

Tales from the Emerging World

# Our Coronavirus Worries Are a Bit Different

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These days, everyone in the markets is obsessed with the coronavirus, which is a tough subject for Tales. We like to speak from conviction, and lacking medical degrees, we are wary of predicting the impact on the global markets and economy, when so much rests on the path of a burgeoning epidemic. So let us concede up front that in our minds, the unknowns outweigh the knowns, and proceed with all due caution.

The bull case, which dominated the conversation after China reported the first coronavirus cases in late December, was built on the reaction of the global market and economy to past contagions. The record seemed pretty clear, and encouraging. After the contagion is first identified, both markets and economies tend to tumble for about three months, but then recover quickly for the next three, and in six months the whole scare is over.<sup>1</sup>

Intriguingly, China (at least the market) appears to be following the bullish path. After the pace of growth in the number of new cases peaked in early February, the market started to recover. Even after joining the global sell-off yesterday, China is still the best performing major market in the world, so far in 2020.<sup>2</sup> The bulls still take some comfort from China, saying its rebound could foretell recovery in the rest of the world.

The bear case is that the virus is imposing a direct hit to economic activity—quarantined cities, cancelled flights, shuttered stadiums, undelivered parts—that threatens to push the global economy into recession, and take the market down further. Our worries are a bit different.

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<sup>1</sup> Goldman Sachs as of February 2020.

<sup>2</sup> Bloomberg as of March 9, 2020.

First, while the number of new cases and deaths is ebbing in China, it is still on the rise in other countries, including the United States, and the New York region where Wall Street lies. This epidemic is unfolding less as a single shock, centered in China, than a series of shocks, now spreading across the world—death by a thousand cuts—with a cumulative and potentially protracted impact on markets and the economy.

Second, no market event is ever fully explained by a single factor. Looking at the average market and economic reaction to past contagions overlooks the unique factors that shaped each of these scares. The Spanish flu killed tens of millions of people around the world in 1918 but stock markets barely reacted, at a time when spirits and economies were recovering from World War I.<sup>3</sup> On the other hand, the SARS outbreak of 2003, though much less deadly than the Spanish flu, hit when the global economy was struggling

to recover from recession, and was followed by a particularly long and severe market drop.<sup>3</sup>

This time, the market reaction has gone from one extreme to another. The contagion struck when the market was bubbly with optimism. The global economy was in an upswing, and the buzzword in the markets was “melt up,” implying that markets could rise as fast in 2020 as they normally do in a meltdown.

The coronavirus barely dented confidence, at first. By Wednesday, February 19, the S&P 500 was up by nearly 2 percent since virus fears first hit U.S. markets in mid-January. As *Display 1* shows, that represented an unprecedented gain for this stage of a global contagion, based on records for the last eight, going back to the Asian flu of 1957.<sup>4</sup>

By the following Monday, all that had changed. Over the course of a few days,

the market mood had shifted from unusual calm to unusual fear.

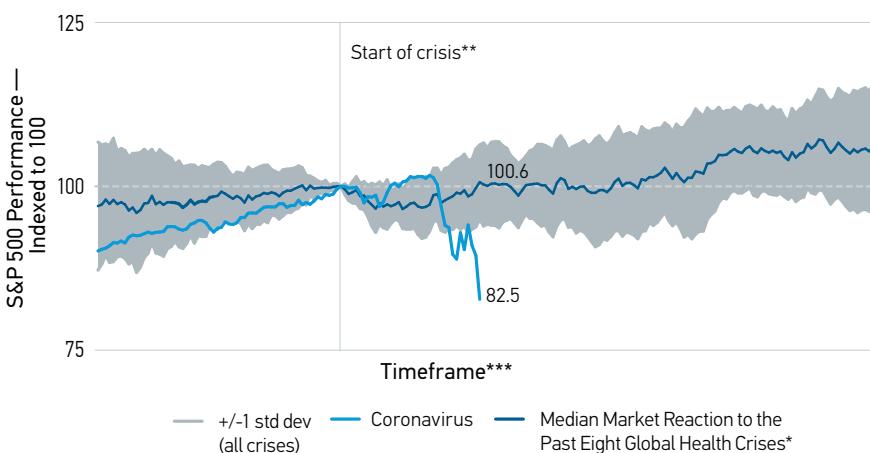
Amid reports that the coronavirus was breaking out of China, spreading across Asia into Europe and threatening the United States, markets started falling, and kept falling. By yesterday, two weeks later, all the major markets had suffered maximum drops of 15 to 20 percent from their recent peaks.<sup>4</sup> The speed and scale of the market drop captured in *Display 1* is the most precipitous plunge the U.S. market has seen since Black Monday in 1987, an event many saw as unprecedented and unlikely ever to be repeated.

