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Where do we go from here?

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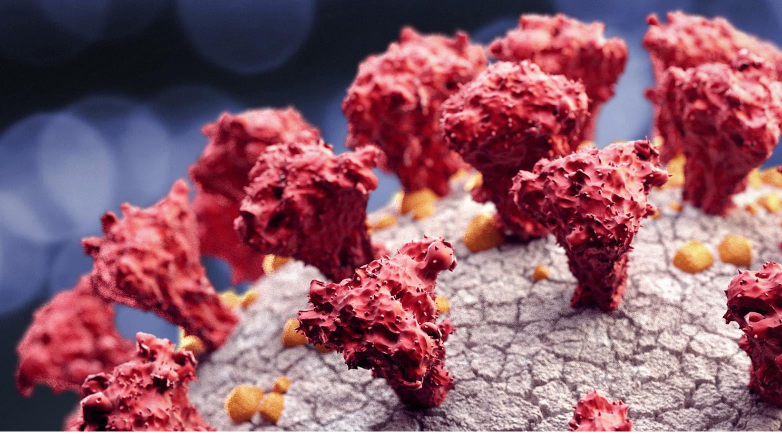


A coronavirus Q&A between Guy Foster and Paul Danis

We are just beginning to see the evidence of how badly the economy is suffering under the containment measures designed to stop the spread of the coronavirus. Markets, though, are forward looking and have shown no adverse reaction to the most alarming of economic data in the last two weeks. Instead they have moved on to what happens next. Guy Foster, our Head of Research, took the opportunity to ask our Head of Macro Strategy, Paul Danis, what we know about the outlook for the coming months.

When does the market expect containment measures to be lifted?

The first thing to say is that when containment measures are lifted is one question. Equally important is the question of how much suppression is lifted, because we are going to have some measure of suppression with us until we get close to herd immunity or a vaccine becomes available.

In terms of when containment measures will start to be lifted, we are now seeing the first countries give timelines. Austria said on Monday that small shops will be allowed to re-open on 14 April, with higher risk businesses like hairdressers due to open on 1 May. No date has been given for restaurants to re-open, but the government is hoping for the middle of May. The Spanish PM said at the weekend that there may be an easing of some economic restrictions, such as keeping all non-essential workers at home, starting after Easter.

In the UK, Neil Ferguson – who led the Imperial College study that has been important in guiding government policy through the crisis – said last weekend that the UK's epidemic was expected to plateau by around 12-15 April. Then he said in a few weeks' time, social distancing could be relaxed. If that is right, we may see containment measures relaxed in early May, but they will not be fully lifted then. In light of what we are seeing in Austria and Spain though, that timeline may be on the conservative side and we could see the suppression measures eased sooner than that.

In the US, a model from the University of Washington predicts that the US will reach its peak in new deaths on 16 April, meaning it is maybe a week or half a week behind the UK.

How quickly does the market expect economic activity to rebound?

If the above assumptions are correct, we will have seen the tightest suppression measures in March and April, with a relaxation in May. So unless second-order effects like job losses and credit defaults filter through in a big way to the rest of the economy, which we think is unlikely given the huge government fiscal packages to limit these, then it is right to think that the coincident economic data – things like the maximum number of job losses, retail sales and industrial production – hits a trough in quarter two, but we get a sharp rebound in quarter three.

How quick the rebound is will be determined by two considerations. Firstly, the extent to which governments can ease suppression measures, and secondly whether there will be a second wave if and when they do.

Turning to the first, there are reasons to be optimistic that measures will be eased in a way that supports a fairly solid growth rebound.

In Germany, a government draft action plan assumes that while the pandemic will last into next year, it should be possible to keep the average number of people infected (the so called R-nought number) below one per person even as economic activity increases.

There are several ways to do this: One idea would be to keep tight suppression measures up on retirees, given they aren't part of the supply side of the economy and are the most vulnerable from a health perspective, and loosening social distancing requirements on workers, who are part of the supply side of the economy and are less vulnerable to the disease.

In addition, there is now much better public awareness – hygiene should be better than it was heading into the crisis, people will leave a bit more space between each other in shops. There will be a focus on more testing, allowing asymptomatic people to tell if they have the virus and then rapid tracing of infection chains. Lastly, mask-wearing in public could be made mandatory.

All these things will help governments optimise the trade-off between the economy and the impact on the health system and mortality.

