Market Commentary

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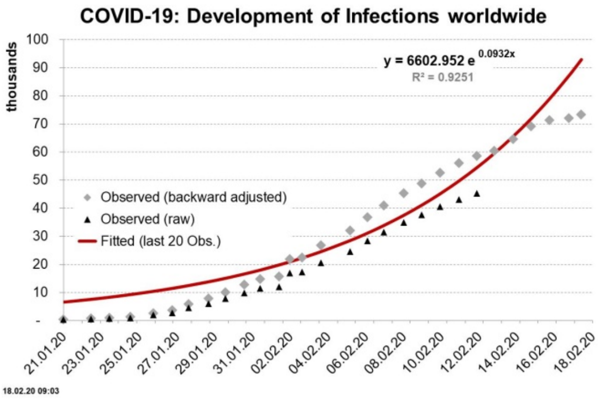
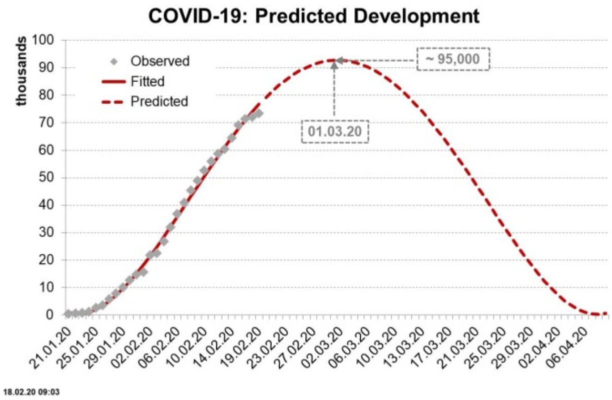
Tracing the virus hit

- **The Coronavirus (Covid-19) is set to weigh markedly on global Q1 growth, owing to a sharp slowdown in China and supply chain disruptions. Just today, Apple has warned over its IPhone sales due to Covid-19 restrictions.**
- **Indications are mounting, though, that a pandemic can be avoided, with the official number of new infections falling for almost two weeks. If the virus is indeed contained, most of the global economic damage – though not all – may be recovered over subsequent quarters. Our 2020 global growth forecast now stands at 2.8%, 0.2pp lower than before the epidemics.**
- **As we anticipated in our Focal Point on Jan. 30, global markets are taking note. Equities in the advanced world have fully recovered their January losses, but we remain guardedly constructive on this asset class.**
- **After the sharp fall, core bond yields are unlikely rebound quickly amid more dovish central bank expectations and subdued inflation.**
- **IG Credit is likely to stay resilient, while USD strength may extend somewhat further until global data confirm a more robust recovery.**

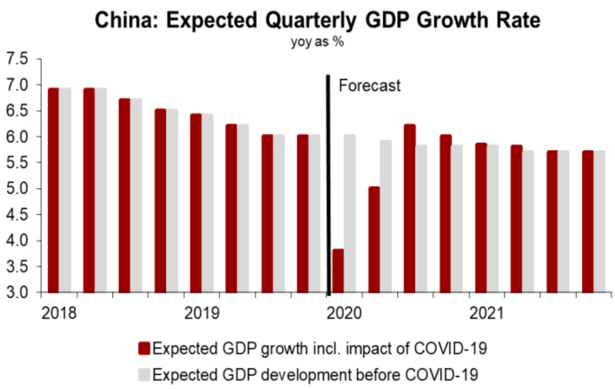
The Coronavirus (now known as COVID-19) continues to spread, but at a decreasing speed (see first chart). The jump in the official number of cases on Feb. 13 was due to a more comprehensive definition of infections. There is no evidence that the underlying dynamics have changed, though. We adjusted our internal model of the spreading of the disease accordingly. Based on our approximations, we currently expect the number of infections to peak at the beginning of March (see 2nd chart below). Assuming a symmetrical behavior before and after the peak and fitting a polynomial trend we would expect the number of infections to culminate at a level around 95.000.

