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Coronavirus: no imminent end to uncertainty

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What's unnerving for markets is that the full downside risk of the coronavirus is difficult to quantify. And it comes when the world economy is facing a downturn, central banks have little policy ammunition left and global leverage is again at record levels. While there are typically several conditions that signal when a bear market in risk assets has come to an end, we don't think all these conditions have been met. Investors should, therefore, remain cautious as the economic effects of the coronavirus continue to spread.

What's happening to the markets?

With financial markets in turmoil amid the continuing coronavirus pandemic, the rout on 12 March was striking and historic in several respects. The fall in the US S&P 500 of almost 10% was the fourth-deepest decline in the past 100 years, exceeded only by the crash in 1987, and by Black Monday and Tuesday in October 1929. The US market officially entered bear-market territory, only 16 sessions after notching up an all-time high on 19 February – a record-fast collapse into a bear market.

Meanwhile, sovereign bond yields, including US Treasuries and German bunds, rose during the beginning of the week as investors slowed their bond purchases – which is not typical behaviour during a stockmarket selloff. There are several possible reasons for this. Market liquidity has deteriorated markedly, not only in spread markets but also in sovereign bonds. And, following the spike in market volatility in all asset classes, tight risk management triggered the sale of safe assets and forced the US Federal Reserve to announce an emergency liquidity package of nearly USD 5 trillion.

With the exception of the slight uptick in bond yields, the selloff this week is a continuation of a multi-week trend in which all asset classes have been buffeted by profit-taking, a shift towards "safe havens" and deleveraging:

– US and global equities (MSCI World) have fallen by roughly 25% since 19 February. The MSCI Europe is down by almost a third, while the TOPIX and MSCI Emerging Markets are off by roughly 20%.

Key takeaways

– Investors will be looking for the best time to re-enter the market, but it is too early to say that market capitulation is over

– Quantifying the downside risk is difficult: we don't know how far or how fast the virus will spread nor how long it will take to contain it

– While expansionary monetary and fiscal policy can mitigate an economic downturn, the events of recent days have shown there are limits to what policy changes can do

– Valuations have begun to normalise, but they are still mixed and are not yet at resounding buy levels, leaving market volatility high

– Cyclical data are not yet capturing the economic downward trend that began in mid-February, so have not yet bottomed out – we expect resulting revisions in growth and earnings forecasts to weigh on the price of risk assets

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- At the same time, government-bond yields collapsed amid an overall flight to quality. US Treasury 10-year yields fell by more than 100 basis points to an intra-day all-time low of 0.31% earlier in the week before rising slightly.
- Spreads in investment-grade, high-yield and emerging-market bonds widened markedly as investors moved away from riskier fixed-income securities.
- The US dollar, normally a "safe haven" during times of market stress, temporarily weakened against major currencies by around 5%.
- By comparison, gold moved down only marginally, having risen by almost a third in the previous 12 months.

What caused the market rout?

The new coronavirus and the recent oil price shock have increased fears of a global recession. The virus is causing a steep decline in aggregate demand and causing major disruptions on the supply side. Moreover, the global economic cycle was already mature and showing signs of fatigue before the virus hit: weak earnings growth has been a drag on capital expenditures, and private domestic demand has disappointed.

Most importantly, though, the virus is increasing the risk of a credit squeeze and a financial crisis, as the world economy is facing a downturn at a time when global leverage is, again, at record levels.

Over the past decade, leverage has increased to around three times world GDP, which is basically the same level as before the financial crisis. Leverage has increased substantially especially, but not exclusively, in the Chinese and US business sectors, in the government sector globally and in the emerging-market financial sector. Since 2008, we have also seen a doubling of USD-denominated debt outside the US to around USD 12 trillion. Many of the economies that have seen strong increases in private-sector leverage have also experienced a boom in real estate markets.

Importantly, non-bank financials – ETFs, mutual funds, hedge funds, pension funds, insurance companies, etc – are playing a much bigger role in the credit system, as banks have lost market share due to tighter regulation following the financial crisis. We know little about non-banks' actual risk exposure, their willingness (or capacity) to act as buyers of last resort or their interconnectedness to one another. In addition, they have no direct access to central-bank funding and some of them, especially hedge funds, are highly levered. This uncertainty is weighing on markets.

