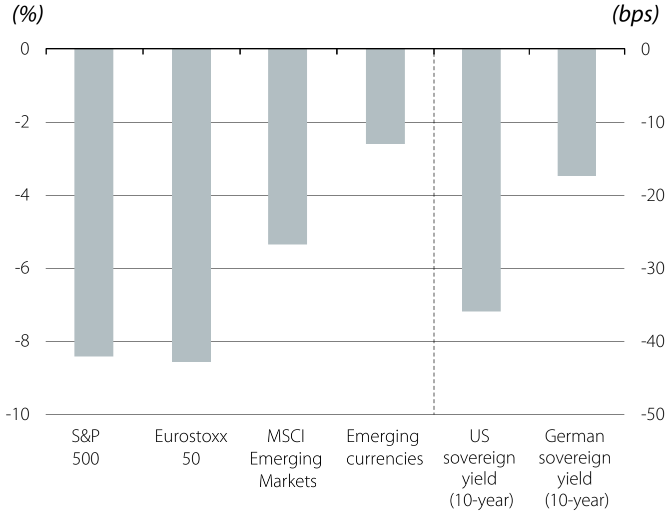
The coronavirus spreads to the financial markets

The coronavirus propagates through the financial markets. Just as occurred at the end of January, the coronavirus gained prominence in the financial markets and added a strong dose of caution to investors' mood. Its silent spreading across the five continents and the high degree of uncertainty over its economic implications at the global level (not only in China, as seemed to be the case in January) became the primary source of volatility and risk in the financial markets. Capital flows towards safe-haven assets, such as the dollar, US and German sovereign debt and gold intensified in the closing sessions of the month, punishing assets more closely linked to the business cycle, such as stocks, emerging currencies and commodities. In parallel with the health alert, business profits and the economic data began to show the first signs of weakness, mainly in China, and overshadowed the modest improvement in economic activity and business confidence that was still reflected in the indicators of advanced economies. In this context, all eyes turned towards the support of the central banks. In China, the central bank took various accommodative measures to soften the economic impact of the health crisis, while the Fed cut its target rate by 50 bps and the ECB will no doubt announce measures at its March meeting.

Uncertainty over demand drives down commodity prices. The fear among investors of a cooling of demand (China is the world's largest importer of crude oil and consumes 50% of all industrial metals) caused a widespread decline in commodity prices. On the one hand, the price of a barrel of Brent oil fell by over 10% in the month as a whole, also driven down by the forecasts for oil demand produced by OPEC for Q1 2020. On the other hand, the price of industrial metals linked to the business cycle (including copper, nickel and zinc) fell to levels of four years ago. In the currency market, risk aversion and uncertainty over the performance of economic activity in emerging economies accelerated the depreciation of their currencies, which are closely linked to the performance of their commodity exports, against currencies considered safe havens (the US dollar, the Swiss franc and the Japanese yen).

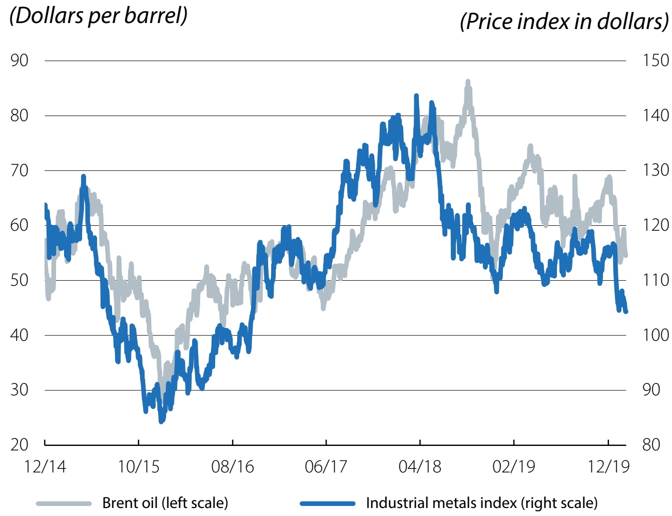
Sovereign yields plummet. In the face of economic uncertainty, a flight to quality saw investors take refuge in assets considered safe havens. As in the past, they sought refuge in US and German sovereign debt, which led to a sharp decline in 10-year yields, amplified by the expectation of a new relaxation of monetary policy by the Fed and the ECB. In the US, treasury yields fell to historic lows. Furthermore, the sovereign yield curve once again inverted, with the 10-year rate reaching 17 bps below the 3-month rate – something that has traditionally anticipated the onset of a recession in the US between 6 and 18 months later. In Germany, yields also fell to their lowest levels this year,

Select financial variables: change of February 2020



Source: *CaixaBank Research, based on data from Bloomberg.*

Brent oil and industrial metal prices



Source: *CaixaBank Research, based on data from Bloomberg.*

Slope of the yield curve: US

Note: *We show the difference between 10-year and 3-month sovereign yields.*
Source: *CaixaBank Research, based on data from Bloomberg.*

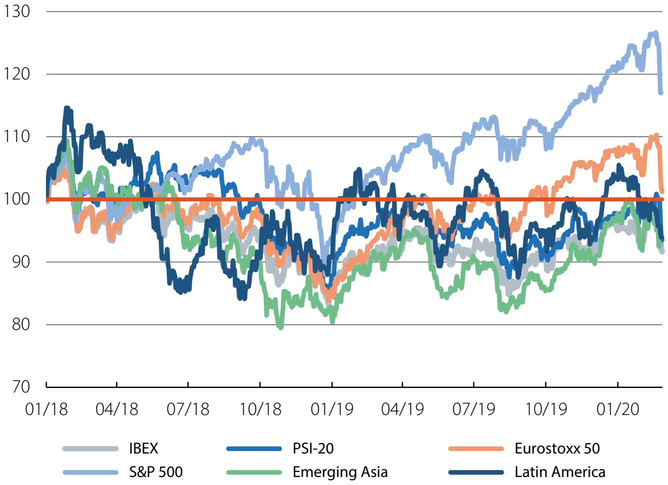
approaching the historic lows registered last summer. Risk premiums in the euro area periphery, meanwhile, were affected by the flows to less risky assets and experienced significant increases at the end of the month, following the rise in coronavirus cases in Italy and Spain.

