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THOUGHT LEADERSHIP:

COVID-19 - A MIGRAINE FOR MARKETS

COVID-19

In late December 2019, 27 cases of atypical pneumonia in Wuhan, a Chinese city of 11 million people, were reported to the World Health Organisation (WHO). Two and a half months later, 118,000 people in 104 countries around the world have been infected with COVID-19, 4,200 people are dead and a global pandemic has been declared by the WHO. The extensive spread of the virus has occurred despite draconian containment measures implemented by the Chinese Government. These measures included the effective sealing-off of Wuhan, and a lockdown of the Hubei Province, as well as many other cities around the country. However, the Chinese Government was slow to act, not enforcing these measures until nearly three weeks after the WHO was alerted about the emergence of this new virus.

While most cases of COVID-19 are considered relatively mild, and the mortality rate is low (approximately 3%) relative to previous similar viruses such as SARS and MERS, the virus is proving to be highly contagious. The Chinese Government's slow response, and its efforts to cover up the full extent of the outbreak in the early stages, has meant that the virus was able to spiral out of control quickly. When the government did respond, it effectively shut down large parts of the Chinese economy for almost a month. As such, the virus has had dramatically poor economic outcomes for China over the first few months of the year, which is significant noting that China accounts for nearly a fifth of the global economy.

It has become apparent that the spread of the virus, or more accurately, the global institutional response to stem the spread of the virus, is the most prominent threat to global economic growth presently. This comes after a few years of relatively anaemic economic growth, and at a time of high private and public debt levels and very expensive asset valuations by most metrics. Central banks have tried to navigate the global economy through the low economic growth in recent years, but it has left them with little ammunition to support the economy and markets going forward, including in the event of a further COVID-19 escalation.

Despite the uncertainty (and the associated widespread commentary) about the economic impact on the Chinese economy, financial markets were relatively resilient during the first six weeks of the outbreak. However, in late February, when it became apparent that the virus was spreading well beyond China's borders, global share markets sold off aggressively, government bond yields fell and corporate credit spreads widened. Looking forward, the financial market implications of the virus outbreak are murky, particularly over the short term. Financial markets are responding every single day to every piece of news, or anticipated news, about the outbreak, including announcements by the WHO, central banks and governments. At the time of writing, financial markets were continuing to exhibit a very high degree of volatility.

The scenarios that unfold from here in terms of the extent of the outbreak obviously play a part in the financial market outcomes, but so too does central bank and government support. Will central banks be willing or, perhaps more importantly, able to support the economy through the economic turmoil that a worst-case scenario outcome would bring about? Will governments respond with enough appropriate and targeted fiscal stimulus that helps economies navigate these difficult times?

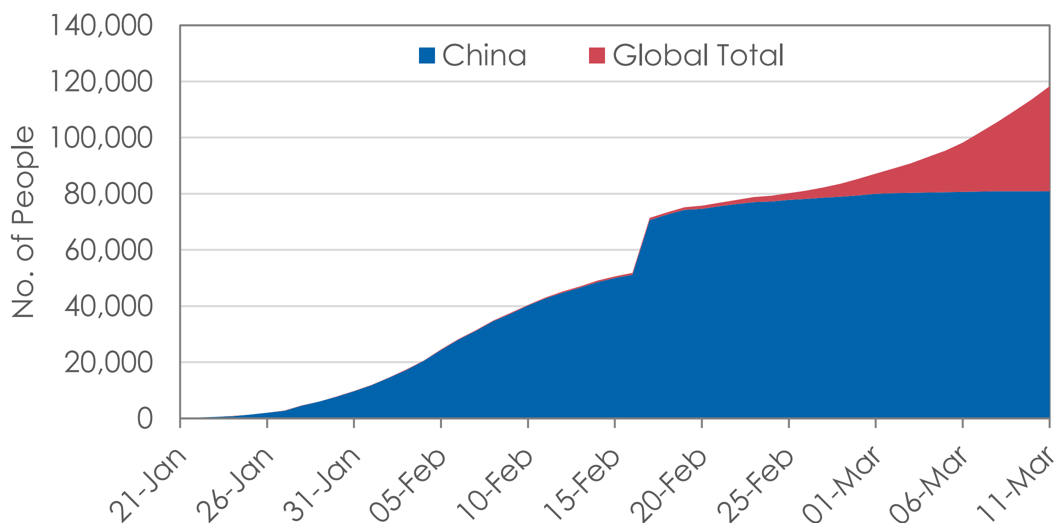
In this month's feature article, we discuss the realised and expected economic and financial market impact of COVID-19. We discuss the demand-side and supply-side shocks that the effective shutdown of China's economy for a month are causing. We also consider the ramifications of two scenarios that could unfold from here, one being relative containment (albeit this is looking less likely every day), the other being broader contagion. In either case, the economic ramifications are hard to predict with any accuracy, given that such an outbreak has no reasonable precedent. Finally, we discuss the implications for financial markets and investment strategy, including those that we have seen since the start of the outbreak as well as areas of concern going forward.

THE IMPACT SO FAR

For the first six weeks of 2020, the COVID-19 outbreak was considered a China issue, by individuals and institutions alike. It was up to the Chinese authorities to implement the necessary measures to both contain the outbreak and to support the economy through the challenges imposed by the containment measures.

The case count was rising rapidly within China's borders in January and early February, but relatively few cases were being declared outside of China's borders. The cases being reported in other countries were largely isolated incidents involving recent travel to China that were deemed brought under control very quickly. However, in late February, the COVID-19 issue notably changed course. The case count outside China was suddenly growing at a faster rate than it was in China, with particularly worrying outbreaks in South Korea, Italy and Iran. At the time of writing, the virus had spread to 113 countries.

