Unprecedented

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We do not use this term lightly. The onset of COVID-19, requiring entire country quarantines in Italy, Spain and France and the closing of several borders has paralyzed the global economy with unprecedented speed. This in turn has caused an epic spike in market volatility and a global stock market crash. With some hindsight, the problem with looking for historical parallels in situations like these (i.e. SARS, Financial Crisis of 2008 and 9/11) is that there is simply no comparable event in recent memory.

Case in point, while no one expected strong Chinese economic data, industrial output fell 13.5% in January and February from a year earlier, retail sales fell 20.5% in the period, and the unemployment rate jumped to 6.2%, the highest on record. This is a prelude to the type of impact we can expect to the economy in Europe and North America in the second quarter as the full extent of social distancing (including the closing of restaurants, theatres, bars etc.) is reflected in official data. While the timing of the upcoming recovery is uncertain, the decline in global equity markets and the lower yields to date are already pricing in the risk of a global recession in our opinion. The amount of additional downside risk and volatility will depend on the length and severity of the contraction. This is why getting a quick, credible and coordinated government policy response is so critical in avoiding a more protracted downturn.

On a positive side, after some delays, governments are now taking this issue very seriously. Public health is clearly the overriding priority and it is hoped that hard decisions like quarantines will act to slow the rate of contagion. Despite the very difficult situation in Italy and Spain, our research partners at JP Morgan still see the potential for a peak in active cases in Europe by the end of March. South Korea has emerged as a mini-success case study as the country of 50 million appears to have greatly slowed its epidemic through world class testing and isolation of infected individuals; it reported only 74 new cases on March 17, down from 909 at its peak on 29 February (according to sciencemag.org). Encouragingly, COVID-19 vaccines are being developed at an unprecedented speed with human trials having already begun.

Economically, a number of fiscal stimulus measures are being announced. This is critical, since it is necessary to keep businesses afloat and provide some income to the millions of impacted workers. Notably, on March 18, the Canadian Government announced an $82 billion package which includes $27 billion in direct support for individuals and companies and $55 billion in tax deferrals for both households and businesses. BMO Chief Economist Doug Porter notes that "this is a significant set of steps which, at just over 1% of GDP in direct support, should begin to help in relatively rapid fashion. We doubt that this will be the last word, and the Prime Minister suggested that the federal government stands ready to do more as needed" and the Minister of Finance Morneau stated that they would do "whatever it takes to ease the situation". Note that the U.S. is currently considering stimulus of over $1 trillion, or about 5.5% of GDP, including the possibility of direct cheques to all adults.

Additionally, global central banks have announced unprecedented monetary stimulus including lower short-term policy rates, new or increased asset purchase programs (e.g. buying fixed income securities) to maintain longer-term yields low and targeted lending facilities to provide short-term liquidity. Just yesterday, the European Central Bank said it could buy up to 750 billion euros in government and private sector bonds as well as commercial paper by year end. Also, greater

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flexibility is given to financial institutions to deploy capital to help households and corporations meet their requirements. Our economists believe some economic activity could start to come back in May with a real rebound possible in June/July.

Longer term, extremely low interest rates on loans and mortgages will turbo-charge the recovery when it comes and support the crucial housing market and ancillary services (housing's contribution to GDP is around 24% for Canada and 17% for the US). The approximately 1% decline in mortgage rates in the last year has improved housing affordability by approximately 10% in North America.

The crash in oil prices is clearly an overall negative for the Canadian economy but it will have the virtue of saving consumers substantial money at the time it is most needed by lowering gas prices to levels not seen in years. This is akin to a tax cut and will support consumption, helping the economy recover. The rule of thumb is that every penny gas prices go down adds $1billion to consumers in the U.S. (and close to $100 million in Canada).

Looking at over hundred years of market history, some facts are undeniable. First, the stock market leads the real economy by approximately six months, so stocks will begin to recover before official economic data shows any improvement at all. Second, the market is inherently "mean reverting". This means that excesses to the upside or downside (i.e. like we saw during the financial crisis of 2008) typically lead to a powerful opposite reaction. Think of the classic analogy of a stretched elastic that eventually snaps back when it is no longer held back. Most importantly, as we noted in last week's note ("In the Eye of the Coronavirus and Oil Storm"), the market has weathered countless wars, epidemics and other major shocks and has always managed to make significant new highs over time.

While the environment will remain volatile for some time and more downside is certainly possible, the key is to maintain a well diversified portfolio including cash, bonds, and high quality stocks. Please contact your BMO financial professional if you would like to discuss your investment portfolio.

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