BERGOS BERENBERG

MARKET COMMENTARY

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UPDATE ON THE CORONAVIRUS AND POTENTIAL SCENARIOS

SUBSTANTIAL MOVES ACROSS ALL SEGMENTS

Uncertainty among investors continues to be high and we have seen increased volatility across all asset classes and regions since our last commentary on the coronavirus (COVID-19). Risk aversion led to a further flight to safety, with ten year yields in the US reaching record lows. In parts, markets were driven by nothing but fear around the spread of the epidemic across the world and the increased number of infections, especially in South Korea and Italy, did not help in calming the situation. According to WorldOMeter, at least 93'526 infections have now been reported globally (80'282 in China, 5'621 in South Korea, 2'502 in Italy and 2'336 in Iran) and tragically, 3'204 individuals died as of today (2'981 in China, 33 in South Korea, 79 in Italy and 77 in Iran). As a response to heavily-affected Italy and fears that globally-exposed Germany may suffer a technical recession, our economists revised their projections for 2020 GDP growth in the Eurozone downwards to 0.5% from 1.0%. Similar in the US, we also cautiously lowered our forecast for 2020 GDP growth to 1.8% from 2.1%, and finally, the OECD cut its global GDP growth forecast by half a percentage point to 2.4%, reflecting the hit to economic activity.

THREE POSSIBLE SCENARIOS

Given the current situation, we see three possible scenarios for the economy and markets going forward. Scenario A (containment) implies that the outbreak will be more or less contained by late March/early April and production activities normalize until then, limiting the disruption mainly to the first quarter. Global growth declines but recovers significantly from the middle of the second quarter onwards. As of today, this scenario seems to be more than fully priced by markets. Scenario B (escalation) suggests that new cases continue to rise around the world but with increased data collection and more intensive use of tests, the mortality rate decreases. We would see a culmination of the situation by late May/early June and the disruption to economic activity continues until the end of the second quarter. Global growth slumps but picks up in the second half of the year. This scenario should be more or less priced by markets by now and certain segments already appear attractive under these assumptions. In a third Scenario (C – massive escalation), the virus continues to spread into the third and maybe even the fourth quarter of this year, covering all relevant economies worldwide, causing disruption until year end. Global growth remains weak for a long time, possibly triggering a global recession – a scenario that is certainly not priced by markets today.

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ULTRA-LOW YIELDS FOR LONGER

Central banks also fear that the virus poses downside risks to the economy and that the sharp decline in the stock market may hit consumer confidence, a factor that has been supporting solid gains in consumption and housing (especially in the US) while industrial production, business investment and exports have been weak. To prevent this, the US Fed held an emergency conference call meeting and cut its federal funds rate target yesterday by 50bp to 1%-1.25%, two weeks before its scheduled March 17-18 FOMC meeting. The magnitude and timing of this rate cut has come as a surprise for markets and whether it proves to be effective or wise is yet to be determined. The ECB will most likely also react to the epidemic but unlike the Fed, it has limited room to act as its key rates are already at zero or negative. Further fiscal expansion is expected to be taken up around the world, with measures aimed at providing near term relief for disrupted sectors and measures to support aggregate demand. While the coronavirus is unique and scary, we expect it to be a temporary phenomenon and investors should not discount the benefit of the mentioned global policy responses which should outlast the impact of the virus. Insurance cuts at a time when the US economy is close to full employment and the participation rate is on the rise could result in a return to solid economic growth once the COVID-19 impact rolls off and stimulus remains.

EQUITIES RELATIVELY ATTRACTIVE COMPARED TO BONDS

Among the above mentioned three scenarios, we consider scenario B to be most realistic at this point in time. The epidemic is severe but no threat to the entire financial system. We expect virus-related disruptions to constrain demand and supply in affected regions and to weigh on global confidence for the next two to three months but forecast a gradual return largely to the pre-virus trend thereafter. As the advanced world is not suffering from serious excesses that would require a cleansing recession, economies should recover once the coronavirus shock starts to fade. Further declines in risk assets can certainly not be ruled out and investors might be best-served by accepting volatility, rather than taking it as a signal of inevitably worse outcomes pending. However, as soon as market participants gain confidence that the spread of the coronavirus is under control, stock markets are expected to recuperate most of the recent losses and there is a good chance markets will ultimately be higher at the end of the year. Supporting this view is the relative attractiveness of stocks versus bonds, which increased considerably over the last two weeks and it seems that there is no real alternative to equities in the medium term in a liquid portfolio.

TILL CHRISTIAN BUDELMANN

As capital market strategist of the private bank Bergos Berenberg, Till Christian Budelmann regularly comments on events on the international capital markets and examines them in the context of economic and political trends. Since 2004, Budelmann has been responsible for various investment strategies and sits on the bank's Investment Committee. He has been Managing Director since 2013.

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