Investment Insight

March 2020

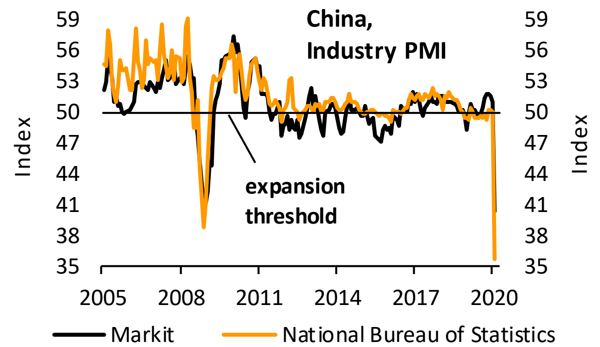
Epidemic causes downturn

The corona epidemic has reached the real economy and the equity markets. A slump in growth is inevitable for Q2 2020. However, if the virus can be contained, the chances of a renewed economic recovery are good.

Although the number of new SARS-CoV-2 infections in China is declining, there has only been a moderate increase in activity figures reported daily on energy consumption, real estate sales and traffic density in the major cities. The purchasing managers' indicators for February show that businesses are under much more pressure than previously assumed. China's National Bureau of Statistics reported a drop for the manufacturing sector from 50.0 points to 35.7, while the Markit equivalent plummeted from 51.0 to 40.3 points. Both of these marked historical lows (see figure right).

These slumps indicate that economic growth in the first quarter of this year is likely to have slowed even more sharply than expected (from +6.0% in Q4 2019 to +2.0% – +3.0%, year-on-year in each case). However, this does not change our assessment that this is only a temporary phenomenon. The first requirement for a recovery, though, is that the overriding trend of declining new infections continues, but that the simultaneous increase in travel activity does not trigger a second wave of infections. The second requirement is that the government's various support measures for businesses and households are successful. If companies can tide over the financial dry spell and if the epidemic subsides, the chances that China's economy will start to recover during Q2 are good.

China: Indicators show sharp decline



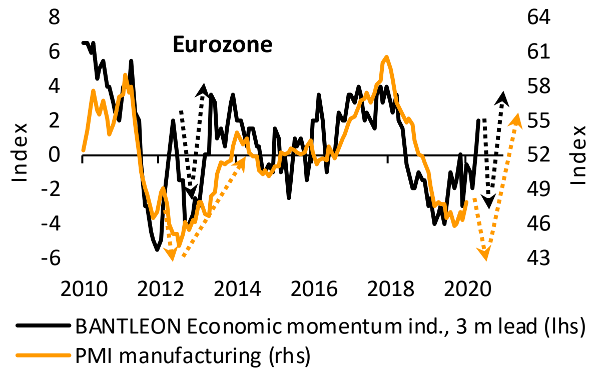
Sources: Markit, NBS, BANTLEON

Unlike China, the USA was directly spared from the coronavirus epidemic for some time, and the number of new infections has only increased in recent days. This makes the effects barely visible in the latest economic data. Only Markit's Service PMI points to concern for February, with a decline from 53.4 to 49.4 points. Activity data for January, on the other hand, proves the US economy to be in a robust condition and actually shows signs of increased momentum. In particular, the increase in new orders and deliveries of nondefense capital goods points in this direction.

However, this was before the virus epidemic began. As in other countries, travel restrictions to combat the epidemic will soon be imposed in the US, large-scale events will be banned, schools closed and social contact restricted. This will be reflected in declining consumer spending and lower capital and personnel expenditure by companies, and will slow down economic growth. In parallel, PMIs and consumer confidence indicators will start to point downwards. The US economy is therefore likely to temporarily come under greater pressure than expected. It is vital that a self-reinforcing downward spiral not be triggered – which could happen if companies lay off staff due to temporary slumps in demand, in turn putting an additional brake on consumption. Given the manifold uncertainties at present, this kind of negative spiral cannot be completely ruled out, although we only see it as a risk scenario. We see the negative effects of the virus epidemic primarily as a temporary phenomenon, and therefore stand by our overriding forecast of an economic recovery in the US. However, after a dry spell with disappointing economic data in March/April, this is unlikely to become apparent until later in Q2 at the earliest.

The ifo index recently confirmed a positive trend in Europe too, with business expectations rising by 0.5 points to 93.4, and an increase in French, Italian and Dutch business confidence. But in view of the latest developments regarding coronavirus, we now expect a small economic shock and fear considerable negative effects on private consumption, primarily in March and April, although we see some evidence that warmer temperatures and higher humidity will noticeably reduce the spread of the virus thereafter. In this case, we expect leading indicators to recover quickly. (see figure right)

Eurozone: Bottoming out



Sources: EU-Commission, Markit, BANTLEON

The changed assessment of the impact of the coronavirus pandemic is affecting the development of GDP in Germany and the Eurozone. Following stagnation in Q1, we expect a noticeable decline of between 0.25% and 0.50% in Q2, compared to the previous quarter. Although the foundations have been laid for a strong economic trend reversal in the second half of the year, we still have to revise our annual forecast significantly downwards due to the »unfortunate« first half. We are now only forecasting GDP growth of 0.6% for the Eurozone for 2020 (previous forecast: 1.4%) and are also lowering our inflation forecast from 1.4% to 1.2%. In addition, we expect the ECB to increase its bond purchase programme from the current EUR 20 billion to up to EUR 50 billion per month.

Meanwhile the coronavirus is not just causing bad sentiment on the financial markets, but rather panic. The sharp rise in the number of infections in Italy and South Korea has proved to be a game changer. The reaction of the public, businesses and authorities is the same everywhere; schools are being closed, events and travel cancelled, and social contact restricted. The first to suffer are airlines, hotels, restaurants, trade fair organisers and amusement parks. There have also been some delivery problems due to the quarantine zones in Italy, and demand from China remains weak.

We expect share prices to recover later in the year

This effect caused the largest weekly loss for the equity markets since 2011. Other risk assets such as high yields and government bonds from the euro periphery also came under pressure. We expect more unpleasant surprises from the virus epidemic, keeping risk assets under pressure for the next few weeks. We assume a crisis scenario of medium proportions for the equity markets, i.e. a 20% to 25% slide in prices (from the peak). There should only be greater declines (35% to 50%) if production comes to a complete halt for several weeks in Europe. If our baseline scenario plays out (recovery starting in Q2), the risk-off sentiment will not dominate the whole of 2020. Instead, monetary and fiscal policy measures, along with declining infection figures are likely to be the triggers for a return to risk-on. It is difficult to estimate when this turnaround will take place, but we expect share prices to recover as the year goes on, and even target new record highs. At the same time, yields on government bonds will start to increase again.

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