Chart 1: COVID-19 Case Count



Source: World Health Organisation, Whitehelm Advisers

It is impossible to estimate what we expect the precise economic fallout to be from the COVID-19 outbreak. The issue, in terms of the spread of the virus, the economic impact and the financial market response is ever-evolving, with changes to the outbreak and the institutional response occurring daily.

That said, the extent of the economic shock to the global economy is dependent on a number of factors, including the following:

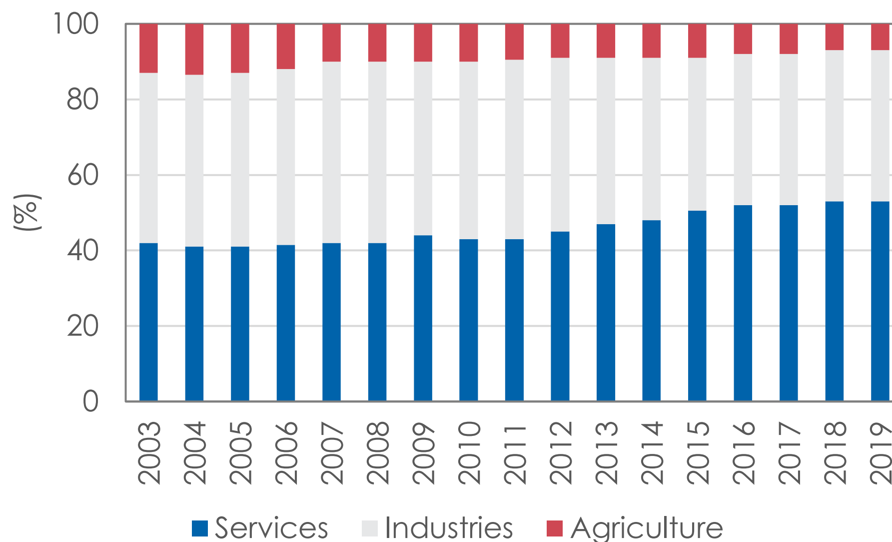
- the spread and duration of the virus, which is largely dependent on epidemiological factors, such as the transmission rate, the incubation period and the mortality rate of the virus;
- the containment measures (successful or otherwise) implemented by governments, and the disruption that the measures cause;
- the level of fear that people have about catching the virus, which then determines their response to the outbreak, including self-isolation; and
- the institutional response to the economic fallout from the outbreak, particularly through fiscal and monetary policy.

With the case count purportedly slowing in China, and the containment measures being lifted (putting to one side the re-emergence risk this brings), we have the benefit of some amount of hindsight in seeing the channels through which the COVID-19 outbreak has so far impacted the Chinese and flowed through to the global economy.

The Chinese Government initially dragged its feet in terms of both making public the extent of the COVID-19 outbreak and implementing appropriate containment measures. The government clearly wanted to face less international scorn than it received during the SARS outbreak, so it was incentivised to downplay the extent of the crisis. However, when it became clear that it had no choice but to act, it opted to implement severe containment measures. Much of the country was locked down. The combination of the fear of the virus and the government's regulation caused much of the economy to grind to a halt. This caused both demand-side and supply-side shocks to the Chinese economy, and the global economy more broadly.

Chinese consumers significantly altered their behaviour. For some, they were in mandatory lockdown and could not leave their house. For others, the fear of catching the virus caused them to self-isolate. Consumption patterns changed as people were forced to or chose to avoid public spaces, including shopping malls, events and public transport. Retail spending and tourism within and outside of China have been two of the sectors most severely impacted.

This is more problematic for China than when the SARS epidemic hit, as over the past few decades, China's economy has transitioned from being a manufacturing-intensive economy to one more dependent on services and internal demand. The composition of China's economy is shown in Chart 2. The increase in the contribution of the services sector to the overall Chinese economy is expected to lead to COVID-19 having a more significant impact on the Chinese economy, specifically output, than the SARS outbreak did in 2003.

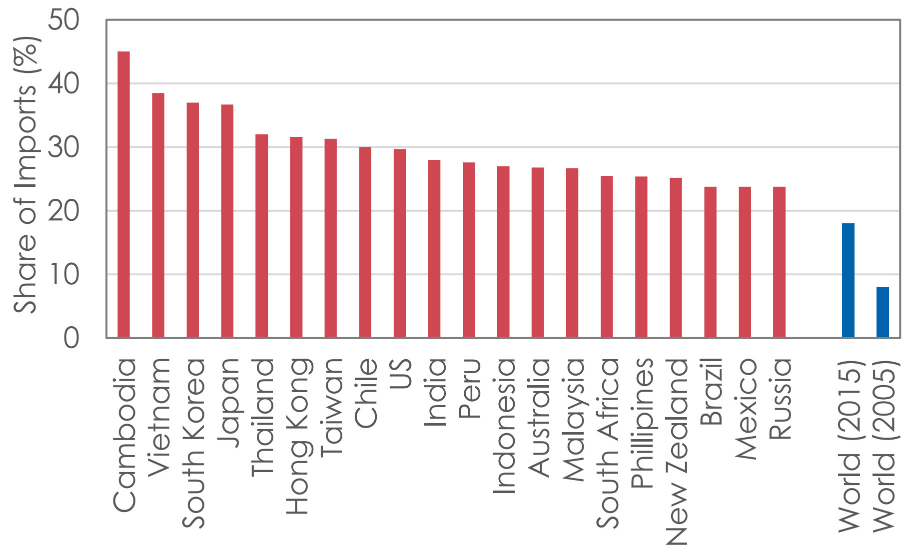


Source: National Bureau of Statistics of China

More damaging than the demand shock to the global economy has been the supply shock. The supply shock has arisen through the forced closure of a significant portion of China's manufacturing sector, but also because of the travel-related containment measures implemented at the start of the Lunar New Year period. Millions of people were dislocated around the country for Lunar New Year celebrations, given that the period marks the world's largest annual migration of people. As a result, employees have been unable to return to work until the containment measures are lifted. Workplaces have been closed or dealing with significant labour shortages for more than a month.

