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Signature Coronavirus Commentary

By Eric Bushell, Chief Investment Officer
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Starting point

Market positioning in January was extended. The combination of the U.S.-China Phase 1 trade deal, the U.S. Federal Reserve's (the "Fed") 75 bps cuts in the summer and a banking system liquidity surge fueled by the Fed's \$60 billion/month U.S. Treasury bill purchase program resulted in a textbook risk melt up. Exhibit A was that credit spreads tightened to post-Lehman lows. Exhibit B was the large-cap technology sector price surge. Levered investment strategies and systematic investors were programmatically swept into the momentum-driven upswing. Paranoid active managers joined in out of fear of passive annihilation.

The point to be made is that markets were due for some sort of reset. In the past week, markets have returned to the levels of October/November 2019, which is not a particularly big deal. Coronavirus is.

What's next

It is unsurprising that the virus has spread from China to the world; the question that remains is how effective efforts to contain additional outbreaks will be. The global expansion of the virus, now in Korea, Iran, Thailand and Italy, and questions about the mishandling of testing in the U.S. and Japan have undermined the complacent notion that western countries were somehow immune. In fact, the market is drawing the conclusion that the isolation containment strategy has failed. Fortunately, it appears that despite being highly contagious the mortality rate of the virus is relatively low – please watch for a more in-depth summary from my colleague Jeff Elliott on coronavirus.

What follows is a huge test of national health care delivery systems and public health leadership. These are long and complex chains of command which are often uncoordinated. I am no expert here, but health systems are hard to manage at the best of times given the chaotic nature of the populations they serve. Viral outbreaks are by definition not manageable. Media and citizens will be quick to criticize and politicize failures in the crisis management. Cast your mind back to hurricane Katrina as an illustration of the thorny challenges in delivering emergency response with multiple levels of government – wires get crossed and sparks fly.

The severity of the outbreak and the effectiveness of government management of the issue will weigh heavily on the U.S. political campaign. The spillovers to the economy and markets may themselves be decisive factors, but the central role of socialized medicine in the Democratic platform elevate the challenge to the Trump administration to not fumble the coronavirus ball. An element of this political risk is being expressed in the U.S. stock sell-off.

Given the concern over the potential harm to children, the elderly, and vulnerable populations, governments must have their fingers on the trigger to shut school systems and other assembly points to restrict contagion – as Japan has done once and Hong Kong repeatedly. This means that people need to prepare for widespread



remote work and take care to stay healthy. The staff in Signature's Hong Kong office – Gorlen, Phoebe, Jayson, and Connie – have been working at home in some capacity for months now. The Hong Kong protests disrupted transit last fall, and then the virus and school closures have led to effective quarantine. The main lesson they have learned is that many things you take for granted don't function well under those conditions. Two systems need support – Wi-Fi and immune systems. What we are also witnessing right now is the world's largest remote-working experiment. Companies are gaining a better understanding the massive potential of this technology which will propel cloud computing, virtual collaboration software, and productivity to new heights. The long-term effects of this work from home experiment will potentially change how we work forever.

Hong Kong and China provide a glimpse into economic life under coronavirus lock down. Clearly travel, retail, and restaurants have all been shuttered. Wi-Fi enabled entertainment, education and work are thriving. Small businesses have limited capacity to endure the downturn while paying rent and making payroll. Recent surveys in China show that a large percentage of small and medium-sized companies will close shop or lay-off staff within 30-60 days if business activity does not recover. Larger manufacturers have yet to have full staff return from the Chinese New Year which is hampering production for all forms of manufacturing. Parts inventories will run out, impacting global supply chains – in some case for critical components. Vulnerabilities of the globalized system will be illuminated once more, and risk managers and logistics experts will scramble to redesign supply chains. Unfortunately, our deglobalization narrative just got a coronavirus shot in the arm. I think it's clear that the virus impact will run deep in employment, consumption and finance (not to mention health) subject to the depth, duration and breadth of the blow.

The response

China is progressively stimulating its economy with monetary and fiscal policy to limit the blow. Tax cuts, bank loan forbearance, housing support – all are bridging strategies to keep the economy from derailing. Hong Kong and Japan have introduced measures as well. Expect to see more governments respond in similar form.

The U.S. bond market yield has fallen from 1.9 to 1.15% in anticipation of another 75 basis-point rate cut which we see as likely, if the virus outbreaks progress in the U.S. A rate cut is not a vaccine, but it will lower the cost of capital for the economy and provide some support for credit and risk asset markets.

Central banks are caught in a mission impossible – as we described in our May 2019 roadshow presentation. Excessively easy financial conditions with preposterously low rates introduces the risk of bubbles forming; on the other hand, central banks need to avert asset markets falling, confidence breaking, economies slowing and deflation taking hold. Because they are low on ammunition to fend off downturns, central banks are more inclined to risk the bubble. This calculation biases them to further easing. An added outcome could be a lower U.S. dollar, which would permit rate cuts in emerging markets to resume, most notably in China. A semi-coordinated action will boost sentiment in financial markets and help float the real economy over this temporary but highly disruptive episode.



There will be an economic impact

Meanwhile, economic activity in the real world will fall as behaviour changes. Trade and manufacturing have been weak since 2018, and economies have been reliant on consumption – which is precisely what is being impacted by the outbreak. A cocooning until the clouds break will bring a multi-month or multi-quarter hit to activity, sales and earnings. Markets will struggle to measure this, and recession forecasts will proliferate. Ultimately, we will return to trend growth on the other side of this episode – and valuations will normalize. The timing of how this will play out is unknown, but it matters, as it will determine whether we enter a full-blown global recession or not. Interest rates will be numbingly low, making bonds unattractive and forcing investors to look for other investments that yield real returns. Signature will be strategically buying quality companies through this shock as we do not see this as a structural impediment to growth, but rather a very disruptive short to medium-term development.

Our funds are liquid. We are invested in quality companies. We have been underweight equities and overweight cash and golds. Duration in our balanced strategies has been full and our underweight allocations to the Canadian dollar and commodities have minimized our exposures. We are positioned to add stocks as the virus impact mounts in the West. We will remain active.

Sources: Bloomberg L.P. and Signature Global Asset Management as at February 28, 2020.

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