Italy, the coronavirus and markets: a renewed flight to safety

The jump in Covid-19 cases in Italy has prompted a risk-off run in markets with equities dropping worldwide. The flight to safety could see BTP:Bund spreads widen a little further. In the FX space, we think the dollar and gold could continue to outperform

Some shop assistants in Milan are wearing protective face masks

Events in Italy raise broader concern

At the end of last week, markets appeared almost settled with the idea that the risk of a broader spread of the virus looked marginal as the narrative of a Chinese regional story took hold. The movements in the FX market were a good mirror of such a stance by investors. The quintessential safe-haven JPY faced downside pressure on the back of the concerns on the economic outlook. Also, CAD and NOK - that have the highest beta to global risk in G10 – had been outperforming AUD and NZD, which are instead more exposed to China from an economic standpoint.

The developments over the weekend prompted another shift in the way markets are weighing the Covid-19 story. As stock indices in the US opened with sizeable losses following Eurostoxx's 4% drop, there's the impression this is of greater global concern, given the new coronavirus cases we've seen in Italy and Korea. In the case of Italy, here's what's worrying investors:

- Since Friday, the number of cases has risen from 20 to 229. It underlines the risks of contagion, with numbers that can jump in a matter of hours.
- The Italian government reported that part of the contagion came from a person showing no symptoms
- A large number of the cases are in the Milan area, one of the most connected cities in Europe, generating fears that some may have already taken the disease outside Italian borders.
- It's worth noting that Italy had taken preventive measures very similar to other developed countries, such as blocking flights from China.

After the Italian case, global asset markets are now under broad-based pressure, prompting the Vix or 'Fear Index' (traded US equity volatility) to rise to the highest levels since last August when trade war rhetoric was at its highest.

Another challenge for the struggling Italian economy

The abrupt realisation that the risks related to Covid-19 were not so distant but very much local in nature has hit stock markets. Attention must now shift from the obvious channel of inbound tourism flows from China to a much broader extent where Italy may become a less attractive destination and there could also be a 'fear-effect' related to consumption and possible supply disruptions.

The area in Italy now affected by the outbreak of Covid-19, and consequently subject to particularly restrictive measures on movement and businesses, is only limited to a few municipalities affecting some 50-thousand inhabitants. That's at least for the time being. But these areas are close to economically relevant neighbours, such as the province of Milan, at the heart of the rich North. As the two affected regions, Lombardy and Veneto, account for 22% and 9% of Italian GDP respectively, the main concern will now be whether the virus can ben contained without hitting neighbouring industrial and services' activities at a time when the Italian economy is already flirting with another technical recession.

An impact on growth through this quarter can be expected

We continue to believe that the surprisingly steep 0.3% GDP contraction recorded in 4Q19 could well have been down to weather-related, temporary factors. But in this new environment, the chances of a rebound are dimming, adding to the risk of a technical recession. This will very much depend on how long the emergency measures will last, which in turn will depend on the unforeseeable evolution of the virus. However, given its nature and the emergency measures now in place, an impact on growth through this quarter can be expected.

Over the weekend, the Italian government was prompted to put in place relief measures to help out households and businesses located in those segregated areas, broadly following procedures after earthquakes. Measures will likely include beefing up the redundancy fund and the deferral of tax bills and of mortgage instalments. It's too early to say what the impact will be on public finance ratios as far as EU governance issues are concerned, but the exceptional nature of the

Covid-19 along with the poor state of Italian economic activity means we can suggest that any deficit target breach will not solicit any prompt requests for a correction. That will be a first early unwelcome test for the EU Commission's stated wish to balance the excesses of pro-cyclicality.

Italian rates: ECB is still the only game in town

The underlying assumption in Italian government bonds, as is the case in other risk markets globally, is that enough stimulus is on its way to at least keep risk premia contained. In the case of the eurozone, we see no reason for markets to question the view that the European Central Bank is, by and large, the only game in town. In an environment where sentiment is deteriorating fast, BTPs can only perform if the Lagarde-led ECB validates the market assumption that it will react the way it did under Draghi.

