Mining Journal

Bad, bleak or catastrophic?

With so many uncertainties over public health outcomes, scenario building might be as far as an investment strategist can prudently venture.

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Most frequently, scenario construction involves consideration of an attractive upside case, something dire but unlikely and a more acceptable middle ground.

The possibility of the COVID-19 pandemic suddenly and unexpectedly ending as quickly as it arose can be fully discounted. An adverse economic impact is more certain than anything has ever been in investment markets.

The most optimistic scenario involves a return to work sooner than governments had once foreshadowed but not before massive damage to employment and corporate earnings has occurred.

In this scenario, a phased pick up in economic activity begins in a matter of weeks rather than months as lower-than-expected coronavirus infection rates promote confidence about the capacity of local hospitals to cope.

A second scenario involves a more protracted economic shutdown. In this instance, risk aversion among public health officials fearful of the virus re-emerging holds sway over the instincts of politicians to get business going again. Or, even if politicians get their way, the virus returns where it had seemed beaten.

A prolonged depression in economic activity, possibly stretching well into 2021, would edge governments to the limits of their financial firepower. Larger numbers of permanent business closures, necessitating public sector takeovers of firms to protect scarce jobs, would force a redesign of the roles of government and private enterprise.

In this second scenario, a decade-long cycle of sluggish growth could ensue as governments struggle to reignite private sector investment among highly indebted companies with excess capacity.

The third and worst case is a nightmarish public health failure in which a self-reinforcing cycle of death and economic mayhem reverberates uncontrollably between advanced economies and those parts of the world least equipped to treat patients or compel social distancing.

> **An S&P 500 valued at 21 times forward earnings had warranted much more than a 20% correction**

Global deployment of cures and vaccines will be needed before economic rebuilding can be contemplated, let alone started, in badly damaged developing and emerging economies.

Negative impacts on global poverty and life expectancy will be exacerbated by reduced official aid budgets and destabilised political regimes. Emerging economies will face export-market losses and slumping currencies. Roiled sovereign debt markets will threaten systemic financial failure.

Right now, markets appear to be betting on the first and most optimistic of these three scenarios, namely, a return to work soon after casualty rates are seen to fall sustainably within the capacity of hospital systems to cope.

Three pieces of evidence support such a disposition. Chinese businesses are quickly reopening after the government has begun easing lockdowns. Where social distancing is occurring, infection rates have fallen in a matter of weeks rather than months. Pharmaceutical companies are reporting better-than-expected progress in validating treatments and vaccines.

Importantly, investors' fears and suppositions are giving way to more soundly based conclusions about the course of the disease. Professor Hendrick Streeck, director of the Institute of Virology at the University of Bonn, has reported findings from population sampling in a hard-hit area of Germany. His data point to the COVID-19 mortality rate being just a fraction of what had been feared.

A phased return to work beginning in the latter part of the June quarter would coincide with ongoing monetary and fiscal measures to support business employment. Labour market slack and a low rate of goods price inflation would enable these policies to persist with the possibility of further employment incentives in the advanced economies later in the year.

How quickly animal spirits can be restimulated will dictate the eventual economic costs and recovery potential.

In this first scenario, output may sit below 2019 levels for a year or two. Importantly for market sentiment, however, growth momentum in the year or two ahead could still improve considerably.

The bigger the hit now, the stronger the recovery opportunity.

Let's say, for example, that an economy growing at a 3% annual rate coming into 2020 contracts by 10% in the first quarter, stabilises in the second quarter and regains 50% of its output potential over the remainder of the year. Production then gets back to where it was at the start of 2020 by the end of 2021.

Such a pattern of growth implies a 7.1% contraction in 2020 but a sharp acceleration to 6.7% in 2021. Even resumption of a 3% growth path thereafter would result in 3.8% growth for 2022 as a whole.

Starting with low capacity utilisation and highly favourable macro policy settings, the world economy could experience a decade of better than previously expected growth and employment gains, despite income levels forever being lower than they would have otherwise been.

Central banks and governments will once again face the delicate task of withdrawing emergency measures on which asset values will have relied for support. Less accommodating policies will risk market disruption and raise periodic recession fears. Even as economies gather pace, markets may find themselves overpriced for the substantially lower earnings being generated. COVID-19 might be taking

the brunt of the blame, but an S&P 500 valued at 21 times forward earnings had warranted much more than a 20% correction, in any event.

A sentiment-driven uplift in equity prices may simply reflect relief that the worst is over. Sustainable market levels that reflect future economic outcomes, lowered corporate earnings, and less aggressive earnings multiples may require some retracement.

Mining sector leaders, and hence sector indices, are likely to track the direction of the broader market, as they have been doing. Whether miners are competitive investments, able to outperform non-mining stocks, or laggards struggling for attention will depend on how quickly metal supplies adjust to the changed economic outcomes.

The impact on the industry under the most favourable of the three scenarios outlined above will be the continuing subject of next week's 'From the Capital' column. The next two weekly columns will then trace the impact of the remaining two scenarios on the industry's investment standing.

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