Markets monitor coronavirus development

March 18 2020

Since the onset of the Coronovirus epidemic in December 2019 in Wuhan, China, the virus has spread abroad impacting neighbouring Asian countries first and following its path to Iran in the Middle East in late February, and through Italy, Europe making this country the main source of the global outbreak since early March. The worldwide impact on health, economy and financial markets have been considerable. In today's DGAM's Perspective and News update, we share with you our reading of recent events and the actions we are taking in our strategies.

The latest developments of COVID-19

	Cases	Deaths	Fatality rate
2020 – COVID 19 (Worldwide) (As of March 18)	**212 616**	**8 727**	**4.10 %**
2020 – COVID 19 (Canada)	**654**	**8**	**1.22 %**
2003 – SRAS (Worldwide)	8 098	774	9.56%
2009 - H1N1 (Worldwide)	6 724 149	19 654	0.29%
H1N1 (Canada)	25 828	429	0.02%
2018-2019 Influenza (USA)	35 500 000	34 200	0.10%

Source : CDC, John Hopkins

- Recently infected countries can learn from the first ones that have been exposed:
  - Late and insufficient responses in Iran and Italy seemed to contribute to being unable to slow the spread of the virus and allow their health systems to prepare.
  - Conversely, highly restrictive containment measures taken in time by authorities in China and South Korea seemingly restricted spread and contributed to gaining control over the virus's proliferation after three to four weeks.
  - Effective containment measures: border closures, transportation restrictions, cancellations of sports and cultural activities, closures of public places, closures of shops and restaurants, restrictions on government and corporate activities (factories and offices) to their lowest denominator, restrictions on gatherings, social distancing, etc.
- Measures are multiplying around the world: many countries are closing their land and air borders and restricting the activities and travel of their citizens and residents.
- Not all countries with multiple outbreaks are learning at the same speed: municipal elections were held in France on March 15, and Democratic primaries were held in four major U.S. states (Florida, Arizona, Illinois, Ohio) on March 17.
- Medical and preventive equipment is beginning to be in short supply in some areas: the US government is asking construction workers to transfer their supply of N95 certified masks to the health care system and hotels are being converted into hospitals.
- The seriousness of the situation leads to surprising decisions such as the release of 85,000 prisoners in Iran in order to avoid a humanitarian crisis in the prison system.

Impacts on the economy and financial markets

Strictly from an economic standpoint, the cure is more painful than the disease itself, because with symptoms resembling those of a winter cold and a number of deaths possibly similar to or even lower than those of annual seasonal influenza, the coronavirus alone is not expected to have a significant impact on the global economy. But the measures taken to curb contagion has far more impacts on the economy than the virus itself. Corporate and government closures are too numerous in North America and Europe to list them all.

- The global economy was entering 2020 with renewed vigour following the signing of a Phase 1 trade agreement between China and the United States.
  - Both the Canadian and U.S. labour markets remained strong.
- Upcoming economic statistics will be closely scrutinized. They could be disastrous and cause additional volatility which is already exacerbated by the perception that some countries have been too slow to take appropriate action and therefore, as a result, the damage could be more severe and more lasting. The first examples of this are:
  - The Chinese PMI manufacturing survey (35 versus expectations of 45 and 50 the previous month)
  - Chinese retail sales (-20.5% y/y versus expectations of −4.0% and 8.0% the previous month)
  - U.S. industrial production for February (-21.5% m/m versus expectations of 3.0% and 12.9% the previous month) worst variation in history)
- Investors are revising their financial assumptions about economic growth, inflation, demographics and productivity. The range of possible economic scenarios is so wide that the integration of these unknown expectations create volatility that has rarely been experienced.
- Despite being located in the country of origin of the virus, the main Chinese stock market (Shanghai) is curiously down by less than 15% compared to the main indices (S&P 500, S&P/TSX, MSCI EAFE, MSCI EM), which have fallen by nearly 30% since their recent peak in January. Equity markets were vulnerable at the beginning of 2020 after an impressive 2019 in which the S&P 500 and the S&P/TSX gained 31% and 23% respectively.
- On March 16, the S&P 500 suffered its largest correction since Black Monday in 1987. For the first time since 1929 (Great Depression), the S&P 500 fluctuated by more than 9% on three consecutive days. The VIX (volatility index) came close to the historical high reached during the fall of Lehman Brothers in 2008 (89%).
- Listed companies are busy managing a continuously changing environment by adjusting their productive capacity to demand, reducing their workforce and securing supply options. They do not yet dare to update their revenue and earnings outlooks, which handicaps even the most seasoned analysts and investors.
- And as if that wasn't enough for the Canadian economy, an intra-OPEC+ production war began between Russia and Saudi Arabia. Saudi Arabia which is frustrated of being the main victim of production increases worldwide, attempts to compromise higher-cost producers such as American shale producers, by announcing its intention to significantly increase its production (by about 2% of world production). And this at a time when oil has suffered a major demand shock (5 to 8% of world demand) due to the epidemic. The fall in the price of a barrel of oil has been more than -50% since the beginning of 2020.
- The high debt load of Canadian households will need to be monitored as businesses begin their first rounds of human resource rationalization and government tax measures are not yet in place.
- THE CRUCIAL QUESTION as to what happens next: will it be a normal recession or a severe recession degenerating into a financial crisis or even depression? For the time being, we are anticipating a normal recession. The average stock market decline during a recession is 35%, not far off recent levels notwithstanding that today's levels have been achieved quite quickly.

