Private Bank

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Coronavirus implications - short-term negative, medium-term opportunities

Summary

- **We've already dialled back tactical risk exposure.** As COVID-19 started to spread beyond China around ten days ago, the GIC eliminated its overweight to equities globally, including within Europe.
- **Supply, demand, and sentiment all under pressure.** COVID-19 threatens both a demand and a supply shock for Europe, starting with the China linkages – **figure 1**. In addition, there is now a global impact and negative sentiment affecting both world output and markets. The spread of the virus in Europe is likely to accelerate in March.
- **Expect European economic contraction in 1H 2020, rebound in 2H.** COVID-19 should result in a sharp European economic contraction in the first half of this year, but not the start of a recession. We look for a rebound later this year. The strength and sustainability of that rebound will depend on how long it takes to contain the virus, which in turn will partly depend on government actions. A key assumption is that there will be substantial government support across Europe. Further monetary easing is possible. However, direct disaster assistance seems likelier as well as more important.
- **Equity falls creating opportunities.** Equity markets have partly discounted the pending economic weakness already. Decent buying entry points seem likely in the coming weeks. At this stage, we do not believe that the market falls mark the start of a long-lasting bear market. The sustainability of the equity rebound we expect will depend mainly on the time period before the spreading of the virus starts to slow. (It is already doing so in China). Globally, we would advocate adding to adding to equity exposure if broad equities correct by 20% or more (It Is Better to be a Buyer Tomorrow Than A Seller Today).
- **Reiterating our key messages for 2020.** The virus's impact will likely reinforce some of our recommendations from the start of the year. These include staying invested, to diversify sensibly, to embrace higher volatility, and to continue seeking income both from dividend yields and from the more attractive fixed income yields still on offer.

We have downgraded GDP and earnings forecasts

At the start of the year, we expected Europe to benefit from a manufacturing rebound, with orderbooks being rebuilt to meet demand after phase one of the trade deal between the US and China. This gave us confidence that GDP growth might rise above 1%, with earnings per share (EPS) growth of around 8%. Now, though, we think regional GDP in the first half of this year may drop to around zero, with several countries suffering negative second quarters. We also see EPS growth falling into low single digits for the year, even if our base case of a second-half economic rebound proves correct.

Three critical factors will impact growth over the next few months:

1. **Demand shock:** In China, government action to prevent the spread of the virus has caused a severe immediate demand slowdown due to school and factory closures as well as travel restrictions. Chinese manufacturing PMI in February collapsed to 35.7 and non-manufacturing PMI to 29.6. This is negative for European exporters, and also highlights potential risks for the European economy as government-led preventative measures start to take effect.

2. **Supply shock:** China now accounts for around 14% of global exports and plays an integral part in many sectors' corporate supply chains. Disruptions can be expected for European companies, resulting in shortages in some areas as well as lower earnings after inventories have been run down.
3. **Lower global activity levels:** At present, the virus has been detected in about fifty countries. This number is likely to rise. Given the interconnectedness of today's world, the period in which infections are growing may prove prolonged. This is likely to hamper global activity during the first half of this year.

More European Government and central bank support measures likely

Italy – the first European country to be struck by the virus – has already announced government support measures. The Italian finance minister has announced a package totalling €4.5 billion, including tax cuts, tax credits, and support for the healthcare system. This equates to almost 0.3% of GDP, which will almost certainly breach European Union fiscal rules for a period, thus requiring Italy to seek European Union approval. But we believe the economic virus impact could be closer to 0.6%, assuming that the northern Italian economy could start stabilizing in around four to six weeks. If it took longer though, an Italian recession would become an even greater risk. Such a downturn would be very problematic for a country with around €1 trillion debt, a weak banking sector, and a fragile government.

It is likely that other countries in Europe will also provide meaningful local support measures in the coming weeks. In Germany, the finance minister has stated that the government can fund a stimulus package, if necessary. Potential measures include increasing tax relief and reducing taxes. He has also proposed a temporary suspension of the constitutional debt brake. This rule prohibits the federal government from borrowing more than 0.35% of GDP per annum.

European central banks are likely to be supportive too. In the UK, while no explicit measures have yet been announced, the Bank of England is currently working with the UK Treasury to ensure financial and monetary stability. The European Central Bank (ECB) has stated "a temporary supply-side shock would not prompt a monetary policy response unless more member states were to experience more disruption to domestic demand". While the market does not expect any changes in March, current consensus expectations are for a deposit rate cut of 10bp to -0.6% at the 30th April 2020 ECB meeting - High yield markets – Safety sneeze.

