Coronavirus warrants caution

BlackRock.

Global markets have been roiled by fears over the impact of the coronavirus outbreaks, with the 10-year U.S. Treasury yield hitting record lows and the S&P 500 Index on track for its largest weekly decline since the global financial crisis. We are reducing our global equity and credit exposure to neutral from modestly overweight on a 12-month horizon. The speed and scale of the equity slide shows that markets have already reflected much potential economic impact. That is why we maintain benchmark exposures but think it's too soon to add risk.

The spread of coronavirus outbreaks beyond China has opened up a new global dimension to the epidemic – and potential for a sharper contraction from efforts to contain it. Yet we expect the expansion to remain intact. We see a sharp rebound once potential disruptions to economic activity dissipate, even if there are now material downside risks to the growth trajectory and risk assets may overshoot to the downside due to the heightened uncertainty. This may push some developed economies toward the brink of a technical recession, notably Japan and the euro area – both regions that were already on the cusp.

Our base case: This is a temporary shock, albeit one of unknown depth and duration. But the risk is that the disruptions create liquidity crunches that, if not addressed, could trigger a premature end to the economic cycle. A sustained tightening of financial conditions or impairment to market liquidity could be met by coordinated policy easing by major central banks even though many, such as in the euro area and Japan, have limited policy space. Fiscal policy will likely also be an important part of the toolkit, especially in China, with governments ramping up public health spending and providing relief to the hardest hit industries and regions. We see material risks to global supply chains, concentrated in tech, autos and capital goods. Global trade tensions were already leading companies to reassess supply chains. Over time, these supply shocks risk a shift to a macro regime of slow growth and higher inflation as some of the benefits of globalization unwind.

We shift our moderate pro-risk stance to a neutral position. An additional source of financial market uncertainty is the historically wide divergence between the policy agendas of the parties in the U.S. presidential election. We advocate portfolio resilience through the quality and min vol equity factors, the ballast properties of government bonds – especially U.S. Treasuries – and cash.

Key views

We are reducing our overweight equity and credit exposures due to coronavirus outbreaks but maintain benchmark holdings.

Our base case is that the global expansion is intact, but the risk is a premature end to the cycle.

We emphasize resilience through exposures to quality equities, government bonds and cash.

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