March 2, 2020

Weekly Macro & Markets View

Highlights and View

- **Stock markets plunge as investors wake up to the implications of COVID-19**

  From euphoria to fear within a week, equity markets are entering oversold territory, but infections or policy need to change to spark a recovery.

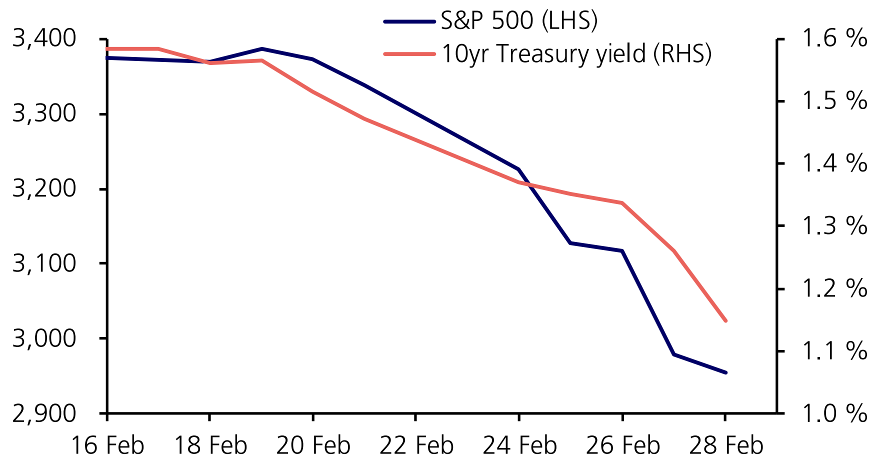
- **Bond yields slump as major central banks get ready to act in an effort to contain the economic fallout of the coronavirus**

  Global growth forecasts have been slashed and a significant amount of central bank stimulus is now priced in to bond markets, limiting prospects for a further sharp decline in yields.

- **China's PMIs plummet on the back of the COVID-19 outbreak**

  The sharp drops reveal how severely the epidemic has affected China's economy.

From record highs to record falls, equity investors head for the door



Source: Bloomberg

Investors can rightly claim that the old saying 'a week in politics is a long time' is equally applicable to financial markets. Stocks plunged from the previous week's record highs at a record pace, with the S&P 500 off 13% since the prior Wednesday. The worst weekly performance registered since the financial crisis some 12 years ago also saw Treasury yields hit record lows as safety was sought. While all these records may be remarkable, it is perhaps more remarkable how complacent investors had been right up until last week. While we could not have predicted the onset of COVID-19, we have been making the point since earlier this year that market complacency had become dangerous and asset prices stretched, never a good combination. Consequently, the current correction should not come as a complete surprise. While risks are still to the downside for stocks, they have become oversold from a technical perspective and we are more encouraged on prospects from current levels. In the near term, investors are pinning hopes on a policy response from central banks. Indeed, market pricing now suggests that at least a 25bps rate cut by the Fed at its March 18 meeting is fully priced in. While this may act as the catalyst for a bounce, we suspect that, as was the case in China, evidence that the rate of new COVID-19 infections is slowing will be a key requirement for a more sustainable recovery to take hold.

Bonds: Treasury yields hit new lows on coronavirus fears and stimulus expectations

Treasury yields have hit new lows on fears around the coronavirus and a repricing of central bank policy. The US 10yr yield fell to a low of 1.11% intraday on Friday but closed slightly higher after Fed Chair Powell communicated a willingness and readiness to act, followed by similar statements from other major central banks. Four Fed rate cuts are currently fully priced in by year end, which is a dramatic shift compared to the beginning of the year. It helps to explain a weaker dollar along with a re-steepening of the Treasury curve and represents a significant stimulus to the global economy, in part as it frees up space for emerging markets to loosen policy. In other core regions, yields have fallen less, partly reflecting limited space for further rate cuts in Europe and Japan. This puts the emphasis on fiscal stimulus along with coordinated liquidity operations. While uncertainty remains high, bond markets have responded strongly, and further downside to yields is likely to be limited.

