Coronavirus - Keep Calm and Carry On

"I CAN CALCULATE THE MOTION OF HEAVENLY BODIES, BUT NOT THE MADNESS OF PEOPLE" Sir Isaac Newton (1642 – 1727)

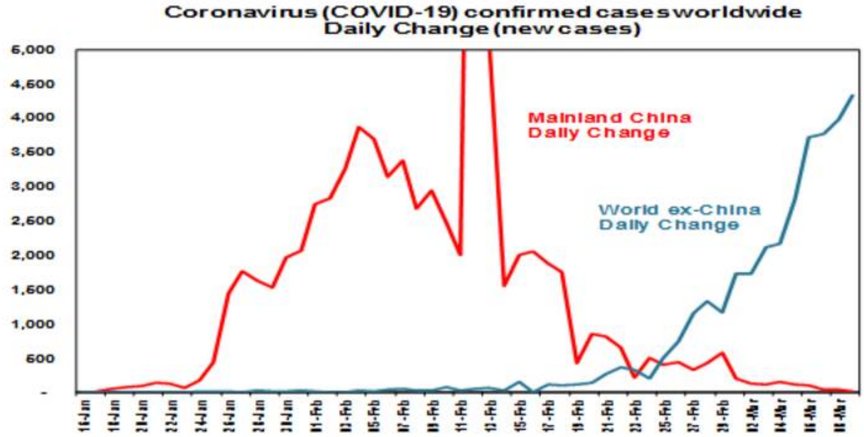
Summary

- The coronavirus rout in financial markets has continued, made worse by a flow on to world oil markets. Fear and panic is driving very irrational behaviour and indiscriminate selling. The risk of a deeper hit to economic activity has risen.
- The extreme containment measures being adopted to control the spread of COVID-19 are going to cause a sharp economic impact over the next 3 to 6 months, but the economic effects are likely to pass quite quickly - within 12 months. We will probably not be talking about it in 5 years time. By then, the virus will have been contained, vaccines will have been developed and the world will have moved on. Humans are resilient and adaptable and solutions will be found.
- Key things for investors to bear in mind remain that: share market falls are normal; selling shares after a fall locks in a loss; share pullbacks provide opportunities; and to avoid getting thrown off a long-term strategy, it's best to turn down the noise during times like this.

Introduction

With the data changing daily, the only things moving faster than the spread of COVID-19 are the financial markets. Share prices are highly volatile as people react irrationally to daily headlines. Given the extreme uncertainty, this eNewsletter looks at various scenarios in relation to global and Australian economic growth over the next few months – noting that short-term predictions are 'best guesses'.

Coronavirus continues to rattle investment markets as the number of new cases outside China continues to rise, posing increasing uncertainty over the impact on economic activity. And its impact has intensified following the collapse of OPEC discipline causing a further plunge in oil prices, raising concerns about debt servicing for oil producers. From their highs, both global shares and Australian shares have had a fall of over 20%.



Source: PRC National Health Commission, Bloomberg, AMP Capital

Some Facts on COVID-19 Mortality Rates

The Table below shows the statistics out of China, which has had by far the largest number of Coronavirus infections. It shows that the Mortality Rate is very low for people up to the age of 50 and is zero for children up to age 10.The mortality rate is significantly skewed towards older people, particularly those aged over 80.

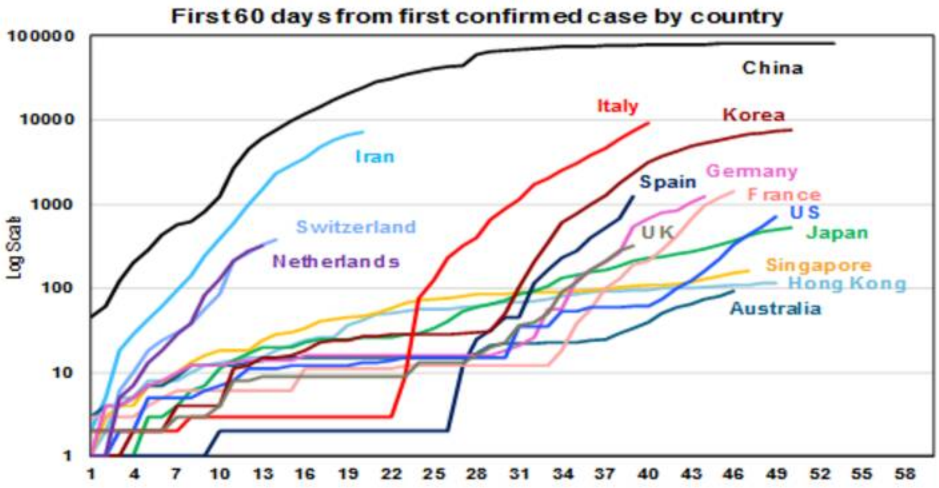
Age	Chinese Population Distribution	Confirmed Case Distribution	Mortality Distribution	Case Fatality Rate
80+	1.9%	3.2%	20.3%	14.8%
70 – 79	4.4%	8.8%	30.5%	8.0%
60 – 69	10.1%	19.2%	30.2%	3.6%
50 – 59	14.4%	22.4%	12.7%	1.3%
40 – 49	16.2%	19.2%	3.7%	0.4%
30 – 39	15.1%	17.0%	1.8%	0.2%
20 – 29	14.2%	8.1%	0.7%	0.2%
10 –19	11.6%	1.2%	0.1%	0.2%
0 – 9	12.0%	0.9%	0.0%	Nil