We therefore think that the bigger risk lies in the non-bank financial system rather than in the banking sector, as well as in the US dollar funding market. The turmoil experienced by certain hedge funds and banks in the UK, India and beyond are a case in point. The poor performance of the banking sector resides on their large credit and loan exposures to many of the most affected sectors – including energy, autos, airlines, hotels, trade and tourism.

What is the downside risk to the economy?

Estimating economic growth at this point is difficult for two reasons. First, we don't know how fast and how far covid-19 will spread. Second, a credit event could materially change the outlook. According to third-party estimates from the Brookings Institution and others, a pandemic with a 10% infection rate is expected to shave off around 1.5%-2% of global GDP relative to a baseline growth expectation. If 20% of the population were to be infected, GDP growth could be more than 5% lower than in a baseline scenario.

We are also seeing the virus move around the globe in waves – with China affected first, then Asia, then Italy and Iran, then Europe, and now the US and UK. It will be very difficult to assess the economic, financial and trade interplay within these economies – not to mention how their containment responses do or don't work together.

Is there value to be found in financial markets?

Overall, equity valuations are still mixed. Based on our estimates, the US cyclically adjusted PE ratio (CAPE) is currently around 22 – compared to an average of 25 since 1987 (when Alan Greenspan became Fed Chair), an average of around 20 since 1971 (the beginning of the fiat money system), and 12 at the trough in 2009. That means despite the recent steep selloff, US equities still don't look overly attractively priced.

European equities are currently trading at around 15-times cyclically adjusted earnings. The average since the 1980s has been 20, while the low in 2009 was 10. Japan's TOPIX is trading at a CAPE of 17, basically at the same low point as in 2012. The MSCI Asia ex Japan (our proxy for emerging markets) is at a CAPE of 13, compared to a long-term average of 16 and a 2009 trough of 10. We believe that earnings expectations were unrealistically high before this volatility hit, so we expect to see substantial downgrades in the future.

Sovereign bonds are extremely expensive on all our metrics. Spreads have widened substantially and are, depending on the market, near the levels we saw in 2015-2016. Even so, they are significantly lower than they were in 2008-2009.

Can fiscal and monetary policy rescue the global cycle and financial markets?

We welcome recent steps by central banks and governments to implement easing measures such as rate cuts and injections of liquidity. Expansionary monetary and fiscal policy can mitigate the economic downturn. However, we have seen in recent days that there are clear limits to what monetary and fiscal policy can achieve at this point:

- Monetary-policy instruments are to a large extent exhausted; globally, interest rates are near zero and central-bank balance sheets are inflated.

- Monetary policy has become much less effective given that private-sector savings rates are still near post-crisis highs and the banking sector is sitting on a huge liquidity pile.
- Liquidity injections from central banks can deal with liquidity issues, but are insufficient to deal with solvency problems.
- The economy likely needs more fiscal stimulus than what can be achieved politically and implemented technically.
- Both fiscal and monetary policy cannot address supply-side disruptions.

In our view, one of the key policy interventions during the financial crisis of 2007-09 was the recapitalisation of the financial sector, including via the Troubled Asset Relief Program (TARP) in the US. Even then, it was almost half a year before the equity market bottomed out. A similar effort for the financial and, especially, for the non-financial business sector would be welcome today.

Time to re-enter the markets?

There are typically several conditions that signal when a bear market in risk assets has come to an end.

- First, valuations must be attractive. While valuations have normalised, they are not yet at resounding buy levels, as outlined above.
- Second, monetary and fiscal policy must be accommodative. This is certainly the case now. We would regard eventual fiscal measures targeting the recapitalisation of the private sector as a clear positive. The German government is already going in this direction.
- Third, cyclical data need to bottom out and the outlook for earnings must improve. This has clearly not yet happened. Most cyclical data don't yet capture the downtrend in the economy which started in mid-February. Earnings estimates have barely been revised downwards either. With the spread of the virus only just taking hold in many economies, we expect the ongoing downward trend in data and the downward revisions in growth and earnings estimates to weigh on the prices of risk assets.
- Finally, it is too early to say that we have seen the final market shake-out. We may watch the market move dramatically within a wide range until investors have a clear view on how events will play out.

In summary, we remain cautious on risk assets at this moment. However, as active managers, we are always in search of ways to add value to our clients' portfolios. In a period of indiscriminate selling such as this one, markets may well overshoot and drive down valuations of companies beyond what their businesses actually merit. We would look to identify companies across markets and sectors that may be poised to benefit from the eventual recovery, and we will look to build our positions in these names when conditions warrant.

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