Interventions by Central Banks and Governments

- Worldwide government yield curves have fallen dramatically in recent weeks to historic lows as investors sought refuge from the volatility of risky assets. But Canadian 30-year government rates have, for example, fluctuated by more than 30 bps twice recently in a single day.
- After lowering its key policy rate from 1.75% to 0.75% in less than two weeks, the Bank of Canada initiated a quantitative easing program of $500 million per week for a total of up to $50 billion of CMB purchases in the secondary market in order to provide ample funding to major Canadian lending institutions.
  - The Canadian key policy rate was 0.25% in 2009 during the financial crisis and was 0.5% in 2015 after the drop in oil prices.
- In addition to having lowered its key rate by 150 bps in less than two weeks, the FED is intervening aggressively on the short-term funding markets with new programs on the REPO market to ensure sufficient liquidity for borrowers.
- Although positive, the reactions of the financial markets to these measures are modest to moderate since the interventions of the Central Banks help avoid liquidity shortages within the financial markets. However, the markets are more hopeful of government fiscal programs that could help financially weakened consumers and businesses whose sources of income are drying up abruptly. As an example, the Hong Kong government has remitted an amount of C$1,700 per each permanent resident adult. It is still too early to measure the long-term impact of this type of measure.

- The U.S. President's intention to provide a fiscal stimulus of 1,000$ per person would total $1.2 trillion, or 4.6% of GDP, bringing the annual deficit to about 10% of GDP. The Canadian government has announced a $27 billion tax package (plus $55 billion in tax deferrals), a stimulus of 1.2% of GDP. These programs should have a positive impact initially, but containment measures will restrain consumer spending.
- THE QUESTION OF IMPORTANCE: Assuming that governments and Central Banks will have helped consumers and businesses enough to get through this crisis without too many bankruptcies: once the pandemic is under control, will consumers come out and start to consume again or will they remain traumatized and change their habits?
- MEDIUM-TERM CONSEQUENCE: a slowdown or even a reduction in globalization in order to reduce the risks to global production chains witnessed during this pandemic.

What are the indicators to monitor that could have an impact on the strategies?

- An accentuated contagion in regions that had so far been largely spared.
- Growth rates in the number of confirmed cases per region which may indicate the emergence of new outbreaks or, conversely, a deceleration of contagion.
- Containment measures taken by local governments as soon as a local outbreak is identified, to prevent the Coronavirus from spreading faster than health systems can prepare for it.
- The current gradual reopening of the Hubei province, and more specifically the city of Wuhan in China, to test the ability to avoid a second wave of contagion. The level of production in this important industrial region reached a little over 60% in mid-March.
- Cancellations/deferrals of sports and cultural activities: a sign that the situation will not be resolved in the short term:
  - The CDC (Center for Disease Control) is calling for a ban on gatherings of more than 50 people throughout the US until May 11th;
  - The 2020 Euro planned as far as June 12 is delayed to 2021.
- Business, and especially, consumer confidence surveys.

Adjustments to our investment strategy

TACTICAL ASSET ALLOCATION

- Initial actions taken were to eliminate active risk when the epidemic spread outside Asia (Italy and Iran) in February, pending a better understanding of COVID-19 and its expected impact on markets.
- The flow of bad news and the containment measures taken regarding the epidemic intertwined with the announcements of monetary interventions by the major Central Banks and fiscal interventions by governments. This is causing extreme volatility, rarely seen in either the stock or bond markets, which prevents any short-term visibility and prompts us to remain cautious for the moment.
- Now that a global recession is almost unanimously agreed upon as unavoidable, estimating its extent and duration, as well as identifying and monitoring leading indicators that will demonstrate a stabilization of the epidemic are our priorities in order to determine the optimal time for further increase risk-taking.
- The resumption of active risk-taking should initially be marginal due to a non-negligible probability of the contagion not being fully contained.

