February 24th, 2020

Complacency Finally Challenged

- **Equities finally fall as the COVID-19 spreads beyond Asia**
- **Policymakers remain unsure about the impact on the global economy**
- **Conventional policies can only mitigate the worst effects on activity**
- **We expect a prolonged disruption to the global economy and markets**
- **Institutional investors continue to show appetite for ESG investing and private debt**

Slowly but surely, the markets are waking up to the challenges at hand. Last week's market action was more in keeping with the consequences of a possible pandemic. Equities were down (-1.1%), government bond yields fell (US 10 year 1.47% -11bps) and gold ($1665) was higher.

Entering a new week, equities look likely to fall further in the coming days while the gold price appears to set to continue its strong run. US Treasuries are in strong demand from investors with yields across the curve down 25-30bps over the past month. We suspect that credit markets will see raised volatility as investors fret that lower-quality credits, particularly amongst high yield which could see some stress if global growth dips more markedly. We expect investors to show more patience with emerging market debt where investors are more prepared to take the view that there is considerable scope for an easing of monetary conditions.

As we had suggested last week, we thought it would take the virus to land at the door-step of the West before equities would start to take fright. With an increasing number of cases in Italy but also spreading to other parts of Europe and the United States investors are beginning to realise that COVID-19 is not just an Asian supply line problem but a significant challenge to the global economy.

The IMF continues to doggedly work with a 'revised' forecast that suggests just a 0.1% hit to global GDP growth for the first quarter. "In our current baseline scenario, announced policies are implemented, and China's economy would return to normal in the second quarter. As a result, the impact on the world economy would be relatively minor and short-lived," said the head of the IMF. To be fair, they say they have other forecasts for a more extreme disruption to global activity from COVID-19.

The hit to the global economy appears to be well beyond a simple 0.1 percentage point off global growth. The authorities in most parts of the world simply had no decent plan to deal with such a problem. Doctors have bemoaned the fact that most governments were not prepared to see the gravity of the damage a pandemic could do to the economy nor how high the risk was of it occurring.

Policymaking for the crisis in too many major countries is on the fly. It is quite frankly being made up as they go along. How, for example, can passengers be repatriated on a flight back from Japan with both infected and unaffected people on the same plane? Coordination between countries is haphazard- one doctor told me that only 500 hospitals in the world are networked together. Just opening up lines of communication to control the virus, and ultimately defeat it are all challenges ahead.

Investors should prepare for a prolonged period of uncertainty. We can hope that the world is plain lucky and either that the virus doesn't leak into more corners of the world or that we can quickly find an antidote. However, most experts suggest that finding a safe credible solution is likely to take at least a year. While the Chinese may be pushing for a return to normality, the seeming reacceleration of cases in some parts of China and a switch to a 27-day quarantine on cities affected must inevitably delay things.

Governments can provide support for their economies, but it can only go so far. Tax cuts are worthless if people are stuck in their homes, fearing for their health. Central banks will have to encourage credit relief for companies hit with a significant fall in their cash flows. The hope is always that there will be a snapback in activity, but we worry that we will have to wait some time and that a snapback may be very muted. The world will, in some way, have changed.

If the virus isn't enough for us to cope with, we still have to deal with the hair-brained musings on monetary policy from some Federal Reserve Governors. Fed governor Lael Brainard last Friday said that she supported a very aggressive stance on monetary policy in the next downturn. By aggressive, she was advocating zero interest rates and capping of long-term interest rates. Such a policy should stay in place in her view until the country achieves full-employment and an inflation rate of 2%. We can't believe that central bankers still want to push on with a clearly flawed policy. The reason that the equity market near collapses every time someone mentions an increase in interest rates is because the market's recent rise has few long-term supports. Companies don't use the low interest rates to fund their long-term growth; they use them to fund share buybacks. The reason that earnings are growing is share buybacks and a tax cut that has brought little second round growth.

Watching how some of the largest pension funds in the world invest often gives good insight into how institutional investors are moving their asset allocation. The California Public Employees' Retirement System (CalPERS) one of the largest pension funds in the world continues to switch away from equities and actively managed equities while switching some of its cash flow to direct lending. In December, CalPers announced it was firing most of its external equity managers. Some of the money is going to their own index strategies managed in house and around $5bn has been earmarked for direct lending. CalPers continues to target a 7% return, and private debt has shown good consistency in achieving those kinds of returns in the past ten years. If some on the Fed Reserve Board have their way funds such as CalPers will be struggling to hit their 7% aspirational returns particularly if most Treasury bonds are yielding close to zero.

The trend amongst institutional investors to focus more and more on green investing is alive and well and spreading into bond and credit markets. The New York State Common Retirement Fund said recently that it had invested $800 million in climate-related investment strategies, focused on fixed income and private credit. In another development, the PFA, Denmark's largest pension fund with DKK560 billion ($82 billion) in assets, is launching a pension product that allows participants to invest their retirement savings in climate-focused investments.

Finally, another major institutional investor **Warren Buffet issued his latest annual letter**. The letter caused more of a stir about his allusion to succession planning than to any significant change in his views on markets. However, in terms of investment style nothing changes. Warren Buffet continues to advocate that investors buy companies with strong fundamentals, strong earnings power. At the core of his strategy is always to think longer term…. A good mantra for us all but very difficult for most investors in these troubling times.

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