Opinion **Markets Insight**

Markets and economists are still too upbeat on coronavirus

Sentiment is too bullish, judging by price-earnings ratios and credit spreads

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The gap between the relatively quick V-shaped recovery that some economists and many market participants predict, and grim coronavirus-driven realities on the ground has narrowed. But the disparity is still significant enough to pose difficult questions for investors.

The quicker those questions are answered, the smaller the probability of another bout of market instability contaminating a challenged economy.

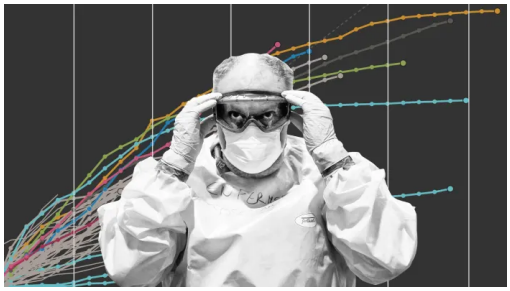
Economists initially — and over-optimistically — embraced the idea of a quick second-quarter recovery after a sharp contraction in the first quarter. That has shifted to a big contraction in the second quarter followed by a more gradual recovery in the subsequent three: a pattern more consistent with the sudden stop to global activity.

But the current projections still underestimate the severity of the virus-driven shutdown of the global economy, an inherently messy restart process, and consequent changes to the post-crisis landscape.

Big companies lack visibility on what lies ahead, and are suspending guidance on earnings — a phenomenon that will increase during the first-quarter reporting season. Many companies have also rushed to raise precautionary cash, including by issuing more debt, even as profits deteriorate and credit rating agencies continue with an avalanche of downgrades.

Editor's note

This surge in issuance of investment-grade bonds has been met by solid investor demand backed by new facilities from the US Federal Reserve, part of an emergency market-intervention programme that



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already far exceeds what the central bank did during the global financial crisis of 2008. Many companies have also raced to reduce costs with large-scale layoffs, resulting in a 17m jump in joblessness in just three weeks. That is equivalent to 10 per cent of the US labour force, equal to the highest unemployment rate during the great recession of 2008-09.

This alarming rise in unemployment, and wage cuts for those still employed, are encouraging households to be more cautious on spending. It is not too early to consider a parallel with lasting frugal behaviour on the part of the generation that experienced the Great Depression.

Consensus economic forecasts are not alone in failing to appreciate fully the impact of the shock and the reactions of both companies and households. Financial markets are too bullish too, judging by US price-earnings ratios for stocks and spreads for the lowest quality segments of the credit markets. Neither takes sufficient account of a whole host of risks including a more difficult earnings outlook, higher levels of indebtedness, a much bigger dispersion between winners and losers, the growing entanglement of government in private sector activities, lasting risk aversion in the real economy and, most importantly, a huge amount of bankruptcies.

That cognitive gap reflects, in part, an inherent structural bias of markets to treat pullbacks as temporary and fully reversible — a result of multiyear conditioning to try to follow and outpace a super-activist Fed.

Another factor is confusion as to what fiscal and monetary policies can, and cannot, do. They can help with short-term liquidity problems and market stresses, but cannot avert corporate and developing-country defaults, or restart the economy quickly.

With this in mind, and with the need to prepare for a changed landscape when the world emerges from this massive economic shock, investors would be well advised to thank the US central bank and use the resulting market rebound to move up in quality in three ways.

First, they should move out of companies and sovereigns with weak balance sheets and into those with large cash buffers, limited short-term debt and, if possible, positive cash generation. They should also sell exposure to companies that will find it hard to rebound fully in the post-crisis world, and buy beneficiaries of what are likely to be durable themes: opting more for self insurance and less for the efficiency of global supply chains and massive outsourcing; physical to virtual; and greater deglobalisation. They should also keep cash on hand for a growing set of attractive opportunities in collateralised credit, distressed and "special situations" that take advantage of a big but reversible market failure.

The timing of a decisive rebound in markets, and then the economy, will come only with medical progress in identifying and containing the spread of the virus, treating illness more effectively, and increasing immunity.

Meantime, economic and market forecasters would be well advised to focus on identifying a bigger set of high-frequency indicators that capture the severity of this coronavirus pandemic, the robustness of the subsequent economic restart and the themes defining the new destination for the global economy.

For investors, the task ahead is tedious but necessary: going through portfolios name by name to reduce downside exposure to corporate and sovereign defaults while also retaining the potential for returns should the Fed continue backstopping markets. The time will come to move into full recovery mode. But not yet.