FIXED INCOME

In an environment of extreme volatility in Canada, the Bank of Canada and the federal government responded with equally extreme measures. In particular, on the Bank's side, not only have aggressive rate cuts been implemented, but many new measures have also been introduced:

  - Rate cuts between officially scheduled meeting dates;
  - Purchases in the secondary market of up to $500 million per week of Canadian Housing Trusts bonds as well as securities guaranteed by mortgages;
  - Introduction of a new collateralized financing facility;
  - Creation of a direct purchase program for bankers' acceptances;
  - Transactions to add liquidity to the bond market;

- On the bond management side, volatility is at historical levels, for interest rates and credit spreads variations. Liquidity has been sharply reduced and some investment opportunities are gradually emerging.
- Long-term provincial credit is at very interesting levels, awing levels reached during the 2008 crisis. Longer-term utilities securities are also attractive.
- Bank securities have reacted strongly and are currently at levels where an underweight would no longer be justified. We are overweight in this sector.
- There are two conflicting forces regarding duration: customers' liquidity needs leading to rising rates versus the economic slowdown and policy rate cuts that should bring them down. The significant underperformance of many equity indices causing the sale of bonds for rebalancing reasons should prevail by the end of the quarter. In light of this uncertainty, duration positioning is more approximately neutral.

CANADIAN EQUITIES

- In a context of total uncertainty and extreme levels of volatility, combined with a significant drop in the price of WTI oil and a decline in rates, our sector positioning in our various equity portfolios has evolved considerably since the end of February. Our portfolio managers have taken a more defensive stance in all these different approaches in order to limit our downward participation in the event of a severe market correction.
- In a context of imbalance between supply and demand for oil, this sector will remain vulnerable and highly volatile. That is why we have reduced our exposure to the energy sector.
- We have neutralized and reduced the weight of sectors deemed more sensitive to the uncertainty surrounding the COVID 19 situation.

POSITIONING:

> Defensive with an above-average cash position (+/- 5%). The higher level of cash will allow us to be opportunistic in the eventual redeployments.

> Overweight sectors that are favoured in a low interest rate environment (e.g. consumer staples, utilities and telecom) and reduced exposure to the financial sector where lower rates are more problematic.

> We also reduced our exposure to the energy sector as it has experienced a significant shock (reduced global demand and increased supply). Overall, we are focusing on large capitalization and high quality stocks).

> Finally, in a market where the volatility is well above average, we are taking advantage of significant declines to increase our position in specific stocks in which we have strong long-term convictions (examples: Metro, Cargojet, Stantec).

Market Data

■ Fixe Income

Yields to maturity - Canada	closing levels	variation 1 day	1 week	1 month	YTD	1 year
Bank of Canada overnight rate	0.75%	0.00%	0.50%	1.00%	1.00%	1.00%
2 years	0.69%	-0.04%	-0.18%	0.74%	1.01%	1.09%
10 years	1.05%	-0.09%	-0.39%	0.23%	0.65%	0.89%
30 years	1.46%	-0.05%	-0.43%	-0.03%	0.30%	0.73%

Credit market	closing levels	1 day	1 week	1 month	YTD	1 year
Mortgage rate (prime rate)	3.0%	3.0%	3.5%	4.0%	4.0%	4.0%
5-yr credit spreads (CDX.IG)	141	123	117	50	45	60
5-yr High yield credit spreads (CDX.HY)	727	648	593	305	280	348
5-yr Emerging debt credit spreads	587	532	444	299	277	361

■ Fixe Income

Yields to maturity - United States	closing levels	variation 1 day	1 week	1 month	YTD	1 year
Fed rate	0.25%	0.00%	1.00%	1.50%	1.50%	2.25%
2 years	0.53%	-0.04%	-0.01%	0.78%	1.04%	1.98%
10 years	1.19%	-0.11%	-0.32%	0.32%	0.73%	1.52%
30 years	1.79%	-0.10%	-0.40%	0.21%	0.60%	1.29%

