COVID-19 contagion, the latest updates

Joint Research & Front Office Communication
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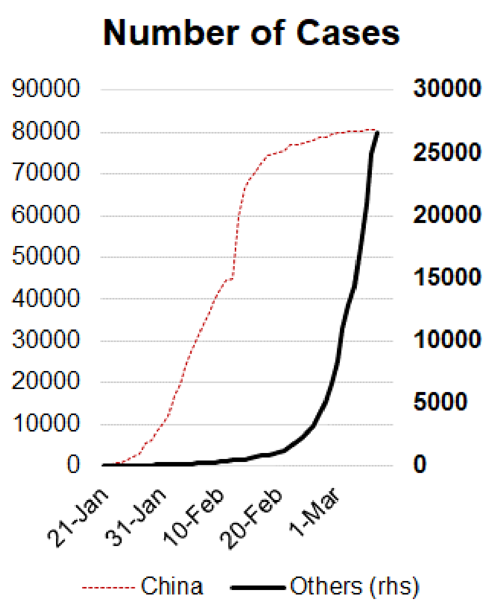
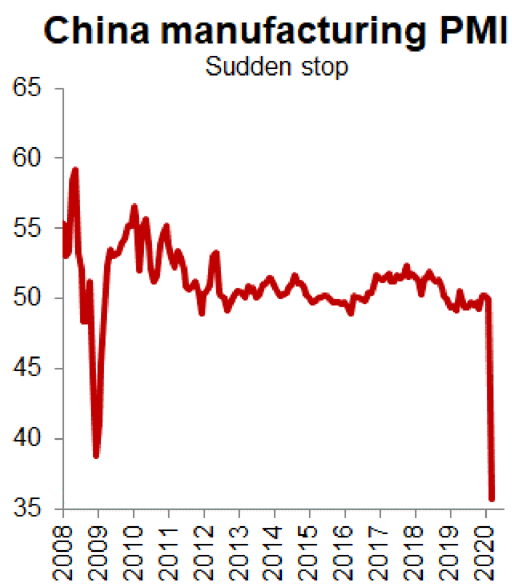
KEY VIEWS:

- Italy has just adopted severe containment measures; other countries will inevitably follow. Those measures will eventually help contagion to slow, though near-term they will also add to the drag on the economy.
- Market trends remain dominated by Covid-19 data (108k cases on 8 March). We stay cautious given 1/ the obsessive focus on the number of cases (challenging for at least another two weeks) and 2/ the risk of an equity drawdown extension beyond 20%. Focus may move to the US, where contagion is at an early stage.
- Positioning is starting to look healthier, as we have seen signs of capitulation over the past week. Selling from systems and automates is well advanced. But outflows from equity and credit funds will continue.
- Saudi Arabia has launched an oil price war, targeting Russia. Timing is most unwelcome. The fall in oil prices creates additional pressure on the US High Yield market (heavy in energy).
- The immediate market response to economic policy measures is smaller than usual, because they cannot address supply-side issues. But they are still greatly needed. Once Covid-19 fades out, they will support a strong turn in investor sentiment.
- The widening in money market spreads (FRA-OIS) deserves attention. Funding stress would support the ailing USD, but hurt global equities; central banks are likely to be very generous with liquidity provision.
- Tactically, reloading assets such as equities and High Yield bonds still looks risky. We expect some resilience in IG credit, more so in Europe where the ECB is likely to increase buying (12 March meeting).
- Longer term we look forward to reload positions and take advantage of the very cheap pricing of equities relative to 'risk-free' bonds. For long-term investors, this sell-off will present a buying opportunity. Once new Covid-19 cases flatten out, hopefully in early spring, incoming policy stimulus will help sentiment turn strongly.





Source: GIAM Macro and Market Research, March 2020

ECONOMY AND POLICY: BOTH A SUPPLY AND A DEMAND SHOCK

Covid-19 contagion. The Coronavirus crisis continues to unravel, with investors worrying about the economic impact, on top of the human cost. In the week to 8 March the number of cases increased by 723 in China and more than 18,000 in the rest of the world (RoW). While still rising, the number of cases in China is flattening out.

This is good news but the market is now focusing on the RoW. Containment measures in China seem to be working; they should too in the western world, but investors want to see evidence that they do. In the best case that will take another two weeks. In the meantime the risk is that new pockets of contagion appear. There are **concerns in particular that the US the healthcare system**, dominated by state and city health agencies, is too decentralized to address a viral crisis efficiently. The lack of infectious disease capacity (hospitals), the personal cost of coronavirus tests and the paid-leave laws (the lack thereof) will make contagion harder to control. The $8.3bn bill is aiming at countering those issues.

