BBGI GROUP Global Investments

Economic Research

WEEKLY ANALYSIS

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What next after two weeks of historic stock market panic?

The Covid-19 threat was totally disregarded. Only active asset management can defend against a market shock. Is Covid-19 a lasting threat? What's the likelihood of a rapid recovery?

Key points

- A genuine threat, albeit completely ignored for close to two months
- Only active and rational asset management can defend against a market shock
- Covid-19 is a wake-up call to passive investors – their strategy is by no means risk-free
- Covid-19 and Saudi Arabia are causing widespread panic
- Does Covid-19 present a lasting threat to the global economy?
- The collapse of financial markets will impact consumer sentiment
- Global output will undergo significant structural adjustments
- How likely are markets to recover swiftly?

A genuine threat, albeit completely ignored for close to two months

On 21 February 2020, in the midst of generalised euphoria, financial markets became aware that, in spite of the extraordinary measures implemented in China to fight against the coronavirus epidemic, the latter had spread to Europe and was starting to have a direct impact on Italy.

Suddenly, it became clear that most investors had completely ignored the threat for several months. The ensuing shock was proportional to the complacency that had prevailed for so many weeks.

Indeed, oblivious to the threat and to related risks, investors had flinched only briefly for three or four days in January, when the seriousness of the situation in China was no longer in doubt and was starting to make headlines.

However, greed quickly overrode objective and rational analysis and risk assessment, fuelling most investors' enthusiasm and confidence in the economic outlook and the future, seeming completely reckless to any measured and rational observer worried about the increasing risks in a context of extreme market valuations.

Only active and rational asset management can defend against a market shock

Aware of the already exceptionally high levels of risk and valuations in global financial markets overall, especially following the most recent rise in market indices at the end of the year, we were already then sounding the alarm regarding the real risks of a significant increase in volatility and in risk factors that might trigger substantial corrections in financial markets in the following months.

In recommending caution and a significantly more defensive allocation with regard to risky assets in general, we were aware that our tactical position went against the consensus.

Indeed, a significant majority of the leading institutional and private asset managers were still very optimistic and relatively oblivious to the risks.

Almost universally the major players recommended overweighting equities in client investment strategies, totally ignoring the threat of a pandemic and the increasing risks of a market collapse.

As these players, both in Switzerland and internationally, were unable to react quickly enough to reposition their clients' assets before the sudden crash, even though it would still have been possible to shift to a strategy better adapted to the circumstances, they will now likely claim that it was impossible to predict that the epidemic would become a pandemic and that it was thus not possible to guard against the potential impact of such a course of events, or they will simply maintain that a rapid recovery will quickly erase the losses incurred.

In attempting to justify their inaction and their lack of vision or faulty risk management, they are in fact demonstrating that their inability to act or react because of various factors and vested interests does not in fact meet the needs of investors, who expect their asset management partners and trustees to have real capabilities in terms of risk and opportunity analysis and assessment such that they are able to rationally and professionally manage their personal wealth or the assets they have been entrusted with (pension funds, trustees, etc.).

Yet this threat was fully predictable. In a world as interconnected as the one we now live in, even the extreme measures implemented by the Chinese authorities could not guarantee that the threat would remain confined within China's borders.

Hence, this risk factor could not be overlooked and would de facto only be taken into account in active investment strategies or approaches emphasising tactical and rational management not only of opportunities but of risks in particular.

Covid-19 is a wake-up call to passive investors – their strategy is by no means risk-free

Investors who opted for an active approach to managing their wealth, including the ability to factor in specific imperatives such as managing absolute risk for instance, were likely better prepared than those who believed in index tracking and were thus convinced that managing market risk and capital loss risk in the medium term was pointless. Not only that, but for active strategies to yield the expected benefits, asset managers also had to possess a real ability to act and a willingness to safeguard their clients' assets.

Furthermore, amongst active asset managers one must differentiate between those who do not hesitate to emphasise risk management and capital preservation when valuations become irrational and when circumstances call for it and those who claim to do so but actually implement relatively passive strategies inconsistent with the approach they claim to be implementing.

