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Coronavirus and all that – the sequel

Uncertainties dominate, and the stock market sell-off will continue. Sell equities and high yield bonds and Buy US long bonds.

We reiterate our view that the financial market sell-off in risk assets is very likely to deepen and we repeat our recommendation 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, the traditional safe-haven assets including precious metals will continue to shine and despite negative rates, even cash will be king for a time.

Coranavirus – it is getting worse

Relative to the common flu, COVID-19 may still prove far more transmissible and to have a much higher fatality rate. WHO last week increased guesstimates for the average fatality rate up to 3.4%, but the data are still incomplete. Most importantly, not enough people are being tested, meaning that cases where the infected person suffers only light symptoms are missed.

On the positive side, China which is the source of the virus, along with South Korea seems to be successful in their draconian measures to contain the spread. Somewhat ironically, this will soon move China's focus on risk mitigation towards protection against the virus to be re-imported from elsewhere back into China.

Italy, the virus hotspot in Europe, is also the petri dish for countermeasure response to the rest of Europe. Italy is the third largest economy in Europe and the region of Lombardia represents 20% of Italian GDP.

Italy's government have announced an unprecedented lockdown of around 16 million people – 25% of Italy's population. Based on the experience from China, such dramatic measures would seem to be just the thing to do. All governments in Europe will be watching if Italy's plans prove efficient.

The United States remain a prime worry. The US recorded its first case more than a month after China swung into action. During that month, the US administration made no preparations for a possible onslaught. Instead the Trump administration had removed US' first line of defence against virus [article]. The administration also delayed pro-active action by downplaying the risk – effectively removing any chance of containing the disease spreading in the US.

Over the past week the virus has gone from 50 to now near 100 countries. The question whether the COVID-19 outbreak should be categorised as epidemic is today merely academic.

About the economy

Since 2018 global economic growth has been steadily moderating ending 2019 at the lowest level seen since the financial crisis. Therefore, 49 centralbanks intervened in 2019 in the largest coordinated action seen since the financial crisis.

As some financial market investors have learned over the past 10 years, regardless of the current state of the real economy, lower interest rates mean asset price reflation - hence stocks rallied.

This dynamic builds on the expectation that the lowering of interest rates/QE will boost the

real economy. By the end of 2019, that had not yet crystalized. The COVID-19 outbreak has brought back the risk of a global synchronised economic recession.

The next financial crisis?

We deem another Great Financial Crisis 2.0 to be highly unlikely. Still, this should be cause for little celebration.

Instead, the global economy faces a potential twin chock to the demand *and* supply side of the economy. This is different from anything seen in the past 50 years. This combination points to the possibility that central bank action of lowering interest rates/QE may no longer effective. Except as a calming influence on markets.

Recent dramatic underperformance of the banking sector stocks is a normal adjustment for a leveraged business faced with an increasingly likely recession scenario, lower income and higher loan defaults.

Yet banks are today much better capitalised, have far less complex risk on balance and buffers to potentially divert capital risk to where it belongs, the shareholders.

It is our view that *THE* problems this time will emerge from companies and hit corporate balances, from investment grade bonds via high yield bonds to corporate equity.

Central banks should adopt a more targeted approach, aimed at bolstering banks in a way that keeps liquidity flowing, not to the banks but to their corporate clients. This Thursday's ECB meeting may offer a first insight in this process, but it is more likely that central banks will need more time.

Our indicators

By mid-February our indicator for risk allocation continued to tumble from an already underweight of risk assets/overweight recession assets to the deepest risk underweight seen in since the Euro crisis in 2011.

In our composite factors for Market Intelligence, we observe continued rising financial stress but not yet extreme levels of stress. We note that the credit risk component is rising from a low level, yet in a way pointing towards further increased credit stress going forward.

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

Conclusion

New data on COVID-19 and economic does not change our view that the unknow factors still outweigh the known ones considerably, creating an asymmetrical risk scenario. Therefore, financial assets are expected to continue pricing in higher risk premia against a worsening economic outcome.

Bonds have been leading stocks by about a month, quickly adapting to the prospect of additional economic slowdown. We deem it prudent to trimming bond holdings for some of the rapid gains and drop in equity prices which has, managed by market, further increased bond overweight. US long bonds have rallied some +23% year to date.

We reiterate to reduce exposure to equities and high-yield bonds and to take holdings to the minimum compatible with the long-term strategy.

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