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“European stocks surge as central banks pledge to tackle coronavirus”

Headline on Yahoo! Finance

What does this mean? Sadly, the prospect of Bank of England Governor, Mark Carney, mopping the fevered brows of sickly Britons is remote. What it really means is that central banks will throw money into the system to keep interest rates low and to provide more liquidity to prop up the major stock markets which fell around 10% globally last week.

The Bank of England has said it will take “all necessary steps” and similar comments were made by the US Federal Reserve on Friday and Japan early on Monday morning. Reading on, The Bank of England statement reads: “The Bank continues to monitor developments and is assessing its potential impacts on the global and UK economies and financial systems,”.

Firstly, the economic impact is likely to be significant in terms of production and trade. In the global economy, if China ceases to manufacture component parts, for example, it will disrupt assembly into finished goods elsewhere. If the spread of coronavirus is contained, or if people recover and go back to work more quickly than expected, then unfulfilled demand for manufactured goods could, to some extent, be pent-up. That is to say, delayed until a future date when consumer confidence returns.

The same can’t be said for the service side of the economy. Restaurants can’t easily make up for a poor first half of 2020. Nor, we suspect, will there be a rapid recovery in travel, hospitality and demand for cruises.

However, in almost all respects, we have been here before. The willingness of central banks to cut interest rates has always been evident in the wake of a number of disasters that have befallen either mankind or the stock markets. The October crash of 1987, Asia crisis 1998, dot.com and 9/11, the Fukushima Daiichi nuclear disaster and, of course, the Great Financial Crisis of 2008.

Our job as investment managers is now, as it was then, to take the appropriate steps to preserve our clients’ portfolio wealth. At the end of a bad week for markets, the middle-risk (or Balanced) portfolios that we manage fell less than half that of stock markets, and our more cautious mandates fell less than 3.5%. Whilst any financial loss is regrettable, we are relatively satisfied that our defensive strategy is currently working. Question is, what now?

As we highlighted in previous Facetology newsletters, the stock market was already looking expensive by the end of January despite many geopolitical and economic concerns still hanging in the air from 2019. Just the global markets woke up the coronavirus story, the US stock market was hitting new highs every few days.

This was important because, as we all know, the US is the engine driving the economic train for the rest of the world. If the US sneezes, the rest of the world gets a cold – if you’ll pardon the expression. The problem really was, and still is, one of valuation. For the S&P500 index to justify a level more than 13% higher than it is today, US companies would’ve had to have put in an exceptional year of profit growth despite the last two quarters being pretty poor. Indeed, this latest drop only takes the index back to where it was in October last year.

The point here is, if the stock market was overpriced a few weeks ago, before coronavirus worries really hit, is a 10% correction enough if the economy is about to tank for 6 months?

The co-ordinated statements from the main central banks gave markets some comfort on Monday morning, but was to be expected around now if previous crises are anything to go by. They’ve had plenty of practice.

Our long-term thinking is that the coronavirus will <u>not</u> have a material long-term impact on the economy and, therefore, stock and bond markets. That is not to say that we won't see volatility and further falls in the short-term as the virus inevitably spreads and people change the way they live and work. For many people, it will be a frightening and difficult time. Although we are told that the death toll is, for the most part, no worse than other flu-types, government actions to constrain travel and mass sporting and social events will lead to people losing wages and jobs. We could be in for a Spring/Summer season of very bad headlines.

Nevertheless, as we say, our job here is to both preserve the portfolios we manage and be ready to invest for the long-term where we see opportunity. One thing is certain, if you believe that the global economy will overcome this crisis, as it has so many times in the last 50 years, you can be sure that the longer this outbreak goes on, the greater the opportunity will be.