The coronavirus market effect

With stock market valuations higher than in 2000 and debt levels greater than in 2008, Covid-19 looks like the black swan event, the systemic shock – like 9/11 or Lehman Brothers – that ends this economic cycle and heralds the next recession. A cascading of events in a globally complex and interconnected world.

The system can handle 'contained' shocks, such as Argentina defaulting, the Greek debt crisis, the Asian tsunami, or the Japanese earthquake/Fukashima death toll, where collateral damage is, to an extent, contained and limited. What the market cannot do is price in systemic hidden risks.

Looking back at the global financial crisis (GFC) is a useful exercise. On 7 February 2007, HSBC announced losses related to Household International's sub-prime mortgages. If it had just been HSBC, the market would have looked through it, but – as history proved – 'lax lending standards' was a virus that had infected huge swathes of the global financial system. New Century Financial filed for bankruptcy in April 2007, Bear Stearns' structured credit hedge funds collapsed in June 2007 – and the rest is financial history. The market bottomed out two years later, in March 2009.

During the GFC, the global economy took multiple body blows (mostly in the financial and real estate sectors), but not all at once, which meant there was time for markets to try to adjust. More importantly, there was a 'medicine' that prevented the 'patient' from dying – lower interest rates, quantitative easing (QE) and fiscal stimulus.

How is it different this time?

Now, the global economy is taking body blows all at once. Covid-19 started in China, but has now spread to more than 60 countries. It comes at a time of growing stress points in the global economy: the regular cycle exhaustion (10-plus years of economic expansion); structural industry issues in auto and retail; trade and tariff wars; global indebtedness; and political uncertainty, with Brexit, riots in Hong Kong, German turmoil and US elections at a time of peak margins and multiples.

Covid-19, though, can be the straw that breaks the camel's back because it is, effectively, grinding global trade to a virtual standstill – and monetary and fiscal policy will have limited impact now. What good is a 50 basis points rate cut if people cannot travel or do not want to travel? If it is one-off in nature – a one- or two-quarter hit to economic activity with transmission slowing and a vaccine in the near future – then investors should be buying the dip... but this is hardly a dip.

If this persists before a vaccine is found (let's call it a year) and transmission continues, then global GDP is in for a demand AND supply shock. Beyond that, behaviour and travel patterns change more semi-permanently – and, with that, global trade flows and foreign direct investment.

If Covid-19 festers, will tourists or business people travel to Asia or the southern Mediterranean or Europe if it takes hold there? Will corporates shift their supply chains closer to home? What happens to loans that cannot be serviced – do banks roll them for three months, six months, a year? And what happens to working capital when just-in-time breaks down? If companies can source input elsewhere, do they pass on the higher cost or take the margin hit? The questions and scenarios are endless.

And belatedly it's been declared a pandemic/ state of emergency

Call me a sceptic, but beyond scaring people, I suspect declaring a state of emergency or a pandemic is a 'get out of jail' card for a contract or event – so avoiding that scenario would have prevented financial contagion (think insurance contracts, banks, loans). What takes precedence, economic activity or human lives, recognising that – if economic activity grinds to a halt – human lives will be impacted regardless?

What happens next?

The market needs a new playbook because this looks unlike anything the global economy has seen before – so widespread and so sudden, unlike previous concerns over rising rates or trade wars. Any green shoots? There are reports that the Chinese government is getting people and factories back to work, but it is a slow process – and the risk remains that, as they return to work, we see a resurgence in Chinese cases. An unknown unknown.

● *This column was written in March 2020*