Now to the question of whether there will be a second wave once governments ease suppression measures.

One thing that is widely agreed upon is that we will likely get a second wave in the near future if the current suppression measures are lifted too quickly. This is obviously something the authorities are guarding against.

Assuming this does not happen, the next question is whether we get a second wave in the autumn and winter when the weather turns colder. Health experts are quite divided on this, but most think it's likely – for example Anthony Fauci, a US infectious disease expert, and Neil Ferguson who heads up the Imperial College team.

However, not everyone agrees. One study last month showed that in a poll, the consensus among epidemiologists implied a 73 percent chance of a second wave.

So while it is probable, it is not guaranteed. That is why everyone is watching what happens in China so closely as it reopens Wuhan.

From our perspective, it is right to assume we get a second wave for two reasons. Firstly, one would expect an influx of cases from other regions as the crisis is hitting countries at different times. For example, if the crisis is raging in another part of the world, perhaps the southern hemisphere, those cases could be brought to the north in the autumn if travel restrictions are lifted. Secondly, there may be continued transmission from people showing no symptoms, which could pick up as colder weather arrives.

However, the intensity of the second wave should be less severe thanks to mass testing and growing immunity in the population which will slow the spread. There may also be drugs available to treat the virus, easing hospital capacity and it is possible the virus may also mutate to become less deadly by the time the second wave hits.

In terms of managing that second wave, we would expect authorities' understanding of how to balance the trade-off between the hit to the economy and the strain on hospitals to increase over time.

However, the trade-off isn't as cut and dry as just the economy vs hospital capacity. Lockdowns aren't just hurting the economy; they are also having an impact on domestic violence, mental health and child abuse and those will also be considerations for policy makers.

What are the implications of the US seriously mishandling this crisis?

We can say this has already occurred. The US and South Korea reported their first cases on the same day, but South Korea took the epidemic seriously, they tested widely, and cases sharply dropped. The United States badly bungled testing, and President Trump repeatedly dismissed the coronavirus, saying it was "totally under control", "will disappear", and insisting he wasn't "concerned at all".

There are a few implications. We know that President Trump tends to downplay the science, and he has done that again with coronavirus. But unlike something like climate change, which is a slow-moving crisis, this has been extremely fast moving, and has cost lives. The handling of the crisis has hurt Trump's re-election chances.

It looks like the US is now handling the crisis better, but if that changes, and markets lose faith in US leadership, then we could see markets drop lower.

What are the long-term implications of governments taking the full burden of this crisis on their own balance sheets?

In the long term, the main risk is inflation.

Following the massive quantitative easing programmes implemented around the world in response to the global financial crisis, there was already a growing belief by most investors that we are already in a situation where central banks are monetizing government debt. We've already seen that in the case of the US, the Fed has a lot of difficulty shrinking its balance sheet. The extra debt now being taken on by governments will make this task even harder. Bigger deficits, combined with other forces like less globalisation, increases the risk that structural inflation pressures pick up in the long term.

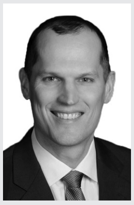
What does all this mean for the markets looking ahead?

There will be a sharp economic contraction in the markets, but it is likely to be a short recession. Historically there hasn't been much of a relationship between the depth of a recession and the depth of a drop in the market. Perhaps this bears out the observation that even though economic data has been worse than forecasters expected, the market has generally rallied. What matters more for the equity market is how long the downturn goes on for.

Like the rest of us, the markets just need to know there's light at the end of the tunnel. The big equity bear markets of the past – like the ones that occurred around the recessions of 1973 and 2008 – were long lasting recessions. Because of the extraordinary offsetting measures being taken by governments, and because this was in essence man-made (albeit in response to a dangerous pandemic), this recession is likely to be shorter.

Guy Foster, Head of Research

Guy leads Brewin Dolphin's Research team, providing recommendations on tactical investment strategy to Brewin Dolphin's investment managers and strategic recommendations to the group's Asset Allocation Committee. He is a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. Guy frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of Brewin Dolphin.



Paul Danis, Head of Macro Strategy

Paul began his career in 1998 trading interest rate futures and options in the pits of the Montreal Exchange. In 2001 he moved into research, and has worked as a strategist on the sellside (Lehman Brothers/Nomura), the buyside (Credit Suisse) as well as in independent research (BCA Research). Paul graduated from McGill University and is a CFA charterholder.

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