Sources: China CDC "The Epidemiological Characteristics of and Outbreak of 2019 Novel Coronavirus Diseases (COVID-19) – China, 2020", Populationpyramid.net

Much Ado About Nothing or a Major Global Catastrophe?

It seems there are two extreme views on coronavirus. Some see it as just a bad flu and can't see what the fuss is all about. Others think that it will trigger a major humanitarian and economic catastrophe killing millions and triggering a major global recession as excessive leverage is finally exposed. Optimists will lean towards the Shakespearean version.

- So far over 118,000 people are reported to have contracted the virus of which nearly 4600 have died. Of course, this number is still growing but in China where the number of new cases has collapsed (see the first chart) the number is 80,754 cases and 3136 deaths. By comparison, in the 2017-18 US flu season alone 44.8m Americans got sick and 61,099 died.
- The actual death rate from Covid-19 may be 1% or lower, rather than the currently reported rate of 3.5% because many of those who get the virus don't get sick enough to seek medical help and so won't be included in the case count. The Diamond Princess episode may provide a rough guide – all 3711 passengers and crew have been tested with 705 contracting the virus of which seven have died and most of those are believed to have been over 70. This would suggest a death rate of around 1% which is only just above that for regular flu for those over 65.
- It appears to be less contagious than regular flu.
- China's experience shows it can be contained. Maybe this is due to extreme containment measures in Hubei that are not possible in other countries. But the case count in the rest of China has also been contained with less extreme measures and Singapore and Hong Kong have had some success in slowing new cases without extreme quarantining.



Source: PRC National Health Commission, Bloomberg, AMP Capital

- Alternatively, at some point authorities outside China may just conclude that containment is impossible and, as the death rate is not apocalyptic, shift from containment to just treating those who get very sick. This could enable life to return to normal, albeit with a change in behaviour - less handshaking (more elbow bumping?) frequent handwashing and wearing a mask.

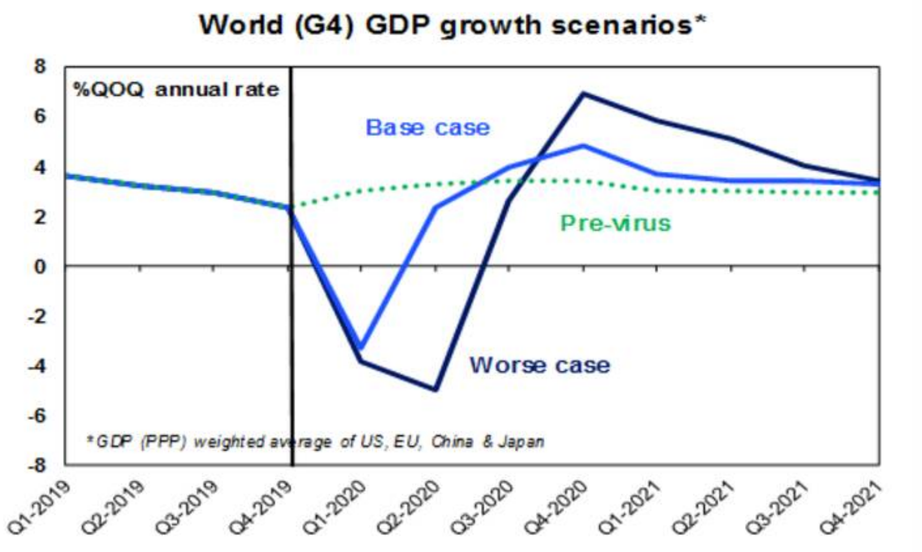
There is much that is still unknown about the virus itself and how long it will continue to spread. And even if there is a switch to just treating the very sick, it's unclear whether there will be enough hospital beds. There is also the human or behavioural overlay, which is intensifying the economic impact. Just look at the toilet paper frenzy to see that this can have a real economic effect even before the virus has really taken hold in Australia. While there may be a boom in demand for hand sanitisers, toilet paper and long-life food, this will be a temporary boost as the spread of the virus globally and the disruption that containment measures are causing is continuing to increase the risk of a longer and deeper hit to economic activity. And there is a risk of secondary effects as the short-term disruption risks leading to business failures and households defaulting on their debts if they can't keep up their payments and so causing a deeper impact on economic activity. The secondary effects of the coronavirus outbreak and its flow on is highlighted by the 45% collapse in oil prices since mid-January. Ultimately lower petrol prices will be a good thing as this will boost consumer spending when the virus goes away but for now all the focus is on the downside of lower oil prices – debt problems and less business investment by producers.

