

Is a corona bear market rearing its ugly head?

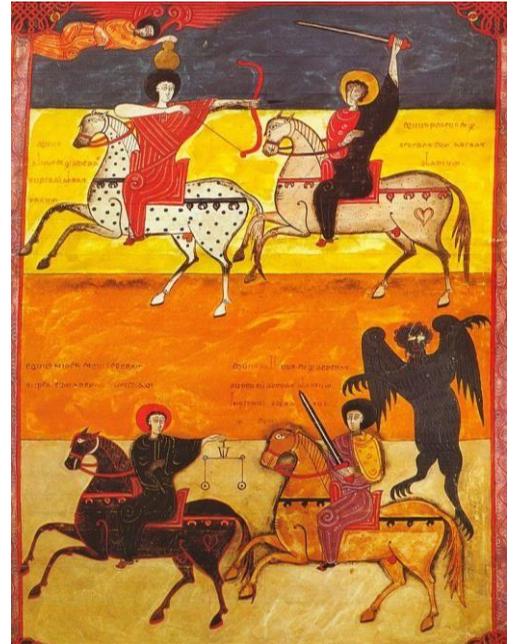
From a public health emergency to the threat of a credit crunch: deflationary pressures are worsening in the short term, with the added risk of a repricing of risky assets.

For the first time in history we are experiencing an epidemic in real time. COVID-19 has now become a global pandemic, to go with history's great pandemics, such as the Black Plague of 1346-1353, smallpox outbreaks from 1518 to 1800, the 1665-1666 London plague, the 1720 Marseille plague, cholera in France in 1832, Spanish influenza in 1918, and AIDS beginning in the 1970s. Many of these pandemics caused several million deaths, killing off a large portion of the population. This is not the case of the current pandemic, which is like a grain of sand in comparison, but one whose full repercussions on the financial markets and global economy are not yet known.

Financial markets initially reacted in accordance with the investor's manual on extra-financial exogenous shocks – with a V-shaped dip and rally. Then came a second episode, with official quarantine measures as the epidemic spread outside of China. Quarantines, such as the one described in Albert Camus' novel *The Plague*, are an old maritime practice, going back to the Council of Ragusa, in 1377. They incur a very high economic cost, more so than a conventional recession. However, failing to react to a pandemic could have an even higher cost. A 2012 World Bank study found that an unmanaged influenza pandemic could subtract 5 percentage points from global GDP and result in 70 million deaths.

The current shock could lower China's growth rate from 6% in 2019 to 1% in 2020. The global growth rate could be halved. There are three ways this could happen:

1. a sudden drop in global trade, with a direct impact from China, triggering a manufacturing recession;
2. a serious impact on the transport and tourism sectors; and/or
3. a disruption of production chains that would spread to retail trade and producers.



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The third episode in the current crisis was the reaction of monetary authorities, the Fed in particular. As we know, in dealing with a demand-side shock, monetary policy is a good place to start, via lower key rates. This helps generate a V-shaped recovery. But what we have here is a supply-side shock. This calls for a fiscal response (by letting automatic stabilisers play out), including extending payment deadlines for companies and propping up the hardest-hit sectors.

The Fed's inter-meeting rate cut (-50bp 10 days before its next scheduled FOMC meeting) has raised several questions. Inter-meeting easing always happens after an economic and financial shock (LTCM in 1998, 9/11, the quant crisis in 2007, and Lehman in 2008). In the current case, the Fed reacted more to a spike in monetary and financial conditions and volatility and a sudden rise in financial stress. The Fed's aggressive pre-emptive action ended up intensifying deflationary pressures (with a drop in inflation expectations and a 10-year US bond yield falling below 0.5% and the 30-year yield below 1% for the first time ever).

We are now entering the fourth episode – a repricing of risky assets. The S&P 500's P/E had approached 20x in January 2020, back to its January 2018 peak. When it fell below 15x in December 2018, that raised the spectre of an equity bear market, which was forestalled by the aggressive shift in monetary policy in early 2019. The current P/E of 17x still looks too high, especially as a technical recession in earnings looks likely. Collapsing bond yields are coming with a spike in risk premiums, whose levels of almost 600 basis points imply financial stress and a P/E of almost 15x

The impact that the coronavirus grain of sand has had reflects the financial system's vulnerability (including the interbank market and the market microstructure) and its accumulated imbalances (including total debt amounting to more than 320% of GDP). The risk is now a deflationary spiral, which would impact the markets far more quickly than a recession or stagflation. Central banks would move to mitigate this risk, but with rates already close to zero, extreme solutions would be necessary, such as central bank monetising of public debt, which would increase the appetite for gold.

The virus could be a game changer at three levels:

1. Politically, with a resurgence in populism and a return to a more aggressive role by governments, including deglobalisation, protectionism, implied nationalisation of banks, fiscal support and welfare spending;
2. Short-term deflationary pressures, and an upturn in inflation in the medium term; and
3. Heightened financial instability, with the threat of a credit crunch and a corporate bond crisis.

One more thing: this crisis is reminding us of three unchanging rules of investment:

1. **The bond market is always right;**
2. Diversification is the only free lunch in finance;
3. Indiscriminate sell-offs offer attractive entry points for quality assets, which should be overweighted late in the cycle..

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