

Markets reassess Coronavirus risks

Matthew Cady, Investment Strategist



Since the World Health Organisation (WTO) was notified of the virus on 31 December, the following 6-7 weeks saw a measured response from markets. Investor stress was not broad-based, but rather more targeted, with investor stress predominantly being felt for example at a regional level in Chinese and neighbouring Asian equity markets, and at an industry level across those sectors thought most likely to be impacted such as airline and travel industries. As recently as mid-February, US equity markets were continuing to post record new closing highs. Noticeably, in keeping a keen eye on a broad range of market dashboard indicators, whilst bond yields saw falls, credit market moves had continued to be broadly muted.

The market falls in the last week have shocked the markets out of this road-map. With equity markets now in technical correction territory, which is defined as a fall of ten per cent or more from peak, the market interpretation of the economic impact of the coronavirus outbreak has clearly shifted.

As epidemiologists will be quick to point out, even after two months since the outbreak, the degree of accuracy around what we know about the virus, such as real-world transmission rates and mortality rates, is not known with any high degree of certainty. While the pace of daily new recorded cases in China have continued to moderate in

recent days, giving confidence to the view that the authorities there have had some success with containment measures, markets have instead become unnerved by the rise and spread of cases in the rest of the world.

Globally, the recorded number of coronavirus infections currently stands at over 80,000 with under 3,000 recorded fatalities, with the vast majority for both within mainland China. From these numbers, a headline mortality calculation rate of some 3% is thought to be artificially high, given the likelihood of a significant number of asymptomatic and unrecorded cases, with some

epidemiology experts suggesting the rate might be closer to 0.5% or possibly lower. For comparison, 'normal' seasonal flu is thought to have a mortality rate of less than 0.1%, but given high infection rates (despite the availability of various known vaccines), still results in as many as 650,000 deaths globally each year according to the WHO, and this year, in the US alone, the US Centres for Disease Control and Prevention (CDC) estimates seasonal flu has led to some 29 million infections, 280,000 hospitalisations, and 16,000 deaths.

The comparison between coronavirus and 'normal' seasonal flu is also interesting in terms of how authorities might respond looking forward. So far, for coronavirus, the focus has been on containment. The challenge for authorities might be how they balance against the economic cost as well as the cost to broader human health, such as the disruption to elective medical procedures which typically dominate western healthcare systems. With coronavirus already present in over fifty countries and territories outside mainland China, alongside containment strategies, might other management strategies start to take over as they do for 'normal' seasonal flu, where containment is not the primary policy tool.

Markets appear to have moved quickly in recent days, in trying to price for a material and sustained impact to economic activity on a multi-regional scale. The experience of previous infectious outbreaks such as SARS in 2003 and MERS in 2012, is that whilst this can drive significant market volatility in the short-term across one or two calendar quarters, economic activity typically recovers, supported by monetary and fiscal policy accommodation where necessary.

There is also an important differentiation to be made to other economic shocks that investors have had to factor in recent years, such as the US-China trade wars over the last two years. Here, had de-escalation efforts not been successful, there would have been a material and permanent diminution in trade and economic activity which would have worked their way into corporate profitability and longer-term analyst expectations. While it remains to be seen whether this coronavirus outbreak affects economic activity on such a sustained basis, such an outcome would not be our central case. Should governments be successful in managing the economic impact through either containment or management strategies, or some combination of the two, then we would expect markets to move quickly to anticipate a recovery in expectations and activity.

Returning to markets, the recent sell-off in bond yields has accentuated the significant gap that currently stands between the earnings yield available on equities as compared to that on bonds, a measure that we frequently reference in support of our structural asset allocation preference of equities over bonds. Record lows have been recorded this week for both US ten-year and US thirty-year government Treasury yields for example. Notwithstanding any material reassessment in the outlook for corporate earnings, there is scope for this differential to close, which would be a supportive backdrop for equities and risk assets in general.

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