The global disruptions to supply have been and are expected to continue to be particularly damaging because of China's position in the world. China is the world's largest exporter, and also plays a very important role in global value chains. Specifically, China is the largest exporter of intermediate manufactured goods, or goods that can be resold to other industries to produce other goods. The world's reliance on such goods doubled from 2005 to 2015, as shown in Chart **3**. Unsurprisingly, other Asian nations are particularly reliant on Chinese intermediate goods, as many of these countries are also manufacturing hubs.

Chart 3: Share of Total Imports of Intermediate Manufactured Products That Come From China



Source: OECD, Bloomberg

Many multinationals maintain 'just-in-time inventories', meaning that they may only have enough stock on hand to last a few weeks. As a result, a supply shock in China creates a bottleneck to global supply. The interconnectedness and rising interdependence of global supply chains increases supply-chain risks, and with an exogenous shock like this one, the risks are being well and truly exposed.

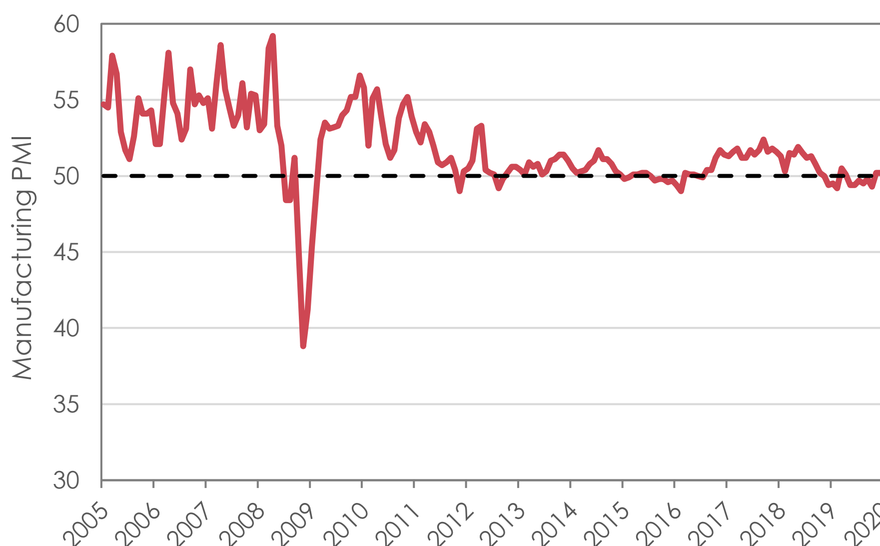
As an example, in February, companies such as Apple and Hyundai issued statements to inform their investors that the supply of iPhones and Hyundai cars would be temporarily constrained because of inventory shortages caused by factory shutdowns in China. While production at its suppliers in China has since resumed, it has been at a slower pace than first expected.

The bottleneck to supply has the potential to last for months. While many of the containment measures have eased, there is still a significant dislocation of people, and thus employees, so capacity continues to be considerably well below normal functioning levels. Now that the virus has spread beyond China's borders, supply chains could be even more impacted, especially when it has spread to manufacturing-intensive countries like South Korea or labour intensive countries. Depending on how long the outbreak lasts, it could lead to a long-term, or even permanent dislocation in supply chains.

Up until the end of February, the extent of the impact of the containment measures implemented in China could only be speculated. However, economic data for February released just after month-end showed the extent of the fall in manufacturing caused by the economic shutdown. The Chinese Manufacturing PMI fell to an all-time low in February, of 35.7, below the level reached during the GFC as shown in Chart 4.

While we are still a few weeks away from knowing the impact that the COVID-19 outbreak has had on Chinese GDP growth in the first quarter of 2020, it is widely anticipated that the country will record a negative growth rate for the quarter. Manufacturing PMIs have historically acted as a reasonable leading indicator for growth. The knock-on implications of the Chinese slowdown (before considering the impact of global spread) for global growth remain to be seen.

Chart 4: China Manufacturing PMI, 2005 - 2020



Source: Bloomberg, Whitehelm Advisers
Note: A reading below 50 represents a contraction compared to the previous month, while a reading above 50 represents an expansion compared to the previous month.

In the early days of the outbreak, the experience of the SARS outbreak in 2003 was being used as the precedent for what markets might expect in terms of Chinese and global economic growth. The SARS outbreak is estimated to have reduced GDP in China by 1% over the course of 2003. Hong Kong was more adversely affected, with a 2.5% fall in GDP over that year.

However, even just a few weeks into the COVID-19 outbreak, the comparison was problematic because COVID-19 had a wider reach and case count than SARS ever did. Over the course of the SARS outbreak, according to the WHO, approximately 8,100 people were infected and 774 died in 17 countries around the world.

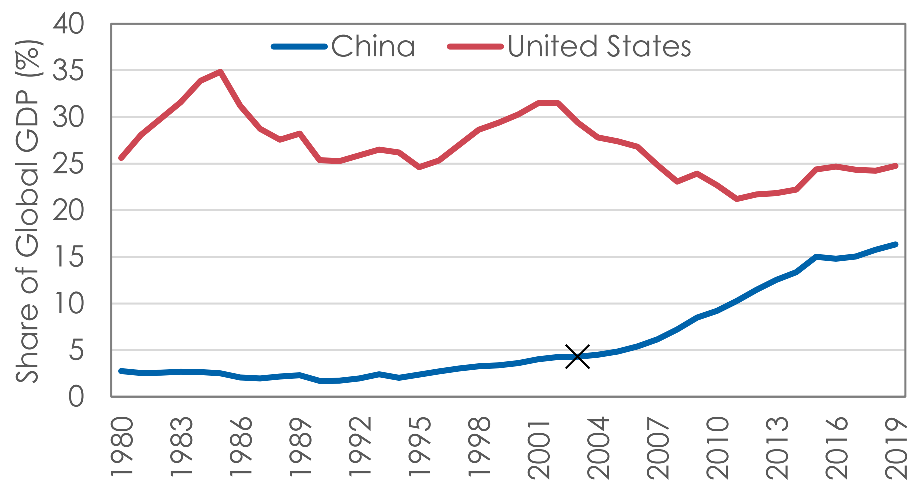
Compared to the time of the SARS outbreak, China has a significantly larger footprint in the global economy. It now accounts for 17% of the global economy compared to 4% in 2003 (as shown in Chart 5) and is the single largest contributor to global growth annually. It has significantly opened itself up to global trade, in response to it joining the World Trade Organisation in 2001, and as a result, supply chains are far more embedded in China now than they were in 2003.

