

Update on Economic and Market Outlook. COVID 19.

In mid-January we noted the following:

Valuations were high. Equity multiples were high, credit spreads were tight and real estate cap rates were low. Whatever it was an investor considered buying, large numbers of investors had already bid prices up and were squatting on large quantities of inventory.

Economic growth was slowing. The global trade war had sapped some of the vitality out of the global economy and the age of the recovery phase was beginning to manifest in some fatigue. Around Q4 2019, there seemed to be some stabilization in high frequency macro data such as PMIs, indicating the potential for a cyclical rebound in economic activity, but the longer term prognosis was not as optimistic.

Central banks were close to or at their capacity for monetary stimulus. The ECB was well into negative policy interest rates and already doing QE. The BoJ's negative rate and bond buying policies are so entrenched anything else would be a shock to the market. The PBOC was already stimulating the economy through reserve requirement cuts, rate cuts and expansion of open market operations like repo. Among the majors, only the Federal Reserve had much room for rate cuts. And even the Fed had already been forced into bond buying by technical ruptures in the financial infrastructure.

The strategy going into 2020 had included the following:

Reducing equity exposure and running a closer allocation to the MSCI World Index, as macro risks were high and it was not clear how the chips would fall if the market corrected.

Being careful with duration. If monetary policy lost its edge, fiscal policy would be engaged, and deficits and big debt burdens tend to steepen sovereign curves. The only way to buy duration would have been to focus on the short end which would mean increased notional exposure, itself a risk.

Prefer IG to HY, senior secured to senior unsecured and mortgages to corporate debt. For caution, the first two preferences are obvious. The third is supported by over leverage in the corporate sector while household balance sheets remain healthy and employment and wages at least appear stable.

Along comes a pandemic: COVID19

How bad is the pandemic? We are not epidemiologists or medical professionals, although it appears even the professionals struggle to quantify and specify the human and social costs. Just observing and not extrapolating or forecasting, the contagion appears to have slowed in China, its place of origin, whereas it seems to be accelerating in the rest of the world. The US has so far been lightly impacted. Distance, relative connectivity and a federal health agency will likely allow the US to escape with relatively less damage. Europe is vulnerable and the numbers support it. No pan European health authority with executive powers, no border controls within the Schengen, tourism and strong economic ties to China have led to relatively intense contagion. The rest of Asia seems vulnerable as well just given how integrated the economies are in China's economic network including tourism. Central Asia is another at risk region. The epidemic within Iran and the Belt and Road activities in Central Asia must lead one to consider interpolation. The near absence of the virus from Africa should also be questioned given Chinese involvement in African economic and infrastructure development.

China appears to have contained the outbreak. If so, the economy should be switched back on in a quarter, maybe a month or two more. China's approach to containment has been intense and effective. There are grounds to erring on the side of caution and it appears China has done so. Countries or regions with poorer surveillance or stronger civil liberties may struggle to enforce similar controls.

How long will containment measures be deployed and what is the economic impact?

Factories can be shut quickly but re-starting can be more complicated. Supply chains need time to resynchronize.

China may have contained the outbreak domestically but will have to vigilant against importing the virus from abroad.

The share of China in countries' imports of intermediate goods has doubled to trebled since 2001. In the US the number has more than doubled from less than 5% to 10%, in South Korea it has gone from less than 12% to over 25% and in Japan it has gone from 10% to 20%.

Before the pandemic, the IMF estimated GDP growth to rise from an estimated 2.9 % in 2019 to 3.3 % in 2020. Current estimates, which are quite noisy, put 2020 GDP growth at 1.5% (revised down from +2.9%).

As of Feb 21, 2020, the S&P 500 traded at 19 times 12-month forward earnings, the highest the P/E level has been since May 23, 2002, according to FactSet. Credit spreads across IG and HY are at similar levels of overvaluation.

Has the COVID 19 market correction broken the buy the dip mentality?

In the last 10 years, buying the dips in the stock market have paid off very well. Market dips resulting from US debt ceiling impasses, European sovereign debt crisis, the China slowdown of 2015, the Fed failing to roll its put in 2018, et al, were all buying opportunities. Growth while positive, limped along at times in the last 10 years, credit quality decayed, earnings fluctuated, yet staying invested with the central bank's stimulus wind at your back always worked. Will it work this time?

I think the downside is more substantial and the risk of a more protracted downturn is real.

Growth was slowing to begin with. Japan was about to slip into recession before any pandemic was contemplated. Europe was slowing precipitously before China flagged the COVID 19 epidemic to the world. America was recovering from a mild slowdown, but it was a weak recovery. The COVID 19 pandemic front loads the slow down and exacerbates it.

What can policy do, both monetary and fiscal?

We have managed to use monetary policy to force the economy to function at an artificially high rate of growth for a long time. Unhappy to let the economy slow, we never allowed the policy levers to be reset even when the economy was stable and growing. The result is that there is little capacity left for central banks to stimulate the economy. There is some room left for the US Fed but the ECB, BoJ and PBOC are mostly close to capacity and facing diminishing marginal efficacy.

The COVID 19 pandemic will allow countries to engage in fiscal stimulation without too much political resistance. Expect budget deficits to expand in 2020 and beyond. This could steepen term structures going forward.

In summary:

- Weaker equity and credit markets still to come.
 - Weaker commodity markets, specifically in industrial metals and energy.
 - Steeper term structures. Could be driven by rate cuts or rising longer term bond yields.
 - Continued strength in USD and gold.
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- China is first in and first out.
 - Europe is slow to react and over-reacts.
 - US might be spared the worst.