# VERMEER NEWSLETTER

March 2020

## THOUGHTS ON 2020

# Blip or Bust

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- Markets finally react to threat of Coronavirus
- Buying opportunity
- Central banks response becoming clearer
- No lasting financial impact

It is somewhat tragic that it has taken a real-life health epidemic with thousands of lost lives to shake the global markets from their zombie like upward progression. Only two weeks ago as the Coronavirus situation was rapidly unfolding, markets remained remarkably complacent with few willing to contemplate a major financial impact. That changed last week as numerous countries started to report a rapid increase in the incidence of Covid-19 outside China and markets reacted in a violent fashion. So aside from assessing the human tragedy of the virus, we unfortunately have to turn our thoughts to whether it will result in a mere hiccough in financial markets, whether it has any lasting economic impact in its own right, or whether it may act as the catalyst to end one of the longest bull markets in history.

We are certainly not equipped to opine on the likely spread of the virus or indeed how and when it may end. We are particularly wary of comparing it to previous epidemics since its composition, medical science and the global economy are in very different positions than they were even in 2003 and SARs. Without trying to underplay its possible severity, all we do know it is that it will end. As such it is in our opinion worth exploring what will happen on an economic basis in the coming months and how this will impact financial markets.

The major gloom and doom theory currently expounded by market Cassandras is that the reason this setback is so serious is because it impacts the supply and demand sides of the economy and is a financial crisis in its own right. Problems usually impact either demand or supply but not both and can therefore be addressed by a specific set of policies. Covid-19 has already had a large demand impact as travel and leisure activities have been hit hard, and supply chains have been severely disrupted, particularly in China, as workers have stayed at home and the transportation of goods has been affected. To date we can find little evidence of any real-world financial impact, but this may come later.

We already have a clear picture of how Central Banks are likely to act since most have either started or given an indication of how they intend to act. In truth they have few options, but they will all focus on reducing interest rates and injecting as much liquidity as they are able into their domestic markets. In doing so they will look to create demand from consumers and corporates to offset the reduction from the virus. The areas most acutely affected, eg Italy and South Korea, have already acted decisively, Japan has started, and the US has broadly indicated what it intends to do. The major problem however is that with interest rates so low, many countries have very limited fire power. Europe is starting with negative rates, the UK with 0.75% and only the US has any real scope for meaningful action.

This means that Governments should step in to take up the slack. Most fiscal measures are too long term to have any immediate impact, but some short-term tax cuts would certainly help the situation. What is required is a period of joined up thinking by individual governments to align public health initiatives with planned transport and industrial/commercial initiatives to limit the spread and economic impact of the virus. Very few have the appetite or capability for such action. The notable exception is China which has the advantage of being a centrally planned economy. It may not be successful, although current signs suggest it may be, but at least it can have a go. This is important because China is one of the only economies that can influence the supply side problems. One possible positive is the current crisis may persuade the ECB and European governments to finally formulate some sort of fiscal response to their ongoing economic issues.

In terms of a real shock to the financial portion of the economy, we remain relatively sanguine. There should be no financial collapse since banks' balance sheets are very robust around the world and there is no major hole in the system as in 2008. The only exception is the level of corporate debt which has risen dramatically in the past decade. The risk here is mainly around refinancing ie will companies be able to take out new loans as their old ones become due for repayment. Actual interest payments should not rise much given that a reduction in base rates will offset much of the increase in individual companies' financing costs. Some companies will definitely go bust but it can be argued that we are long overdue the

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restructuring of many companies which have hidden poor balance sheets by borrowing very low-cost debt.

So, against this backdrop how do we view the outlook for markets? We predicate our thoughts on the basis the virus will be under control by the end of the year and it will have little long-term structural impact on economies. We expect activity levels to rebound quickly once things begin to return to normal. Prior to the recent market falls, we were concerned that the market was anticipating a V-shaped recovery in the areas which were weak in 2019, namely capital spending, and that in fact what we would get was a drawn-out U-shaped recovery which would have disappointed investors. Now we think a V-shaped recovery is very possible. To be fair, that will probably be against a background of low to zero global growth in 2020, but the market is rarely backward looking. That is not to say there will not be challenges along the way. Economic data always lags reality and we will be seeing plenty of poor figures and statistics for some time to come.

We do not share the view that the outbreak will inflict permanent damage on the global economy. It may change consumer behaviours in terms of less travel and corporate supply chains may alter, with perhaps increases in local production, but these will provide as many opportunities as risks. The factors we were basing our positive stance on for 2020, namely no interest rate rises and increased government spending, have perversely been reinforced by the crisis. We expect markets to begin to recover slowly, if and when the growth in infection rates begins to slow. The sell-off in the market has been indiscriminate with many very good stocks suffering as much or more as lesser quality ones. This provides us with opportunities to invest in for the first time, or add to our holdings, in companies with strong financial positions, which will enable them to ride out the current storm even if it is more intense than we envisage.