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Three dimensions of the virus impact on the global economy

Market Comment, March 2020

Unfortunately coronavirus remains the dominant market theme. Because a phenomenon of this magnitude has not yet been seen in the era of globalization, its repercussions cannot be estimated and quantified with any great degree of precision. While possible scenarios can be discussed, they should not be interpreted as forecasts. The repercussions of the virus for the global economy are playing out in three dimensions. While the negative economic impact of the outbreak should be offset by actions taken by governments and central banks, the strength of their response will be key. Either way, gold continues to serve the purpose of diversification, while at the same time benefiting from a further decline in interest rates.

The health of mankind should be the very highest priority of governments, which is why measures to contain or limit the spread of coronavirus are likely to increase in all affected countries, even if their short-term impact is likely to be weaker economic growth. Indeed, without a healthy population it is difficult to imagine healthy economic growth. The repercussions of this virus outbreak for the global economy are playing out in three dimensions.

The first dimension is the supply side of the global economy. The supply of goods will be negatively affected as the production of goods is being undermined by the spread of the virus. And the dependency of global goods production on China, already evident as a risk in the context of the trade conflict, has now emerged as a serious problem. A consequence of this development is that global companies are probably likely to want to be less dependent on China going forward, which will slow not only globalization in the medium term but also the earnings growth of many companies, at least until they make satisfactory replacement arrangements and become more diversified. The first economic data published by China since the outbreak revealed a clear fall-off in production. Companies in many countries can be expected to be confronted by the problem of certain intermediate goods or components from China being unavailable to a significant extent – in other words, global supply chains will be disrupted, at least temporarily. The spread of the virus to (and within) other globally important countries such as South Korea and Japan should likewise not be forgotten. The first dimension of the virus outbreak therefore encompasses global industrial production.

> "Turbulent times call for diversification through high-quality bonds and equities exhibiting below-average stockmarket sensitivity."
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> Gérard Piasko, Chief Investment Officer

The second dimension of economic impact relates to the demand side of the global economy, particularly the key global services sectors. These have become much more significant in recent years, and encompass areas of economic activity such as tourism and consumption, e.g. visiting restaurants and shopping malls, and attending sporting and other events. In many countries, the Chinese have been the most important source of tourist revenues for a number of years now, and their absence is likely to be felt over the next few weeks and months. The outbreak of the virus in the developed countries of the Western world will have to be combated with increasingly rigorous measures, which could reduce consumer spending – as already seen in Japan and Italy – through restrictions to human movement. Should the virus start spreading much faster in Europe and the US, where consumer spending accounts for 60% and 70% of economic activity respectively, the economic decline would take on a more serious hue altogether.

And this is where **the third dimension** of the virus outbreak comes into the equation. The market corrections at the end of February showed how emotionally both markets and people react. A deterioration in consumer sentiment (which in the US has historically shown a strong correlation with equity market developments) has the potential to further depress consumer spending, as we saw in 1990, 2002, 2008 and 2011. Business sentiment is also fragile. Having only just started to recover in recent months from the (half-)resolved trade conflict, it is now being assailed from another quarter. To compound matters, Europe remains confronted by further risks from the detailed Brexit negotiations with the UK, by Turkey starting to send migrants to the EU again, and by domestic and social policy tensions in both Germany and France. Viewed together, the three dimensions show that the global economy faces additional risks of a reduction in growth from countries other than China as a result of the virus outbreak. The OECD has downgraded its global economic growth forecast for 2020 by 0.5%. Given that we were already anticipating a reduction of 0.25% - 0.5% for 2020 as a result of the virus, we now consider the downside growth risks to exceed 0.5%, though this is heavily dependent on the economic stimuli measures taken by governments and central banks around the world, as well as on the further development of the virus itself. The recent rate cut by the Federal Reserve is a step in the right direction, but since the price of money – i.e. the level of interest rates – is not the problem this time (and nor is it rooted in the financial system), the onus is now on governments and central banks to "bring on the big guns". During the financial crisis of 2008, central banks resorted to comprehensive purchases of securities – particularly less liquid securities – in addition to interest rate cuts, while ailing companies of economic significance received direct state support (e.g. US automotive manufacturers) and the money markets were flooded with liquidity. This time around, direct state monetary aid to the private economy and tax cuts – particularly tax relief in the area of healthcare and for those directly affected by the virus – could perhaps achieve more, as interest rates are already at very low levels, particularly in Europe.

Until the virus outbreak recedes and/or more robust economic stimuli are announced by a large number of economically important countries, we can expect this exogenous and unexpected virus shock to the global economy to trigger downward revisions of earnings growth at many companies.

Gérard Piasko

Gérard Piasko is CIO and head of the investment committee of private bank Maerki Baumann & Co. AG. Before he was for many years CIO of Julius Baer, Sal. Oppenheim and Deutsche Bank.

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Maerki Baumann & Co. AG
Dreikönigstrasse 6, CH-8002 Zurich
T +41 44 286 25 25, info@maerki-baumann.ch
www.maerki-baumann.ch