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Asia Matters

Assessing the impact of containment – Views from Asia

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The rapid spread of COVID-19 has triggered a wave of risk-off sentiment and caused market volatility to spike. As the outbreak has led to lockdowns, partial shutdowns and border restrictions in locations across the world, it looks clear that the economic toll of containment is likely to be significant, albeit transitory.

This is a summary of the latest views from our specialists Bill Maldonado and Renee Chen on how we are navigating the markets under these rapidly evolving circumstances.

HSBC Global Asset Management

Macro Impact

Global

A sharp correction coupled with a spike in volatility implies that the market is pricing in a very pessimistic outlook for growth. Global PMI declined substantially last month, contributed mostly by China. We expect PMI to stay weak in the near team as other countries experience the impact of COVID-19. The eventual duration and severity of the pandemic will have a large bearing on the global macro outlook. Hence, the effectiveness of measures to mitigate the spread of the virus and fiscal/monetary measures to support the economy are key to assessing the impact of the virus on the economy.

Keeping a pulse on the global economy, there are two major things we need to monitor – the financial market and the labour market. If financial market stability were compromised, we would experience a longer and deeper downturn. On the other hand, a worsening labor market would result in job and income losses, which in turn would bring about a second wave of negative demand shock to the global economy. At this point we see a high probability of global recession in both Q1 and Q2 of 2020.

China

As China is at the forefront of the COVID-19 situation, we may look to China as a reference for what to expect in the rest of the world. China has experienced a very sharp contraction of economic activity in January and February due to COVID-19; employment has also contracted materially in February.

We have also been tracking high-frequency economic indicators to gauge the state of the Chinese economy. Since mid-February, we have seen pickup in these indicators (for example, electricity; traffic; etc.), pointing to a gradual recovery.

According to official figures, more than 90% of state-owned enterprises have resumed operation, but we also have to observe the low utilization rate and that SMEs are not returning to operation as quickly. Taking in account the January and February numbers, and the slow return of migrant workers, we expect contraction in Q1 but recovery in Q2 of 2020.

Asia

During the first two months of 2020, much of the impact of COVID-19 on the rest of Asia has been spillover effects of demand shocks and supply chain disruptions from China. As an indicator of reduced demand in Asia, air traffic has dropped drastically. The February data for South Korea and Hong Kong show a sharp decline in air traffic. Disruption of the Chinese supply chain has also had an effect on the rest of Asia. About 25% of Asian imports are from China, and 60% of these imports are for intermediate goods. Among Asian countries, India is believed to be least exposed to demand shocks in China, but it is still feeling the negative impact of Chinese supply chain disruption because it produces intermediate goods that require inputs from China.

Major central banks in the world, and particularly in Asia, have worked in a coordinated manner to implement emergency rate cuts. Looking at different kinds of government measures, we rank their order of importance as follows: disease control; fiscal; monetary. We believe that impeding the spread of the virus would be most crucial in helping the economy recover. The main goal of fiscal policies is to prevent massive job losses and keep business afloat. Finally, monetary policies would serve the purpose of providing stability to the financial markets and prevent further credit tightening.
Many Asian economies have rolled out fiscal packages to mitigate the effect of COVID-19. So far, policy-makers in Asia seem to have responded more quickly and in a better coordinated manner than most developed markets.

Source: HSBC Global Asset Management as of 17 March 2020

Portfolio strategy

Long term view

We do not expect COVID-19 to be a drag on the long-term performance of the markets. Although we do not have a clear idea of when it will take place, we believe that the eventual economic rebound should be significant because of the massive economic stimulus packages governments have put in place, resulting in ample liquidity, zero rates, and pent-up demand. As the global economy recovers, rising earnings will not only be good news for equities but fixed income as well, since improving profitability will alleviate any concerns around credit default. Finally we believe that a lot of bad news is already priced in.

Short term positioning

It is very hard to forecast the short-term dynamics of the COVID-19 situation. Markets will remain volatile until it perceives the situation is turning. Therefore, we expect markets to be volatile until the situation turns around in US and Europe.

Our investment approach is to remain broadly neutral during this volatile phase. We were reasonably well positioned going into this. We had strong performance in a number of asset classes and we took risk off from our portfolios prior to the Chinese New Year, so we are now in a relatively neutral position.

We have avoided taking a bearish position because of the upcoming rebound, which we expect to happen strongly and rapidly. We are taking a medium-to-long term view with our strategy, and we shall remain neutral in the short term.