Further immigration and Brexit trade negotiation worries

While Europe faces the eye of the COVID-19 storm, two other risks will be heightened during March and possibly beyond. Firstly, the Turkey-Syria tensions have prompted an EU emergency summit this week to deal with a potential worsening of the migration crisis. There is a renewed call for further financial support for Turkey to prevent further pressures on its border with Greece. Secondly, EU-UK trade negotiations begin this week, with both sides set to adopt tough opening stances. Indeed, the UK has already threatened to withdraw from the discussions by mid-year if insufficient progress has been made on key issues.

Avoid European fixed income in the short-term

We do not advise buying European sovereign bonds and investment grade corporate bonds, which are likely to move from expensive to very expensive in the short-term. With ECB buying support continuing, the upcoming economic data weakness will provide further downside impetus to yields. For areas of the fixed income universe that have recently been under price pressure – notably periphery sovereign bonds and high yield bonds – we'd advise waiting before buying. Those areas would suffer further if the virus led to recession. However, they could also rally substantially if our base case of a second half pick-up in economic and corporate data proves correct. Taking Italy as an example, Cerved, the Italian credit rating agency, has reported the local corporate default rate would rise from 4.9% to 6.8% if the virus were contained in the first half of 2020, but would leap to 10.4% if the virus impact lasted throughout 2020.

Short-term pressures ease on the Euro but mount for Sterling: With the US dollar continuing to be viewed as a "safe-haven," we don't expect an immediate and sustainable bounce in Sterling. That is especially true if the British currency decisively breaches the $1.28 support level. By contrast, investors are now using the Euro less as a funding currency for carry trades as risk aversion stays high. So, the recent rally to $1.11 could be sustained while global risk aversion stays elevated.

Short-term equity market pressures remain significant

European markets have fallen 14% and the UK market 11% from peak levels. **Figure 2** also shows sector falls have been widespread, including defensive sectors, since the initial virus outbreak and the escalation in cases outside of China. Equity volatility has risen to levels last seen after the shock Brexit referendum result of 2016. We expect this to persist in the near term – **figure 3**. Looking at chart levels, we see few signs of markets finding support levels. Towards the end of last week, there were signs of rising intra-sector correlations, and rising demand for downside protection. Short-term headwinds summarized above – COVID-19, migration worries, and Brexit trade negotiations – are likely to weigh upon the economic outlook and raise headline risk, limiting any short-term rallies.

In addition, corporate earnings are likely to see weakness. A number of European corporates have already reported disruptions on the back of COVID-19. For example, Fiat Chrysler has seen significant supply chain disruptions, given its dependence on parts from China. As **figure 4** shows, the majority of European countries and sectors have seen sizeable revisions lower in earnings expectations over the past month. Only financials and utilities have reported marginally higher earnings revisions, following positive fourth quarterly earnings results. Existing consensus expectations for 2020 EPS growth are currently around 8%. While quantifying expectations remains difficult given the fluidity of the virus and containment measures, we may see negative EPS growth across the first and second quarters of 2020, with low single-digit growth at best for the full year.

Look to buy European and UK equities selectively upon further weakness

As markets approach 15-20% falls from their highs, we expect prolonged consolidations. If virus pressures ease during the second quarter, we would then expect renewed market strength. European equity markets continue to offer high average dividend yields of 3.7% and a reasonable average earnings multiple of 17.7X. Regional markets are under-owned by institutional investors and offer pockets of deep value. The UK offers an even more attractive average dividend yield of 5.3%. We also see pent-up demand among investors, who will have been comforted by the Conservative government's resounding election victory in December as well as by the increasing clarity as to the likely Brexit roadmap.

