MARCH 3, 2020

COLUMBIA THREADNEEDLE INVESTMENTS

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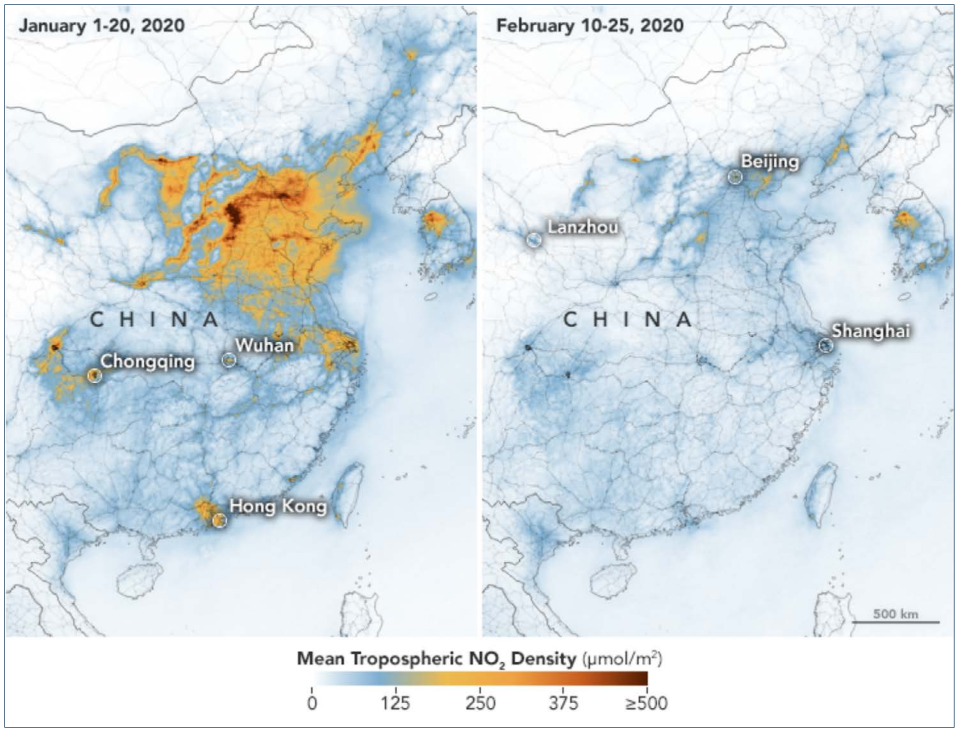
GOING VIRAL

According to Collins dictionary, a story goes “viral” when it spreads quickly and widely on the internet through social media and email. Factual accuracy is not part of the definition, however. In the context of recent market volatility, “virality” is of little help to investors seeking to understand an extremely complex situation at a global level, as there are numerous variations and interdependencies. Obviously, we have concern and sympathy for those people and their families directly impacted by the virus. However, to understand the potential economic and financial market impacts, we need to take a detached view, creating a clear demarcation between short-term and long-term/permanent impacts.

The rapidly spreading fear around COVID-19 is affecting multiple aspects of daily activity. Photographs of empty shops, roads and factories abound. Sporting events, major auto shows, et cetera. are being canceled, and colleges are suspending study-abroad programs. The airline industry is reporting that personal and business travel plans are being curtailed. Images of journalists reporting while wearing face masks have become ubiquitous. Analysis of past infections such as SARs, MERs and others is informative but not conclusive. This is a novel virus and therefore has novel characteristics. It appears to have a higher transmission rate but, thankfully, a lower mortality rate than other case studies. It also appears the news of rapid spread is exacerbating fear more than the mortality rate. The dichotomy we face is the stronger the immediate containment efforts, the greater the short-term economic disruption, but the greater the mitigation of long-term impacts. Consequently, the dramatic images that containment creates pushes fear of COVID-19 toward hysteria.

