EDISON

Illumination: Equity strategy and market outlook

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Global perspectives: COVID-19 shatters calm

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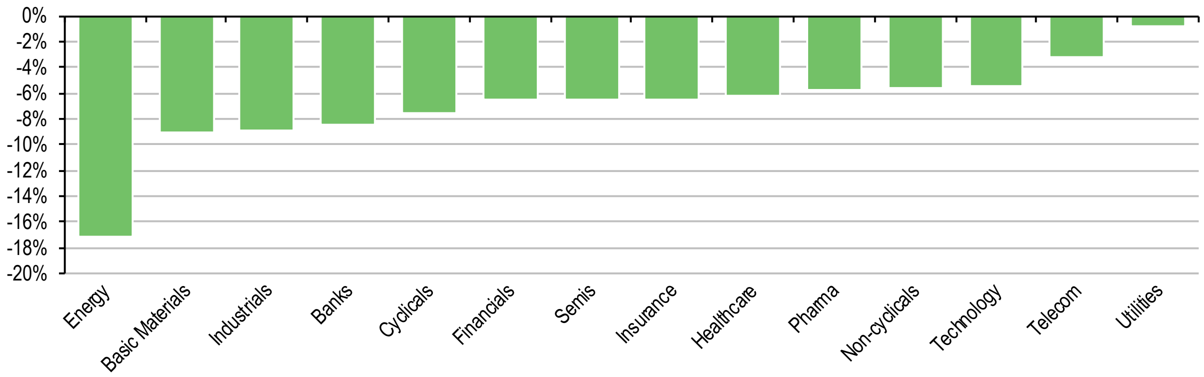
- **Elevated asset prices and a new risk in the shape of COVID-19 have combined to drive equity markets lower.** Investors have finally woken up to the economic challenges presented by the spread of COVID-19 and the associated public health measures required in the absence of treatment options or a vaccine. Coronavirus has spread across the world and the economic impact is increasing by the day.
- **Significant contraction in economic activity in China signalled by alternative real-time data.** Despite calls from China's administration for people to return to work, real-time indicators of energy consumption, air pollution and traffic congestion all point to a continued slump in activity at levels more consistent with holiday rather than working days. There will be a material slump in China's economic activity during Q1.
- **Earnings forecasts move lower with more downgrades likely.** We have observed a 1% reduction in earnings forecasts globally since the end of January. There have also been numerous specific profit warnings both in discretionary, travel and leisure sectors. Less obviously, we note increasing concerns in respect of global supply chains for diverse sectors such as pharmaceuticals, auto parts and IT hardware.
- **New COVID-19 cases may have peaked in China (although many investors will be wary of data quality), but this week infections have reached Europe.** The economic chain reaction triggered by even a single infection is severe. A single infected patient on holiday may quarantine a cruise ship or hotel for thousands, while nearby transport facilities may be locked down. Such drastic action has been clearly sanctioned by the World Health Organisation (WHO) this week, but the economic costs of such an approach are high.
- **Safe-haven trades have performed strongly in recent weeks as gold and government bonds have outperformed.** While we would agree that central banks will look to offset the impact of COVID-19 there is little policy room for conventional monetary policy and the reality is that a lack of financial confidence is hardly the problem at hand. Similarly, fiscal efforts outside China are likely to be slow to materialise and modest in scope.
- **We believe disruption in developed nations is only likely to increase in coming weeks.** Despite the recent declines in equity markets, investors seem to be relying on a theory of a Q1 and V-shaped recovery later in 2020. This is an over-optimistic assumption in our view and we remain cautious on equities for now. Government bond yields are likely to remain low and precious metals elevated, at least until developed market infections have peaked.

COVID-19 shatters market calm

Control measures have a disproportionate impact on corporate profits

The urgency of the public health crisis in respect of COVID-19 has usurped the usual position of the economy as the primary consideration in government policy. For investors, complacency has given way to the realisation that public health control measures are now likely to be necessary on a global basis. Such action may slow the spread of the virus but is also likely to have a significant impact on corporate profits. A combination of elevated asset prices and the new risk in the shape of COVID-19 has set the stage for the sharp declines seen in global equity markets in recent days.