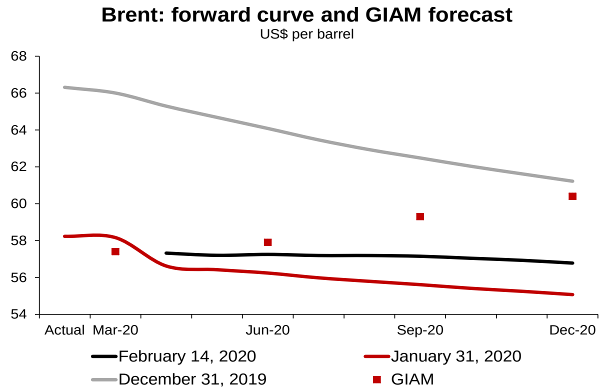




COVID-19 has still spread much faster than SARS back in 2003. Accordingly, we consider the historical guidance from SARS as limited and revise our 2020 growth outlook downwards. **China's growth** will be hit most strongly in the current quarter, for which we expect growth to drop slightly below 4% yoy (from 6.0% in Q4 2019). Subsequently, we see activity to improve as the outbreak will be brought more and more under control. We see growth to improve in Q2 to around 5% yoy before rebounding and even overshooting to some extent in H2.

Of course the timing is still very uncertain. Improvements could show up earlier but a major setback cannot be ruled out. Overall, we revised our growth forecast in our central scenario for this year down to 5.4% (down from 5.9% before the epidemics) and see 5.8% in 2021. Monetary policy (MP) and fiscal policy (FP) will continue to support the economy. The PBoC already cut its reverse repo rates and the Medium-term Lending Facility (MLF) by 10bps, which will be reflected in the Loan Prime Rate (LPR). It also provided liquidity and other targeted measures. We had expected the PBoC to ease its MP during 2020 due to the still negative tariff impact from the US-China trade conflict. We now expect in 2020 a total cut of 40 bps in the LPR, with the next two moves likely by the end of Q1/early Q2. We revise the total reserve requirement rate (RRR) cuts up by further 50 bps to 125 bps. We also expect more targeted FP measures, like tax breaks, temporary exemptions, waivers on fees, especially to help SMEs which provide the bulk of employment. The government could also start to stimulate investment and support private consumption once the outbreak is under control. The virus also added to already existing inflation pressures on top of the 20% yoy food price inflation seen in January as a result of swine flu.. We revised 2020 CPI inflation up to 3.5%, after 2.9% in 2019.





Moderate impact on euro area growth

China is the **euro area's** fourth biggest export market. It absorbed 5.6% of all goods exports in 2018 and the deterioration of the Chinese growth outlook hence is bad news. Also, bottlenecks in international industrial value added chains have the potential to additionally hamper activity, especially in Germany. The longer the COVID-19 epidemic lasts, the more pronounced will these effects become. That said, lower oil prices and a weaker effective euro (-1.5% since mid-Jan.) provide some support for the fragile recovery. We lowered our growth expectation on the back of a weak start into the year to 0.8% for 2020 and still see downside risks prevailing. We expect the ECB to monitor COVID-19 closely but to consider policy action only in case it morphs into a pandemic dampening inflation and activity on a longer lasting basis.

Disruptions of supply chains and lower tourism from Asia will prove a drag throughout H1 for the **US economy**, on top of the damage form the halt to the Boeing 737 production. The impact on supply chain is likely to show up gradually: goods shipped via sea usually take a month to reach the US. We have reduced our H1 growth projection from 1.4% to 1.2% qoq annualized. Growth will rebound in H2, as the bounce back in trade and investment will add to resilient consumption. Overall, we thus leave our 2020 growth forecast of 1.6% unchanged. In the press conference after the January meeting, Chair Powell underlined that the **Fed** stands ready to intervene should the situation deteriorate. However, in our baseline case of a contained shock, the central bank will mostly look though the slowdown, with another 25 bps cut in Q2 our base case.

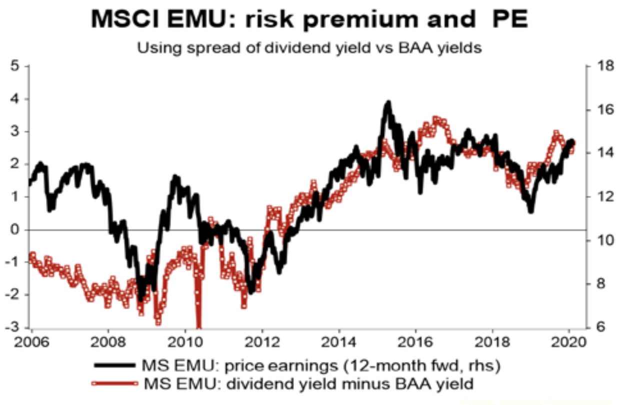
Overall, we now expect **global growth** at only 2.8% this year, 0.2 pp lower than ahead of the COVID-19 epidemics and unchanged vs. the previous year. This shall be followed by a slightly faster expansion in 2021 (3.1% vs. 3.0% before).

