https://blog.en.erste-am.com/distortions-on-the-financial-market/

Distortions on the financial market

Gerhard Winzer

The distortions on the financial market continue, and the prices of risky asset classes such as equities and corporate bonds with low credit quality are falling. By contrast, the prices of safe-haven asset classes (safe government bonds and gold) are on the rise. The market prices have increasingly come to reflect a global recession.

4 uncertainties

The driving factor of the markets is the spreading of the coronavirus (COVID-19). This involves four uncertainties:

1. The development of the virus. The confirmed new infections of COVID-19 outside of China are still rising at high rates. Questions about the characteristics of the virus cannot be answered reliably: seasonal (i.e. dependent on temperature) or permanent? Therapy? Vaccination? Mutations? Number of asymptomatic cases?

2. Measures taken to contain the virus from spreading. The measures necessary to contain the virus of course come with a strongly negative effect for the economy. Global GDP for Q1 2020 is likely to shrink.

3. Spill-over effects to initially unaffected sectors and countries. This includes the disruption of supply chains and the more cautious stance with regard to consumption and investment. Also, the risk of increasing default rates is on the rise, given that sales revenues might plummet but fixed costs (taxes, interest rates on loans) still have to be paid. While China is probably going to recover in Q2, the likelihood of the GDP shrinking again has increased significantly in Japan and the Eurozone. The risk of recession is rising in the USA as well, because the virus keeps spreading.

4. Measures to dampen the negative economic effects. The central banks have already reacted by loosening their monetary policies on a global scale, mainly through interest rate cuts. In countries where the key-lending rate is already very low, other steps such as targeted, higher liquidity provision for banks and stepped-up asset purchase programmes could be taken. This is meant to stifle the negative feedback loop between the tightening financial environment and economic activity.

In addition, governments are considering economic stimulus packages. The most important measures are the ones aimed at preventing the number of defaults from rising (reduced working hours, tax moratoria).

OPEC issues

All of that adds to the gravity of the oil cartel OPEC and Russia's failing to agree on curbing output. The massive slump of the oil price has a disparate set of effects on the global economy (oil-importing and oil-exporting countries).

The common denominator is the fact that the pressure towards lower inflation rates resulting from this situation will rise further. The focus is currently on highly geared oil-producing companies and countries (falling creditworthiness and, as a result, possibly rating).

What are the likely scenarios

Conclusion: asset prices have reflected the revision from initially positive to negative economic scenarios over recent weeks.

- Phase 1: recovery in 2020
- Phase 2: quick recovery in Q2 after slump in Q1 (scenario "V")
- Phase 3: recovery in the second half – scenario "U"
- Phase 4: assets prices are in regions that increasingly suggest a recession – scenario "L"

Conclusion:

Put differently, initially investors with short-term horizons were selling, but in the meantime some of the investors with long-term (cyclical) orientation have thrown in the towel as well. Probably the most important factor for the future development of asset prices is the spreading of COVID-19 from here on in.

On the upside: a noticeable decline in new infection rates could trigger the recovery of risk asset classes.

On the topic of "Coronavirus and the consequences for the global economy" you can read further analyses on Erste AM Blog: https://blog.en.erste-am.com/coronavirus-the-economic-effects-of-epidemics-and-pandemics/

Legal note:

Prognoses are no reliable indicator for future performance.

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