Finally, China is not nearly the growth engine in 2020 that it was in 2003. When SARS was contained, the Chinese economy rebounded very strongly, marked by an annual growth rate for 2003 of 10%. This is not expected to be the case in 2020, given the headwinds to economic growth that China has experienced over the past few years. That said, China has implemented some financial policies to try to help support GDP by relieving the stress on businesses affected by the outbreak, including tax exemptions and subsidies.

Impact in Australia

Even before considering the impact that a local outbreak could have on the domestic economy, the experience in China is expected to be a major headwind for Australian economic growth in the first quarter of 2020. China is Australia's largest trading partner. A slowdown in China's growth will impact its demand for our two largest exports, being iron ore and coal. The third largest is education-related travel, which makes the ongoing travel bans particularly impactful. Australia's business supply chains will also be impacted by the Chinese supply shock, through the reduced or temporarily halted import of Chinese products into Australia. Following on from the bushfire crisis, we expect a significantly lower GDP print for the first quarter than would otherwise be the case.

Chart 5: China and United States GDP as a Share of Global GDP, 1980 - 2019



Source: World Bank, Whitehelm Advisers

The longer-lasting impacts of the COVID-19 outbreak remain to be seen, notwithstanding that we likely have not seen the peak of the crisis yet. At the time of writing, it appears as though there are a few possible scenarios that could unfold from here. The most benign is a relatively quick containment of the spread of the virus in countries that are currently experiencing outbreaks. This could come about through extremely effective containment measures or the discovery of a vaccine or a cure that could be distributed in a far more expedient timeframe than anticipated. The experiences that Italy and South Korea have had in trying to contain the virus illustrate how difficult this is. Even with an imminent discovery of a vaccine or a cure, the use of either would need to follow months of medical testing. So, a somewhat plausible scenario that could play out from here is the notable outbreak we have seen in China, but relative containment in the rest of the world because of effectively implemented containment measures.

A second scenario, and the more sinister one, is broader contagion outside of China, through much of Asia and the developed world. This could even include a re-emergence of an outbreak in China, or at least in the parts of China that have so far been relatively unaffected. Such an outbreak would be expected to arise following the lifting of all the containment measures that have been in place. The former scenario is what the OECD is currently naming as its base case for 2020. The surge in the case count in some developed nations and the WHO's declaration of a global pandemic shows that we are on the precipice of falling into the latter scenario, if we are arguably not already there. In the following sections, we discuss the potential economic fallout that we could see in either of these two scenarios, starting with the broader contagion scenario.

Broader Contagion

Even though the mortality rate of the virus continues to be low (at 3% at the time of writing), if we see a rapid transmission of the virus in many countries around the world, we would expect an increased level of panic above that already evident. Containment measures from governments would be expected to be enforced quickly. However, governments may choose to avoid the economically debilitating measures the Chinese Government implemented unless absolutely necessary (as is proving to be the case in Italy). For example, the Japanese Government encouraged the postponement of events and the closure of schools, but the measures were not enforced, so it has been broadly business as usual across the country.

Countries that have previous experience in trying to contain similar viruses, notably SARS, are ultimately more prepared to act quickly and effectively. For example, Singapore acted swiftly in response to the COVID-19 outbreak – it imposed restrictions on anyone who had recently travelled to China and parts of South Korea, implemented strict hospital and home quarantine regimens and conducted thorough tracing measures. The Singaporean Government did not shutter its economy, rather it implemented significant risk mitigation measures. Its measures have been reasonably successful – at the time of writing, it had just 166 confirmed cases and no deaths, despite being a hub for Asian and international travel.

South Korea and Italy have been slower to act, and it has shown. South Korea was unwilling to implement timely and severe containment measures in the worst-affected city of Daegu. South Korea's case count surged in late February, and at the time of writing, had nearly 7,800 confirmed cases of the virus. Italy's difficulties in managing the spread of the virus and its open borders with the European Union caused Italy's case count to surge, to also be just shy of 10,200 at the time of writing.

Based on China's recent economic experience, we may see governments shy away from the draconian measures that stall economic output, and instead find ways to try to ensure that the economy continues to function, while also implementing strict health protocols. Such measures may be to encourage or force employees to work from home where possible, or to provide income support to companies and/or individuals where working from home is not an option. However, the WHO's declaration of COVID-19 as a global pandemic on 11 March may encourage countries to enforce far more severe measures than previously thought. Even with differing institutional responses, we could see similar impacts in other countries to what we have already seen in China, including significant demand and supply shocks.