Specific areas of potential equity opportunity

- **Sectors that have suffered the largest price falls and downward earnings revision.** These could see the biggest short-term bounces and include energy, industrials, financials, and consumer discretionary.
- **High dividend payers and high dividend growers.** Focusing on income strategies in Europe continues to be advisable given their defensive characteristics. European dividend growers have returned an average of 7.1% annually over the past 18 years, outperforming broader European equities' 4.3% annual return. Dividend growers have also shown more resilience versus the broader market since the virus first erupted (-10% versus -12.6%). We expect this resilience to continue, as volatility is likely to remain high.
- **Energy.** This sector has suffered the largest price falls since the beginning of the COVID-19 outbreak, falling over 20%. Energy stock prices have moved disproportionally lower than the weaker oil price would imply, driven by virus related uncertainty (see Europe Strategy | A Cleaner Way to Play European Equities). We anticipate short-term rallies within the sector.
- **Financials.** The higher beta European banks have also suffered more recently, declining nearly 20% over the last fortnight. The sector still faces challenges, with profitability facing continued pressure as yields move even lower. Longer-term, though, we see compelling value in many of the better-capitalised names. (Europe Strategy | European Banks – Update following the 30% rally)
- **Our long-term preferred themes.** We continue to favour opportunities in renewable energy sources, cyber security and fintech, as outlined within our Outlook 2020.

Figure 1: Chinese data tends to lead Germany with a 6- month lag

Source: Bloomberg as of 2nd March 2020

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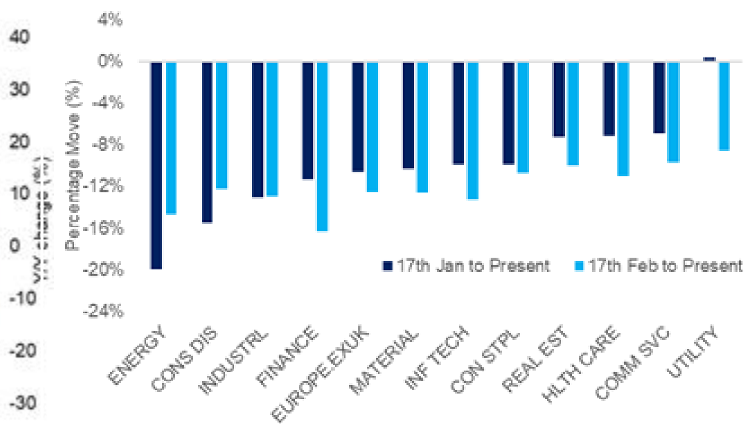
Li Keqiang Index: Tracks Chinese economic activity linked to rail freight, electricity consumption and bank lending.

Ifo monthly orders index tracks monthly new orders in Germany.

Figure 2: All sectors weaker



Source: Bloomberg as of 2nd March 2020

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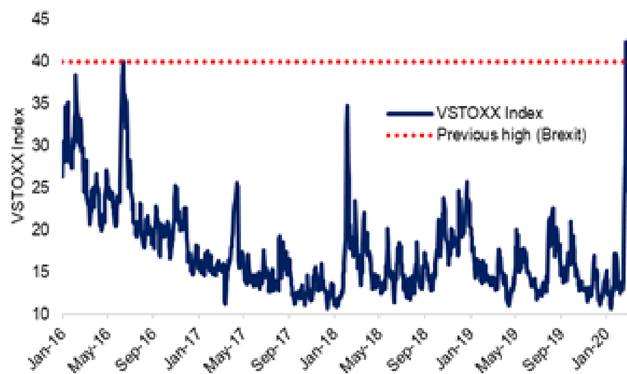
Figure 3: European equity volatility



Source: Bloomberg as of 2nd March 2020

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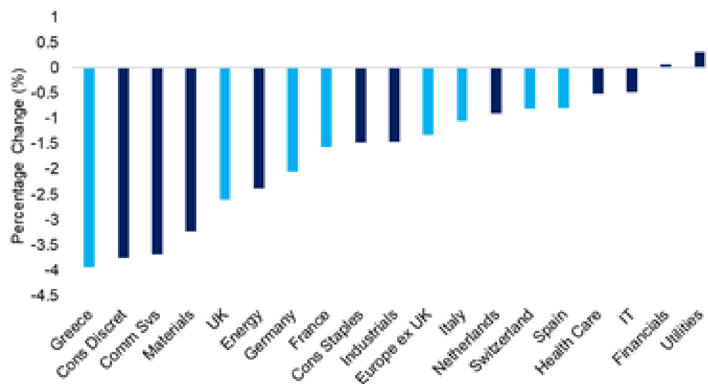
VSTOXX Index: Tracks European equity volatility

Figure 4: 1M earning revisions sharply lower



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Medium grade	Baa	BBB	BBB
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Low grade (speculative)	B	B	B
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Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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