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Coronavirus Pandemic: Do Whatever It Takes

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Investors are in full panic mode as COVID-19 morphs into an official global pandemic. The Dow-Jones Industrial Average went from a 52-week high to a 52-week low in 10 days, the fastest reversal ever recorded. The scale of volatility registering across markets reflects the unusual nature of the uncertainty fostered by the spread of the virus. It is a potent mixture of anxiety about the disease itself and implications for the world economy. Feeding the fear are the relentless media headlines warning of potential catastrophe.

I have no expertise to form a meaningful opinion on how great a health issue COVID-19 truly is; it seems more serious than the flu, especially for older people; 90% of the fatalities in Italy have been for people over the age of 70. The U.K. authorities seem to be zeroing in on this factoid and are reportedly gearing up to ask all Britons over that age to stay home for up to four months. In the meantime, there is a lot of cherry-picking going on with respect to interpreting or extrapolating the data we are all watching. Optimists focus on the possibility of overstated mortality figures due to under-reported cases with milder symptoms. Pessimists project alarming contagion: 70% of the world population and a mortality rate in the low single digits. Noteworthy in all the discussion is the dispersion of views within the scientific community, owing in part to the unpredictable nature of viruses in general and the novelty of COVID-19.

As investors, what matters are the economic and financial consequences from the disease, policy initiatives, and public reactions. What seems evident from current developments is that last year's stabilization in the global economy has been snuffed out. The world economy is lurching its way into recession. How long the world remains in recession is now the critical investment issue. The latter depends on reactions to the spread of COVID-19 and efforts to contain the economic fallout.

Lessons from China

A lot can be learned from what has happened in China to date:

The good news is that traditional health measures *are extremely effective at controlling the spread of the virus.* Dr. Bruce Alyward—the Canadian doctor who has led the WHO-China joint mission—confirms the success of near virtual containment in China, notwithstanding the suspicion many attach to China's data reports. South Korea, Singapore, and Taiwan also seem to have had great success in containment.

The bad news is the cost of containment from this approach, at least in the short term:

- **China's annualized GDP growth for the first quarter is estimated by most to be around -20%**
- **Coal consumption fell over 50%**
- **February auto sales dropped 90% from their peak last year and 80% from a year ago**
- **There were virtually zero housing transactions up to two weeks after China's New Year**
- **The PMI Services Index collapsed to 27**

***These are depression-type economic stats.*If there are green shoots beyond the declining number of virus cases, they are in China's capital markets. They don't play the same role in the Chinese economy as America's markets by a long shot, but are worth noting. The Shanghai Composite bottomed on February 4 shortly after the authorities got aggressive about containment. The 10-year Chinese sovereign yield has moved lower all quarter**

but credit spreads have not widened, a sign that a range of directives aimed at shoring up business liquidity are working.

The low point for Chinese economic activity was February, based on high frequency data. Activity is slowly building as the country inches back to work, mindful of an echo-effect as people come out of quarantine. And China's government continues to ramp up monetary and fiscal measures aimed at getting things moving again.

The Virus Outside of China

Outside of China, a meltdown in investor sentiment has been underway since February 20. Until last week, U.S. and European officials generally downplayed the virus and provided little leadership, coordinated or otherwise. This has given time for fear to spread as the world watches events unfold in places like Italy and Iran. *If the experience of other countries repeats, there will be an explosion in the number of reported cases in Europe and the United States during March and April.*

Markets generally panic until policymakers start to react. This year's slide in Treasury yields—the global fixed income market's risk-free benchmark—reached an extreme level of overvaluation last week based on our modeling metrics. From the high on Friday March 6 to the low on Monday March 9, the U.S. 30-year Treasury yield dropped 86 basis points, more than half the drop in yields recorded since the start of the year. The speed of the descent in yields and the abrupt slide into extreme economic pessimism is unprecedented.

The good news is that last week policy makers finally began to react to the turbulence. It started with President Trump's announcement of a travel ban on flights from Europe, followed by his declaration of a national emergency and the public-private strategy for meeting the health emergency. Chancellor Merkel has warned of a 70% infection rate. Various leaders around the world are self-quarantining due to risk of exposure. News of Hollywood celebrity Tom Hanks's illness went viral over traditional and social media. The March 12 decision to close Capitol Hill for a month could become symbolic. The western world's leaders "get it" and know that full scale mobilization of activity and resources is required.

