Coronavirus and Falling Oil Prices Roil Markets; Long-Term Perspective Is Key

March 13, 2020
by Team
of Matthews Asia

Amid a volatile start to the week, members of the Matthews Asia investment team met to discuss the outlook following recent events: Yu-Ming Wang, President and Global Chief Investment Officer; Robert J. Horrocks, PhD, Chief Investment Officer and a Portfolio Manager; Richard Gao, Research Principal, China; and Portfolio Managers Teresa Kong, CFA, John Paul Lech, Yu Zhang, CFA, Sharat Shroff, CFA, Andrew Mattock, CFA, and Tiffany Hsiao, CFA. Expecting volatility to continue in the near term, the team believes that maintaining a long-term perspective is crucial for meeting long-term goals.

Q: Can you help us put the current markets in perspective?

Yu-Ming Wang: High yield corporate bond returns have fallen about 8% (as represented by the ICE Bank of America Merrill Lynch U.S. High Yield Index), while global equities returns have fallen about 17% from recent peaks (as represented by the MSCI All Country World Index). In 2008, corporate bonds fell 36% while the equity market fell 56%. In prior market calamities such as the global financial crisis of 2008, the dot-com bust of 2000 and the Asian Financial Crisis of 1998, respective benchmark indices fell 40% to 50%. So, today's volatility is still "young" compared with past market drops. But is our current market rout going to be like those prior crises? That is the trillion dollar question. I think this market crisis is still evolving. Some signs:

- Monetary boost is unlikely to be as potent as in prior crises
- Any fiscal boost is still unclear. Given the geopolitical tensions of the past two years, I am not counting on any global coordinated efforts
- The virus contagion has not yet found a peak
- On top of these, the energy market is adding great stress to the credit market

Q: What are the root causes of the current market volatility?

Richard Gao: I see the coronavirus as the primary root cause. Ironically, the market closest to the epicenter, China A-shares, has experienced the least amount of damage. This will likely change in the coming weeks as it becomes increasingly clear that the U.S. and Europe will experience a consumption shock. This will in turn negatively impact orders in China and the recovery that is underway. We are ready to put money to work when this happens.

Teresa Kong: What we are seeing today in the market is a knee-jerk reaction to a lack of certainty on the worst-case scenario of the coronavirus spread in the U.S. and Europe; and an additional shock to the U.S. and global energy sector with oil prices being down in the US$30 per barrel range. The timing of the break-up of OPEC (Organization of the Petroleum Exporting Countries) production reduction talks certainly is unfortunate—it came at a time when the market already was reeling from the uncertainty of the coronavirus.

Robert Horrocks, PhD: We are seeing falling bond yields, falling share prices, a weaker U.S. dollar. These are the symptoms of a deflationary shock in the U.S. Is that the coronavirus? It seems hard to attribute it all to the coronavirus, which is surely a supply shock. Yes, people will stay home and stop spending (after splurging on emergency goods). But the shock to supply is bigger. Also, we have been through virus shocks before and not had such reactions.

However, there is another element to the market backdrop. Yields have been falling since late 2018. I would contend that the central bank balance sheet "normalization" was already causing worries over growth and an inverted yield curve. The coronavirus is perhaps the straw that broke the camel's back. With yields now all under 1% in the U.S., and real yields sharply negative across the developed world, the market is saying that the world is going into recession and will stay in recession for a while.

Q: Is it reasonable to expect the world to stay in a recession?

Robert Horrocks, PhD: Well, we saw it in Japan. I think that it is possible in the U.S.

Q: What are actions that could prevent such an outcome in the U.S.?

Robert Horrocks, PhD: First, quantitative easing. We have seen in past rounds that quantitative easing tends to raise long-term yields as it causes inflation expectations to rise. It is possible, however, that balance-sheet normalization dug a hole for this form of monetary policy in that it convinced people that the U.S. Federal Reserve would not continue such nontraditional policies for an extended period of time. Second, fiscal policy. With long real yields negative, the government can borrow heavily. It matters little what it borrows for—infrastructure spending, tax cuts. Just borrow and build and spend. Unfortunately, I am already hearing people say that “balance-sheet expansion got too far” and that “the government has to have a specific reason for borrowing.”

Q: What else does the market need to see before stabilizing?

Teresa Kong: We need to be able to get our arms around the unknowns. One area is policy response as Robert described. We have experienced sectoral and regional recessions in this cycle. For instance, in 2011 in the euro area there was a debt crisis, then in 2015 we saw a drop in oil prices that hurt U.S. oil producers, as well as a correction in Chinese equity prices in 2015. Each time, policymakers did enough to avert a global slowdown, although market fears of global recession certainly rose significantly during those periods. What's different this time? We are very late in the cycle, meaning policymakers have already used up a lot of their easing space. Rates do not have much room to fall. Many countries also have gone through fiscal easing (China in 2016—2017 and the U.S. in 2017—2018).

Andrew Mattock: The biggest question in my mind is: “Do we go into a job-loss scenario? Or will companies just ride it out?” In particular, the 2008 crisis went from an asset market issue/liquidity issue through to the general economy as the financial system failed. The 2001 crisis was more of a general economy issue in an over-capex cycle that was always going to lead to job losses, and more typical of the past cycles in the previous 50 years. The optimist in me doesn't see a major job-loss fallout. Markets could, however, extrapolate further in the near term. The longer the virus paranoia lasts, the bigger potential for a sustained, secondary real economy impact as companies take the step to cut jobs. Then all bets are off, as governments (ex China) don't have firepower to stimulate out of the quandary.

Q: Let's pivot to what is happening with companies on the ground, starting with earnings growth in China.

