February 10th, 2020

Viral Complacency?

- **Robust equity markets suggest some complacency amongst investors**
- **We have low confidence that the spread of coronavirus is yet under control**
- **Economists are busy slashing their 1H 2020 forecasts, corporate profit forecasts at risk**
- **Bonds have discounted trouble with 10 year below 1.60%**

It is tough to gauge whether financial markets are being complacent or patient. With equities up modestly year-to-date implies that investors believe that the threat from coronavirus will abate within a matter of weeks. In the last few weeks, as I have travelled through London and the Middle East, I have found limited awareness of the extent of the impact of the virus on everyday life in Asia. China has a lockdown in many cities, and in cities less impacted, residents have massively adjusted their daily lives. In Singapore, the government raised the risk to level amber, advising residents to exercise significant care in the way they go about their daily lives.

Economic data will be slow to pick up the extent of the damage to economic growth. However, already we have seen firms such as JPMorgan cut their global GDP forecasts for the first half to 1.3% at an annualized rate the weakest growth since the world financial crisis. Economists expect China's growth to drop to 1% this quarter from 6.3%.

A more sanguine view of how things will play out depend on two crucial assumptions; firstly that we will see the peak in the outbreak of coronavirus in the next month or two, and secondly that policymakers will respond with sufficient policy easing to stimulate the global economy back to health.

Given that China is the epicentre of the crisis, a country that many commentators are suspicious of the transparency of the scale of the impact of coronavirus, **we are surprised that investors are backing the positive (quite frankly less likely outcome) that all will be resolved within a couple of months.**

We simply don't believe that there will be an elegant snap back in economic activity, particularly in Asia. People's lives are being particularly interrupted by the virus, leaving householders to cancel things that they would ordinarily do whether that is travelling eating out, attending conferences or meeting people for business. The legacy of the virus, whenever it is brought under control, may linger longer than many economists are forecasting/hoping.

While the coronavirus is not proving to be the deadliest at a mortality rate of just 2%, relative to say Sars at 10%, the pace at which it is has spread is startling. The virus is reported to have killed 902 people surpassing all the Sars deaths in only three weeks. The WHO Director-General has warned, "we may only be seeing the tip of the iceberg".

For the moment the financial markets appear to be taking the view, held for much of the past decade, that bad news is good news. The assumption is that the bad news will shortly pass and that policymakers will be forever helpful. Help is at hand - the Chinese authorities delivered a package of stimulus measures last week that for certain mitigate the risks of their being a damaging lack of liquidity in the system. Other Asian central banks are set to ease with interest rate cuts expected from Korea, Malaysia, and the Philippines. The central bank of Thailand pre-emptively cut interest rates by 25bps last week.

In the asset markets, the resilient year-to-date performance of the equity markets contrasts with the marked slip in commodity prices. Commodities ex gold are down 9% while equities are flat to up. Also, ten-year bond yields in the US price trouble in the economy, with yields at the lower end of the recent trading range at 1.56%.

We believe that life could get more challenging for equities in the coming week as companies start to reflect on the impact of the coronavirus on activity. After all, China is 30% of global manufacturing. Supply shortages must ensue, and companies selling to China will undoubtedly see at the very least see a pause in demand. Companies will hesitate to give updates on trading waiting for some trend to develop. As we go through the annual results season, there will be less focus on last year's trading and more the hanging off every adjective used to describe the challenges since the start of the year. Fiat Chrysler commented last week that the impact of coronavirus on the supply of components from may force them to close one of their European factories.

It can only be a matter of time before more companies allude to the challenges that the impact of the virus presents. Several Chinese companies have promised to start to go back to work this coming. If that doesn't happen then the markets may begin to get more worried. Some companies have already delayed still further their re-opening, including apparently Apple component manufacturer Foxconn.

Part of the reason for the robust performance of equities year-to-date is that US economic data has continued to come in in line to better than expectations. Any fears that the US labour market would begin 2020 on a weak note were allayed by the healthy payrolls number released last Friday. For January, 225,000 new jobs were added, better than market expectations. The slight jump in the unemployment rate to 3.6% can be ignored because it was driven by a rise in the participation rate, and not by job losses. Nonetheless, there was hardly any reaction from the US bond market. Due to the anticipated weakness in global, any short-term signs of economic strength will be ignored by the market - as was the case here. US ten-year yields are still below 1.6% at the time of writing, a level not commensurate with a labour market that seems to be humming along without serious risk.

Ordinarily, we look to the macro environment to be the driver of interest rates. In this context, the coronavirus would count as macro, as would the payrolls number. Supply issues in the bond market tend to be more transitory. However, the recent announcement of the US treasury new issuance in the 20Y segment of the curve stands to potentially alter the dynamics of the curve. The sheer amount of new bonds coming to market is likely to cause a drain away from short-dated bills and into the new longer-dated bonds. The Treasury will offset new issuance at the long end by reduced issuance of short-dated paper. By some analyst estimates, this will cause the 3-month Libor rate to potentially decline below 1.5%, from the current level around 1.7%.

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