Base Case versus Global Recession and Beyond

Given all these uncertainties it's still too early to say that shares, commodity prices and bond yields have bottomed. The following chart presents ***3 scenarios for the global economy:***

- The prediction for global growth, prior to the virus. Basically, the outlook was for a mild pick-up in growth.
- A sharp downturn centred around the March quarter, as the Chinese economy contracts sharply but rebounds in the June quarter, offsetting recessions in developed countries including in the US. This is the base case, or most likely outcome.
- A worse case downturn that sees global growth contract in the March quarter (led by a sharp contraction in China) and the June quarter as (as developed countries get badly hit) resulting in a global recession to be then followed by a rebound as life returns to normal led by China.

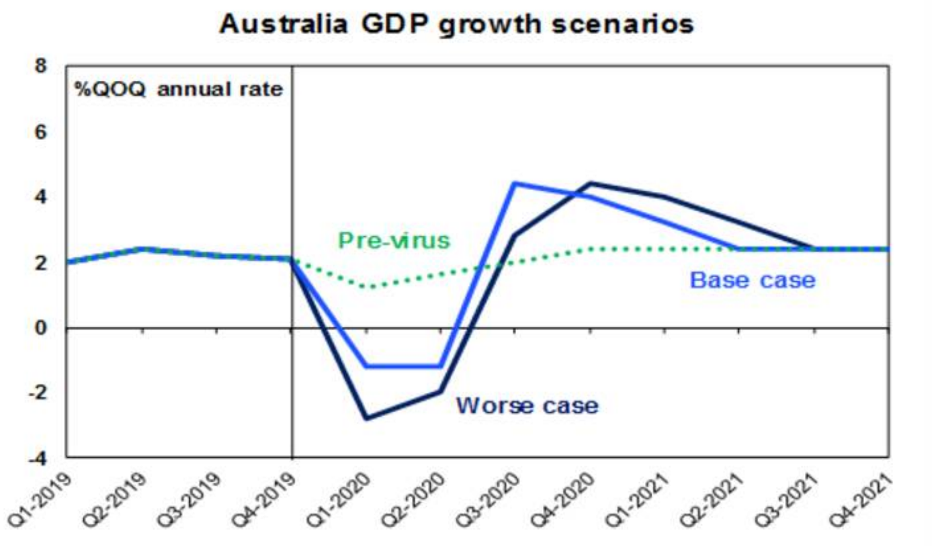
Note: the scenarios show quarterly annualised growth. The key is to focus on the pattern of growth rather than the precise level.



Source: Bloomberg, AMP Capital

The next chart shows ***3 scenarios for Australian growth:***

- How Australian growth looked like panning out prior to the virus.
- Mild downturns in the March and June quarters driven initially by the lockdown in the China and then the coronavirus flow on to the rest of the world and Australia, followed by a second-half rebound. This is the base case, or most likely outcome.
- A worse case downturn that sees deeper downturns in the March and June quarters then followed by a rebound as life returns to normal.



Source: Bloomberg, AMP Capital

It is likely that growth for the March quarter will be negative, on the back of the bushfires and the hit to tourism, education exports and commodity exports from the slump in China. But the spread of coronavirus globally and in Australia has made it likely that Australia would also see a contraction in the June quarter too. As with the global outlook, this should really be “a disruption” that will pass once the virus runs its course - hopefully at least as the Northern Hemisphere heads toward summer. The worse case scenarios would likely see a deeper decline in shares and bond yields.

Australian Government Stimulus Package

The forecast above is why the Australian Government has announced a $17.6 billion stimulus package with $750 cash payments going to 6 million Australians – all Centrelink and DVS benefit recipients and Commonwealth Seniors Health Card holders and Family Tax Benefit recipients

The Prime Minister last night also announced a stimulus package for business designed to protect jobs, with a five-fold increase in the instant asset write off to $150,000 and cash flow relief through tax refunds of up to $25,000 for small business. The fiscal stimulus of 1.2% of Gross Domestic Product (compared to 0.9% of GDP at the start of the GFC) may be enough to stop Australia going into a recession.