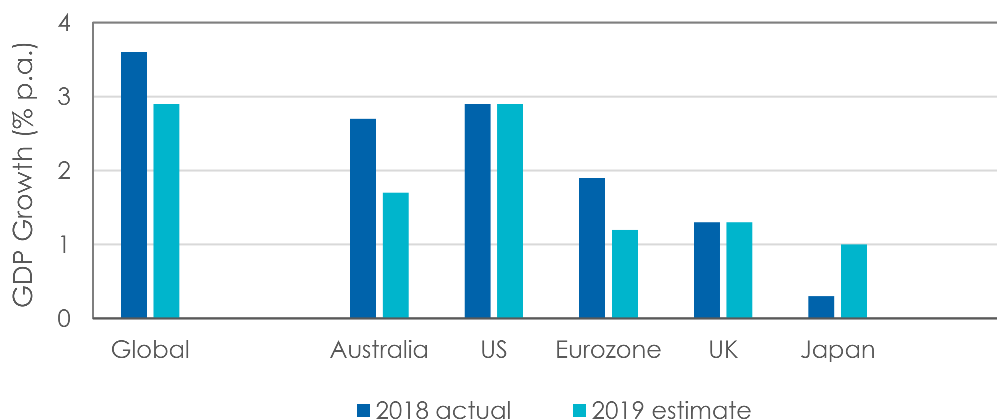
The demand shock that could come with a rapid spread of the virus is particularly challenging in light of the current global economic backdrop, notably weak consumer sentiment and spending across much of the developed world (aside from the US, where the consumer has been relatively resilient). Australia is a prime example of this - consumer spending has been weak despite an income tax cut and three cash rate cuts in 2019.

The supply shock that came with the containment measures implemented in China is likely to be more pronounced than for any other singular country, given the world's reliance on China's manufactured intermediate goods. However, a dramatic spread of the virus and a globally coordinated institutional response would lead to labour and supply shortages, which have flow-on implications for manufacturing levels and output. Commodity-exporting countries such as Australia will be particularly exposed to global supply and demand shocks.

We expect that if this scenario were to play out, we could see a notable fall in economic growth. A recession is normally defined as two consecutive quarters of negative economic growth. With most economists expecting negative growth in China in the first quarter, and China's economy accounting for 17% of the global economy, global growth will already be taking a big hit even before a broader spread of the virus. Now classified as a global pandemic, the broader spread of the virus seems very likely, so the economic impact could be severe.

The global economy in general, and developed market economies more specifically, are not positioned to be particularly resilient to the severe economic headwind posed by the COVID-19 outbreak. Chart 6 shows the 2018 growth rates and the estimated 2019 growth rates for select economies. Aside from the United States, 2019 economic growth was weak. Developed market countries are not currently growing strongly enough to cushion a blow to economic growth, such as that which would be experienced in a broad contagion scenario.

Chart 6: Actual and Estimated GDP Growth, 2018 - 2019



Source: International Monetary Fund

It is safe to say that a full-blown contagion scenario has the potential to tip the global economy into a recession. We would expect a sharp fall in global trade and growth, and very low inflation. The depth and duration of the recession would be largely dependent on the fiscal and monetary policy stimulus measures enacted in response, as well as the length of time it takes for the case count to legitimately stop growing. We have already seen central banks' willingness to stimulate through 'normal' monetary policy measures, evidenced by the cash rate cuts made by the US Federal Reserve, the Reserve Bank of Australia and the Bank of Canada in recent weeks. However, a deep global recession would require unconventional monetary policy measures outside the realm of normal, similar to what was enacted following the GFC, including extensive quantitative easing (QE) measures. This is particularly the case in an environment where there is limited room for interest rates to move further down and central bank stimulus is not proving anywhere near as effective as desired.

Governments have already been discussing and enacting fiscal stimulus measures. In early March, the G7 finance ministers issued a joint statement illustrating that they are willing to use '*all appropriate policy tools to achieve strong, sustainable growth and safeguard against downside risks.*'[1] Many governments have pledged their commitment to supporting their economies through this difficult period. Governments will need to enact targeted stimulus measures, including income support for the small to medium-sized enterprises that are most directly affected by the labour shortages caused by the outbreak.

The likelihood of a broader contagion scenario has increased from highly unlikely (or at the very least, hopefully unlikely) at the start of the COVID-19 outbreak, to increasingly likely and inevitable with every passing day. The WHO's 11 March 2020 declaration of the outbreak being a global pandemic highlights its concern that a contagion scenario is probable, despite its messaging that containment is still achievable. This scenario ends when the outbreak has finally been brought under control, which may be months or years away.

Impact in Australia

Clearly, a large-scale outbreak of COVID-19 in Australia will be very challenging for the Australian economy. The extent to which this is the case is anyone's best guess. However, Prime Minister Scott Morrison noted that Australia is more vulnerable to experiencing a recession because of the COVID-19 outbreak than it was during the onset of the GFC, because of the nature of the economic shock. The GFC was largely a balance sheet shock centred in North America, and China's quick recovery from the crisis meant that its demand for Australian commodities allowed Australia to avoid entering a recession. Given that the catalyst for the COVID-19 outbreak and the economic fallout is based in China, Australia will likely not be propped up by China this time around. With the RBA only one rate cut from its stated lower bound of 0.25%, Australia would likely end its 27-year track record of continuing economic growth. The Australian Government's financial stimulus package comprising tax relief and cash payments for businesses and support for welfare recipients is an attempt to increase spending to circumvent the slide into recession.

[1] Refer to https://home.treasury.gov/news/press-releases/sm927

Successful Containment or Slow Spread

This scenario is what the world is currently hoping for, but the global panic buying of toilet paper suggests that there is a widespread belief this scenario is already unattainable. Up until the middle of February, it looked as though this scenario was potentially more likely than the broader contagion scenario, as the outbreak remained focused in China.

We expect that this scenario could play out if we see a reasonably quick and effective containment of the spread of the virus in the countries outside China that are currently experiencing outbreaks. Alternatively, a scenario with a different path but a similar result would be if we see a very slow spread of the virus, where rather than a sudden spike in cases, we see reasonably slow community transmission. Hundreds of thousands or millions of people could be infected over the virus' lifetime, however the slow spread could mean that governments treat each case individually rather than shut the economy down.

