

Macro Insight

Policy support to the rescue?

Global market volatility has risen following the coronavirus outbreak

In our view, the outbreak will deliver a short term, but sharp, setback to China's growth

However, policy easing is likely to help cushion the blow to the global economy and financial markets

Our views

While COVID-19 is likely to deliver a significant hit to global activity, it can be relatively short-lived. Automatically adopting risk-off investment strategies may prove costly given current market pricing

Following the outbreak of coronavirus (COVID-19) this year, global market volatility has risen. Investor pessimism initially took hold in the second half of January, as cases rose sharply in China and the actions Chinese authorities took to limit the spread had an unavoidable negative impact on economic activity.

Through much of February, however, global equities recovered as investor focus switched to the potential for policy easing to support global growth and risk assets. But recent days have seen another bout of risk-off sentiment and a sharp reversal in global equities.

In our view, a number of factors explain the abrupt fall in equities since 20 February:

Equity markets had possibly been excessively optimistic. The S&P 500 hit a new high on 19 February, despite the looming downside risks to growth from COVID-19. The rally was also at odds with investor pessimism as reflected by depressed commodity prices and government bond yields. At some point a correction may have happened of its own accord.

Growth of cases in Europe and South Korea picked up quickly. Initially, the COVID-19 outbreak could be viewed primarily as a China issue with the main impact on developed markets (DM) coming through trade links and supply chains. Now markets are likely to be pricing in some probability that other economies may be pushed into taking actions similar to those in China to limit the spread of the virus, thereby further damaging growth.

The perception that the US economy would be largely unaffected by developments was challenged. After a run of upward surprises on US data, the IHS Markit Purchasing Manager Index (PMI) for February was much weaker than expected.

How the COVID-19 outbreak develops from here and its economic impact is highly uncertain; case growth and location are hard to predict and supply chain links between economies are complex. But what seems likely is that it will deliver a significant hit to China's growth rate in Q1, with spillover effects to the global economy. Nevertheless, we also believe the impact could be relatively short-lived and automatically adopting risk-off investment strategies could ultimately prove costly given current market pricing.

Policy support for economies and markets

Crucially for the outlook, we see policy supporting economies. Authorities in China have already eased monetary policy, pledged tax cuts, and rolled out financial support for firms in order to limit bankruptcies and a permanent loss of output. Eight of the G20 economies have cut interest rates this year, with low inflation and recent oil price falls aiding room for manoeuvre. Lower oil prices also help many economies that are large net oil importers.

Fiscal policy can also provide support. The UK government is expected to announce a significant package of easing measures in its upcoming budget on 11 March. Meanwhile, eurozone finance ministers have signalled a willingness to spend more if a downturn hits its economy, and could be a prelude to a loosening of EU fiscal rules. In Asia, South Korea was already expected to implement a fiscal booster this year worth around 1.5% of GDP.

Investments, annuity and insurance products

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Moreover, prior to the onset of COVID-19 there was increasing evidence that policy easing and reduced trade tensions were leading to some recovery in global growth, despite some scepticism in markets at the time over the effectiveness of the measures taken.

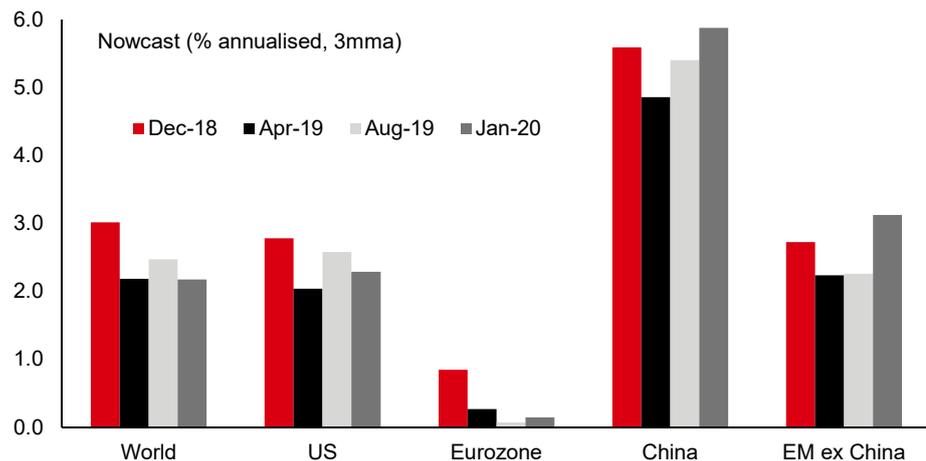
Indeed, our Nowcast (big-data estimate of “real-time” growth) was showing clear signs of improvement in China and other emerging markets through the turn of the year, consistent with an upturn in the global manufacturing and technology-cycle (Figure 1). In our view, policy easing can again prove pivotal to growth later in 2020.

A strong and relatively insulated US economy is another reason to remain positive

The big lesson from 2019 is that even if uncertainty is elevated and the outlook appears “difficult”, we should not automatically adopt a cautious investment strategy

Nevertheless, it will be important to monitor corporate earnings data, and we also acknowledge there are limits to what policy support can achieve

Figure 1: EM growth improving ahead of COVID-19 outbreak



Source: HSBC Global Asset Management, as at 25 February 2020

Finally, for markets, as we saw in 2019, a pivot to looser monetary policy (including Fed rate cuts and a restart of net bond buying by the European Central Bank) was probably the single most important reason why risk assets performed strongly.

Solid US economy

Although the US economy is likely to be affected by temporarily weaker demand from Asia and disruption to supply chains in the near term, the fundamentals of the economy are sound, and it is likely to remain an engine for global growth.

US consumers in particular are in good financial health by historic standards – wage growth is robust, inflation and debt service costs are low, and house price growth is on an upward trend again. The savings rate¹ is also comfortably above its 30-year average, meaning there is room for consumers to save less, to support spending if needed.

More widely, US financial conditions are already accommodative. Indeed, prior to the recent shock from COVID-19, risks to US growth appeared to be diminishing, with indicators in the housing sector picking up strongly. Importantly, the Fed can maintain loose conditions, or even ease further if needed, given inflation remains below its target rate.

Market considerations

The big lesson from 2019 is that even if uncertainty is elevated and the outlook appears “difficult”, we should not automatically adopt a cautious investment strategy. With global policymakers again on standby to support conditions, and favourable relative valuations for many risky asset classes, we maintain a pro-risk investment strategy. However, we need to monitor developments closely, with particular attention on:

Trends in corporate earnings and default rates. Before the coronavirus outbreak, earnings growth was expected to pick up this year. A big disappointment may weigh on investor sentiment and corporate appetite for hiring.

¹ The savings rate is calculated as savings as a percentage of disposable income. Disposable income is income after taxes and social security charges.

COVID-19 case growth. There are limits to what policy easing can achieve if lockdowns and supply chain disruptions persist or become wide-spread. Moreover, some regions also have limited policy space. In this respect, among DMs, the export-dependent and globally integrated manufacturing hubs of the eurozone and Japan look vulnerable.

High-frequency Chinese activity data. An upturn in indicators such as daily passenger transport volumes, average road congestion and coal consumption would indicate the shock to the Chinese economy is fading well before more traditional data sources show signs of improvement.

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