Our concern now is that, compared to their size during past contagions, the markets are a much bigger beast. And that changes the risks. In 1980 the total value of financial markets was about the same as global GDP: Today it is four times larger.<sup>5</sup> The traditional worry was that economic tremors would rattle markets. Now, the bigger risk is that tremors in the market will take down economies.

One possible implication: Bloated markets could magnify the impact of the coronavirus. In the postwar period, recessions have been triggered by central banks tightening interest rates, or oil price shocks, never by a virus. But now, the transmission channel has changed. The virus has already provoked unusual panic in the markets, which has unprecedented potential to disrupt the economy.

Magnifying this risk is the fact that the world is now deep in debt, which has risen to 300 percent of global GDP from 100 percent in 1980,<sup>6</sup> and much of the riskiest debt is concentrated in corporations. The average U.S. company owned by a private equity firm has debts six times its earnings—a level twice what bond rating agencies consider junk.<sup>7</sup> And that is not necessarily the weakest link. According to the Bank for International

## DISPLAY 1 The Market Reaction to Past Contagions, and This One



Source: MSIM, Bloomberg, FactSet, Haver. As of March 9, 2020.

\* Those crises are as follows: global health crises, as defined by the World Health Organization, include SARS (14 Jan 2003), Swine Flu H1N1 (11 Jun 2009), Bird Flu H7N9 (29 Mar 2013), Ebola (30 Sep 2014), MERS (22 May 2015), Asian Flu (4 Oct 1957), Hong Kong Flu (13 Dec 1968), Russian Flu (27 Jan 1978).

\*\* The start is the day the WHO publicly declared a global health crisis or (where the initial market reaction is clear) the day the market started to fall in response to the WHO announcement.

\*\*\* Crises re-centered around their starting date and indexed at start of coronavirus case.

<sup>3</sup> MSIM, Bloomberg, Factset, Haver. As of March 4, 2020.

<sup>4</sup> MSIM, Bloomberg, Factset, Haver. As of March 9, 2020.

<sup>5</sup> BIS, WFE, IMF, McKinsey. Calculations: MSIM. Global financial assets are defined as global stock market capitalization, total loans, debt securities and currency and deposits to private non-financial sector, government debt securities, and financial corporations' debt securities. As of June 2019.

<sup>6</sup> Michael Roscoe, U.S. Fed, BIS, Economist, IFF. Last data point as of Q2 2018. Note: Includes debt at all levels: household, corporate and government.

<sup>7</sup> Bloomberg as of October 2019.

Settlements, 16 percent of publicly listed companies in the United States, and more than 10 percent in Europe, are “zombies,” meaning that they earn too little to make even interest payments on their debt, and survive only by rolling over their loans.<sup>8</sup>

This is a worst case scenario, but clearly bloated and debt-riddled markets change the way this contagion will impact

the global economy. The direct hit to economic activity—quarantined cities and so on—is now a double hit, as the virus panics markets, and markets disrupt the economy. If the economic hit lasts more than a quarter, it could trigger a negative feedback loop: As earnings fall, cash flow dries up, heavily indebted companies can no longer service or roll over the loans, and dying “zombies” further depress the markets.

What happens next depends first of all on how far the coronavirus spreads, how long it lasts, and how high the global toll—currently near 110,000 cases and more than 3,800 deaths<sup>9</sup>—rises. All of those are epidemiological unknowns, on which we withhold our non-medical opinion. Hopefully, the bulls are right, the epidemic peaks and passes quickly, and the world dodges its first virus-driven recession.

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<sup>8</sup> Bank for International Settlements. As of September, 2017.

<sup>9</sup> John Hopkins as of March 9, 2020.

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