Exhibit 1: Global sectors wake up to the COVID-19 risk during February



Source: Refinitiv, 17 January 2020 to 27 February 2020. Note: Declines shown in US$.

The WHO has strongly praised China for its determination to implement traditional quarantine measures used in earlier historical periods to control the spread of the virus. In the absence of treatment options or a vaccine, the indications are that other nations are likely to follow suit, despite data which suggest 80% of cases are relatively mild.

The WHO has pointed to the success of these efforts in supressing the community spread of COVID-19 in China with reported new cases per day falling recently. During a press conference following its visit to the worst-affected regions of China, the WHO also highlighted the use of advanced technological solutions for implementing a modern-day quarantine, but without details. However, without these details it is difficult to understand whether these techniques would be implementable outside China.

The current position of the WHO appears to be that other nations must also be ready to implement China's aggressive control measures in order to control the spread of the virus. This is likely to represent the path of least resistance for governments globally. We note that China is now imposing restrictions on international travel, despite criticising other nations for the same policy earlier in the likely pandemic.

Consequently, the position for investors is not straightforward. The paradox is that in the absence of a vaccine or treatment options the rate of spread of the virus might still be controlled via stringent quarantine measures and is therefore nothing for populations to fear. Yet for financial markets, this control is only at the cost of massive disruption to both production and consumption which will have a significant impact on the outlook for the economy and corporate profitability.

Furthermore, Epidemiologists have indicated that they do not expect these control measures to achieve anything other than a spreading of the peak of infections over time, which will help minimise the overload on limited healthcare facilities. For now, there has been relatively little pushback on the societal and economic costs of quarantine.

All governments appear to have followed the precautionary principle so far and shown a clear preference to shut down transport links and implement extensive quarantine procedures, most recently in Italy and the Canary Islands. Clearly, this is not being handled as a normal or even severe influenza outbreak.

Given the demonstrated ease of transmission of the disease and the 14- to 21-day incubation period previously observed, the recent outbreak in Southern Europe is likely to represent the start of the problem there rather than the end of the matter as the most recent infection of a Danish tourist returning from a holiday in Italy demonstrates. In the near term, headlines are unlikely to turn positive.

We are therefore struggling to see this as a Q1 phenomenon followed by a quick recovery. The progression of the crisis is likely to be a sequence of outbreaks and lockdowns across the globe. If, as appears likely, resumption of normal activity in China triggers further outbreaks there is likely to be a stop-start nature to the recovery rather than a V-shaped rebound. The WHO has even spoken of ‘a new normal’ for the coming months.

Vaccines and other treatment options likely over medium term

Before becoming overly negative, it is important to balance the economic realities of the short-term public policy response to the virus with the likelihood of a vaccine and other treatment options becoming available over the next 12 to 24 months. This prospect should limit the ultimate market downside from the likely pandemic. Once vaccine and treatment options become available, the balance of the policy response can shift back towards pharmaceutical measures to control the virus, with a fraction of the economic cost of a global quarantine.

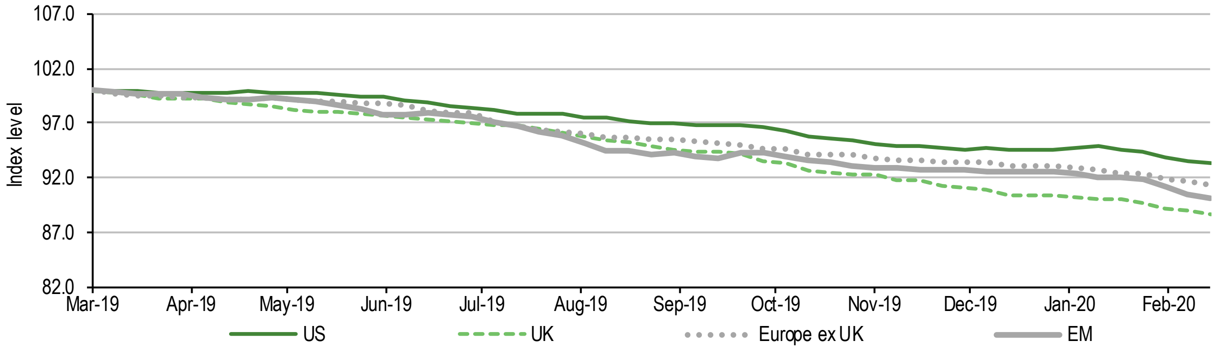
Furthermore, although the data are still sparse indications from China suggest that in most cases the symptoms are relatively mild and do not require medical intervention, with the risks heavily skewed to older members of the population. While the short-term impact is escalating, this particular viral outbreak does not appear to be an existential threat to the modern, globalised way of life, even if there may be changes to global supply chains and an acceleration of remote working which would in any case have the meaningful benefit of immediately reducing the carbon footprint of office-based work.

