Fed moves can't erase economic uncertainty of coronavirus

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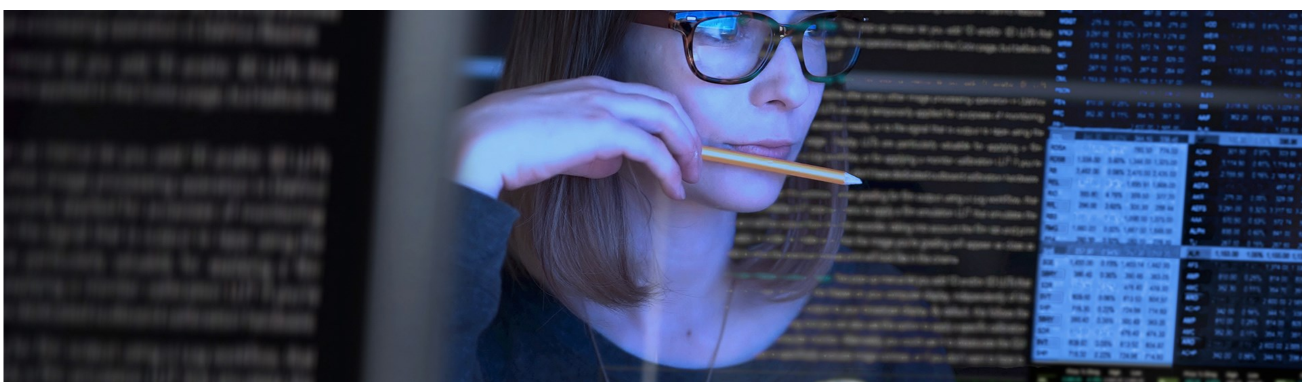

Summary

The US Federal Reserve cut rates to near zero over the weekend in a bid to ease pressure on the global financial system. Yet stockmarkets are unlikely to be reassured. With the course of the coronavirus outbreak uncertain and governments acting increasingly aggressively to contain or delay its spread, a global recession looks all but certain. Investors should recognise that we are in bear-market territory and adjust accordingly. US Treasuries and gold could do well, but investors may also want to add risk in undervalued sectors such as energy.

Key takeaways

- The financial markets are uncertain about the course of the virus and unlikely to find reassurance as the global economy edges towards recession
- China has met with some success at containing the coronavirus, and its economy seems poised to recover — though demand for some goods will likely be muted as the virus inflicts economic damage elsewhere
- Central banks globally are pulling out all the stops to provide the liquidity their economies desperately need, but many don't have much ammunition left
- "Safe" assets such as US Treasuries and gold could see more upside, while investors may want to add risk in areas such as energy that have already priced in a likely recession

The US equity markets ended last week in better spirits, with the S&P 500 notching up its biggest one-day gain since 2008, as President Donald Trump announced a package of measures to combat the growing threat of the new coronavirus. But sharp bear-market rallies are a common feature after steep falls and markets tend to slip further in the months ahead — as witnessed after the 1929 and 1987 crashes.

As if to prove this point, European and US stocks tumbled in morning trading on Monday — despite a move by the US Federal Reserve on Sunday to cut rates to effectively 0%. The Fed also announced a package of quantitative easing worth at least USD 700 billion and stated that it would open central bank US dollar lines as it did during the financial crisis of 2008.

These moves suggest there is still huge pressure inside the global financial system — and indeed, non-US parties have incurred USD 12-18 trillion in debts borrowed in dollars. The Fed has again become, in effect, the central bank of the world.

Economies around the world are in serous situations

The financial markets are uncertain about the course of the virus and unlikely to find reassurance anytime soon. Economies around the world are in serious situations, and many could suffer a dead stop similar to the one China experienced in the first quarter.

- In Asia, efforts at containment seem to have had their desired effect, with China getting back to work — which will be good for domestic China and China A-shares. Less certain will be China exports in the coming months, as other parts of the world contend with the virus and its impact.
- The virus is now taking a terrible toll in Europe. Germany, Spain and France are starting to introduce lockdown measures of the kind already seen in Italy — and the outbreak isn't even expected to peak until late April through May. We don't expect Europe's outlook to improve in the near term, regardless of how much fiscal support governments provide.
- In the US, the number of confirmed coronavirus cases is rising as quickly as confidence is falling — which could slow spending by consumers and businesses. Given our house view that the US already looked quite recessionary, it seems certain that the US will fall into recession soon. The question is, how long will it last and how deep will it be?

Central banks are pulling out all the stops, but will it work?

The move by the Fed reflects efforts by central banks globally to provide the liquidity their economies desperately need, even though this will place huge strains on government finances and enormous pressure on banks. Investors should look to local monetary policy for guidance:

- **China** — The People's Bank of China is providing liquidity, and additional monetary and fiscal stimulus is expected. This has led to hopes that China's economy will recover. Market valuations are attractive, having not reached new highs for the last five years.
- **Japan** — The Bank of Japan is buying bonds, ETFs and equities, which is supporting risk assets. The market is now near five-year lows and relatively cheap on valuation measures.
- **Europe** — The European Central Bank did not reassure investors last week, and it does not have much ammunition left in its arsenal. Valuations are cheap and markets are near five-year lows.
- **UK** — The Bank of England seems to be setting a strong coordinated response now. The market has also underperformed for the last three years of Brexit uncertainty, and it is near five-year lows.
- **US** — Its markets have done tremendously well over last few years, powered by Big Tech firms. But despite steep selloffs, the S&P 500 Index is still trading above its five-year lows.

Investment implications

We expect US Treasuries to do well as the Fed starts another round of quantitative easing, despite the worrying signs of illiquidity in those markets. Many weaker securities are falling to "yield to worst" levels, suggesting there is little appetite to add risk here now. Active managers who focus on the fundamentals may be well-positioned to find opportunities here.

With the Fed at zero, we may see the US dollar weaken, though no economy will want a strong currency now. This may be good for gold and other commodities.

As we consider the next six months of uncertainty, investors may want to add risk where assets are already pricing in a recession. The energy sector is a prime example. But other sectors will likely face extended trouble — particularly tourism, travel, restaurants, manufacturing, autos and aerospace — as workers are "furloughed" and knock-on effects spread.

At times like these, it is difficult to ascertain much information from the markets, but investors need to accept that we are now in bear-market territory. As the global economy freezes, we expect to see recessionary — and perhaps depressionary — conditions spread.

Exchange-traded fund, ETF; US dollar, USD.

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Summary

While the world battles the coronavirus pandemic, China has already made strides towards mitigating the virus's effect on its people and economy. Although the country is not yet out of danger, we expect China's economy to recover in the second half of this year – which could be another positive signal for China's domestically driven A-share market.

Key takeaways

- After China's economy ground to a virtual halt earlier this year, most companies have resumed work – which should ease pressure in the global supply chain and help Chinese manufacturers
- Even with the coronavirus outbreak, "onshore" China A-shares have outperformed "offshore" China H-shares this year, and significantly outperformed equities in the US, Europe, Japan and emerging markets
- Given that China A-share companies get almost all their revenues domestically, they are likely to have an advantage over exporters amid a slowing global economy
- With coronavirus causing widespread volatility, it's worth noting that A-shares have had a very low correlation with other major asset classes – including them in a global portfolio helps diversify away some portfolio risk and helps generate a much better risk-return profile

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