As for the ECB, there is an increasing risk that the Governing Council's take on the economy could be more downbeat at the March meeting than the latest round of staff projections. In terms of policy reaction, it is a trickier one as there is clearly nothing it can do to stop the virus. Given that the ECB has become more concerned about the adverse effects from its unconventional measures, it is doubtful they would easily cut rates or step up QE. Instead, we think the ECB would rather emphasise forward guidance and stress that they stand ready to act. The ECB may also much prefer to see a fiscal reaction here.

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Central bank easing steps also have to be assessed against their economic impact. There is ground enough to doubt that both rate cuts and QE would be sufficient to get Italy, and the eurozone, out of a recession on its own. This raises two risks: Firstly, markets should question how aggressive central banks can be in using tools that have diminishing marginal benefits (if any benefit at all). Secondly, in a recession, economic underperformance and volatile political uncertainty will weigh on BTP valuations. That Italy is the current centre of Covid-19 fears in Europe is an additional worry but we would make the same argument for wider Italian spreads even if another European economy had been hit first.

Barring an aggressive change of tone from the ECB regarding QE being the last line of defence, we expect the 10Y Italy-Germany spread to drift wider to 175bp. This is not our central scenario, but if the coronavirus proves a catalyst for a more acute Italian political crisis, the combination of economic damage and political instability would propel this spread above 200bp in no time.

FX: Safety, Liquidity and Return

Fears of a broader spread of the Covid-19 virus have triggered the sharpest one-day losses in US equities since last August, and in the FX space we see investors shifting to very cautious positioning. Relatively high interest rates no longer protect the likes of the CZK and the MXN and instead, the requirements of safety and liquidity are being given a higher priority. In absolute terms, this should favour the likes of the dollar and gold, while the JPY and CHF should outperform their regional peers.

The requirements of safety and liquidity are being given a higher priority

Conservative portfolio managers, such as global FX Reserve Managers, typically allocate their FX investments on the basis of safety, liquidity and return. The private sector, under fee pressure from the growth of ETFs and passively managed funds, are typically more driven by the need for outright return. As Covid-19 spreads, it now seems that the private sector is going to have to suspend its search for carry-driven return and temporarily increase its weightings towards safety and liquidity.

FX surveys (e.g. the BIS triennial FX survey) continue to show the dollar as by far the most liquid currency. Whatever one feels about the direction of the US sovereign balance sheet, the dollar is still additionally seen as a safe currency as well – as judged by the 5-year US sovereign CDS trading at just 17bp, only fractionally wider than that of Germany. Thus at this stage, we doubt the wholesale capitulation of global equity markets – including US equities – will turn the whole dollar bull trend.

Gold looks the cleaner story here. In a world of negative rates for two of the top three safe-haven currencies (EUR and JPY versus USD) the lack of coupon for holding gold is less of a problem. Gold also proves a good hedge should Covid-19 prompt serious financial dislocation such that the Fed is forced into emergency cuts and even the dollar starts to fall.

Within G3 FX, we would say the EUR/$ downside still looks vulnerable (corrective rallies may well stall at 1.09), while USD/JPY looks very mixed. We discussed a few of the factors driving USD/JPY to 112 last week, but in addition would say there is a risk that, as during the Asian crisis in the late 90s, the JPY is traded weaker alongside Asian FX. We wouldn't necessarily then chase the current move lower in USD/JPY.

EUR/CHF continues to press the 1.06 area and given the threat to European activity – and Italian activity over coming months – we suspect the SNB will have to tolerate a move in EUR/CHF to the 1.05 area. Total CHF sight deposits have been nudging higher over recent weeks (suggesting modest FX intervention from the SNB), but as usual, we suspect it would only offer a temporary floor for EUR/CHF.

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