Aviator Update – February 2020
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Corona Chaos

This coronavirus thing is getting real. Seems it's beginning to take over the world without any solution in sight. Financial markets sure are rattled.

Before I get to the financial aspects of this situation, please indulge me for a moment…

Maybe it's just me but in recent years I've been sensing there's another pandemic sweeping much of the world – a pandemic of "self-interest".

There's nothing inherently "bad" about self-interest. In the simplest sense it's just instinct. It's always been considered an important part of economics - indeed, the father of economics, Adam Smith, wrote about the role of self-interest in the economy over 200 years ago.

Acting in one's self-interest is generally regarded as subconscious – that survival instinct. But to me, in recent years we're seeing a dramatic increase in cases where people are very consciously acting in their own self interest and, unless they are complete sociopaths (certainly in some cases), they surely know their actions are either detrimental to others or simply not the right thing to do.

The coronavirus situation has highlighted further glaring cases. The Australian (and also New Zealand) governments have made the difficult decision to ban travel from the epicentre, being China. Since then, various international student bodies and Universities have been fiercely lobbying to have the ban lifted, citing it as totally unnecessary and some even being brazen enough to call it "racist".

I mean come on… This is serious. Yes, universities will lose out on some lucrative fees but any normal person can see that taking aggressive actions to limit the spread of this virus is clearly in the national interest and the right thing to do.

As investors, I feel it's not silly to be conscious of this. This sort of behaviour is having an influence on political and economic outcomes. Look at the way these Democratic presidential hopefuls are shamelessly attacking each other… the way the US media outlets have become shamelessly partisan without any regard to unbiased reporting or even accurate reporting. Maybe it's just me, but I really feel shameless – and dangerous – self-interest is more prevalent than in the past.

Anyway, enough on that… Markets sure are "fast-moving" at the moment with the catalyst cited as coronavirus. Of course, it's important to first acknowledge that share markets had worked themselves into such an overbought, overvalued state with massive volatility compression that a strong breeze could have blown them over.

And also, can we please hold the "investors panicking" soundbites. Maybe some are, but I'd suggest the vast majority of trading activity that's causing recent moves is not being driven by emotion. In fact, a lot of it is probably being driven by machines that don't even feel emotion! They are simply running their high-speed trading algorithms.

If you're a major hedge fund portfolio manager and your trading algorithm dictates a reduction in leverage from 100% to 50%, you dump a bunch of index futures. You don't think. You don't wait and hope you can get a better price tomorrow or this afternoon. It's not personal… just business. The fact that these very algos were probably the previous source of buying pressure explains why price adjustments become large at junctures like this. Buy orders vanish. Sellers just dump what they need to on what bids are left.

The timing of market corrections are of course hard to predict. But the conditions from which corrections occur are easy to spot… and the setup was perfect.

So what now? Well let's start by thinking whether markets might be over-reacting. Could this coronavirus thing be having an impact on the economy? Absolutely. A massive impact! But even with the global economy chugging along at stall speed, the impact to date need not be disastrous. If the virus situation gets under control the economic hit endured so far won't necessarily morph into a downturn.

Regarding this, be ready to hear a lot of one particular term in coming weeks/months – "pent up demand".

On the flipside, the longer the global economy is locked down and the worse the situation gets, the more economic damage is done and the harder it will be to bounce back. Make no mistake, coronavirus can absolutely sink the global economy. Could it be the next GFC?

When you think about it, this is a *hugely* binary situation – particularly in terms of shorter-term market direction. If things start to look under control, the markets will almost certainly roar back towards recent highs. On the flipside, if things get more out of control, in view of their historically extreme elevation, markets will likely continue to tank. Its normally an "escalator" up as we climb the wall of worry but often an express "elevator' down when things change.

The problem we have is that nobody has any real clue what's going to unfold with this coronavirus. Sorry I can't offer anything more insightful.

There's one outcome we can be sure of. We know what actions our central bankers will take in response to coronavirus. When your only tool is a hammer, every problem tends to

resemble a nail. Be sure that interest rates will be cut. That is, in those places where official rates are still able to be cut. A bit more "quantitative easing" might be thrown in there for good measure.

It will be interesting to see the US Fed's response in the coming months. They have been insistent that they are "data dependent" – their actions will be dictated by the data. So will they opt to take pre-emptive action before anything shows up in the data? Certainly, President Trump is pushing hard for this.

In part, you can link this back to self-interest. Central bankers don't want to be remembered as the ones that sat by and did nothing. From another angle, there's probably a narcissistic part of them that feels they can save the world.

Like a good Pavlovian dog, market participants have been conditioned that liquidity equals gains. But this sadly won't be the case in the face of a proper economic downturn. As various commentators have facetiously remarked, the market's recent selloff perhaps can be put down to a realisation that the Fed can't print vaccinations.

Speaking of President Trump, it will be interesting to see what impact this has on the US election set for later this year. We will surely talk more about this in coming months. Essentially, at present, we have Trump appearing to be more popular than ever. Unless its stolen from him by the Democratic establishment, it seems his election opponent will be self-confessed "Democratic Socialist" Bernie Sanders.

Bernie has plenty of supporters. And then he will get plenty of votes simply because he isn't Trump. Will the sum of those two camps be enough to secure him victory?

My guess at this moment is that it won't be. But an economic downturn changes everything. A downturn will clearly make Trump's re-election bid a lot tougher.

Although devastating on a human level, I must admit it is nice to see some action in financial markets. If only it was a little easier to predict what might happen next…