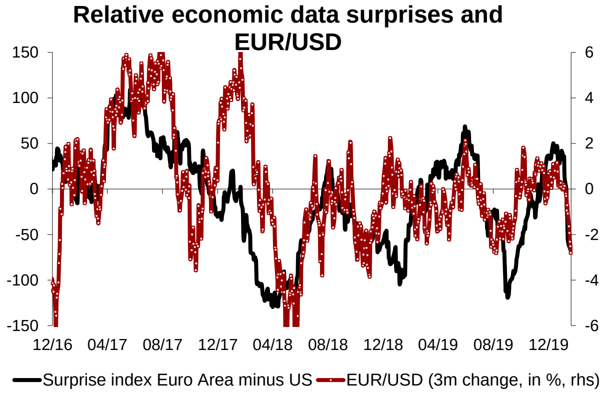
The uncertain impact on Chinese activity has raised fears on **global oil demand**. OPEC and Russia will most likely implement a 0.6 million barrel/day production cut in Q2. This and the pickup in global activity will likely help to stabilize price of Brent oil to around 60 US$/bbl by year-end.

Guardedly constructive on equities, bond yields to recover only very mutedly

Equities remain underpinned by the low yield environment despite less upbeat growth expectations. In our last Coronavirus update at the end of January we highlighted the reasons behind our still guardedly constructive stance on equities. Since then, markets moved higher and the MSCI EMU index (+4%)

outperformed both the S&P 500 and the EM index (both 3%). Indeed, the equity risk premium remains high by historical standards, the riskier EU banking sector's valuations already subdued (40% discount to the EU index) and the VIX structurally contained (13.7 currently). A weaker euro could additionally help to cushion pressures on the earnings momentum in the euro area. Recently, market sentiment has been further supported by a rise in Trump's re-election chances, an improved US macro surprise index and reassuring signs from the Q4 reporting season. We continue to see moderate upside in equities as we expect monetary policies to linger even more on the dovish side. This maintains the relative appeal of equities vs bonds, notwithstanding higher market multiples and reduced growth forecasts.





While equities rallied and spreads tightened, international **government bond yields** have remained at very low levels since late January. We trace this mainly to the expectation that central banks stand ready to step in, limiting the economic fallout of a spreading COVID-19. This constitutes a strong backup for risky assets, but limits any significant upward trend in sovereign yields. As long as overall market concerns about COVID-19 remain, we do not expect this to change. However, in light of the low sovereign yield levels the additional downside potential appears limited. Given the unattractive risk/reward potential we do not recommend going long. In contrast, once the news flow regarding the COVID-19 turns more reassuring there is upside potential for government yields. A recovering global economy will trigger some unwinding of safe haven flows and financial markets are likely to scale back their aggressive policy rate cut expectations.

Credit markets have been split. High quality papers (IG) have proven extremely resilient throughout the last weeks. HY, by contrast, suffered in synchrony with equities, before paring most of the widening over the last few days. Hence we consider that the credit market has already mostly priced out the effect of the epidemic. Unless the COVID-19 impacts global growth more severely than currently foreseen, we see IG Credit to remain well supported, with spreads marginally tightening further from current levels. HY is set to trade range-bound in the near term, while spreads should go wider in H2 as we expect default rates to start rising globally.

Even after this year's rebound, the **USD** will see continued support by the fallout from COVID-19 near term. The USD remains largely driven by the growth outlook of the US vs. the rest of the world. While US data continue to surprise on the upside, the global recovery will be withheld for some more time. Furthermore, entrenched markets expectations of prolonged Fed and ECB support will keep FX volatility low. This will continue to favor EUR-funded carry trades, incl. in the higher yielding USD. We consequently trim our 3m/6m targets for the EUR/USD to 1.09 and 1.11.
Further out in the year, though, the global recovery from COVID-19 should trigger more visible headwinds to the Greenback. This is why we still see 1.15 for the EUR/USD within reach by year-end. EM FX remains at risk of further setbacks after relatively muted drag from COVID-19. But a prolonged accommodative stance by the Fed and the ECB and a recovering growth in China could turn such dips into buying opportunities.

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