2020 earnings forecasts decline on COVID-19 impact

In just four weeks, consensus earnings forecasts have fallen by around 1% on a global basis. The sharp decline in the oil price has led to notable downgrades in the oil sector and leisure and entertainment have also lagged. We believe that these downgrades are largely due to the initial impact of China’s efforts to control the spread of COVID-19 at the end of January.

So far in Q120, China has sacrificed its economic expansion in its attempt to control the spread of the disease. The ongoing effect on supply chains and global demand growth is becoming increasingly obvious as the early trickle of cautious trading statement have turned into a torrent. In the context of declining earnings forecasts and extended forward market valuations, global equities are, in our view, still too sanguine in respect of the ongoing risks to growth. The 1% decline in global consensus earnings forecasts for 2019 during the past four weeks does not in our view even account for the known disruption to the world economy.

Exhibit 2: Impact of COVID-19 on global estimates



Source: Refinitiv, Edison calculations. Note: Chart shows index of 2020 earnings revisions over past 12 months, rebased to 100.

Despite the optimism on show amongst investors in January, 2020 consensus earnings forecast revisions have turned markedly negative over the past four weeks, coinciding with the increasing awareness of the COVID-19 epidemic in China and the associated control measures which have been put in place. The impact has been on both Chinese demand and supply. In terms of demand, luxury goods stocks have been affected by shop closures while auto sales have stalled. Airlines have been hit by flight cancellations. Furthermore, second order effects are now becoming increasingly visible. The extended industrial shut-down in China has disrupted global supply chains, leading to a risk of plant closures in developed nations as China-made parts become scarce.

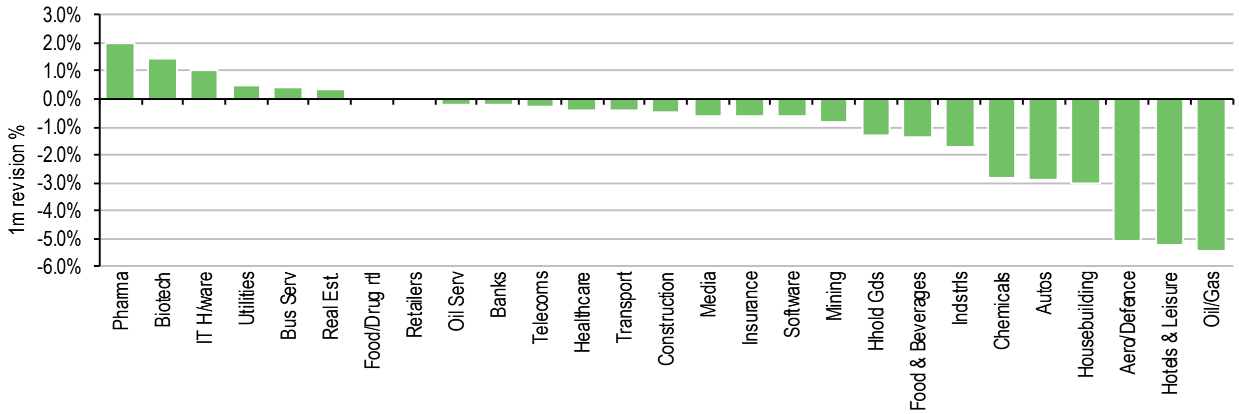
Energy markets have suffered as China's oil demand has weakened by 20% during Q1. Furthermore, Chinese LNG importers have controversially declared force majeure, leading to LNG tanker diversions. Real-time data from China suggest that for now at least the country has not returned to work, as was originally hoped-for. In this interim period, oil demand is likely to remain subdued. Measures of coal consumption, air pollution indices and traffic congestion continue to suggest only a very gradual return to normal seasonal levels of economic activity in China.