The longer the crisis, the bigger the economic impact. It is clear already that **China's economy has suffered a "sudden stop"**: the manufacturing PMI dropped to below the levels seen through the 2008-09 crisis. On that basis, there is little doubt that the government will deliver a powerful policy support package (see the 2nd chart on page 1). Given the huge shock currently unfolding in Q1, we have slashed our 2020 global economic growth from 2.9% to 2.4%. The risks are still very much to the downside. 2.5% is usually the tipping point defining a global recession. That said a recession technically sees at least two poor quarters in a row; hopefully growth will rebound in Q2. This requires the viral contagion to flatten out sooner rather than later. The Italian government announced severe restrictions this weekend that will effectively impose a strict curfew on the Northern part of the country – similarly to what China did. The restrictions are valid for four weeks, up to 3 April. France is mulling a shift to Stage 3, which would also sharply step up 'social distancing' measures; in theory such stage is planned to last for as long as 8-12 weeks – this would of course aggravate the economic damage.

In a worst case scenario contagion would extend well into spring, causing a more severe economic shock. The OECD last week warned that in such a case global growth could fall to 1.5%.

The International Institute of Finance said it could be as slow as 1.0%. The IMF has not released an update yet (due in the coming weeks) but already warned growth would be the **slowest since the 2008-2009 financial crisis.**

Policy support urgently needed, despite immediate ineffectiveness. The supply shock, coming essentially from containment measures that have been most severe in China and have disrupted global supply chains, is exacerbated by a global demand shock (sharp decline in travel bookings, leisure spending, tourism etc). **Hence the policy measures to support demand.** On Tuesday 3 March the Fed delivered an inter-meeting rate cut of 50bp (Fed Fund target now at 1.0-1.25%). On the fiscal side Italy has announced a €7.6bn package, with emergency measures for healthcare and sectors most affected so far. More will follow and the European Commission will not object to a much higher deficit (2.2% of GDP planned this year). Germany and other countries are also mulling significant action – now unavoidable given the extent of the shock. Those measures so far have failed to reassure investors. To a large extent this is because **measures to support demand will not work before supply can be restored**; hence the obsessive focus on the coronavirus counting.

ECB meeting this week. In this context it will be hard for the ECB, which lacks policy room, to rescue financial markets on 12 March. The market is pricing a 10bp rate cut (and another 10bp later this year). We are not convinced, given the ineffectiveness of pushing rates ever deeper in negative territory. But it is true that the recent surge of the euro makes a cut a bit more likely (still not our central case). We will be looking for more **targeted measures from the ECB:** TLTROs to support bank lending to SMEs (in order to avoid that a liquidity problem turns into a solvency one); and a temporary increase of CSPP (corporate bond purchases). The wild cards would be an increase in PSPP (public sector bonds) associated with higher issuer and issue limits (currently 33%), or the purchases of new assets (e.g. financial bonds). Every little helps, but in the near term all that investors want to see is a containment of the coronavirus crises.

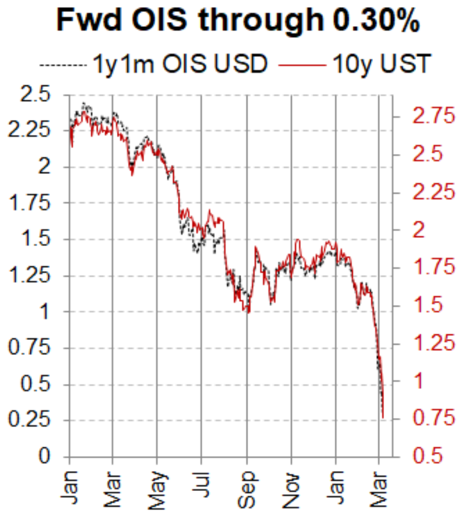
FINANCIAL MARKETS: STILL SCARED

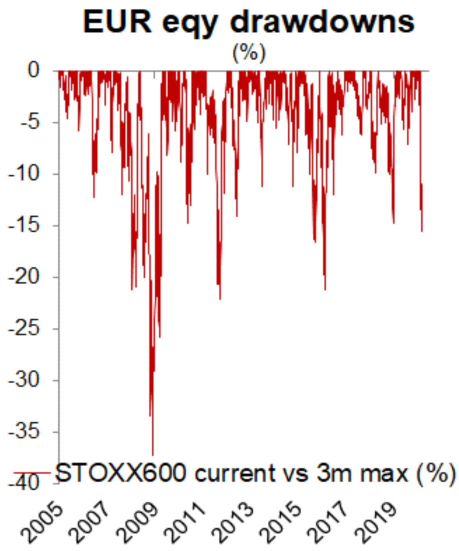
Safe-havens have continued to shine over the past week (US Treasuries, gold prices, volatility etc). US equity volatility is trading at levels unseen since 2011. Long-dated Treasury yields have sunk to record low levels, at some point on Friday to below 0.70% (10-year). Forwards are pricing aggressive rate cuts towards 0.30%: **investors are maxing out on Fed cuts -** knowing that the FOMC has an aversion for negative rates. **Talk about the Fed looking at new tools for the future** (extending the type of assets it could buy, beyond government bonds, Agencies and ABS) should be sweet music to the ears of investors. 10-year Bund yields have dropped back to record lows, through -0.70%. Equity markets rebounded by mid-week, before testing new local lows on Friday. Cyclical sectors are selling off, e.g. European bank stocks are down more than 25% from the mid-February high; airline companies are doing even worse. Credit markets have been under pressure, with liquidity quickly vanishing in times of stress (e.g. CDS indices widening much faster than individual components).

