

Dove in the Time of COVID-19

A Publication of BMO Capital Markets Economic Research • Douglas Porter, CFA, Chief Economist, BMO Financial Group

If a week is a long time in politics, it's been an eon in financial markets these past seven days. For more than a month, markets had been warily keeping an eye on the coronavirus, well aware of the risks of it spreading beyond China, but seemingly assuming that it would not infect the rest of the world.

All of that changed this week, with investors and economists rapidly adjusting their views on the balance of risks. Equities, in particular, have had a complete rethink, swinging from record highs just last week to a full-blown correction in a matter of days—with stocks posting their largest weekly drop since the 2008 financial crisis. As of noon on Friday, the S&P 500 was down roughly 12% for the week, and its 7-day slide from last week's apex was pushing 13%. The TSX, which peaked a day later and had the added issue of a Thursday technical glitch, is now off 10% from the highs.

The dislocation in equities, and a further slide in commodities, has ratcheted up odds of major interest rate cuts by central banks, and fuelled an already raging global bond market rally. Record-low yields for Treasuries fell like dominoes, with the 10-year dipping close to Canadian territory by week's end at 1.17%. That's a massive 30 bps below just one week ago and a towering 75 bps in the past two months alone. Not to be outdone, Canadian 10-year yields also tumbled nearly 20 bps on the week to just 1.10%, although that remains a bit above the record low of 0.95%, reached in 2016.

The trigger for the massive repricing in financial markets was the **sudden and coincident spread of the virus in Korea, Italy, and Iran**, as well as a series of new cases in almost all continents. Investors have seemingly moved from assuming that the virus would stay contained and have limited economic impact outside of China, to pricing in a widespread pandemic and a worst-case scenario for global growth. We would assert that the likely outcome will land somewhere in between those two extremes. But while there is still plenty of uncertainty over what path the virus will take, there is no debate that COVID-19 concerns are having a real economic impact. Between travel restrictions, supply-chain issues, events being cancelled, and—now—confidence being rattled by the stock market correction, growth will be dampened.

As suggested in this week's Focus Feature, we believe the economic impact will be a short, sharp, shock to growth and activity will rebound relatively quickly. Nonetheless, conditions have changed, and we must recognize that in all our forecast assumptions. As a result, **we are officially adjusting our base case outlook as of today**, on the assumption that there is at least a limited outbreak in North America. Details of the revisions are explained further in today's Focus Thoughts, but in summary:

- **Global growth** is now expected to be just 2.4% this year, a slowdown from last year's soggy 2.8%, which was weighed down by the trade war. We had already cut into this year's estimate on a big downgrade in China, but now we have also cut other economies.

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- **U.S. GDP growth** is now pegged at 1.5% this year, versus 1.8% previously (which was already a big step down from 2.3% in 2019). That is below potential, and is likely to prompt some upward pressure on unemployment, and renewed downward pressure on inflation.
- **Canada's GDP growth** is being clipped a bit more heavily, as we are taking it down 0.5 percentage points to 1.2% (from 1.7%, and 1.6% for all of last year). The reason why Canada is hit a bit harder is the related slump in commodity prices (especially oil, where we are cutting this year's call by \$5/bbl) and the specific weight of issues like the rail blockades. Piling on, was news of the cancellation of the Frontier oilsands project.
- **The Federal Reserve and the Bank of Canada** are now expected to react with rate cuts totalling 50 bps. The timing is still an open question, with markets suddenly front-loading the timing of expected moves. Given the very sudden market re-pricing of risks, **we cannot rule out an intermeeting move**, and perhaps a 50 bp cut in one fell swoop.
- **The Canadian dollar** has been hit by a weaker global backdrop and lower oil prices. We continue to believe that the currency will gradually recover in the second half of the year and somewhat further into 2021. However, the weaker starting point and Canada's specific issues mean that the currency's average will be lower this year.

Amid these forecast downgrades to 2020, note that we are, at the same time, lifting our views on 2021. With growth likely to snap back relatively quickly from this presumably short-lived shock, there is also the **very real possibility that any near-term rate cuts could be reversed by early next year**. We would strongly suggest that if markets were wildly underpricing growth risks a week ago, they are overpricing those risks now.

In an exquisite piece of timing, the cover of last week's Economist magazine read "Big tech's \$2trln bull run", replete with five rampaging bulls representing the mega-five U.S. tech companies. Of course, pretty much as soon as that issue was out, stocks promptly wilted from last week's all-time highs. Even the mighty Nasdaq has corrected by 13% from its high. The pair of 1,000 point drops in the Dow on Monday and Thursday this week was an eerie replay. The index has only ever fallen by 1,000 points on two other occasions, and they both were in a single week in 2018... in February... on a Monday and Thursday.

It may surprise you that economists are not always treated like rock stars when out in the public domain; and certainly not always like a Zamboni driver-cum-emergency goaltender. In fact, following a presentation by yours truly a few weeks back in a mid-sized Canadian city, a client offered this constructive observation: "I counted that you just mentioned the word 'coronavirus' 40 times in your talk." Presumably, this wasn't meant to be a compliment; in fact, the tone betrayed a hint of annoyance. Beyond the fact that someone was actually doing a word count, in hindsight, maybe I should have used it 50 or 60 times that day.

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