Credit: Coronavirus concerns creep into credit markets

Increased volatility and the risk-off mood have pushed credit spreads wider, with the spread moves becoming larger towards the end of the week. The widening of spreads was substantial across all the sectors and jurisdictions, with strong underperformance in higher beta names and high yield, and the transport and energy sectors being hit hard. Technicals weakened amid a sharp acceleration in outflows, concentrated in HY. Junk bonds were hit with the biggest week of outflows since 2018 for US mutual funds and HY ETFs. IG funds however, continued to enjoy strong inflows, both in Europe and in the US, as buyers continue to move up in quality. Primary corporate markets were on hold with no issuance at all in the US and only two borrowers in Europe for a mere global EUR 1bn. During the latest volatility, credit has for the most part been relatively resilient compared to the mayhem in equities but we don't expect this outperformance to last in the coming weeks.

US: Economic data, the calm before the storm

With financial markets in turmoil, economic data last week painted a picture of relative calm. Of course, this needs to be viewed in the context of predating much of the Covid-19 fear and disruption. Housing data remain robust, with home prices showing a decent rise of just under 3% YoY with prices up in 19 out of 20 cities in December. New home sales and pending home sales surprised positively, which generally has a positive impact on spending in subsequent months. The first revision to Q4 GDP data showed the headline reading unchanged at 2.1%, but the composition weakened somewhat, with inventories rising and consumption down to 1.7% from 1.8%, and a sharper decline in equipment investment to -4.4%. Given the increasing calls for the Fed to cut rates, with consumer confidence under pressure, one thing that it doesn't have to worry about is inflation. Targeted core PCE came in at only 1.6% in January, with the prior month revised down to 1.5%. Even before the virus disruption, we were of the belief that further Fed support was required for a slowing economy, something that is now imperative.

Eurozone: Data hold up, but Euro Stoxx falls 12% as coronavirus spreads

European investors finally reacted to spreading coronavirus last week with risk assets selling off sharply. Data in the Eurozone held up, but most of it pre-dates the arrival of the virus on European shores. The German ifo business climate index for February picked up, led by the expectations component, especially in manufacturing. The French INSEE national business confidence survey for February also improved, led by manufacturing. This provides further evidence that the sector was stabilising before the coronavirus arrived. However, as it spreads in Europe, economic activity in Q1 is likely to be severely curtailed as events are cancelled and travel is restricted. Earnings will also be hit and companies may even cut back on investment and hiring, with a potentially longer-lasting impact even after the worst of the actual virus spreading is over. The upshot is that sentiment and activity data are likely to get significantly worse over the next few weeks, increasing the chances of one or two quarters of negative growth.

Asia: PMIs stumble amid the coronavirus outbreak

China's Caixin Manufacturing PMI plunged from 51.1 to 40.3 while the Official Non-manufacturing PMI hit a record low of 29.6, falling from 54.1, far worse than the consensus expectation. The Manufacturing PMIs for Taiwan, South Korea and most ASEAN countries also weakened, but not as substantially as in China. Subcomponents in many countries, including output and new export orders, showed clear signs of deterioration. However, these were offset by better readings in delivery times. Usually, longer delivery times are signs of stronger demand, but we suspect in this case supply chain disruptions due to business shutdowns in China were the main driver. A number of governments, including South Korea, Malaysia, Hong Kong and Singapore announced large fiscal packages, varying from handing out cash directly to households to cutting taxes and providing loan guarantees for SMEs. The Bank of Korea kept its policy rate unchanged and increased the ceiling on the intermediate lending facility, providing credit to financial institutions facing funding shortages and SMEs in need of extra support.

What to Watch

- A plethora of news flow this coming week in the US concludes with the jobs reports on Friday, where expectations are for 175k change in payrolls, with unemployment remaining at 3.6%, but it will be the ISM manufacturing and services releases and PMI Manufacturing data earlier in the week that could be market moving.
- In the Eurozone, various business confidence surveys and industrial production data will be released but will still not capture fully the impact of the coronavirus.
- The central bank of Malaysia will probably maintain its policy rate after delivering a cut last month while it is a close call for the Reserve Bank of Australia. This week, housing, retail sales and trade data for Australia as well as CPI readings for several ASEAN countries will be released.

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