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The consequences of fear

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It's not reasonable to expect finance professionals to turn into epidemiologists within a short period of time. Yet, this is precisely the challenge faced by every analyst in recent weeks. I will not feign competence.

There are many possible scenarios for the evolution of the Covid-19 virus, but the level of uncertainty around each outcome is extraordinarily large. We will not even have a reasonable estimate of the mortality rate of this virus until well after it has infected a much larger share of the population.

But facts regarding the Covid-19 outbreak may matter less than the degree of fear it has engendered, and the reaction of governments and the public to the outbreak. Containing the virus maybe an impossible task. Britain, for example, is now focussing on "delaying" rather than containing the epidemic, in order to better prepare health services deal with the crisis.

It is a mistake to dismiss market movements as a transitory increase in risk premia. The measures taken by businesses and governments have significant repercussions. Some activity has come to a sudden stop. Factory closures in China have disrupted global supply chains. Closure of businesses, schools, cancellation of travel and conferences around the world are having a material impact on economic activity.

Some activities that have come to a sudden stop can be resumed with relative ease once risks abate, implying a rapid recovery in those areas. But this can't be the fate of all activity. For leveraged companies, for example, a liquidity squeeze can quickly escalate into a solvency crisis. This is permanent economic damage.

What can economic policy makers do in these circumstances? The market was unimpressed by the G-7's lack of resolve for coordinated action. It was equally unimpressed by the Fed's emergency rate cut. This is not surprising. To understand why, we need to look at the nature of the crisis.

The first instance of the Covid-19 crisis is a supply shock: some businesses closed, eliminating the production of certain goods and services. What can monetary policy achieve in such a situation? A rate cut will not reopen the business. This is precisely why monetary policy is seldom used to cope with supply shocks. Indeed, if we think of the oil supply shocks of the 1970s, loose monetary policy compounded the problem by fuelling inflation.

But this crisis also has second-instance elements of a demand shock. For example, working from home and closed schools, reduces the demand for catering of school meals or fast dining options. A cursory look at a travel website will quickly reveal the drop in the price for hotels in many cities, as demand for travel comes to a sudden stop. It is this demand shock that minimises the inflationary risks of an expansionary monetary policy.

What then is the use of a Fed rate cut? It is difficult to argue that the Fed cut was genuinely expected to have any impact on the real economy. However, the violent market movements and high level of uncertainty is sapping liquidity from the markets. A rate cut and repo operations by the Fed can help support market liquidity, even if they will have no impact on the real economy. In other words, this was a policy move designed to reduce potential damage rather than arrest or reverse damage that has been already done. Unless we see developments that improve the outlook for the real economy, it is hard to see how markets can stabilise.

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What can investors expect from policy makers at this stage? The nature of this crisis is difficult to address through standard macroeconomic policies. Targeted, micro-level policies (addressing certain industries, or class of consumers, for example) take time to formulate and implement. France, Japan and Korea are providing subsidies to firms and individuals for leave taken to stay at home to care for children. China is accelerating unemployment insurance benefits. Italy and China are offering tax extensions. But much of the spending announced by governments is targeted at supporting public health systems, not to compensate for the drop in demand.

This crisis has erupted precisely at the time when last year's global economic slowdown was stabilising, and prospects were looking more promising. Given that growth in some regions – such as Germany, Italy, Japan – was barely close to 1%, it is difficult to argue that these economies will avert a recession. Whether the US will also experience a recession is an open question. Whether or not a recession is averted, however, is less material than the outlook for earnings. It is difficult to see how earnings can be sustained at last year's level.

Investing at this time is a challenge. At Parkview we were well positioned with underweight position and partly hedged position in equities prior to the sell off. We further reduced our equity positions last week. But it is naïve to think that anyone can time the market in these times. And one can expect that some companies will be well positioned in this crisis. Healthcare is one obvious area. This is precisely why we have maintained exposure through active, rather than passive, vehicles.

Fixed income investors have benefited from the rally to safe haven assets, and the compression of yields. But this also comes with two big challenges. First, expected returns in risk free assets are now negative. Unless one takes a view that long term US Treasury yields are heading to zero, there are very limited returns to be had. Second, liquidity in many fixed income segments has dried up. This means that bid/ask spreads are high, and this is hardly the right time to reduce exposure. Once liquidity improves, the key challenge for investors will be finding the low risk alternatives to high quality fixed income.

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