Video Transcript: An Update from Francis Scotland on Recent Market Volatility
Francis Scotland
Brandywine Global Investment Management

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Here we are on Friday, March 13. In my view, investors are in full panic mode about this virus as it morphs into sort of a global pandemic. As you know, the Dow Jones dropped from a 52-week high to a 52-week low in 10 days—that's the fastest reversal ever recorded. That kind of volatility is registering across some markets. It just reflects the scale of the unusual nature of the uncertainty that's fostered by this—the spread of this virus.

There's a lot of anxiety about the disease as well as implications for the world economy. And, we've been bombarded with these relentless media headlines warning of a potential catastrophe. All of that has inflamed a lot of the fears surrounding the pandemic.

We have no particular expertise relevant to trying to figure out how great a health issue this virus is. It seems like it's more serious than the flu, but there's a lot of cherry-picking going on with respect to interpreting the data that we are all watching. Optimist's focus on the possibility that the milder cases are not being recorded so that the mortality statistics are being overreported. Pessimists talk about alarming contagious figures like 70% of the population, 2% mortality rates. These are really scary statistics. But it's noteworthy in all this discussion that there's really a big dispersion of views within the scientific community as well, owing in part to the generally unpredictable nature of these viruses and especially the novelty of this particular virus.

As investors, obviously what matters are the economic and financial consequences for the disease, policy initiatives, and public reactions. What seems evident from current developments is that from last year's fledgling stabilization, the global economy has been snuffed out. The world economy looks like it's lurching its way into a recession. And really how long the world remains in recession has now become the critical investment issue. And the answer to that depends on reactions to the spread of this particular virus and efforts to contain the economic fallout.

One of the things that we can focus on here to give us some insight is how things have played out in China. And the good news is the traditional health measures seem to be very effective at controlling the spread of the virus and that a lot of that information has been confirmed independently, notwithstanding some suspicion that a lot of people have attached to some of China's data reports. South Korea, Singapore, Taiwan—they all seem to have had some success, great success in containment.

The bad news is the cost of the containment from this approach. The economic downside. China's annualized GDP growth for the first quarter is estimated by some experts to be around -20%. Coal consumption dropped over 50%; February auto sales were down 90% from their peak last year, 80% from a year ago. There were virtually no housing transactions up to two weeks after China's New Year. PMI Services Index dropped to 27. These are depression-type economic statistics.

Besides the fact that the number of cases is actually dropping dramatically, if there are any green shoots there, China's capital markets don't play the same role in their economy as America's markets by a long shot, but they're worth paying attention to. The Shanghai Composite bottomed on February 4, shortly after the authorities got aggressive about containment. The 10-year Sovereign Yield moved lower all through the quarter, but credit

spreads have not widened. The sign that a lot of the directives that the Chinese government has been using to shore up business liquidity conditions are working.

The low point for China's economic activity seems to have been reached in February based on high-frequency data. Activity is slowly building as the country gets back to work. People are mindful of some sort of echo effect of infection as they come out of quarantine. In the meantime, China's government could use trade and fiscal measures aimed at getting things going again.

Overall, they got through the virus. They used a lot of monetary and fiscal stimulus to provide offsets. The economy is still operating way below capacity, but we've seen a low point in activity and things look like they're turning there.

Outside of China, of course, a different story. There's been a meltdown in investor sentiment that really started around February 20. And until this week, U.S. and European officials really were downplaying the virus. They provided little leadership, coordinated or otherwise, that's given time for fear to spread as the world watches all the events unfolding in places like Italy and Iran. The bad news here is if the experience of other countries repeats, there's going to be an explosion in the number of reported cases in Europe and the U.S. during March and probably most of April.

This panic that we've seen in the markets, markets panic usually until policymakers begin to react. And we've seen some dramatic market moves. This year's slide in Treasury yields, global fixed income, and risk-free benchmark. The 30-year bond reached a 5 sigma level of overvaluation this week based on our modeling metrics. From the high on Friday, March 6, to the low on Monday, March 9, U.S. 30-Year Treasury Yield dropped 86 basis points—more than half the drop in yields recorded since the start of the year. So, the scale of economic and pessimism embedded in that price profile is very extreme.

