February 17th, 2020

Be Prepared

- **Listen to the medical experts as much as the economists**
- **Financial markets discount the likely stimulus but not the challenges of CONVID-19**
- **A US 10-year bond yield below 1.60% discounts trouble, but equities are up 3.1%**
- **Investors should be prepared for a more prolonged disruption to global activity**
- **Policy makers are expected to deliver easier fiscal and monetary policy**

As I sit in Singapore, it is difficult to communicate what the threat of COVID-19 means to daily life. I read economists based in London or New York blindly write that a few cuts in interest rates and a bit money printing will sort it all out by the middle of the year. Financial markets discount the complacent view that the West can enjoy the easy policy conditions that will inevitably come with the virus and yet avoid any significant medium-term disruption to their respective economies.

I would encourage readers to listen to medical experts as much as economists. Balancing the views of medical experts against the economists, we have our doubts that the crisis will simply blow over in a couple of months. The impact of this crisis is not just about the unfortunate victims, but the disruption to everyday life as countries try to contain the spread of the virus. Those controls could remain in place for some quarters to come. We are not advocating that investors sell everything and living under a rock. It is about risk mitigation and being prepared for a very challenging time.

I am privileged to be resident in Singapore, one of the medically safest places in the world. This is a naturally clean country with an enviable health care system, and yet the virus is taking its toll. Everything you do is about sensible risk mitigation. Many in the workforce are working from home; face-to-face meetings with people are seen as 'risk events'. Many public events are being cancelled as are regular church services to sensibly control the spread of this terrible virus. The Singapore Tourism Board estimates that there could be a 25% to 30% drop in visitor arrivals this year.

So, for just a moment, let's listen to a medical expert.

"The emergence of a pathogen with pandemic potential, moving rapidly from country to country and requiring an immediate and large-scale response in countries…..it is impossible to predict which direction this epidemic will take…… We call on all governments, companies and news organizations to work with us to sound the appropriate level of alarm, without fanning the flames of hysteria." WHO Director-General speech, February 15th, 2020.

And that final point is an important one. Unless investors are sensibly alarmed and prepared, then, what could ensue is a hysterical and emotional response that leads to a marked selloff of financial markets.

Ask yourselves the following questions.

1. As an investor, am I taking an inappropriate amount of risk with my wealth now relative to my longer-term goals?
2. Have I got sufficient liquidity for my extended everyday needs?
3. Am I overly exposed to risky assets that could see significant selloff if weakness in global GDP is more pronounced and extends for a lengthier period than economists currently forecast?

The global economy was already showing signs of weakness coming into the COVID-19 crisis. JPMorgan estimates that global manufacturing and retail sales contracted in December completing the weakest quarter in five years.

The January **US** retail sales report released last week was below expectations. The economy may only achieve a modest 1% GDP growth in the first quarter ahead of the likely hit from the consequences of the virus. Also, there are some signs of a weakening in the labour market data. The JOLTS report of job openings showing a further 5.4% decline on top of the 7.8% decline in November.

The **eurozone** economy seems again to be slipping back into the economic doldrums. Real-time data reports were disappointing in recent weeks, especially in Germany and France. Weaker German factory orders signal more pain to come. Eurozone industrial production fell 2.1% month-on-month in December down 4.1% year-on-year. This, in turn, fed through to a flat quarter-on-quarter GDP growth result for the region in the fourth quarter, +1.2% year-on-year, the slowest growth in six years. The French and Italian economies contracted.

At this point, economists do not foresee a recession in the eurozone in 2020. They expect GDP growth to be at the same pace as last year. Yet forces are finely balanced. The ECB's Executive Council meets on March 12th but is likely to hold off on any further easing until there is more clarity on the impact of COVID-19. The euro has already taken on board the news and sunk to $1.0843, the lowest level against the US dollar since May 2017. Further weakness is entirely plausible.

In **Japan**, the first business sentiment survey taken since the virus hit activity saw a sharp fall. The small companies' diffusion index for the outlook fell to 41.8 from 45.5. This coming week sees the fourth-quarter GDP report released, which is expected to show a drop of 4% quarter-on-quarter mostly a reflection of the impact of the government's imposition of the consumption tax hike.

The financial markets' confidence that all will eventually be well is based on the hope that we will soon signs that the spread of COVID-19 infections is abating and that policymakers will deliver a stellar boost to the global economy.

Policy responses are already underway, but to date, they have been quite modest. The Central Bank of Mexico cut rates by 25bps last week, Brazil the week before. The market expects the central bank of Turkey to cut rates by 50bs this coming week. But all eyes are on the Chinese to see if they announce a significant stimulus. To date, the announced measures have been mostly technical, providing liquidity with a further easing of monetary conditions and liquidity injections for the SME sector. The Singapore government is expected to announce a significant fiscal boost to the economy in the annual budget due on Tuesday.

For the moment the money markets are not pricing any Fed rate cut hence those countries with dollar-pegged currencies will have to find other ways of stimulating their economies rather than hoping for some relief through a rate cut. Like Singapore, we could see more Asian governments minded to providing a fiscal boost to their respective economies in the coming weeks.

We wouldn't rule out a rate cut from the Fed; however, they will be concerned that cutting interest rates again for external reasons we leave them with even less ammunition to fight a domestically generated slow down.

When you look at the performance of financial assets, it is difficult to square a US 10-year bond yield of just 1.58% (down 33bps year-to-date) with global equities returning +3.1%. Technically speaking, you could say that the 10-year bond reflects the expectation of the monetary stimulus in the form of both a lower Fed funds rate and further quantitative easing. It may also reflect the fact that investors are prepared to hold onto their equities but buy insurance through adding to their US Treasury positions. The last time that the US 10-year bond yield was below 1.60% the S&P500 was trading at 2800-2900, significantly below today's 3380 level.

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