However, the reduction in current economic activity is real. Perhaps the most vivid illustration was detected by NASA and the European Space Agency (ESA) pollution monitoring satellites. They have “detected significant decreases in nitrogen dioxide (NO^2) over China.” The photographs below show the dramatic change in NO^2 from January to February following the introduction of quarantines. (Note: that period also included the holiday period for the New Year.) This implies a significant reduction in power generation, industrial activity and vehicle emissions – a useful proxy for an important portion of economic activity.



Source: NASA

The inference from the images above is supported by recent comments from the American Chamber of Commerce. They note that their members in China are reporting substantial disruption to production. Recent purchasing managers indices (PMIs) from emerging markets also indicate there is material short-term impact.

As illustrated above, there are clearly meaningful short-term impacts. Some economic activity has been lost. A simple example is eating out. If you canceled a restaurant booking last Tuesday, it is unlikely you will eat two meals out of the house next Tuesday to make up for it. Other forms of activity may simply be deferred. As factories resume working, there may be a need for additional shifts to replenish inventory. In this case, the activity was not lost but put off to a later date. Nonetheless, we should not underestimate the magnitude of the short-term impact.

Consequently, the biggest short-term risk is liquidity. If economic activity has slowed, then cash flow has also slowed. The focus on interest rate cuts is misplaced. Central banks have a role to play, but governments must take a prominent role in providing liquidity. Hong Kong, South Korea and Italy appear to have recognized this. At times of heightened fear, liquidity is a material issue; therefore, providing liquidity should be the focus – rather than the cost of money. Obviously, they are related, but leading with liquidity creates more policy options than leading with rates. Central banks will cut interest rates, but lower rates alone may only stabilize market sentiment; it will likely have limited impact on consumer/business confidence if it's the only response.

A medium-term issue may be the globalization of supply chains. These efforts have reduced costs, and just-in-time production has reduced inventories, but globalization has also exacerbated the economic sensitivity of one country to disruption in another. Supply chains cannot be changed overnight, but I suspect there is a lot of management time being spent on supply chain diversification. If lower cost was previously the primary objective, reliability and security may now feature more.

While short-term impacts clearly exist but remain hard to quantify, long-term or permanent consequences appear limited. While the relatively high transmission rate is impacting the fear level and current activity, it is the mortality rate that will impact longer-term aggregate demand and supply. Unless the mortality rate materially impacts the size of the global labor force, global economic growth will normalize reasonably quickly. The length of time to recover may vary between industries, and there may be winners and losers at the corporate level, but aggregate economic activity is unlikely to be affected long term. As an example, it will probably take a lot longer for tourism to pick up than visits to the local grocery store/market, et cetera.

Consumers may distinguish between major expenditures such as cars and homes, versus consumable items such as clothing. Are online shopping and entertainment services going to witness an increase in demand beyond current trends? Many companies have curtailed business travel. Will that resume at the previous level or will videoconferencing receive a structural boost during the travel hiatus? This last point illustrates the problem with analyzing COVID-19 impacts in isolation. As more businesses/investors seek to show their Environmental, Social and Governance (ESG) credentials, the catalyst of COVID-19 restrictions may force a thorough testing of video meetings, which is more consistent with environmental concerns, such as the use of jet fuel.

Understandably, the focus of investors has been on COVID-19. This was clearly the catalyst for the market correction, but we must acknowledge that valuations in U.S. equity and credit markets were relatively high given the low economic and earnings growth. The risk of a recession has grown because of the short-term economic impacts of the fear of COVID-19. However, the duration and depth of a recession, if one occurs, is likely to be quite short but may be deep in the most affected countries, like China.

As stated earlier, there are numerous interdependencies that need deep research in order to reach a conclusion, and this is where our research analysts will focus their attention. There is a lot we still need to understand, so this is a time for careful global research, not going viral.

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CT-TL/**115426 A (03/20)** LFX3/2977949