Is This Coronavirus Different, or Are We?

While the urgent response of national and local public health officials and the medical community at large to contain the spread of COVID-19 is eminently sensible, the extreme reaction of financial markets and many ordinary citizens to the virus might appear to be excessive or even hysterical. After all, we have experienced several incidents of contagious viruses going global this century, including SARS, MERS and H1N1, but none elicited the intense public reaction or financial market response that COVID-19 has unleashed, especially here at home. What makes this episode so unique?

In particular, the H1N1 influenza A virus of 2009 seems an apt comparison. The World Health Organization declared the 2009 H1N1 outbreak a global pandemic in June 2009, a few months after its outbreak. According to estimates from the CDC, there were 61 million cases of H1N1 in the United States, representing approximately 20% of the U.S. population, resulting in 274,000 hospitalizations and 12,500 deaths between April 2009 and April 2010. Its mortality rate was very low, less than 0.02% percent. Worldwide, H1N1 killed at least 150,000 people (or 500,000 at the high end of its range estimate), according to CDC estimates, with 80% of virus-related deaths occurring in people under 65 years of age. The reaction to H1N1 outside the global medical community was far more restrained than it is to COVID-19, and its impact on the global economy was not material. Yet here we are a decade later, with many folks seemingly in near-panic mode as reported case numbers and deaths accelerate sharply within weeks after its arrival on our shores.

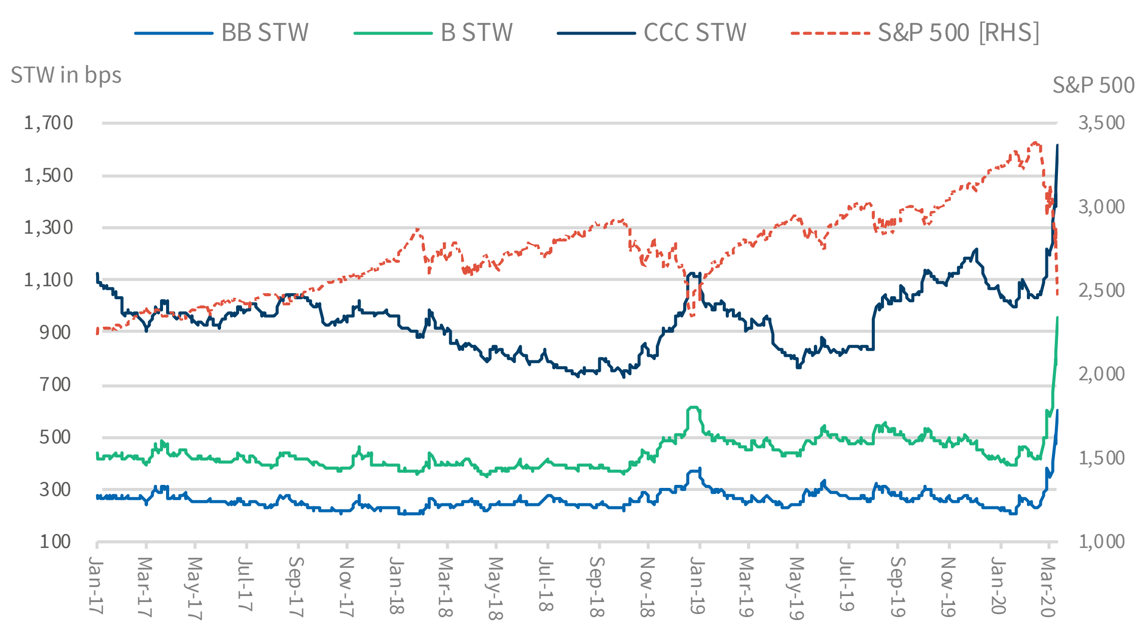
This raises a fundamental question: Is COVID-19 a pathogen so much more contagious and/or lethal than the common flu or H1N1 that it merits such an extreme public response, or has caution and prudence given way to irrational behavior? There is much that we still don't know about COVID-19's uninhibited transmission rate and its lethality, as experiences differ across countries—and until we do, there will be visible signs of panic in the public's response, such as the hoarding of sanitizers, food staples, masks and gun ammo.