For the technology sector, Apple has highlighted a double whammy of supply constraints and a sharp fall in Chinese demand while Microsoft has warned its PC hardware business will be affected. This is in addition to the difficulties that contract manufacturer Foxconn has previously highlighted, as it tries to restart factory production with many staff failing to turn up for work.

Separately to the impact from COVID-19, the UK once again represents something of a special case for the wrong reasons. Despite the resolution of the political deadlock following the election last year, investors' relief in respect of Brexit has given way to fears of a no-deal outcome by December 2020. The rhetoric between the UK and EU has at times been close to hostile. This has had a negative impact on both sterling and consensus earnings forecasts.

Following a relatively weak performance for profits growth in 2019, 2020 UK estimates continued to fall in the first six weeks of 2020 and now indicate just 5% growth for the year, compared to 8–9% for the US and continental Europe. UK PM Johnson's new Conservative government has to date disappointed those hoping for strategic policymaking (even if it represented a more confrontational approach). Instead, both domestic and foreign policy has at times looked almost chaotic, knocking investor confidence in the process.

Exhibit 3: Global sector revisions show oil, hotels and leisure suffering largest one-month downgrades



Source: Refinitiv, Edison calculations

Conclusion

2020 has shown that asset prices must also factor in unknown risks to the outlook. Early in the year consensus shifted towards expectations of a recovery based on declining trade risks and the lagged impact of the marked easing of the stance of global monetary policy during 2019. In only 28 days, a previously unknown new virus has spread across the globe, shutting down economic production and disrupting not only the travel and leisure sector, but also global supply chains. Investors are no longer complacent.

Moreover, the incidence of new cases continues to accelerate outside China. As public health measures are only just being put in place the impact on corporate profits for 2020 is yet to be properly quantified. It is now difficult to see this as a China-only or Q1-only phenomenon, which seemed a consensus view only a fortnight ago. Even if we optimistically assume that developed markets will be able to eliminate community transmission through public health measures, a prolonged process of case alerts followed by lock-downs appears set to disrupt national economies during 2020.

We suspect in recent days many investors have been obliged to focus on managing portfolio risk. However, long-term investment processes should not be suspended during this period of increased volatility as specific equity opportunities may arise as market valuations move lower. We expect equity markets will be discounting the time to an approved vaccine, the availability of which could quickly shift public policy towards pharmaceutical countermeasures for COVID-19. This could eliminate the need for the economically costly quarantines, facilitating a return to normality. Nevertheless, uncertainty remains high and the probability of still-incubating cases in developed markets suggests difficult headlines will continue for now.

In terms of global equities, we believed asset prices were too high before the COVID-19 outbreak and the recent market declines represent a correction to more realistic levels. Yet given that globally consensus earnings forecasts for 2020 have only fallen by 1%, the evident slowdown in economic momentum both in China and other markets as a result of COVID-19 has not been fully incorporated into consensus forecasts and further downgrades are likely, in our view. In the scenario of a period of broad-based downgrades, while there may be specific opportunities, equities are not in our view likely to stage a rapid rebound in the short term.

Given the shock to the economy from COVID-19, we expect central banks to respond to declining activity with an easing of monetary policy. However, the room for manoeuvre is limited, particularly in Europe where the impact of a sharp contraction in the rate of China's growth is likely to be more keenly felt and interest rates are still below zero. Therefore, while the US Federal Reserve is unlikely to tolerate the current inversion of the US yield curve for very long, we believe cuts to interest rates may merely match current market expectations.

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