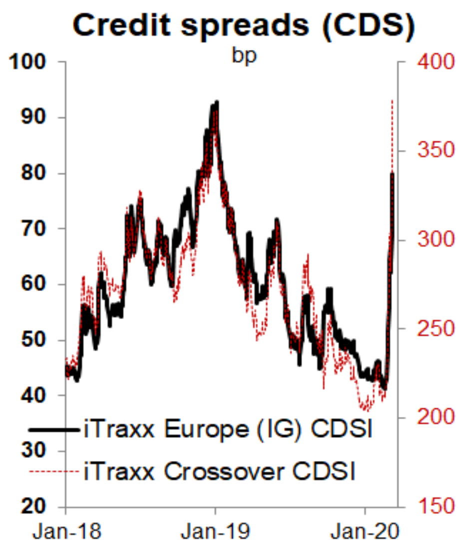
EUR High Yield spreads are back to the highs of December 2018; the stress has been more contained in Investment Grade (see middle chart below). Mind that, thanks to the fall of risk-free yields, year-to-date total return in IG is still positive. Similarly for Italian BTPs, despite the 45bp widening vs Bund in the past two weeks. **This should limit fund outflows in the medium-risk segments of FI funds.** The USD has lost its safe-haven status as the Fed stepped in and the coronavirus picked up in the US; EUR/USD has surged from 1.08 to 1.13 in just two weeks.

How far the risk sell-off? The drawdown in EUR equities (STOXX 600) is now -15.5%. In the 2012 and 2015 it exceeded 20%; in 2008 far worse (see final chart). As we said last week, no one wants to catch the falling knife. **Buyers will first want to see some containment in coronavirus, or formidable policy action.** This week is starting on the wrong foot as the Saudi Arabia vs. Russia oil price war is causing a sharp fall in prices (which has reverberation to the US High Yield market, heavy in energy). On the positive side, our indicators suggest that systematic trading (e.g. vol control funds) and CTAs (momentum funds) are mostly done with de-risking. But outflows are likely to continue: equity funds saw $23bn of redemptions over the past week, following nearly $20bn the week before. Credit and EM bonds funds have also seen $16bn of outflows, the second largest ever.

Money market funds are in fashion (largest inflows since August 2019).







Source: GIAM Macro and Market Research, march 2020

FIXED INCOME COMMENT

On the rates side, the market is positioned for a **flattening of the swap curve**. In the last days, market reported Swap Receivers on Long-Term tenors, buyers of the OAT 15Y after the good auction, buyers of OAT 5y-6y and Long 30Y OAT vs Short 10Y OAT or outright. Profit taking on long term asset swaps (ASW). Limited buyers on very long-term Sovereigns. **Buyers of BTP have been reported** on 3Y-5Y and 10Y, probably by domestic investors. We notice **poor liquidity conditions on BTPs**; indicators are not yet as bad as in May 2018 but are deteriorating; poor liquidity also on Spanish Bonos. Liquidity has worsened significantly on semi-core papers, with spread widening. Overall liquidity conditions are deteriorating.

We expect a **bull flattening of US Treasury curve** (with 30Y Treasury yields sliding below 1.5% for the first time) and US rates to keep outperforming € rates. Meanwhile the EUR swaps yield curve may keep **inverting in the long end given the need for convexity.**

Volumes in credit index have been meaningful, especially for hedging purpose. On the cash credit side, volumes are still not high but index-level concerns keep pushing bonds wider. In general, there is **demand for quality** bonds, and **duration extension** from Real Money clients.

We still expect **euro IG credit to offer good resilience** in terms of total return. We deem **corporates will keep over-performing financials**, particularly within peripheral non-systemic names were some concern of asset quality deterioration may resurface alongside growing recession risks. Although there is room for IG credit spread to drift wider, we expect any short-term price action on spread to be offset by further compression in risk-free yields.

EQUITY COMMENT

The MSCI World is down 9% year-to-date and 12% since the beginning of the sell-off (-15% for STOXX Europe 600), triggered by the expansion of the outbreak in develop countries, notably South Korea and Italy.

The sell-off has been widespread, hurting all sectors but **most brutally banks and travel & leisure**, which are most impacted by current events.

In terms of style factors, the recent sell-off has favored definitively **quality stocks over value stocks** – the latter being the most beaten.

In terms of positioning, the sell-off has triggered a major equity de-risking, especially for what concerns systematic strategies. **Volatility target funds are estimated to be at the 5th percentile of equity exposure**, whilst trend followers at the 25th percentile and HF equity beta at the 10th percentile.

Long-only funds have been slower in reducing the equity exposure at the beginning of the market sell-off and are accelerating in this second leg of market sell-off.

The recent rebound was mainly driven by rebalancing activities of global pension funds and some re-risking from systematic strategies but they have turned seller again.