But the good news is, it looks like we saw the beginning of a major policy shift starting this week with President Trump's announcement of a travel ban on flights from Europe. And there are reports today that he's going to declare a national emergency over the weekend. Germany Chancellor Merkel has warned of a 70% infection rate. Various leaders around the world are self-quarantining. Hollywood celebrities, like Tom Hanks, have gone rabid over social media. Thursday's decision to close Capitol Hill for a month could become symbolic. The point here is the western world's leaders get it. And they now know that full-scale mobilization of activity and resources is needed.

We're at a point where politicians and policymakers are beginning to react to the message from the financial markets, which is—do something. It's hard to imagine a presidential decree to lockdown New York, which is a city comparable in size to Wuhan, China, where the virus started, but it’s basically what the Chinese did. Extensive quarantines may come.

The reaction to stem the virus in the Western world is coming from the bottom-up rather than top-down, which is what happened in China. And developments are unfolding very rapidly. There are reports of cities canceling events of more than 500 people, and the NBA and the National Hockey League have suspended their seasons. Other sporting events around the world are being canceled. Universities are suspending classes and going online. Businesses are adopting strict protocols for visitors, healthy office etiquette, and more businesses are encouraging employees to work at home. These things are really happening very, very rapidly across North America and Europe.

In the meantime, I think economic policymaking is beginning to shift to more of a wartime mentality, which is—what measures do we need to put in place to make sure that companies don't fail because people have to stay at home for a few weeks to put the brakes on the virus spreading.

There's been a lot of news lately at major companies drawing down revolving lines of credit to boost their working capital. That only hammers home the message that companies and institutions need cheap credit in order to operate for a period of time in order to not to lay off people. China has managed to do this. Corporate spreads in China have not blown out because the Chinese government has insisted that Chinese banks roll lines of credit to companies. U.S. and Europe need to execute policies with the same goal.

The Federal Reserve (Fed) slashed rates. It has announced balance sheet expansion. More needs to be done to strengthen the dollar. Over the last few days, warnings of a possible funding shortage caused by the depletion of working capital, a rush to cash. All this may accelerate a shift to a more modern monetary footing with the Fed driving rates to zero and accommodating funding needs of the Treasury as its shore up industry and incomes. And that's essentially what I mean by shifting to more of a wartime footing.

In Europe, the European Central Bank (ECB) has modified, expanded its targeted longer-term refinancing operations (TLTRO) program. Banks are going to be able to borrow at sub-zero rates and post a wide range of collateral. And the ECB has temporarily allowed European commercial banks to operate with lower capital adequacy ratios.

So, policymakers are beginning to move. I think this is going to continue as long as the stress from the virus continues to build and people are quarantined—inactivity stays on its back—these measures are going to stay in place.

If all the coronavirus stress wasn't enough, of course, the Saudi-Russia oil price war adds another layer of risks in the near-term outlook. Hard to understand from the Saudi viewpoint, the arithmetic doesn't make any sense. No gain in market share is going to make up for the revenue loss that the country is about to incur. High cost producers around there will be marginalized as long as this plays out, which includes the Canadian tar sands and U.S. shale producers.

The move seems more political. There's speculation that it's rooted in Russia's desire to get back at U.S. sanctions by hurting the oil producers in the U.S. More generally, there's a lot of policy stimulus that is going to build up over the course of the next several months, and that stimulus in combination with low energy prices and super low interest rates is going to be a very potent form of stimulus activity.

After the virus panic subsides and life becomes more normal, if and when that comes, it's really going to dramatically alter financial conditions, particularly for interest rates. Obviously, it's not a time to be dogmatic, and the risk of a more nightmarish scenario cannot be dismissed. But overcoming this threat at some point, followed by a global recovery of some magnitude, seems to be the most likely outlook for the future.

Are You Expecting a V-Shaped Recovery at Any Point in 2020?

That's very hard to assess at this point. If we look at what's happening in China, the low point is February. I expect every month from year forward to be better in China. Is that a powerful V-shaped recovery? Not necessarily, given what's happening in the rest of the

world right now, because the rest of the world now is, as I said, only now beginning to lurch into recession. So, China's the world's factory without the demand. The factory isn't going to be producing very rapidly. But at some point, if the Western world emulates the China profile, even if it's stretched out, there will be a bottoming-out point. And as I said in my summary, with all the stimulus that's already in place and the stimuluses to come, at some point we could exit that—when exactly that comes, I'm not sure. We just need to see how this thing plays out. But I think that by the end of April, you know we all have become amateur epidemiologists, I would be looking for some real signs in the Western world that we're getting ahead of this based on this scale and the speed with which things are starting to move right now.