Equity

During a market panic, companies with good fundamentals are being indiscriminately sold off along with the rest of the market. We are thus looking for good bargains in companies with solid long-term stories that might also have defensive equalities. In particular, we are looking into tech, healthcare and e-commerce for opportunities. We are adding to these positions in a very careful and gradual manner because of the extreme volatility.

Credit

With the help of our large credit research team, we are doing our best to stay on top of a very rapidly changing situation. Spreads have widened significantly in both investment-grade and high yield, which might be viewed as an opportunity for investors with sufficient risk appetite. To the extent that there might be deterioration in credit quality, we don't believe it justifies the amount of the spread-widening we observe in the markets now. We remain very careful with our positions to stay ahead of potential downgrades and liquidity issues.

Multi-asset

We are pretty close to neutral in all asset classes. We were also fortunate enough to have taken some profits on equity and on our Yen currency position. For now, we are keeping our powder dry.

Source: HSBC Global Asset Management as of 17 March 2020

FAQs from our clients

Is the worst case scenario already priced in asset prices?
A very pessimistic scenario has been priced in, but it's hard to evaluate whether a worst case scenario has been fully priced in simply because we don't have enough information to ascertain what a worst-case scenario looks like. However, from a medium-to-long term perspective, the current sell-off has already made risk assets very attractively valued. Investors should focus on long term fundamentals rather than trying to time the market in the short term.

Is liquidity drying up in the credit market?
We are seeing a decline in liquidity in the credit markets as well as other markets. When volatility is high, people are much less likely to transact. That said, it is still manageable at the moment; we can still do all the things we want to do in our portfolios. On a side note, Philippines has closed down their capital markets, but we do not expect other Asian markets to do the same. For now, things are challenging but are still working relatively normally.

Do you think the PBOC will let rates go to zero? Will that be necessary for China?
We do not believe the chance is very high. In the context of the COVID-19 situation, monetary policies are not very effective in boosting economic demand and/or supply, so unless there's a very significant downturn, there is no reason for PBOC to cut rates to zero. China has a combination of measures it can deploy – policy rates, credit policies, fiscal policies, regulatory relaxation, etc. Cutting rates to zero is not a productive move at this point.

Have lessons been learned from the global financial crisis (GFC) to help respond to this crisis?
The need for rapid and significant action and for coordination in government policies were important lessons learned during the GFC. Those qualities have clearly been on display over the past days and weeks. For example, rate cuts had taken people by surprise given their size and swiftness. However, the current situation is not the same as GFC and investors don't have analog to rely on to predict what will happen. Wartime is not good analog because productivity picks up during wars. Lessons have been learned from past events, but this new crisis presents new lessons as well.

Why does gold behave weirdly? Why is it not doing well amid market turbulence?
People expect these safe-haven assets to go up with market uncertainty, but they have gone down instead. We believe it is mainly due to the need of investors to liquidate, possibly in response to margin calls or redemption flows. Some investors might simply want to hold more cash. Another reason why gold is not performing as well as expected is because its traditional role as an inflation hedge is not perceived as useful in the current situation.

Please give a concrete example that illustrates consumption recovery in China.
There are many signs that the Chinese economy is reverting back to normal. Official statistics tell us that factories and shops are reopening, and people are getting back to work. Road traffic is beginning to go back to normal. As a proxy for discretionary spending, weekly automobile sales are showing recovery. Official statistics of retail sales show recovery in consumption since mid-February. Unless there's a resurgence of virus cases, the worst might be behind us in China.

PMI is down sharply, does it mean there will be recession?
PMI decline is signaling a recession, but our view is that it will be a relatively short phenomenon – 3 to 6 months.

Are we in a bear market?
We are in a technical recession if the market is down by 20% or more, and clearly that has been the case in many parts of the world. However, that in itself is not particularly indicative because it is just an arbitrary definition. It's much more important to monitor the wide-swinging volatility, both up and down, in the market.

Is the oil price drop an additional recessionary factor?
In monitoring the impact of the oil price collapse, we believe we should focus our attention on the credit markets. Global high yield and US high yield have been impacted due to the rise in downgrades and default risks. At this moment, the credit stress level seems to be better than in 2016 because the industry had taken steps to adjust their operations in response to the commodity price drop during 2015-2016. On a positive note, the low oil price would benefit certain economies – particularly oil importers, helping them recover from the current downturn.

Source: HSBC Global Asset Management as of 17 March 2020
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