible slowing of growth will influence the economies in at least the first two quarters of 2020.

There appears to be a consensus that the global markets will roar back once there are compelling reasons to believe that the epidemic is about to recede.

This conclusion is built on an assumption that most of the impact will play itself out within a quarter or so, and that the global economy will come roaring back due to pent-up demand.

This is an assumption that barely stands up to scrutiny. The longer the virus is out of control, the deeper the disturbance to global supply chains will be. Conversely, even if there will be a pent-up demand this is no guarantee of a quick return to smoothly functioning production. The V-shaped recovery may yet prove elusive.

Significantly, IMF has very recently released an analysis, stating that if the word economy would be subject to a demand chock half as big as in 2008 and 2009, some 40% of all high yield bonds could end up defaulting due to the stress on the issuers.

It indicates that many companies have used to the low interest rates to gear up their balance sheets and it appears that the debts have not been deployed in order to make investment in the business, but rather to secure high dividends or to buy back shares of the company.

Highly leveraged companies have less resistance towards a period of slower demand and may fold quickly if the slow demand drags on.

What we know about the markets

2019 was bumper year for the stock markets, mainly due to the central banks returning to policies of quantitative easing in order to ward off a moderation in growth. At the same time, bond yields have plummeted in expectation that slower growth will materialise some time in 2020. This has created a divergence in the two main assets stocks and bonds.

Many pundits have pointed to the fact that central banks have little "firepower" in case of a new recession. With interest rates zero and bloated balance sheets, the central banks indeed may have reached the limits of the current monetary policies. Monetary policy initiatives have been disappointing in so far that it has led to investments in securities and properties while business investments have been weaker than hoped. Together with the increasing savings rate of households This has contributed to the anaemic growth over the past decade.

In other words, fiscal policy initiatives are needed to pull the global economy ahead. With German politics in disarray and US politics in election year mode, this will not happen any time soon.

The contradiction between optimistic stock markets and pessimistic bond markets is usually resolved by a visible correction in the stock markets. We see no reasons to expect otherwise this time.

What we know on the basis of our indicators

Since late January our indicator for risk indicators has taken a tumble from 70 to 40 (with 50 meaning ”neutral”) and will very likely continue its tumble throught this week and beyond.

It indicates that the traditional risk assets as stocks and high-yield bonds are likely to be hit further.

Conclusion

The unknown factors outweigh the known factors considerably, creating an asymmetrical risk scenario.

With an already weakening economic growth at a global scale before the Corona virus outbreak, we err on the side of believing in a visible further slowing of growth that may affect the global economy for the rest of the year.

We recommend reduce exposure to equities and high-yield bonds and to take holdings to the minimum compatible with the long-term strategy. There will be days of relief rallies, but the undercurrent towards lower prices is strong.

Long duration bonds have rallied early and strong in 2020 leading in the outlook for weaker economic activity. The corona uncertainty has just provided an additional boost to long bond prices through safe haven flows. It may be time to reduce excess investments in this asset class.

There will be time enough to rebuild holdings as the uncertainties are gradually cleared away. In the meantime, of course it is of course possible to play the rebounds in the markets. Without having facts available, doing so is speculation.

24 February 2020
This document is for investment professionals only