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Market meltdown and the virus

As valuations come into a more sensible range, take a deep breath and hold your nerve

Akash Prakash **March 17, 2020** Last Updated at 00:32 IST

What a month it has been for global financial markets! We have just seen the steepest decline ever into bear market territory for global equity markets (less than 20 days), the steepest rise in US treasuries and the steepest single-day fall in oil prices, all in the last few weeks. Fear and volatility are all pervasive. Financial markets are dislocated. The volatility index, the market gauge of fear, has now hit the second highest level ever, just below the peak seen in 2008.

What started out as being seen as a regional crisis, largely confined to China, has now quickly morphed into a global pandemic. It is also painfully obvious that the more advanced countries of the western world have been badly caught out by the Covid-19. They were complacent, unprepared and are now scrambling to control the spread of infection. While China took the hard road of accepting the severe short-term economic pain of shutting down large parts of its economy and not relying just on substantial fiscal and monetary support to flatten the curve of the infection, the West took the easy alternative. They seemed more worried about saving the financial system and equity markets. The initial response of the European Union (EU) and the US was to focus on interest rate cuts and liquidity support as opposed to focusing on testing and controlling social interactions. The Fed was leading the US response not the Centre for Disease Control (CDC).

While China has been successful in controlling the spread of new infections, with daily new cases dropping from a peak of almost 4,000 on February 5 to less than 30 today, they needed to literally lock down Hubei and large parts of the country in order to stem the spread. We also have examples of Singapore, Taiwan and South Korea, which have stopped the spread of the virus through extensive testing, isolation and tracing.

Illustration: Ajay Mohanty

Once the virus spread to Italy, and rapidly multiplied, it soon became clear that Europe does not have the social structures, laws, institutional capacity or resources to adopt the methods employed successfully by Singapore or South Korea. Italy and the rest of Europe have no choice but to adopt the heavy- handed Chinese approach of locking down large parts of the country. In the absence of this, their healthcare systems will be swamped. The US will follow suit, with a time lag of 10-15 days. The economic costs of the lockdown-approach are horrific, as is visible in China. Even today, despite new cases having dropped dramatically, most factories in China are just about approaching 65 per cent of prior capacity, and the country will have negative growth for Q1. Despite the economic costs, given how infectious the virus has been and with fatality rates approximating between 1 per cent and 3 per cent, not adopting the measures needed to flatten the curve, are unacceptable at a societal level. The costs, in terms of lives lost will simply be too great, if action to shut down all social interactions is not taken immediately.

It is now inevitable that the world economy will go into a recession. The only debate is whether this is a technical two-quarter event or something longer and deeper. In a typical recession, corporate earnings decline and markets fall by 25-30 per cent. This, however, is unlikely to be a typical recession, as it is a sudden stop to the global economy. Many sectors are going to face severe stress, as consumption evaporates and supply chains collapse. We have no idea how long this will go on. The central banks cannot solve this crisis. It requires action from government. This is primarily a public health crisis, which will morph into a financial crisis. Before this ends, we will most likely see bailouts of the airlines, hospitality and leisure industries.

Markets are also spooked because this is likely to lead to a severe shock to the high-yield markets globally. With a global recession, and the collapse in oil prices, large parts of the high-yield complex are in trouble as cash flows are in stress. Credit spreads have spiked, but still have a long way to go before they approach the levels of 2008. As new issuance dries up, many otherwise solvent companies can face maturity risk as they are unable to roll over maturing bonds. There is at least $1 trillion worth of BBB paper, which is likely to be downgraded and slip to non-investment grade status. This will more than double the size of the high-yield asset class and force yields up, as there aren't enough buyers to absorb this flood of paper. Simultaneously, we are seeing redemptions hit many of the high-yield funds and ETFs. These redemptions are hitting when the banks have cut back on their market-making, leading to illiquidity and dislocations in prices. Expect margin calls, as given the extremely low yields leverage is rampant among the investor base. Even small trades of $5 to $10 million are proving difficult to execute. For a long time, many commentators have been pointing out the huge surge in leverage among corporations globally. Corporate debt has hit record levels. High-yield markets had seen record issuance. Covenant lite loans had also hit a high. The music may be stopping for this asset class. We need to closely monitor what happens here and the possible contagion. This could be the canary in the coal mine.

Policy-makers have now hit the panic button. The Fed has just cut rates to zero and restarted quantitative easing (QE), a fiscal response is the next step. Expect measures globally to ensure liquidity and credit flow to small and medium enterprises, leveraged corporations and other stressed parts of the economy. Coordinated central bank easing is a given.

We will get through this, and both markets and the economy will normalise. One should, however, be buying slowly, and in a calibrated manner. The critical event to look out for will be a peaking of new cases in Italy. Once it is clear that Italy has been able to slow the spread and bring things in control, markets will extrapolate other countries in the west doing the same after a lag.

For India, if we can manage to keep the virus under control, then this will be a buying opportunity. India benefits from lower oil prices, enhanced global liquidity and record low rates. We have been in a slowdown for more than a year, and are not as closely aligned to global supply chains as other countries. The huge redemptions in the EM world (last month has seen outflows of $36 billion) have hit India equally hard, as much of these are passive flows. Some of the tail risks for India are finally being addressed. Much of the corporate clean-up has been done. Valuations are coming into a more sensible range. If India sees a spiral in cases, then we have a problem. Otherwise, this is a buying opportunity, with a significant longer-term upside. Take a breath and hold your nerve.

The writer is with Amansa Capital