

Coronavirus: macro impact: short-run vs long-run effects

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Financial market volatility picked up sharply in February as the COVID-19 coronavirus spread internationally. Investors had been expecting a transient economic slowdown centred in China and the Asia-Pacific region followed by a V-shaped bounce later in 2020, which would have limited the full-year global impact. As the contagion continues spreading internationally with new waves of localized infection in diverse locations from Italy to South Korea, investors have started to price-in a greater chance of disruptions in global production and income.

Investors were initially reassured by China's robust measures to contain the rapid outbreak. Stimulus measures announced by China, and the scope for central bank easing in advanced economies, were expected by many investors to offset a temporary sag in global demand. China's equity markets recovered in February from peak-to-trough losses of over 10% while equities in developed markets largely continued gaining ground in anticipation of an economic bounce later in 2020. However, the coronavirus narrative began to shift in late February as the contagion accelerated internationally. The S&P500 index lost about 10% during February 19 to 27 and the 30-year US Treasury yield reached a new record low below 1.8% as investors sought safe haven assets.

Forecasting the short-term economic impact of the outbreak is inherently uncertain given the unprecedented nature of the virus. The economic outlook can be broken down into its potential short-term, cyclical and long-term investment horizons:

Short-term Horizon. Government measures to contain local outbreaks, such as quarantines and border closures, reduce the short-term productive capacity of the economy and lead to scarcer supplies of goods and services. Key short-term economic implications include lower world trade and disruption in globally integrated supply chains.

- From a macroeconomic perspective, these effects impact the economy like a supply-side shock, reducing output growth and raising inflationary pressure.
- Standard macro policy tools are not well-suited for supply-side shocks. Central bank easing and fiscal stimulus can help cushion overall demand when private spending falls, but these policies cannot easily compensate for tighter supply-side constraints on the production side when businesses are closed and workforces are quarantined.
- The duration of the short-term horizon depends on the highly uncertain progression of the outbreak and the timeline for bringing treatments into production.
- Financial markets are likely to remain volatile in the short term as pockets of new infection emerge and new economic data are reported.

Cyclical Horizon. As the spread of the contagion stabilizes, we expect a bounce in economic activity as global supply chains resume normal functioning.

- The impact of central bank easing will provide a tailwind for pent-up consumer demand and business investment, boosting private spending on goods and services.
- Price pressures for some goods and services may persist even after the outbreak stabilizes because of bottlenecks in production and transportation once firms return to business as usual.
- In financial markets, risk premiums are expected to decline and asset prices to rebound as investors price out the uncertainty related to the virus.



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Long-term Horizon. The economic fundamentals in the long term should be largely unaffected by the short-term contagion.

- Intuitively, asset prices in the long term are linked to the discounted value of future cash flows. In this way, the intrinsic value of risk assets like equity markets is related to long-term interest rates and the long-term average growth rate of earnings.
- These variables are determined by the potential growth rate of the underlying economy and productivity growth. The coronavirus is mainly expected to impact short-term growth and interest rates, implying little expected change in the long-term fair value of risk assets.
- We expect asset valuations to converge towards largely unchanged long-term intrinsic valuations. To the extent that asset prices decline in the short term, the average expected return going forward is likely to increase.

Investors with long-term investment horizons and tolerance for short-term volatility should avoid panic selling equities.

Many investors with RRSPs and RESPs who are saving for retirement and university expenses typically have a long term investment horizon of about 10 years or longer.

It is important at this juncture to step back and assess the broader context. Discuss your time horizon with your advisor. Time horizons extend beyond days, weeks and months and your investment portfolio needs to be positioned accordingly. As your partner, we will continue to keep you informed with timely and relevant updates

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