Sparinvest

Monthly comment by
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# Coronavirus fills the news

The global corona outbreak was the number one news story in February. In the beginning of February, the equity market seemed to shrug off the outbreak but then took the largest and most abrupt plunge in recent history when the number of newly infected people in Northern Italy almost exploded in mid-February. Thus, the MSCI World (EUR) dived by more than 13% from 19 February to end-February.

Most virologists have urged the population not to fear the coronavirus more than seasonal flu. Regardless, semi-panicking behaviour is reported, with people hoarding facemasks, disinfectants, kitchen paper towels etc.

Actually, it increasingly seems that fear and panic behaviour should be feared more than the virus itself. The streets of China are empty, and images of weary eyed Chinese nursing staff with facemasks easily make it to the front pages of newspapers in the West. Surely, the situation in China is serious, but we should keep in mind that cases of coronavirus are predominantly found among elderly people (+60) with one or more health problems, such as high blood pressure, bronchial infection, diabetes, cancer and asthma. Almost no children have died from the virus.

The first mortality estimates from China have likely been on the high side as people showing symptoms have mainly been subjected to testing, whereas infected people showing no symptoms have been rejected in the Chinese health chaos. Even though the virus has infected thousands of Chinese, the number of new infection cases seemed to have stabilised at end-February.

However, infection cases outside of China still seem to show an exponential trend, with Iran being severely hit, along with Italy and the U.S. It is reported that corona was registered in the U.S. already in mid-January, meaning that the virus has had quite some time to spread locally.

## Economy takes severe, negative blow – in an upturn phase

The countries hit the hardest by the virus until now have seen quite a drastic capacity utilisation decline in industry due to staff in quarantine, closed schools (Japan), postponed flights and cancelled restaurant reservations. Part of this activity will of course move online or be deferred until the virus is accepted as a basic economic condition. However, until then I foresee that the virus will restrain economic activity and that its peak is yet to come.

In that sense, the coronavirus impact on the economy may be deemed a permanent negative blow to consumption and a negative blow to supply (plant closures and downturn in orders). Luckily this blow has set in during an upturn phase in the world economy, shown by the renewed rise in the OECD's composite leading indicator (LCI) about three months ago. The situation would have been even more serious in my view had the world economy seen a CLI reversal after a long-term upturn period and then been hit by the blow to supply and demand as described above.

## Difficult times ahead for China's Communist Party

The coronavirus outbreak will also affect the global supply chain where particularly China has played a central role since becoming a member of the WTO. China's position was already under U.S. criticism before the outbreak due to both Trump's fixation on "America First" and the trade policy, which set out to renegotiate trade deals with China in particular. China is increasingly being viewed as a problem for the Western World, and Trump's tariffs have already caused widespread relocation of production from China to other Asian countries that have kept a lower profile than China.

This development is accelerated due to the coronavirus outbreak and adds to undermining China's global trade position now that the world economic vulnerability towards a much-centralised Chinese role in the supply chain has been revealed. Other things being equal, the western society and its businesses will in future seek to diversify the geographies of their sub-suppliers even more, to the detriment of China.

The Communist Party's handling of the virus outbreak has also called forth internal criticism. In China, internal criticism comes at a price, and it is indeed a token of massive and widespread frustration when the rank and file Chinese men and women in the healthcare system and elsewhere risk their careers and freedom by airing their frustrations over the handling of corona on social media. In an economy where the total debt/GDP ratio has grown historically fast to a historically high level, and where the Chinese, thanks to the unprecedented rise in living standards, have accepted restricted civic rights, the Communist Party may only maintain its legitimacy if it keeps delivering on its promises.

Current events may therefore potentially destabilise China and undermine the role and responsibilities that the country has taken on in the international community. China-derived economies and goods (such as Australia) and the entire raw material complex therefore appear to be vulnerable in coming months.

## Central banks take action

Central banks are facing a major challenge. Traditional monetary easing will not incentivise consumers to visit more restaurants. Needless to say, the infection risk is indifferent to lower interest rates. Nevertheless, consumer-related businesses are facing large-scale liquidity challenges if the infection continues at its current rate and consumers take a defensive wait-and-see stance.

The Federal Reserve resolved to cut the rate by 0.5% at the beginning of March to counter the problems outlined above. The rate cut was widely awaited, but nevertheless, the USD depreciated in response to the news. We are also likely to see minor interest cuts in Japan and from the ECB and the Bank of England in the first days of March.

By contrast, PBOC in China has opted to counter liquidity problems faced by particularly small businesses by extending credits through the banking system; the risk of credit default would otherwise have been impending due to the economic slowdown. The Chinese approach will probably be a more relevant and focused solution to the problem but also one of the most relevant in mixed economies like the Chinese, where authorities through the banking system have more direct control of the national economy.

## Fiscal policy revival ahead?

Authorities in Italy, China and Hong Kong are now the first to start warming up to fiscal easing to support the economy in response to the negative chock from the coronavirus. The significant rate cut has eased the states' burden of funding large public expenditure. Markedly lower, long-term yields are also the bond market's way of signalling the acute need of a large-scale, targeted effort.

At no time since the financial crisis has the need – from a macroeconomic theoretical point of view – been imminent for fiscal policy support (in the form of a temporary rise in public expenditure). Bond investors should thus not consider the current yield trend as a one-way trend. If large-scale infrastructure or health packages are announced, long-term yields may very well rise again, which would also be in line with the CLI development.

## Joe Biden post-Super Tuesday candidate

The U.S. presidential primary election day Super Tuesday, which is held by selected federal states, is over. The most interesting battle stood between the Democratic candidates, with Bernie Sanders, the number one favourite at the beginning of February, running against a number of other, more moderate candidates. The fact that several of the moderate candidates have decided to drop out of the presidential race and endorse former Vice President Joe Biden has significantly boosted Biden's candidature, and he now looks like a clear winner.

However, things may still change, and we will not know whether Joe Biden will be the Democratic presidential candidate until the Democratic Convention in July. Joe Biden's surge is good news for the equity markets as Bernie Sanders in the Oval Office would be a poison pill for Wall Street.

## Equity allocation

Regional momentum and volatility indicators (MomVol) have gone down quite a lot since end-January but are still above the threshold value of 0.6 at end-February, for which reason we may expect robust equity markets in March, other things being equal. The OECD's leading indicator for the entire OECD area is still trending upwards, which is also supportive of equities.

Therefore, despite the – admittedly – strong uncertainty surrounding the coronavirus, I recommend that investors overweight equities and risky assets relative to their long-term target allocation in the near term.

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