The stock markets suffer their worst setbacks in years. In the context set out above, the increase in risk aversion among investors punished the stock markets, which at the beginning of the health crisis had cushioned the uncertainty with only modest declines. However, in February the faster advance of the epidemic was accompanied by warnings from major technology companies about the negative effect of the outbreak on their supply chains from China and, therefore, on their profits. Faced with the deterioration in investor sentiment, the major stock market indices in advanced economies experienced sharp falls (S&P 500 –8.4% and the EuroStoxx 50 –8.6%). In the case of Europe, there had not been a monthly correction of this magnitude since 2011, while in the US we have to go back to the decline of December 2018 (–9.2%) and, previously, to that of May 2010. All in all, stocks remain relatively high and, following the corrections seen in February, the S&P 500 and the Eurostoxx 50 are at the levels of last October and August, respectively.

The markets look to the central banks for support. In China, the central bank took an active role in the decision-making process to address the economic impact of the coronavirus. In particular, it cut the interest rate on the medium-term deposit facility and repo rates by 10 bps, as well as carrying out significant injections of liquidity, in order to cushion the negative impact of the stagnation of economic activity in the country. On the other hand, in advanced economies the central banks were initially apprehensive to act in the face of the coronavirus, recognising the risk posed by the epidemic but reiterating that economic activity indicators remained favourable. However, with the intensification of new cases of the virus outside of China and the turmoil that began to shake the financial markets, at the end of the month the Fed, the ECB and the rest of the central banks of advanced economies began to take steps, insinuating that they will announce a new relaxation of monetary policy in March. In fact, in the case of the Fed, it already made an urgent announcement of a 50-bp cut in reference rates, brining them to the 1.00%-1.25% range (at the end of the month, financial asset valuations reflected the expectation of a 100-bp cut in the year as a whole). The ECB, meanwhile, has much less scope to further reduce rates (the financial markets reflected the expectation of a single cut of 10 bps). Nevertheless, it could focus the bulk of its support in measures to ensure even more abundant liquidity, with the aim of preventing the coronavirus from causing difficulties for firms that are creditworthy but are experiencing liquidity problems due to disruptions in the production chain.

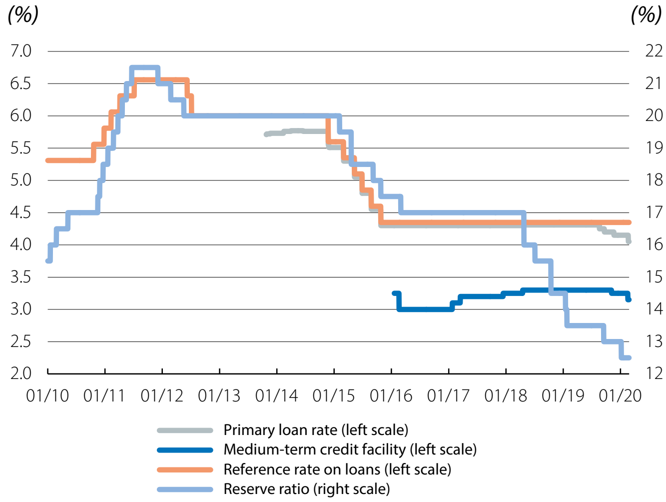
Main international stock markets

Index (100 = January 2018)



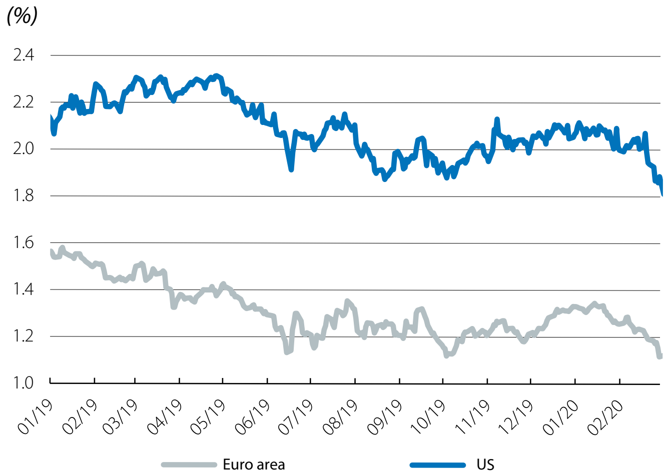
Source: *CaixaBank Research, based on data from Bloomberg.*

Main interest rates in China and the required reserve ratio for major banks



Source: *CaixaBank Research, based on data from Bloomberg.*

Market inflation expectations for the euro area and the US



Note: *5-year, 5-year forward inflation expectation rate.*
Source: *CaixaBank Research, based on data from Bloomberg.*