In this context, passive or index-linked investment strategies or momentum-based approaches, which have been implemented by a growing number of institutions over the past few years, will no doubt result in shock and disappointment in the wake of the historic collapse in share prices and ensuing plunge in the value of clients' financial assets. Indeed, following a multi-year bull market bolstered by active central banks, many investors may have forgotten that exogenous factors could trigger sudden financial crashes, wiping out within just a few days capital gains amassed gradually over the years.

For example, European investors using an index-linked approach lost within just a few days all gains accrued since June 2013, namely 26 quarters of patient accumulation annihilated in the blink of an eye. Passive investing enthusiasts will likely attempt to take comfort in the hopes of a market rally that might justify their inaction.

Covid-19 and Saudi Arabia are causing widespread panic

On 21 February, financial markets were dealt a first blow caused by the realisation that the coronavirus might spread beyond China's borders and have a significant potential impact on global populations.

Gradually, the world realised, without being able to guard against it, that Western economies had become vulnerable due to their extreme interdependence with the Chinese economy. Suddenly, the collapse of economic activity in China, which had initially barely affected financial markets, emerged as a major threat that could impact supply and production chains in many industrial sectors, as well as in service sectors.

Airlines, shipping, and transportation in general suffered massive blows that will undoubtedly result in potential bankruptcies if governments do not step in with bailouts over the next few weeks. At the same time, the risks of an economic slowdown appeared to become more severe, pushing down interest rates, equity markets and commodity prices. Markets had already fallen significantly, which was then exacerbated by the shock caused by Saudi Arabia in the oil market. On 6 March, announcing a decrease in crude prices (OSP) to its clients after failing to reach an agreement on quota reductions amongst OPEC+ members, Saudi Arabia unwittingly added fuel to the fire, causing a -40% drop in WTI prices in two days.

In the following days, Covid-19 and plummeting oil prices pushed equity markets down a further -20%, causing a day of complete panic (-9.5%), which will no doubt remain for a long time as the second worst day in the history of the S&P 500 after Monday, 19 October, 1987 (-20.4%).

Does Covid-19 present a lasting threat to the global economy?

Following two months of health crisis and extreme measures implemented by the Chinese government, according to official figures and published statistics (to be taken with the usual precautions), it now seems that the epidemic has likely peaked in China.

However, resumption of economic activity is still very tentative, and it will likely take some time before clear signs emerge of a return to business-as-usual. On the health front, the WHO reports 125,048 confirmed cases of Covid-19 and 4,613 deaths to date (12 March 2020), including 80,981 cases and 3,173 deaths in China.

The WHO has now declared that the Covid-19 outbreak is a pandemic and that, while it can be controlled, this will require many countries that still have not implemented all the required control measures to scale up their responses.

The situation is thus dire and will likely continue to develop significantly over the next several months. Beyond the public health aspects addressed by the competent authorities, our analysis of the situation in terms of economic impact leads us to believe that the potential impact on global economic growth will be substantial.

Several European governments recently claimed that the impact on growth would be no more than -0.1% in 2020.

However, the precautionary health measures implemented this week by most European governments and today by the Swiss government, aimed in particular at limiting contact amongst residents and amongst populations by closing the borders, will have a significant impact on global economic growth.

The declaration of a state of emergency in the US and the ban on flights from Europe (ex UK) will no doubt increase the level of stress in an already especially anxiety-inducing climate. Many sectors will be hard hit by bans on travel, gatherings, and cultural and sports events.

Closely tied to how long the health measures impacting the economy will be in effect, the risks of an increase in unemployment and corporate bankruptcies will rise.

Most countries seem to estimate the risk window to be approximately two months, which is likely the shortest amount of time during which economic activity will slow significantly in most OECD countries.

While economic activity in China may now be slowly normalising, it may be possible to hope that the experience and precious time gained in finally preparing our healthcare systems for the wave of cases expected in the next few weeks will allow the countries that implemented the right measures to weather the impending crisis in better shape.

