TRIASIMA

COVID-19 Coronavirus and Financial Markets

February 28, 2020

A Sudden Equity Market Correction

Equity markets have been in a pullback over the last several days. The descent began Friday, February 21.

It has been sudden and large. It reached correction level, a drop over 10%, in just five days. (11% for the S&P 500 index and 9% for the S&P/TSX Composite Index)

Concerns about the possible economic repercussions from the COVID-19 epidemic have been the triggering factor for the correction.

Investors began selling holdings vulnerable to the effects of the spreading epidemic. A good example is Air Canada due to falling travel demand.

The selling wave quickly became generalized while few buyers were steeping up to counterbalance the order flow. In addition, over a matter of only a few days, quantitative and trend based and other forms of automated investing joined the fray adding to the selling pressure.

It also seems holders of Exchange Traded Funds have turned into net sellers, forcing ETF managers and sponsors to indiscriminately liquidate equity holdings. This has probably contributed to the market downdraft. As is well known, ETF now occupy a significant part of the equity investing landscape and are enlarging market movements, both on the upside and the downside.

The selling pressure emanating from all market participants will gradually abate and the market collapse will exhaust itself as equities reach lower valuation levels. Already, as at February 28, the pullback appears to be largely behind us.

Looking forward, we believe news about this epidemic will continue to get worse before they get better. Meanwhile, equity markets may meander or experience other selling waves interspersed with partial rebounds. A rapid recovery appears unlikely.

The COVID-19 Put

Triasima has been monitoring the COVID-19 epidemic closely.

We noted equity markets pulled back in the second half of January 2020 when news the epidemic, initially focused in Wuhan, China, had begun to spread out to other geographies. Market sentiment, a short-term factor, was influenced at the time.

Bourses subsequently recovered for three weeks, from late January to late February, as the epidemic took a back seat to other considerations and factors. However, the epidemic continued to spread out steadily to other countries during that quiet period.

Over the same three weeks, Triasima estimated it was increasingly likely a second selling wave would hit the equity markets when the epidemic would again become a focus for investors, due to the apparent inability to constrain its spread.

This happened over further contagion news from Italy, Iran, and South Korea.

Our expectations had been this second corrective wave would be longer and deeper than the first pullback because of rising worries the epidemic would impact economies and be accompanied by worst case scenario talks of a pandemic and a global recession.

It is not possible to accurately gauge the economic cost of the epidemic over the mid-term, say four to ten months, but there will certainly be negative repercussions to economic activity and corporate profits.

Staying with the Methodology

Throughout this recent market episode, as always, Triasima simply continued to apply its Three-Pillar Approach.

Given the suddenness of the correction, no changes of significance have taken place in portfolios. The only exception is a reduction in the exposure to Canadian oil and gas producers for some strategies.

900 de Maisonneuve Blvd. West, Suite 2520
Montreal, Quebec H3A 0A8
T 514 906-0667

COVID-19 Coronavirus and Financial Markets

February 28, 2020

We are assessing the extent of the changes to the scenarios and expectations associated with each holding. Assuredly, many Fundamental ratings will be reduced.

A key factor for any holding is whether the mid-term impact translates into considerations that diminish its appeal over longer periods.

Meanwhile, Trend ratings are deteriorating for nearly all holdings. As for the Quantitative ratings, they are more of a lagging nature and there is nothing of importance yet to report for that pillar.

Lower Fundamental and Trend ratings will result in adjustments to portfolios in the normal course of affairs, and short-term reserves may increase as a result.

Some industries are more impacted than others, such as energy, transportation, base metals, certain consumer-based industries or companies operating in or exporting to China.

With respect to companies lowering guidance, we are still too early in the first quarter and the epidemic is still too young for expectations to have been revised down to any large degree. However, a small percentage of companies have already issued warnings. Some examples:

Air Canada: Management indicated that for 1Q 2020, EBITDA is expected to be $383MM, below the previous year of $583MM, impacted by MAX aircraft grounding as well as the recent service suspensions to mainland China and from Toronto to Hong Kong caused by the COVID-19 concerns.

Bausch Health: Management estimates a $50 million hit on 1Q 2020 topline caused by the COVID-19 outbreak.

Canadian Pacific: The company has seen China production slowdown and expects to see empty shipments from China in the coming weeks, which could impact volumes in March but expects a rebound when the virus disruption normalizes.

Insurers Sun Life and Manulife have stated that they are expecting a slowdown in their respective Asian operations. Sales will decline in those regions, combined with modestly higher claims. Management for both companies added that the impact of the slowdown is too early to tell.

Conclusion

The COVID-19 is mostly present in the northern hemisphere, where it is winter. A reasonable scenario is to assume the epidemic will peter out next summer. In this case, over the long term, one year and longer, it is likely there will be no lasting significant economic impact from it.

A worst case scenario assumes the epidemic turns into a pandemic and last beyond next summer. In this case, it will take longer for the economic impact to dissipate.

Either way, equity markets may well experience further weakness in the weeks and months ahead. A rapid recovery to the record levels of mid-February is quite unlikely in the short term.

Notwithstanding all of the above, looking back, we will venture that, in the future, the current episode will be seen as one more event that buffeted equity markets for a short period of time, adding to a long list of historical footnotes.

900 de Maisonneuve Blvd. West, Suite 2520
Montreal, Quebec H3A 0A8
T 514 906-0667