Tiffany Hsiao: My best guess is that overall market earnings for the first quarter of 2020 will be down 20% year over year. In the second quarter, earnings could still be down 10% year over year. So full year, flat earnings are likely. Just remember, January and February were actually very strong as people started restocking after the U.S.–China trade deal. So the first quarter may not be that bad. My view is that Chinese small companies would support overall earnings growth. Most companies expect to get back 80% of staff by the end of March. Even with 80% of staff, however, output is at only 50% with clients cutting orders in smartphones, consumer electronics and PCs. Servers were the only bright spot, helped by people working from home. It is hard to get rural workers back so companies are having to increase staffing, recruitment and training costs. They expect to pass on the majority of the cost increases to the end client. Nothing alarming.

Q: What about the broader earnings picture for Asia?

Yu Zhang: The unforeseen COVID-19 outbreak is adding severe near-term headwinds for Asia's economies and corporate earnings. My view continues to be, however, that this will mainly delay the earnings recovery in Asia. After all, Asia's markets were on the cusp of an earnings recovery after the 2019 earnings recession and the overhang of the U.S.–China trade war also was subsiding. China already has the outbreak under control, meanwhile, and a manufacturing recovery is well underway. Singapore and Taiwan have done an excellent job in containing the virus without causing drastic disruptions. Even the situations in South Korea and Japan are stabilizing. With the valuation discount against the U.S. market, Asian equities are looking particularly attractive as well.

Sharat Shroff: Up until the onset of the coronavirus, we were starting to see an improvement in corporate earnings in Asia, especially in China. It appears that the lower cost of capital, fiscal stimulus measures in Asia and lower oil prices create a positive backdrop for corporate earnings across most of Asia. Lower oil prices are a benefit for most companies and consumers in Asia with the exception of Malaysia, a major oil-exporting country. A note of caution: the timing of an earnings recovery is uncertain and I am not anticipating a snapback, but China is likely to emerge first in the process.

Q: Why has China not reacted as badly as the U.S.?

Robert Horrocks, PhD: I think it is partly lower starting valuations; partly, the fact that in the U.S., all other areas of the economy except consumer spending were already contracting and so a recession in the U.S. seems assured; partly more confidence that China can and will offset growth concerns through fiscal spending more readily; partly because falling oil prices may hit parts of U.S. industry hard; and partly because the People's Bank of China has started to ease.

Q: What are the implications of the OPEC breakdown last weekend?

Teresa Kong: We are in a prisoner's dilemma. Saudi Arabia would likely win a price war if this is very short. But if it lasts a year, then there will be social-stability considerations. While Saudi Arabia's production costs are very low, it basically uses oil revenue to pay for an entire social welfare state. So we estimate its fiscal break-even is about US$80 per barrel. Russia has a fiscal surplus, and its fiscal break-even is roughly US$42. So Russia might be thinking that it could probably win the long game, a game of attrition and belt-tightening. Although Aramco's cost could be as low as US$2.80 per barrel, it also employs a bunch of people. So its profitability break-even is more like US$40 per barrel. An additional fragility is that Saudi Arabia's currency is pegged. In contrast, the Russian ruble is floating. So a depreciating ruble can help Russia adjust, while Saudi Arabia will need to spend foreign reserves to defend its currency. Maybe the next key risk is that Saudi Arabia will need to break its peg—something that was feared in 2015.

John Paul Lech: In any downdraft of duration, Russia definitely “wins” (in quotes because no one really wins). The Russian government's balance sheet is totally unlevered, with the lowest break-even budget of any major oil producer globally. In addition, the oil industry in Russia is unlevered. The ruble has a floating exchange rate and a majority of capital expenditures is also in rubles. Once you look at marginal costs in local currencies, it is not clear who will blink first in this game of prisoner's dilemma.

Q: What is the impact on capital markets?

Teresa Kong: At US$30 per barrel, the price range is difficult for many shale producers in the U.S. The estimated break-even price (including CapEx) is around US$40 per barrel. The U.S. high yield market is about 10% energy-related based on market value, but we believe that number is depressed because a high percentage of the energy issuers is already trading at distressed levels of lower than 60 cents per dollar. So on a notional adjusted basis, energy is closer to 15% of the total U.S. high yield market. The current oil price will likely cause stress in the U.S. high yield energy sector, leading to increased defaults in the space. By comparison, in Asia high yield energy is only about 2% of the market. Most of Asia's energy-related companies are investment-grade and tend to be state-owned, so the fallout from a repricing of U.S. high yield will negatively impact Asia credit, but to a lesser magnitude than U.S. credit.

Q: Speaking of the impact on Asia, what are the key takeaways?

Andrew Mattock: China has shown that preventing the spread among the general population is key and that it can control the virus relatively quickly. There is likely to be a rough two weeks ahead, but it may be time to buy earlier than in past crisis scenarios as the worse secondary, real economy impacts are avoided.

Robert Horrocks, PhD: It is possible that we are entering into a prolonged period of slow developed-world growth that will demand “permanent stimulus.” In this situation, it is entirely possible that the economies of Asia, which still have positive investment growth, as well as positive long-term yield, may find it easier to manage economic policy than the developed world. China's and Asia's growth will be even more important for global aggregate demand.

Index Definitions

The ICE Bank of America Merrill Lynch U.S. High Yield Index tracks the performance of U.S. dollar-denominated below investment-grade corporate debt publicly issued in the U.S. domestic market.

The MSCI All Country World Index captures large and mid cap representation across 23 Developed Markets (DM) and 26 Emerging Markets (EM) countries.

reliable and accurate at the time of compilation, but no representation or warranty (express or implied) is made as to the accuracy or completeness of any of this information. Matthews Asia and its affiliates do not accept any liability for losses either direct or consequential caused by the use of this information.