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Coronavirus and all that – the margin of error is getting narrow

We are getting worried. Not about the progress of the Covid-19 pandemic, but about specific areas of the financial markets. We have a sneaking feeling that the markets are heading straight for a situation where a risk-off reaction could wreak havoc on the stock markets.

Our last call was for a major portfolio change in our missive "the cost of bailout" of 24. March, reiterated in "the safety net is in place" of 26. March as we called on investors to increase risk assets, predominantly stocks, as a minimum back up to benchmark weights. This was after a near two month period where we had recommended to hold no risk assets – only traditional recession assets as US long bonds. That proved prescient, as stock markets have since then regained most of the lost ground.

About the Covid-19

Most countries have taken steps to re-open their economies as the social distancing measures have proven effective. USA and the UK are behind the curve because of their initial dithering and hesitation to introduce lockdowns. USA has begun to open even before all states have passed their peak. At the same time, all kinds of obstacles are being erected to prevent us from knowing the actual number of new cases and deaths.

Brazil now begins to look like an unmitigated disaster due to president Bolsonaro's stubborn denial that the coronavirus is anything but a "sniffle". Perhaps unsurprisingly, recent studies have shown that countries with a populist government have a higher than average coronavirus death rate.

At the same time a study from Luxembourg shows that the virus lives the longest at 4 degrees centigrade, while being subjected to 70 degrees for 5 minutes will kill it. So with higher temperatures on the northern hemisphere together with more people out and about we see a nice fall in the new cases reported. So far so good.

Financial markets

Stock markets have moved up and have more or less recovered since the collapse in late February. The view is apparently that we are heading for a V-shaped economic recovery and that everyone will largely have forgotten all about the Covid-19 within a few more weeks.

Stock markets may even be in another acceleration upwards, as asset managers who missed the market turn in the start of April and who do not want to be caught underweight in stocks at the upcoming end of quarter. Market dynamics may also be helped by speculative short positions as they are squeezed out in a classic "blow-out".

And then what??

Our risk indicators suggest that risk assets are now pricing in a near perfect world scenario with very little risk.

It is becoming increasingly clear that the V-shaped recovery, an economic traditionalist view, is an unrealistic expectation. Most countries are opening gradually and it appears very likely that some kind of social distancing measures will be with us for a long time – at least until we see if the virus comes back in the autumn. An additional complication is the unclear strategy of the US administration which creates a risk that among the industrialised countries, the US may be the last to recover economically. That would act as a brake on the rest of the world, simply because of the size of the US economy.

If we summarise: the stock markets and high yield bond markets have nearly recovered to levels seen before the Covid-19 pandemic. We signalled early this year that the stock markets had failed to discount gathering clouds over the global economy. Given the less than rosy forecasts for the rest of the year, we believe that the disconnect between particularly markets and the reality is growing. Add that simple market technical factors are pushing markets higher and the situation begins to feel distinctively uneasy.

More government support is less likely

A final word on government initiatives to shield the economies from the fall-out of the pandemic. In March we analysed the overall stimulus planned and concluded that it would not be too far off the mark. On one condition, though: that the economic contraction lasted for one quarter and that the recovery would be swift.

What if the downturn drags on? Well, then additional support will be needed as stated very plainly by US Federal Reserve chief Powell latest reiterated at the Peterson Institute on 13 May.

At this moment in time, there seems to be only a limited political appetite for further help. Politicians are beginning to worry about the effects on the debt.

So yes, we do not like the situation. Too many things point in the wrong direction. But we still do not know which specific event that could trigger it.

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