In the last week of February and the first weeks of March, we saw the sharp rise in cases in countries outside of China. Some countries are no longer dealing with isolated incidents, but rather are now facing high rates of community transmission, which is particularly difficult to contain when carriers of the virus can be asymptomatic. However, in many other countries, including in Australia, the case count is rising, but slowly and the cases have been theoretically reasonably well contained.

Clearly, the containment of the virus would lead to far superior economic outcomes than a contagion scenario. Governments may enact strict quarantine measures (which would bring about a significant increase to health care costs), but without a dramatic escalation of the outbreak, the measures would be expected to be short-lived, and their coinciding impact more temporary. We would not expect to see the extensive lockdown measures, whereby workplaces and schools are closed and all public events are cancelled, such as those enacted by the Chinese Government, so output would not be as constrained by severe labour shortages. Only a small quantum of consumers would lose income from being unable or unwilling to work, so consumer spending patterns would likely return to normal relatively quickly.

In the event of a slower but extensive spread of the virus, companies would be expected to face relatively minor labour shortages as people self-isolate, so stay at home rather than going to work. However, the entire workforce would not be doing this at the same time, but rather on a rolling basis. The impact on national output, therefore, would be small relative to the contagion scenario we just discussed. Given how the COVID-19 outbreak has unfolded so far, a scenario of slower community transmission appears to be reasonably unlikely.

The fiscal stimulus and monetary policy measures that have either been announced or widely speculated about show that governments and central banks are prepared to support the economy as best they can through any scenario that unfolds from here. If the outbreak is contained relatively quickly, we expect that central banks might ease up on the monetary policy stimulus that has already been enacted, especially in consideration of the very limited room for monetary policy manoeuvre at the moment. For example, we would expect that the Federal Reserve would likely reverse its 50 basis points cash rate cut, in light of the otherwise reasonably strong US economy.

Clearly, the likelihood of this scenario seems to be falling with every passing day. The WHO's declaration of COVID-19 as a global pandemic on 11 March reinforces this view.

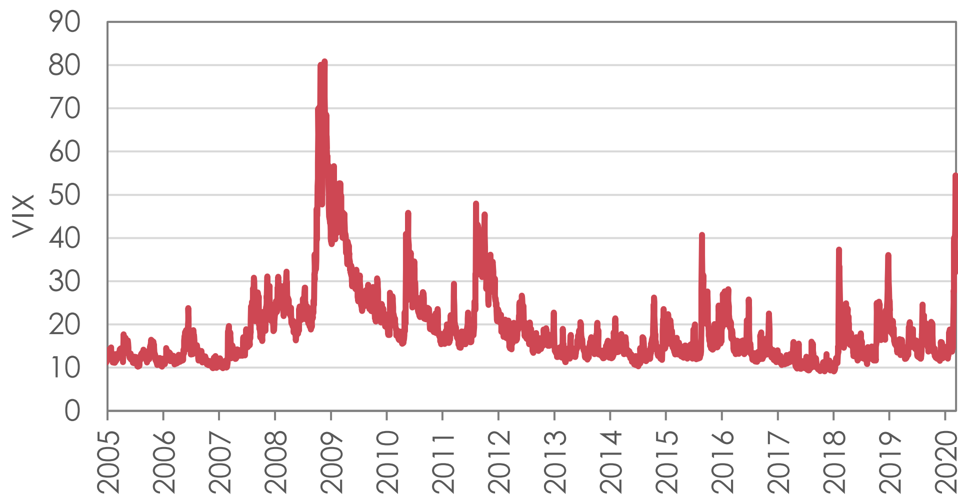
FINANCIAL MARKET AND INVESTMENT CONSIDERATIONS

Calendar year 2019 was a remarkable year for developed market equity markets. The S&P 500 index returned 18% (in US dollar terms), the S&P/ASX 200 returned 21% and the MSCI World Index returned 28% (in US dollar terms). These strong equity returns came despite an environment of slowing economic growth, the playing out of the US/China trade conflict and Brexit uncertainty.

Equity markets shrugged off a relatively rocky start to the 2020 calendar year, noted by the sudden escalation of US/Iran tensions and the COVID-19 outbreak in early January. Equity markets treated the latter as a China issue, rather than a global one. Aside from an increase in market volatility in late January and a short-lived market sell-off, equity markets surged to new all-time highs in February.

However, a sudden spike in cases in countries around the world in mid to late February brought a renewed focus to the potential breadth and duration of the virus outbreak. Seemingly overnight, the number of cases outside of China was growing faster than the number of cases in China. Furthermore, the economic ramifications of the containment measures in China were starting to be seen through economic data releases. Financial markets had to grapple with the potentially catastrophic outcomes, both in terms of human life and the global economy.

Market volatility spiked, as shown by the VIX measure in Chart 7, and equity markets sold off aggressively. From 19 February to 28 February, both the S&P 500 Index and the MSCI World Index fell by 12%, while the S&P/ASX 200 Index fell by 10%. In early March, markets were volatile, as central bank and government announcements caused rapid changes in sentiment and a see-sawing of equity indices. Then, on 9 March, global equity markets had their worst day since the GFC, falling by close to 8%, due to the COVID-19 outbreak, but exacerbated by the oil price crash following failed OPEC discussions over the preceding weekend.