Stock Markets Have Always Bounced Back After Heavy Falls

Globally, shares have just suffered some of their worst performances since the days of the Global Financial Crisis (GFC) in 2008/2009. On March 9, 2020 the US S&P500 fell 7.6% and the Australian ASX 200 Share Index dropped 7.4%. It is a fact that the biggest one-day falls in the past, have been followed by substantial returns over the subsequent 5 years, though generally it has happened within one year.

The US Stock Market's 10 Worst Days and Their Rebounds

Date	Reason	One day fall	Return after one year	Return after five years
15/10/2008	Global financial crisis	-9.0%	24.0%	109.0%
01/12/2008	Global financial crisis	-8.9%	39.3%	146.3%
29/09/2008	Global financial crisis	-8.8%	-1.5%	69.9%
09/10/2008	Global financial crisis	-7.6%	20.9%	103.5%
27/10/1997	Asian economic crisis	-6.9%	23.4%	8.7%
31/08/1998	Russia defaults on loans	-6.8%	39.8%	13.0%
20/11/2008	Global financial crisis	-6.7%	48.8%	164.3%
08/08/2011	Eurozone debt crisis	-6.6%	28.1%	117.0%
13/10/1989	Black Friday	-6.1%	-5.8%	63.8%
19/11/2008	Global financial crisis	-6.1%	39.2%	147.5%

- *Source: Schroders. Refinitv data correct as at 3 March 2020, for S&P Total Return Index. Past performance is not a reliable guide to future returns*

US Lessons from the Past – As the table shows, the pattern is repeated on many other of the 10 worst one-day crashes. Falls associated with the GFC account for 7 of the 10 worst days since 1989. The most severe was a 9% fall on 15 October 2008. This was followed by a 5 year return of 109%, or an annual equivalent of 15.9%. The data doesn't stretch back to Black Monday in October 1987, when US stocks fell 22% in a day, the biggest ever one-day fall.

Australian Lessons from the Past – Using data for the ASX All Ordinaries Index going back to June 1, 1992, the strongest recovery from the 10 worst days was a 112% 5 year gain following the September 11, 2001 terrorist attacks on New York. Over the whole period since 1992, the average recovery from the 10 worst days in Australian markets in the following 5 years, was a 67% return

What to Watch

Shares will bottom when there is confidence that the worst is over in terms of the economic impact from the virus. So, the debate is largely now about how big the hit to growth will be and this relates to how long the virus will weigh on global growth and any secondary effects it may cause. In this regard the key things to watch are as follows:

- A peak in the number of new cases – as per the first chart.
- News of successful vaccines or anti-virals.
- Whether governments switch from containment.
- Timely economic indicators, eg, jobless claims and weekly consumer confidence data in the US and Australia.
- Measures of corporate stress, eg, spreads between corporate bond yields and government bond yields.
- Measures of household stress, eg, unemployment and non-performing loans.
- Measures of market stress, eg, bank funding costs as measured by the gap between 3-month rates and central bank rates. These have risen but are well below GFC
- The monetary and fiscal policy response – this will be critical in terms of minimising the impact on vulnerable businesses and households from the coronavirus disruption, ensuring financial markets remain liquid and driving a quick recovery once the threat from the virus is over. So far so good, with policy makers moving in the right direction. As noted above, the Morrison government has just announced a $17.6 billion stimulus, as has Trump in the US and Johnson in the UK – but there is a fair way to go.

What Investors Must Remember

The rapidity of the fall in share markets has been a shock, driven by fear and panic. The important things for investors to remember are:

- Periodic sharp falls in share markets are healthy and normal, with the long-term trend ultimately remaining up. Shares provide higher returns than other more stable assets.
- Selling shares or switching to a more conservative investment strategy after a major fall just locks in a loss.
- When shares fall, they are cheaper and offer higher long-term return prospects. So, the pullback will provide opportunities, to buy 'when the blood is running in the streets'. It's impossible to time the bottom but it is possible to average in over time.
- While shares have fallen, dividends from shares haven't. Companies like to smooth their dividends over time – they never go up as much as earnings in the good times and so rarely fall as much in the bad times.
- Shares and other related assets bottom at the point of maximum bearishness, ie, just when you feel most negative towards them.
- The economic effect is likely to pass quite quickly.
- Central banks are doing their bit by reducing interest rates and are likely to go further. An even lower interest rate world is supportive of higher valuations, of both shares and income producing assets such as property and infrastructure.
- The best way to stick to an appropriate long-term investment strategy and to see the opportunities that are thrown up in rough times, is to **turn down the noise**.

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