It is hard to imagine a presidential decree to lock down New York, a city comparable in size to Wuhan, China. But extensive quarantines may still happen. The reaction to stem the virus is coming from the bottom-up in the U.S. rather than from the top-down, like in China. Developments are unfolding very rapidly:

- There are widespread reports of cities canceling events with more than 500 people
- The National Basketball Association and National Hockey League have suspended their seasons, with other sporting events cancelled around the world
- Universities are suspending classes and going online
- Businesses are adopting strict protocols for visitors and office health etiquette, with more businesses encouraging employees to work online at home
- Community hot spots of infection are being ring-fenced
- Senior residences are forbidding visitors in order to protect the vulnerable

Similar events are happening around the world.

Policymakers Need to Do Whatever It Takes

Economic policy thinking/action is rapidly shifting to a "whatever it takes" semi-wartime mentality to stem the panic and get through the economic upheaval. The main economic policy issue is the measure(s) needed to keep companies from failing and people from losing income caused by social distancing in order to put the brakes on the virus spreading. Companies and financial institutions need cheap credit in order to operate at a loss for a period of time without layoffs— people need support if they are laid off.

China has managed this through a variety of means including state directives to the commercial banks instructing them to roll their loans to businesses. Stable corporate spreads suggest that their strategy is working despite the contraction in the economy.

In the U.S., the Federal Reserve (Fed) has slashed interest rates and indicated substantial willingness to expand its balance sheet by hundreds of billions of dollars' worth of Treasury debt—a message it coordinated with several other major central banks around the world this past weekend.

The main aim of the Fed's operations is to provide insurance against systemic financial system risk, although this could help the U.S. housing sector. Zero-bound interest rates are not going to encourage people to borrow money to buy a cheap ticket to Europe. Instead, the Fed is trying to ensure that counter-party credit risk does not seize up the financial system the way it did in 2008. In Europe, the European Central Bank (ECB) has modified and expanded its targeted- and long-term refinancing operations (TLRTO) and (LTRO) programs. Banks will be able to borrow at sub-zero rates and post a wide range of collateral. Additionally, the central bank has temporarily allowed European banks to operate with lower capital adequacy ratios.

The Fed has more options. Re-opening the commercial paper backstop facility could be done. More controversially, there is a defensible case for buying corporate bonds.

The more likely policy direction—and the one the Fed and other central banks want to steer toward—is sizeable fiscal intervention. This may look like a speedy approach to Modern Monetary Theory, but reaction to the virus has created a demand shock. Easy money alone won't rejuvenate demand due to the nature of this disaster. It needs coordinated fiscal and monetary stimulus. Japan is clearly moving in this direction. On Friday, Vice Finance Minister for International Affairs Yoshiki Takeuchi said that the government and Bank of Japan "stood ready to work as one." Germany has quickly moved in this direction with Finance Minister Olaf Scholz's declaration to provide unlimited cash to businesses hit by the virus. Echoing President Trump, Larry Kudlow, Director of the National Economic Council, stated that the White House would do whatever it takes to stem the panic. Kudlow quoted a list of possible action items, which he estimated would cost $800B. Under these circumstances, the Fed would buy the debt required to fund these activities.

Oil Prices

As if all the coronavirus pandemic stress were not enough, the Saudi-Russia oil -price war adds another layer of uncertainty to the near-term outlook. No possible gain in market share will make up for the revenue loss Saudi Arabia is about to incur. High-cost producers around the world will be marginalized as long as this plays out, which includes Canadian tar sands and U.S. shale producers. So, the move seems more political as some have suggested, possibly rooted in Russia's desire to get back at U.S. sanctions by hurting oil producers.

Outlook

More generally, a lot of policy firepower is likely to build up over the course of the next several months in the form of sizeable fiscal intervention with full monetary support. This stimulus, in combination with low energy prices and super low interest rates, will provide a potent boost to economic activity long after the virus risk aversion subsides, and some semblance of normalcy begins to return. If and when that comes, it would dramatically alter financial conditions—particularly for interest rates. Obviously, this is not a time for dogmatic views and the risk of a more nightmarish scenario can't be dismissed yet. However, overcoming the viral threat at some point, followed by a global recovery of some magnitude, seems the most likely outlook for the future.

In summary, it's not the time to be a hero in the short term, but markets do appear to have reached some sort of extreme—coming out the other side could be gangbusters. In the meantime, wash your hands, no hugging or handshakes, work from home if you can, video conference calls instead of personal meetings, and avoid public transit and large gatherings of people.

Take care.

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