Sanctum
Wealth Management

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Will Risk Aversion Go Viral?

- **Markets hoping coronavirus is SARS-like.**
- **Bonds have discounted a more marked slowdown in global growth than equities.**
- **Central bankers back in action but policy tools are quite blunt**
- **Gold approaching $1600 remains an asset of choice**

The coronavirus continues to dominate the headlines and as yet still does not appear to have reached its peak impact on public health. News of virus-related deaths outside of China has exacerbated the risks of a further scaling up of the potential implications for the global economy. The human cost of the virus will remain unknown for some time, and market participants collectively lack the medical knowledge to make sensible predictions about the result of the outbreak.

What do we know for sure? By February 1st, there were around 14,000 confirmed cases globally, increasing at a rate of about 2000 to 3000 per day. Fatalities stand at 304, with one recorded outside of China. It is probably too early in the life of the virus to make definitive statements either in purely medical terms or in connection with the markets. Market predictions were made even

more difficult with the Chinese market closing for Chinese New Year celebrations due to the outbreak.

In purely economic terms, most forecasters see a dip in global growth and then a recovery. Shang- Jin Wei, a professor at Columbia Business School, estimates that the aggregate impact on Chinese GDP growth could be as little as 0.1% for the calendar year 2020. His forecast is based on what happened with the 2003 SARS crisis when an initial significant decline in GDP was made up by a sharp recovery. The good news is that the crisis arrived at a time when China was on a public holiday, and Chinese companies would have naturally been standing idle. The higher penetration of internet shopping means that consumption should not have dropped as markedly as it did in 2003.

The Chinese authorities have moved to support the economy by pumping 1.2 trillion yuan ($173 billion) of liquidity into the banking system. The move comes ahead of the re-opening of the local financial markets which had been closed since January 23rd.

In the wake of the spread and impact of the virus on human life, global stocks have given up their gains for the year. Except for the technology sector, US equities are now flat for the year after the S&P 500 posted a drop on Friday. European stocks were already lower for the year, by between 2% to 3%.

As might be expected, bonds have been safe havens. US 10-year government bonds rallied by ten basis points last week to touch 1.50%. Across the government bond curve, yields dropped by much the same magnitude. That extends quite a sharp rally in US bond prices after yields peaked at 1.90% late last year.

The rally in bond yields might be somewhat more unnerving for markets than a drop in equity markets. Thus far, the modest slip in the stock market levels could just as well have been a random move or a minor correction from peak levels after a strong run. In the period after the Global Financial Crisis, a useful rule of thumb for events of geopolitical nature – or natural disasters – is that the effect on markets is transitory unless it impacts directly on economic activity by causing a recession. At a more localised level, it can be more severe as specific industries can be heavily affected.

At the broad macro level, the decline in bond yields was already established before news of the virus broke. Industrial activity in several economies was edging downwards.

Is the bond market right to discount a slower Q1 and perhaps Q2 and beyond? The Fed for one is not of the view that inflation is about to make a comeback. At its most recent press conference last week, Fed Chair Jerome Powell made it clear that an undershoot of the Fed's inflation target will not be an acceptable outcome. To be clear, the Fed has an inflation target of 2.0%. Strictly speaking, it is failing in its mandate to deliver on that outcome. The obvious conclusion is that the Fed is signaling that it thinks the next move in rates will be lower. Yes, that's right: The Fed is beginning to indicate it is considering cutting rates some more.

In tandem with bond markets, it is necessary to keep a beady eye on commodity markets to get a

sense of where investors think things are heading. In that context, there are some stark numbers to report. The Bloomberg Index of Industrial Metals (BOCIM) has been dropping fast through January. The price level has fallen from 116 to 105 from January 16th. This index measures the price moves of aluminium, copper, zinc and nickel. It has historically been a close correlator to the growth rate of the Chinese economy. For the last fortnight, the index has declined quickly as concerns grow over the effect of the virus on the broader Chinese economy.

Other commodities have also behaved in ways that need monitoring. Oil has been on a downward path. As in the case of bonds, it is no simple matter to unscramble the effects of the virus (or the market's fear of the virus) from what was a mild down leg in output. WTI Crude Oil is down from $59 per barrel to $52 per barrel through the last two weeks of January.

Finally, despite growth concerns and the universally perceived death of inflation, gold continues to make headway. Last Friday's closing price of $1589, is the highest since 2013 and slowly but surely heading towards the magical $1600 mark.

Taking in all of the developments above leads to two possible main conclusions. In the first place, the global economy came into 2020 at a pace that was slower than one would have believed purely looking at the price action going on in stock markets. Record highs were being set in the absence of earnings growth to match. Continued expectations of further declines in interest rates drove much of the market hype.

In the second place, commodity markets and the bond market were already cocking a suspicious eye to the stock market, with bond yields falling and some specific growth-sensitive commodities feeling the strain and declining as a result. How much of this was viral and how much was baked into the markets already?

So that leaves the impact of the virus as something of a binary outcome. Something along the lines of the SARS outbreak; it will have a localised effect in Asia, but limited impact globally and over time. However, until we know more about the spread of the virus, there is still a small chance that it will be sufficiently disruptive to cause much wider economic distress.

The critical question will be whether investors see the equity market sell-off as a buying opportunity – as they have tended to in the past. The Chinese central bank's response in injecting liquidity into the system is a very typical response that lends itself to recovery or at least stabilisation of the markets. We will be more worried if the virus leaks more substantially into the rest of the world, leading to a more substantial interruption to global economic activity. China has set a high standard for reacting to the crisis with a lockdown of over 100 million people. Could you imagine how that would look in the United States or Europe? If either the Federal Reserve or the ECB were then called on to stimulate their respective economies, how useful would a monetary stimulus be with interest rates already around zero.

Longer-term, the structural worry will be that the shock of the crisis will leave some scars on the Chinese economy and/or on China's relationship with the rest of the world. Several countries are putting severe restrictions on the free movement of people. A US Senator has raised the concern that the source of the virus may have been a research facility in China. Such thinking only serves to ostracise China in the global economy.

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