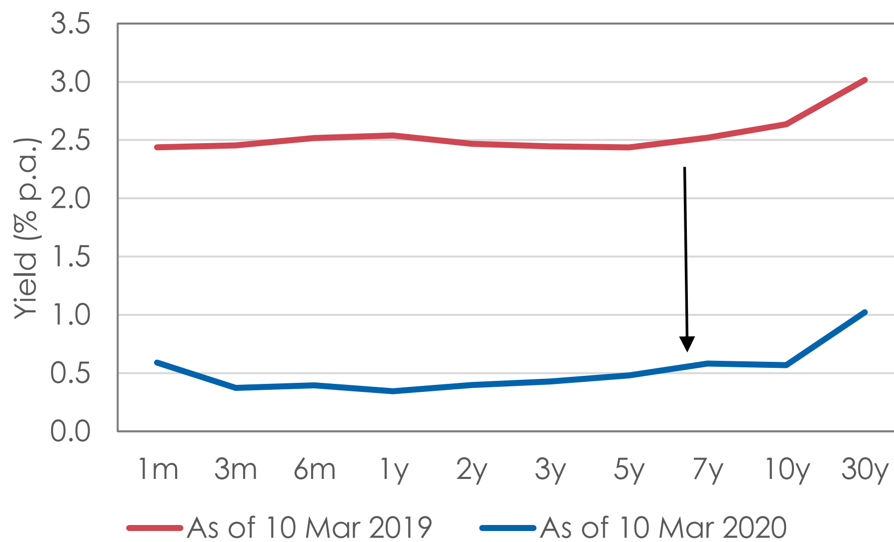


Source: Bloomberg

The dramatic moves in asset prices over the past few weeks are consistent with what is expected in a sustained risk-off environment. At the time of writing, equity markets had shed nearly all of the strong 2019 gains, currencies such as the US dollar, the Swiss franc and the Japanese yen have appreciated, and the price of gold has surged. Government bond yields reached all-time lows, and the entire US government yield curve was below 1% as of 9 March. The change in the US government yield curve over the past year is shown in Chart 8.

Since the GFC, and especially in the past few years, financial markets have not been particularly closely linked to economic fundamentals. Extreme and unconventional monetary policy implemented since the crisis has caused a decoupling of the two. Bad news in economic terms could mean good news for financial markets. Despite a tumultuous few years of a populist push, trade wars and slowing global growth, share and bond markets continued to push to new highs. Central banks willing to accommodate at the first sign of financial market wobbles has been the most significant driver of this.

However, the market response to the COVID-19 outbreak over the past few weeks suggests that there are two main concerns about the outbreak from here. The first is that we end up in the broader contagion scenario we discussed in the previous section. The second is that this exogenous shock is the straw that breaks the camel's back in terms of central banks being able to stimulate away every problem. The prolonged risk-off environment highlights a rational concern - cash rate cuts may be entirely inadequate if we end up in a recession. Reducing borrowing costs will not resolve the ongoing supply shock or encourage consumers to spend more given the fact that they do not want to leave their house.



Source: Bloomberg, Whitehelm Advisers

Looking forward, outcomes in financial markets will largely be driven by investor sentiment about how the containment of the virus is progressing, the realised economic impact of the containment measures, the expectation for how the global economy will recover, and the announcement of additional monetary policy and fiscal stimulus measures. If the scenario of successful containment unfolds, we may see a sharp recovery in share markets, through the more optimistic sentiment and the effect of the monetary and fiscal measures already implemented.

However, if the broader contagion scenario unfolds, we can expect to see the first quarter China experience unfold globally. Growth will contract, trade volumes will fall and share markets will undoubtedly see continued weakness, or at the very least, volatility. The nature of a global pandemic is that it will inevitably come to end – we just have absolutely no indication of when that might be. The recovery will occur and will likely be strong, which is good news for risk assets such as equity and commodities, but it could be six months, 12 months or 18 months down the road.

In the meantime, an area of particular concern going forward is the current state of play in corporate debt. There has been a rapid rise in corporate debt since the GFC around the world, but notably in the United States and in China. The fastest rate of increase in corporate debt has been among borrowers rated BBB, one notch above 'junk' status. These BBB bonds now make up about half of all investment-grade bonds on issue. Over the past few years, investors have become increasingly concerned about the ballooning of BBB-rated debt because any ratings downgrades, such as those that occur in the event of economic or financial market stress, would mean that there would be a large influx of corporate debt into the junk market.

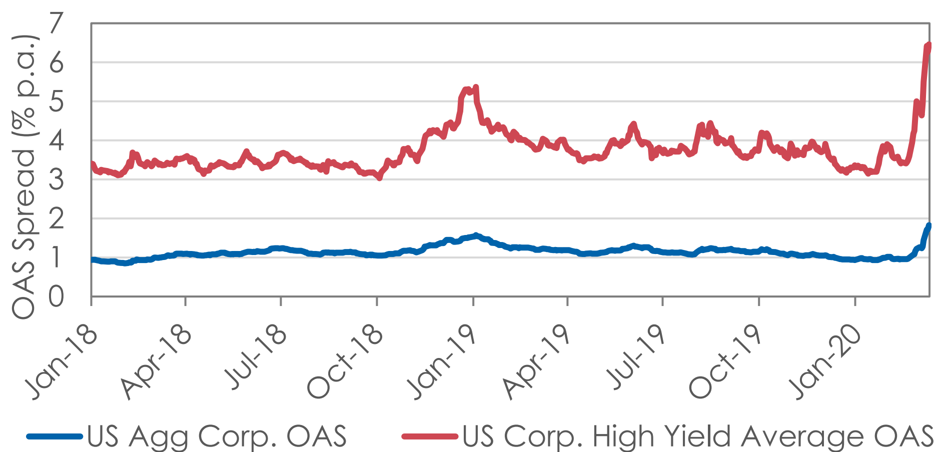
The outbreak of COVID-19 is posing significant problems for corporates, notably those in exposed industries such as travel, tourism and airlines and/or those who are either situated, or have some parts of their production in the most affected regions. For such corporates, the outbreak has caused revenues to fall and spending to increase. Inventory issues relating to the supply chain disruptions are causing corporates to blow through their cash reserves. A survey of small and medium-sized Chinese firms conducted in February showed that two thirds only had enough cash to cover fixed expenses for two months.[2]

It is evolving into a problematic situation for corporates as they have large amounts of debt coming due. Debt has been so easily accessible to issuers at the lower end of the investment grade spectrum, however the recent spike in corporate high yield spreads related to the rising global panic surrounding COVID-19 exposes the risk (as shown in Chart 9). A severe economic downturn could create a major headache for such companies, given they will be unlikely to cut their borrowings or cut debt by selling surplus assets in such an environment. This could result in widespread ratings downgrades.

