BOND YIELDS AND EQUITY MARKETS HAVE ALSO BEEN INFECTED BY THE CORONAVIRUS

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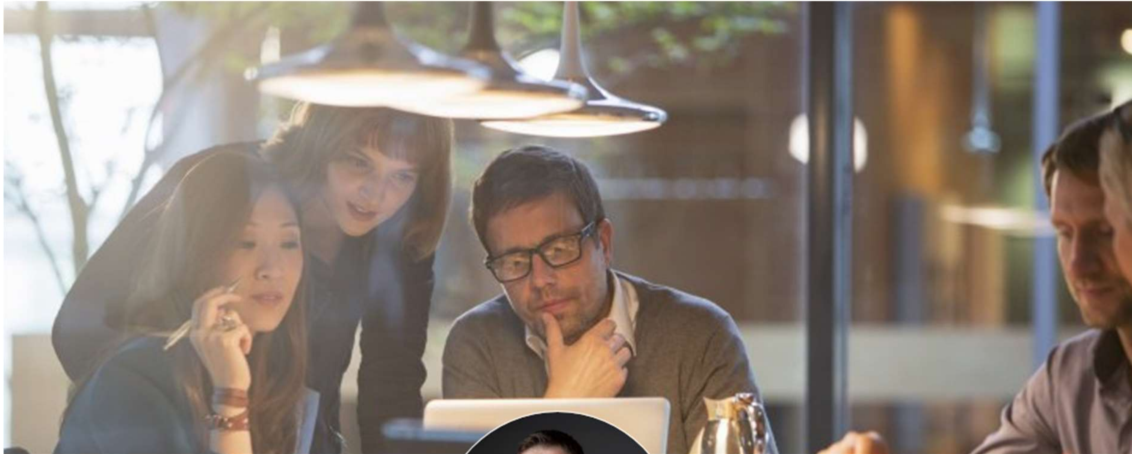

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IN A WORD:

The club of eurozone countries with sovereign bonds offering yields of more than 1% is shrinking. We stick to our "buy on dips" recommendation in equity markets.

So far the markets had reacted differently to the coronavirus and the ensuing fears over global growth. European and US equity markets had remained optimistic until the fall on Monday 24 February. The rise had been buoyed by abundant liquidity and the belief that central banks would remain accommodative, or even relax monetary policies further. On the other hand, bond markets had been worried (and continue to be), as seen in the tumbling bond yields.

Bond markets

The fall in bond yields has accelerated since the emergence of new cases in South Korea and Italy, benefiting from a broad risk aversion. Ten-year yields have fallen by about 0.30% in the eurozone and about 0.40% in the US since the first cases were registered a month ago. The yield on the German Bund is currently trading at -0.49%, about 0.20% above its historical low (0.71%). In the US, the yield on the 10-year Treasury has slid to 1.39%, very close to its historical low (1.36%) and the 30-year yield is at an all-time low (1.85%). Moreover, 30-year yields in Germany and the Netherlands have turned negative.

Will benchmark yields fall below their all-time lows? The decline in bond yields can be explained by the purchases of safe-haven investments, and coincided with weakening inflation

expectations, which were reflected in lower oil and commodity prices. The prices of these assets have now stabilised. As the ECB chief economist said, ***the history of these risks [epidemics] shows that there may be a significant short-term effect, but no long-term effect***. The latest statistical data - if we can indeed rely on them - show that the number of new infected people in China is diminishing, and that China accounts for 97% of cases worldwide. So there is limited contagion outside China. However, the spread is frightening and China is the factory of the world. Global production chains are therefore impacted when Chinese employees are in quarantine. For the past ten days or so, Chinese production has been picking up slowly. It is estimated that approximately 75% of calendar days in the first quarter will have been partially or completely interrupted. Bond yields should therefore continue to come under pressure in the coming weeks or months, before fundamentals recover and allow yields to rise a little. We expect -0.25% for the Bund and 2% for the Treasury bond in 12 months. We do not believe that the ECB or Fed will cut their key interest rates in March.

Faced with a period of heightened risk aversion, the markets distinguish between government bonds: Greek and Italian 10-year yields rose by about 0.05% on Monday 24 February while those in other eurozone countries fell. In any case, if you look at a longer historical horizon than a morning, the decline in Greek and Italian yields has been dramatic. The Italian 10-year yield has fallen below 1% (0.95%), and the Greek yield is hovering around 1% after hitting an all-time low of 0.94% last week. And this occurred even though Greek debt is still classified as junk by the large credit rating agencies. So there is hardly a country left in the eurozone with 10-year yields of more than 1% and there are only 50 government bonds in the eurozone still offering yields above 1%. Investors have jumped on periphery country bonds in search of yield, ignoring the high price and risk, betting on continued support from central banks and taking advantage of the political stabilisation in Italy and the improvement in the Greek economy. New Italian, Spanish and Greek sovereign issues in particular have been in great demand in January and February. On average, new sovereign issues in the eurozone have been six times oversubscribed.

As a logical consequence, **the share of negative-yielding bonds around the world has soared since the health crisis**, from 19.8% about a month ago to 23.6% on 24 February. In the eurozone, the rise is more impressive: one in two bonds (50.4% precisely) now offers a negative yield, compared with 39.0% last month. A peak was reached in August 2019 at 56.2%.

Equity markets

Before Monday morning, equity markets preferred to look beyond the valley. Now they are starting to consider the risks to growth and profit estimates. As our scenario is based on a V-shaped recovery in economic activity in the second half of the year, we expect stock markets to pursue a fundamentally bullish trend. The coming months should, however, see no momentum. This is partly due to the extremely overbought situation since the start of 2020, reminding us of the prevailing trend in January 2018. This reflects investors' expectations that are well ahead of fundamental developments. On the other hand, the economic situation and company profits will be penalised in the first half of the year by the negative impact of the coronavirus, but they will recover thereafter.

However, short-term downside risks are limited in our view. Cautious investor positioning is the first factor reducing the risks of a correction. Private and institutional investors have been net sellers since 2009. **As long as risks of a recession remain low, they will aim to capture periods of price weakness to buy shares**, with earnings still growing and valuations not exaggerated by historical standards, particularly compared with bonds.

More specifically, we expect prices to remain above 200-day moving averages. In the MSCI World Index (All countries), the downside risk since the highs should thus be limited to 8%. If the bearish trend in stock prices were to accelerate, it should be short-lived. This message is confirmed in the charts, when the 200-day moving average shows a steep upward slope. Moreover, we forecast an improvement in the economy in the second half of the year. **Investors are thus likely to adopt an approach of buying on dips in equity markets**, with a view to seeing stock prices reach new record highs within the next 12 months.

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