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ASK FORSTRONG:

STRAIGHT TALK ON COVID-19

WHAT IS YOUR INVESTMENT TEAM'S TAKE ON THE UNFOLDING CORONAVIRUS CRISIS?

Tyler Mordy
President and CIO
Forstrong Global Asset Management Inc.

Speed Read:

- The economic impact from Covid-19 will be severe but not long lasting.
- A combination of fear and misinformation has created a dangerous breeding ground for investor mistakes.
- A globally coordinated policy response to support growth is underway. This will lead to a V-shaped recovery into the second half of 2020 that is not priced in markets.
- A substantial reversal for several asset classes and a change in investment leadership is now underway.

This week the widening Covid-19 crisis finally pierced the public consciousness. All major equity indexes plunged. Bond yields hit new lows. The coronavirus choke hold is now fully tightened on global financial markets. The catalyst? Italy reporting an outbreak near Milan on Monday. This was the disease's first foray into a developed nation. Suddenly, it was not just China's issue but the world's problem too.

Over 40 countries have now confirmed infections. With clusters of cases appearing all over the globe, the worry is that economic consequences will not be isolated to sectors dependent on Asian supply chains. The entire global business community is now threatened. And yesterday the head of the World Health Organization declared that we are at a decisive stage where Covid-19 has the potential to become a pandemic.

This is all serious stuff and deeply tragic on a human level. But investors need to maintain the right perspective. Yes, Covid-19 is a new virus, but panic and fake news surrounding epidemics is not. The latest conspiracy theories — which range from believing the disease is a political weapon to bring down Trump to the result of eating bat soup — are all playing a familiar historical chord. In hindsight, these views prove to be overly alarmist, xenophobic and just plain wrong.

What is different this time is the rise of social media. Information now travels much more quickly. Yet faster data flows have disadvantages. Misinformation arrives into the world fully formed. No supporting evidence is required. Untested theories simply spread without checks and balances. Ultimately, hysteria is transmitted more effectively.

Even back in 2003 reactions to SARS (despite a far higher mortality rate) were measurably slower than today's outbreak. Reaching back further to the Spanish Flu during 1918-1920, many people would have fallen ill and died without ever hearing of the disease. Fake news was easier to contain.

By contrast, facts are slower moving. Truth takes time to appear. But when existential risks are involved, patience is

in short supply. People want instant answers. No surprise then that digital information channels are now clotted with false information (for the record, this also applies to this author's family group chat — for sure, the trickiest of social arenas).

Of course, there is an upside to faster global connectivity. Government response times to epidemics have been faster. Beijing acted forcefully — almost immediately quarantining some sixty million people (roughly the size of Italy). In time, China's response — which has been praised by the World Health Organization for its aggressive approach to the virus — may be seen to be more effective than many leading developed nations.

Business responses have been swift too. For example, 31 airlines quickly cut their services to China. By comparison, no shutdowns occurred during SARS.

Where to next? Conditions in China — where the vast majority of Covid-19 cases reside — are now improving. Critical numbers such as newly confirmed cases (falling) and recovery rates (rising) are all encouraging.

Business conditions in China are also gradually improving. This is crucial as China holds the key for world growth, given the country's vital position in the global supply chain and the sheer size of its economy. In the last 15 years, China has accounted for a third to two-thirds of world growth. If improvement continues, the positive impact will start to spread to the rest of the world.

Meanwhile, boosting growth has become a top priority of Chinese policymakers, with concerted efforts to revive the economy from the epidemic-led slump. The People's Bank of China has already lowered a series of policy benchmarks and further easing is almost certain. Fiscal policy is also becoming more active with targeted tax incentives, easing regulations and large infrastructure projects.

To be sure, global growth will face a sharp slowdown in the first half of 2020. The first quarter will be downright ugly. Investors should not be overly complacent about this. Yet slowing growth and any further fears of an impending pandemic will only lead to more vigorous policy reflation around the world. The US is now primed to cut rates, with futures markets now pricing in three cuts in 2020. This reflation follows a year when G-20 central banks cut rates a whopping 47 times. There is now an enormous amount of monetary stimulus ready to be unleashed.

Fiscal stimulus is also primed for takeoff. The UK is readying its largest fiscal boost in history. Japan is next. And even Germany seems to be getting the message. Should developments around Covid-19 start to head in the right direction, a V-shaped recovery is well set for the second half of 2020.

Investment Implications

The reality is that viruses and other epidemics, by definition, are not predictable. The only line of defense here is to build robust, globally diversified portfolios. And, our current prescription is to actively avoid steady doses of apocalyptic porn and conspiratorial blog-spam.

Yet investing is still all about evaluating risk-return tradeoffs. Investors are now debating whether the economic impact of the coronavirus crisis will be deflationary (i.e. a shock in demand) or inflationary (i.e. a shock in supply). What also matters is where markets are priced. Currently, most assets are priced for a protracted deflationary slump. Bond yields just hit new lows, with the Canadian 30-year government bond tumbling to an unbelievable low of 1.286%.

Even before this week of carnage, "deflationary winners" — US growth stocks and bonds — were a very crowded trade. Eternal stagnation is now fully in the price. This is a huge assumption. Even a small surprise at the margin in higher growth or inflation could lead to a rapid reversal in these crowded trades.

The market is nowhere close to pricing in this scenario. This will turn out to be wrong, leading to a substantial reversal for several asset classes. In fact, market corrections of this magnitude usually produce leadership changes. Looking ahead, the beaten-up emerging markets stocks and other cyclically-oriented assets are among the candidates to take the lead. Our investment team is monitoring the situation closely.