Central banks have already shown their readiness to support credit markets through this period, including by the 50-basis point rate cut by the Fed in early March. The Chinese Government has also cut interest rates and is encouraging banks to boost lending to SMEs.

Central banks could also opt to implement QE, which could involve purchasing corporate bonds. Other measures are also not out of the question, including longer-term asset purchases, negative nominal interest rates and interventions to directly target long-term yields. Given the already low interest rates, central banks may have to embark on a more aggressive QE program. For example, by buying corporate bonds, central banks could provide liquidity to the corporate bond market and lower credit spreads, leading to cheaper debt costs and more stable credit markets. However, while any of these options may temporarily appease markets, it will amplify the debt overhang and make any future monetary policy normalisation increasingly challenging.

Chart 9: US Corporate Spreads, 2018 - 2020



Source: Bloomberg, Whitehelm Advisers

[2] Refer to Bloomberg article on 23 February 2020: *Millions of Chinese Firms Face Collapse if Banks Don't Act*

Investment Considerations

Over the past several years, there have been plenty of downside events that could have (and at times, should have) caused the financial market stress that we have seen over recent weeks. Economic fundamentals, including lower economic growth, high public and private debt levels and extraordinarily accommodative monetary policy meant that a defensive portfolio positioning should have been considered prudent. But the reality in markets was that central banks were always there to step in to accommodate, which has continually pushed risk assets higher, punishing investors that have based their portfolio positioning decisions on the underlying economic backdrop.

At the time of writing, defensive investors, or those with lower allocations to equity and higher allocations to government bonds for example, were being rewarded for their patience. The extent to which this lasts is entirely uncertain, as we have seen markets see-saw on announcements made by central banks, governments and the WHO. In past cases of global health pandemics, the downturn has been steep, but the recovery was also very strong. The extent and the timing to which that happens means that investors need to be nimble to the changing market conditions. Being able to limit exposure to the extreme downside moves but partake in the upside recovery will be of increasing focus, particularly given the challenges of determining just how far into a downturn or recession the COVID-19 catalyst may push markets.

IMPLICATIONS BEYOND THE PANDEMIC

Embedding global supply chains in China has been happening for the past few decades, marked by multinationals offshoring their manufacturing processes to China, largely to take advantage of cheaper labour conditions. The trade wars, and the impact that tariffs had on the price of intermediate manufactured goods made in China, brought about increased costs for multinational companies. Now, the COVID-19 outbreak is causing headaches of a different kind to multinational companies, through major supply disruptions. The consecutive headaches caused by these two issues could cause multinational companies to reconsider, or at the very least appreciate, the complexity of their supply chains. It may lead to multinationals choosing to diversify their supply chains, or to re-shore some parts of production. Even for businesses with far less direct global interaction, the global disruption will have significant consequences. The resulting overall impact on global economic growth could be prolonged beyond a short term dip and beyond what is currently being priced into markets.

In many ways, the containment measures that have been enacted are a taste of deglobalisation that right-wing politicians, such as President Donald Trump, have been calling for over the past few years. Barriers have been enacted to stop both goods and people from moving across borders. One of President Trump's main campaign rally cries leading up to the 2016 election related to the reshoring of businesses and their profits. The virus outbreak is helping strengthen Trump's argument for the benefits of deglobalisation.

Interestingly however, time and again over the past three years President Trump has taken credit for the stock market highs, claiming that it is the economic policies that he has pushed through that have sent the stock market higher. To some degree, this is accurate. The late 2017 tax cuts provided a boost to the economy and financial markets. However, central banks, particularly their accommodative monetary policy, have played a crucial and overwhelming role in driving the stock market higher, despite the geopolitical uncertainty that President Trump has evoked.

Tying himself so closely to stock market gains could prove to be very damaging for President Trump, particularly given the ongoing market crash is occurring just eight months before his re-election bid. Trump may be able to convince his supporters that the correction is only caused by the media and the fear that he thinks the media is generating about the virus. However, if the market correction is severe enough and long-lasting enough, it may be enough to see a changing of the guard come November.

CONCLUSION

The impact of the COVID-19 outbreak is certainly difficult to pin down. This is not only because it evolves every single day, with both the case count and the institutional response, but also because there is no reasonable precedent (certainly not in modern times anyway). It has evolved from being a China issue to a global pandemic, from the case count being in the hundreds to being a hundred thousand and from receiving a dismissive shrug from financial markets to the cause of the most treacherous financial market conditions since the Global Financial Crisis.

While we have discussed the expected implications for the global economy and for financial markets, both in terms of what we have already seen and what is expected, there are so many unknowns. As such, we will continue to monitor the ongoing spread of the virus, as well as the global coordination of the institutional response to the crisis.

In our view, it was only a matter of time before a downside risk to the global economy materialised into an event that sent markets into a state of turmoil. The economic conditions are ripe for it – a decade long period of economic growth, ultra-high debt levels and monetary policy with little room to manoeuvre. It could have been trade wars, a difficult Brexit outcome or a sharp escalation in geopolitical tensions that caused a significant market correction. In recent years, central banks have managed to support the global economy through these difficulties, at great cost. The uniqueness and suddenness of the COVID-19 outbreak may be too great for central banks to handle alone.

In this time of heightened market volatility, investors need to be vigilant. With so much uncertainty remaining about the health and economic impacts that this outbreak will have, it is too soon to tell if central bank support will be able to yet again turn a 'bad event', such as a global pandemic, into new stock market highs. As it currently stands, we consider there is a real possibility that the situation to get worse before it gets better. As such, we will be monitoring this situation closely, with the intention of providing real-time portfolio advice if investment settings need to change.

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