Credit Market	closing levels	1 day	1 week	1 month	YTD	1 year
Spreads Ontario - 10 years	111	103	93	64	59	72
Spreads utilities - 10 years	173	156	134	97	87	116
Spreads communications - 10 years (BBB)	266	249	209	149	146	157
Spreads banks - 10 years	172	144	104	59	56	79

■ Fixed Income indices — Total return

	closing levels	1 day	1 week	1 month	YTD	5 years (ann.)
FTSE Provinces index	1346	-1.6%	-5.9%	-3.4%	0.1%	2.7%
FTSE Municipal index	1419	-1.6%	-5.3%	-2.8%	0.4%	2.9%
FTSE Corporate index	1249	-1.5%	-5.6%	-5.3%	-2.8%	2.4%
FTSE Overall	1129	-1.2%	-4.6%	-2.3%	0.5%	2.4%

■ Equities — Total return C$

	closing levels	1 day	1 week	1 month	YTD	5 years (ann.)
S&P/TSX Composite	11721	-7.6%	-17.8%	-32.0%	-30.9%	-2.1%
S&P 500	2398	-2.9%	-7.4%	-18.0%	-16.4%	7.9%
MSCI World	1682	-2.8%	-9.7%	-20.7%	-19.6%	4.6%
MSCI Emerging Markets	788	-2.4%	-11.9%	-18.3%	-20.6%	1.2%
MSCI Global Small Cap.	268	-5.8%	-17.5%	-31.6%	-32.2%	0.8%

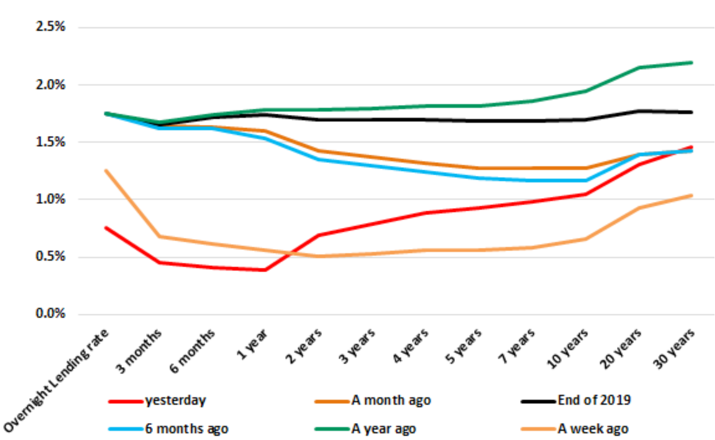
■ Currencies — Variation

	closing levels	1 day	1 week	1 month	YTD	5 years (ann.)
CAD/USD	0.69	-2.1%	-5.0%	-8.7%	-10.4%	-13.8%
CAD/EUR	0.63	-1.3%	-1.9%	-7.3%	-8.0%	-11.6%
CAD/GBP	0.59	1.7%	4.9%	3.8%	2.3%	14.6%

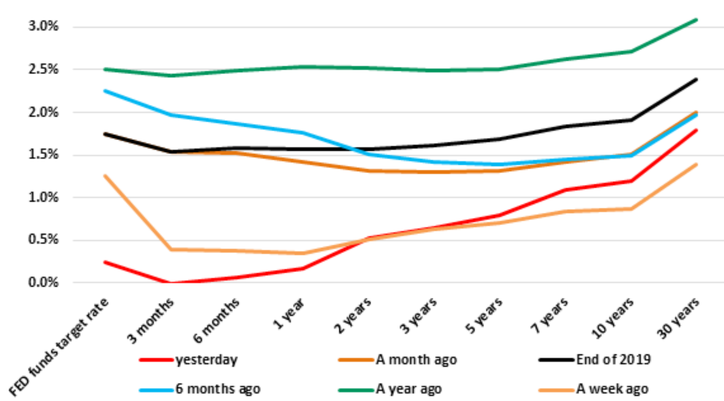
■ Misc. — Yield / return

	closing levels	1 day	1 week	1 month	YTD	5 years (ann.)
VIX *(level)*	76%	76%	54%	19%	14%	13%
Bloomberg Commodity Index	59	-1.8%	-7.8%	-12.6%	-17.5%	-7.6%
Gold	1486	-2.8%	-9.1%	-6.5%	-2.1%	4.1%
WTI crude oil	20	-24.4%	-38.2%	-60.6%	-66.3%	-21.7%

GOVERNMENT OF CANADA YIELD CURVE



UNITED STATES TREASURY YIELD CURVE



Source : Bloomberg, DGIA

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