Regarding the global economy, the slowdown in China and Asia will significantly impact global growth in Q1, while the slump expected in Europe and the US will likely occur at the beginning of Q2.

This time lag should help global growth stay resilient and potentially avoid a recession both in Q1 and Q2 2020, in spite of likely significant downturns in most countries.

The collapse of financial markets will impact consumer sentiment

Nevertheless, we should emphasize that the approximately -25% drop in financial markets between 21 February and 12 March will impact growth, in particular due to the sharp decline in consumer sentiment. It is likely that households, already worried about health risks, will decrease consumption and increase precautionary saving.

The outlook for private consumption for the next months will likely be revised downwards, which is not a positive factor for countries whose GDP is closely tied to household consumption. In this context, public consumption is likely to be a clear support factor for the economy and could make up for the decline in private demand. Investment in capital goods is likely to stall, as the current environment is clearly not conducive, especially in energy-related sectors.

Finally, supply and production chain disruptions will not abate quickly, even as Chinese production recovers. It is difficult to predict when things will get back to normal, and this will vary greatly depending on the sector and on the existing interdependencies amongst countries and production zones as well as on developments in terms of regulatory constraints and limits on the transport of goods and merchandise.

Global output will undergo significant structural adjustments

The Covid-19 crisis highlights the interdependence between most economies and China, which was previously known but whose negative impact had not been as keenly perceived as it is today.

While the crisis plainly underscores the vulnerability of these economies and the limits of their capacity to react to an external crisis, it also calls attention to the deleterious absence of political and economic forethought.

When the global economy recovers from this crisis, global production will likely undergo substantial structural adjustments, which will likely offer particularly attractive long-term positioning and investment opportunities.

Finally, the Covid-19 crisis is only just beginning, and the economic news flow over the next few months will probably not be optimistic.

Thus, investor sentiment, which in the matter of days went from extreme optimism to perhaps exaggerated panic in the short term, is unlikely to improve rapidly or for any length of time.

Economic statistics will thus likely be negative overall in H1 2020, which will confirm expectations of an economic slowdown. However, we believe that the negative economic impact of the Covid-19 crisis will not last beyond H1 2020.

Global demand should be more solid in H2, in particular following aggressive central bank interventions to stimulate the economy. We also predict that fiscal policies will quickly become significantly more expansionary and pro-growth in 2020, which will limit economic risks.

How likely are markets to recover swiftly?

The corrections that hit all stock markets over the past weeks have probably reached levels likely to generate interest among certain short-term investors. Our risk-return calculations for various equity markets pointed to extreme levels of risk in January 2020 according to most of our indicators.

Currently, price corrections have reduced and occasionally almost normalised the risk parameters we monitor.

Following massive corrections in Europe (-34%), the UK (-32%), Japan (-30.8%), the US (-26.8%), and Switzerland (-25.8%), we believe that the economic risks tied to Covid-19 have now sufficiently been factored in, based on our current understanding of the issues, to justify a likely rally in stock indices over the next few days, which could be swift and substantial, especially if central banks and governments do ultimately implement convincing and effective economic stimulus measures.

However, a technical market recovery will inevitably have a negative impact on market valuation and risk levels, which could lead to another fall in the market before the situation truly improves.

Volatility is unlikely to decline significantly in the next few weeks, and caution should thus be exercised given the very uncertain context overall in order to take advantage of the opportunities that already seem to be arising.

The fall in crude prices over the past weeks calls to mind a similar drop in 2015, when crude sank to $26/barrel before bouncing back up above $50 and then stabilising for four years between $50 and $60.

While Saudi Arabia's initial strategy sought to reduce OPEC output to maintain supply and demand equilibrium given the deterioration in the economic outlook resulting from Covid-19, Russia did not follow suit. Saudi Arabia thus caused prices to fall temporarily with two goals in mind.

The first is undoubtedly to bring Russia back to the negotiating table, while the second is probably to penalise high-cost US shale oil producers, who are solely responsible for the increase in the global crude supply.

Crude prices are unlikely to stay low for long, and we expect they will return to the equilibrium level of $50 in the next few months.

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