Much of the panic stems from our limited understanding about COVID-19's potential to infect and kill Americans, which is largely attributable to a shortage of test kits to date. This likely has caused reported cases to be understated and the mortality rate to be overstated here at home. Looking abroad for answers doesn't provide the desired clarity, as COVID-19 statistics coming from South Korea are somewhat encouraging while the data coming from Italy are alarming. Hard as it may be to believe at the moment, a plausible scenario for COVID-19 domestically, if transmission remains unchecked, is that tens of millions may come down with the virus in some form, and the mortality rate likely will be at least 10 times that of the common flu, according to Dr. Anthony Fauci, Director of the National Institute of Allergy and Infectious Diseases. This math would translate into several hundred thousand deaths attributable to the virus in the U.S., disproportionately afflicting the elderly and those with respiratory health issues. If this sounds alarmist, consider that German Chancellor Merkel recently warned that up to 70% of her country could become infected with the virus. What is known with certainty is that we are still in the early stages of this battle.

Modern life in the 21st century has given us a stronger sense of control over our lives, largely made possible by the tech revolution. Many of us can choose where and when we work, we can monitor our homes and our kids through various apps. Our Fitbits and other wearables monitor our vital health signs continuously and can relay those readings to our doctors. Genetic testing lets us analyze our DNA to understand which diseases we are genetically predisposed to, so we can take appropriate action. Medical advancements are allowing people with some life-threatening illnesses to live longer than they would have just a couple of decades ago. These many breakthroughs have amplified our internal narrative that we are in near-complete control of our lives. And then a potentially lethal virus comes along and abruptly threatens that narrative. The reaction for many, understandably, is fear and panic, and our flight response will be to hunker down in our homes to the extent we can until it is safe to resume our normal daily lives. There is no way of knowing precisely how long that will take.

There is consensus agreement within the medical community that COVID-19 is more contagious than the common flu and more lethal, especially for older age cohorts and those with compromised immune systems. The good news is the recognition that self-quarantine, restrictions on large public gatherings, and social distancing absolutely can slow or curtail the transmission

Exhibit 1 - High Yield Bonds: Spread-to-Worst



Source: Bloomberg

of COVID-19. The ability of many Americans to work from home and shop from home makes such a scenario plausible for many of us. The bad news is that such actions will come at a significant cost to the U.S. economy. Quite simply, Americans will spend less if they become homebodies for any extended period, say one to three months. Vacations will be postponed, concerts, public events and other large gatherings will be cancelled, more meals will be eaten at home and shopping center traffic will continue to decline (it has already accelerated to high single-digit declines in recent weeks). Such a downshift in consumer activity, combined with an already cratering energy sector, holds the potential to push the U.S. economy into recession.

Economic stimulus intended to mitigate this damage should specifically target affected industries and people, giving some monetary relief to beleaguered sectors, furloughed or laid off workers, and sick pay to infected workers whose employers don't provide it. Remedies designed to give financial relief to all Americans, such as the Trump administration's proposed payroll tax holiday, are either misguided or politically motivated, and will be ineffective and hugely expensive. If working Americans need to or chose to stay close to home for any extended period, their collective spending will be curtailed for a while, and a few extra bucks in all our pockets won't induce us to spend more if we are housebound.

While everyone is fixated on the plunge in global equity markets, leveraged credit markets are the potential crack in the economic foundation, and they are not holding up so well either. High yield bond issuance has plummeted since late February while spreads have widened by at least 300 bps, a huge leap in two weeks' time [Exhibit 1]. Despite many tens of billions of dollars in lendable capital residing with private credit platforms and other non-bank lenders, you can be sure that new leveraged lending will slow sharply if neither borrowers nor lenders have much visibility into operating performance beyond one quarter. Some directly impacted businesses have already begun drawing down fully on revolvers in response to this uncertainty. As has often happened historically, default cycles begin when leveraged credit markets go into retreat. For all the recession chatter that has lingered for over a year, nobody imagined any such scenario would play out in this particular way. But for complacent financial markets, it could only happen this way.

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