A testing time

Deon Gouws - CIO, Credo Wealth - 02 March 2020

Only last week, we focused on the coronavirus in our monthly Equity Spotlight document. Since then, financial markets have been particularly weak, and we've just witnessed the quickest ever correction (defined as a decline in excess of 10%) in share prices.

How does one make sense of this? As I see it, there are probably three main elements to the whole discussion. On two of them, I am in no position to have strong views; I do however have somewhat more conviction about the third. Allow me to elaborate.

The first and no doubt most important question must be the actual medical one: how bad is this virus really?

Numbers released by the Chinese Centre for Disease Control and Prevention suggest that the answer may not be as alarming as some people appear to make of it: up to the age of 40, the disease has killed approximately one in every five hundred people affected. (It's obviously more dangerous if you're much older, but is that not true of practically every other disease?)

What is also important, is that the vast majority of deaths have been patients who were already in ill-health: according to the same source, those suffering from cardiovascular disease or diabetes appear to be most at risk, with coronavirus mortality rates approximating 11% and 7% respectively for people in these categories; for those with no pre-existing condition, the death rate has been under 1% (across all age categories).

Furthermore, and as pointed out in the New England Journal of Medicine over the weekend: if one assumes that the number of asymptomatic (or minimally symptomatic) cases is several times as high as the number of reported cases, the fatality rate may in fact be considerably less than 1%?

I am not trying to make light of something which is clearly of concern to most people: even a one in a hundred chance of death is odds which should not sound appealing to anyone. But my guess is that most (otherwise healthy) people who might end up reading this, may

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actually be in significantly less danger today, given inter alia where they reside (i.e. I would assume in mostly developed areas, such as cities, with access to good medical facilities in close proximity, et cetera).

The bottom line in my view is that the general level of public fear is likely to be overdone today, and for that I blame the age we live in: we have inter alia 24 hour news channels and the proliferation of social media, not to mention fake news... who knows what to really believe these days?

I did however say at the outset that ultimately I don't have particularly strong views on this first and most important question – I am no medical expert, after all. Like most readers, I have perused a number of pieces over the past few weeks and suffice it to say that there is no real certainty about the ultimate outcome: will the danger dissipate when warmer weather arrives in the northern hemisphere, for example? And how long until there's an effective vaccine?

For me, life will go on (as it always does). I don't plan to behave differently and I will keep coming into the office on a daily basis, for example (unless and until they stop me from entering the building, perhaps)…

The second question relates to the economic impact of the virus, and clearly this is a real issue.

Large parts of China have been in effective lockdown for some time, supply chains have been affected, a number of large international events have been cancelled, and many people have abandoned travel plans.

Clearly none of this is good if you've already been worried about a slowing GDP trajectory around the world, and economists have started adjusting their forecasts accordingly: the International Monetary Fund has adjusted its global growth forecast for this year from 3.3% to 3.2%, for example. Bank of America Merrill Lynch has made a bigger adjustment: their projections have decreased from 3.1% to 2.8%.

The interesting but ultimately also very frustrating part of this, is that one can argue most of the economic damage will essentially end up being self-inflicted: people (including governments) over-react to news flow, and it's the reaction that causes the bulk of the harm, not the original bit of bad news as such. George Soros explained this when he described his theory of reflexivity decades ago. More recently, Nobel prize winner Robert Shiller came up with a similar point in his book Narrative Economics: stories such as the danger of a life-threatening virus (which may or may not be overblown) keep on escalating, and ultimately they result in some very negative consequences in the real world as people start changing their behaviour (perhaps unnecessarily).

Be that as it may, there is no doubt that global economic activity will continue to be impaired for some time: the question is whether this will continue for weeks or months? How much pent-up demand will there be in the system when the dust eventually settles, and how quickly will the rebound be?

The truth is that the answer to practically all of these questions is unknowable at present. Not only that, but I'm also not an economist, which is ultimately why I am not in a position to put forward particularly strong views on this second question either.

The third (and in my personal view, perhaps the most interesting) question, centres on the behaviour of financial markets in response to the first two questions.

After seemingly shrugging off most of the negative news flow for approximately the first seven weeks of the year, last week ended up being brutal for investors of all descriptions (even the price of gold – which is normally considered to be a safe haven asset in any crisis – collapsed on Friday).

What changed all of a sudden? I don't believe the medical risk of coronavirus has gone up of late; on the contrary, some of the updated

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numbers that we've seen relating to e.g. mortality rates seemed to support a more sanguine conclusion?

Neither has the news flow in terms of the economic impact of the virus changed much. To illustrate, our commentary in last week's Equity Spotlight included the following paragraph:

"The impact is already starting to be felt. Shipments of copper have been delayed or cancelled by Chinese importers and it has been reported that up to 70% of February's imports of seaborne natural gas could be cancelled. Companies including Apple, JCB and Hyundai have already acknowledged disruption to their supply chains, with differing abilities to mitigate the impact. Multinational luxury goods companies, including Burberry and Pernod Ricard, have warned about the impact on sales, whilst fast fashion houses' supply chains are also affected. Meanwhile in the tourism industry, flights, both in and out of China, have been cancelled. Macau has closed its casinos for 15 days. Disney has closed its Shanghai and Hong Kong theme parks, and the Chinese Grand Prix, amongst other events have been cancelled."

Whilst none of this is good news, it needs to be borne in mind that this paragraph was originally drafted more than two weeks ago. One can therefore argue that most of the bad news should have been "in the price" previously…
so once again the question is: what changed so suddenly?

Personally I would argue that one of the catalysts for last week's market volatility may have been the fact that the narrative seemed to change from largely a China / developing markets issue, to something that people in the West started experiencing to a much greater extent, and in particular a lot closer to "home". The outbreak in Northern Italy, paralysing several towns, felt like a bit of a tipping point, for example.

Human nature started taking over, as it usually does. It's a truism that financial markets are driven by greed and fear, and after many greedy months and years, it's clearly been the turn of fear to govern trading behaviour over the past week or so.

It is typical for investors to feel frightened when big risks stare them in the face, whether these come in the form of geopolitical concerns, economic fundamentals, the rise of populism, or trade wars – to mention but a few. But none of those examples come with the added detriment that they may in fact end up killing many of us (in a worst case scenario); it's therefore probably understandable that markets have been reacting the way we've seen.

The principles of behavioural finance suggest that markets are prone to over-react in situations like the present, and I believe this is what we've been witnessing over the past week.

Does that mean that we're calling a bottom now? Not in the slightest: I fully accept that things can get worse before they get better. But I will say with some conviction in response to this third and final question that when the tide starts to turn (whether it's days, weeks or months away), it will start to become apparent how much of an over-reaction we've been through in the markets, and some of the recovery from these depressed levels could be relatively quick.

We have said to clients in the past that the biggest danger to their wealth is not the next correction or crash, but their own behaviour when one of these events inevitably happens: will they blink at the bottom, sell out at what proves to be the wrong time, and end up suffering the inevitable opportunity cost as a consequence?

It is easy to say things like this when the mood is bullish and equities are trading at or near all-time highs. But every now and then, our resolve is tested and this question comes into focus.
This, I believe, is one of those times.