MARCH 2020 MACRO BRIEF

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LAST WEEK IN MACRO

The Virus

There is a both good and bad news tied up in the last few days worth of data. The number of new laboratory confirmed cases in Italy have formed a noticeable peak, the spread rate has slowed markedly, and we can quite reasonably declare that the total number of infected is no longer growing at an exponential rate.

Unfortunately, the situation in Japan is worsening. Policymakers over there are contending with increasing new cases, a rising spread rate and exponential growth in the number of infected. Mind you, with new cases in the hundreds rather than the thousands, they are still some way from a level which might threaten to overwhelm the health service.

The outlook for the UK lies somewhere between Italy and Japan. There are early indications – though they could easily be reversed – that the number of new cases have plateaued. The spread rate held at around 1.30 (or 30 percent) during the middle of March but registers 1.10 today. For comparison, the spread rate in Italy and Japan is 1.04 and 1.12 respectively.

Of course, we still don't know how many people have been infected and how many people remain susceptible. Consequently, we just don't know how deadly this virus is - the mortality rate could be as high as 1.0 percent or it could be as low as 0.1 percent.

In turn, we don't know if the policy response – and the unimaginable damage these lockdowns are doing – is proportionate. There is a debate to be had here.

Market Functionality

This virus, even after it is defeated, will have a lingering effect on our economy and society in ways I've not yet imagined. There is a great deal to worry about and the negative effects
will be increasingly visible in the next few weeks, but in the fullness of time there will be some positives too.

I am, thus far, hugely impressed with the policy response from the big four central banks (the Federal Reserve, the Bank of England, the European Central Bank and the Bank of Japan) and others (notably in Canada, Australia and Switzerland).

Any signs of distress at the senior end of our markets (the money market and that for government bonds and investment-grade corporate bonds) have been met with rapid
and effective remedies.

So long as our markets remain functional, the worst effects that come with this crisis will be muted and the chances for a vigorous recovery will be amplified.

The Outlook For Interest Rates

In ordinary times, you can look to the bond market as a guide to all kinds of things. The prices for bonds reflect the outlook for interest rates, inflation, appetite for risk… you name it.

And so, in ordinary times, we could look at the bond market, infer some path for short term interest rates and use that as a guide for how long the current malaise might last. If the markets anticipate that Bank Rate might move from 0.1 percent today to 0.25 percent by this time next year, we could quite reasonably conclude that market participants expect a recovery to be underway some time before then. Afterall, why might the Bank of England raise interest rates in the face of a faltering economy?

In ordinary times, that is the conclusion I would draw right now.

Of course, these are not ordinary times.

The measures the central banks have adopted to underwrite fully functioning markets have the unfortunate effect of distorting those prices. Quite whether those interventions interfere to such an extent as to undermine the predictive power vested in bond yields (and reflective of the wisdom of crowds) is a moot point.

For now though, it's the best we have.

As it stands, I expect a bad Q1, a horrid Q2, a better Q3 and a cracking Q4. I'm not hugely confident in that prediction for all sorts of reasons, and it is contingent on current trends in viral infections and on markets remaining functional. But if we take the bond market as our cue, that's not an unreasonable narrative.

Market Internals

You show me a stock market and I'll show you opportunities for gain in the long-term – opportunities that have not been apparent to this extent for years.

Of course, I'm not discounting the possibility that those opportunities won't be even more compelling tomorrow. Any deterioration in the proper functioning of those markets and we can expect a horror show in the prices of risky assets. Expect the same if there is a resurgence in the spread of the virus.

Nevertheless, I think opportunities are apparent in today's prices. I'm drawn to stocks here, there and everywhere but I am mostly drawn to those here in the UK.

Beyond the stock market I am also drawn to high yield bonds, floating rate notes and convertible bonds. Mind you, I would hold off on the risky side of the bond market if you're unfamiliar or of an otherwise nervous disposition. I'm confident that the senior components of the capital markets will remain functional but much less confident in the junior/subordinated end. Still, I like bonds of all kinds, don't I.

Indeed, it is my stubborn insistence on material exposure to gilts (and government bonds more broadly) that affords me the opportunity to buy into riskier positions today.

NOTES.

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