The impact of covid-19 pandemic on global financial markets: a qualitative analysis

El impacto de la pandemia del covid-19 en los mercados financieros globales: un análisis cualitativo

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RESUMEN
Justo después del acuerdo comercial de fase uno acordado entre los EE. UU. Y China, el mundo se ve envuelto en una gran pandemia de infección por coronavirus. El coronavirus ha afectado a casi todos los sectores de la vida, incluidos todos los lados de la economía y los mercados financieros. Ha provocado fuertes caídas en la demanda y ha ralentizado considerablemente las actividades económicas. El brote del virus se ha convertido en una de las mayores amenazas para la economía mundial y los mercados financieros. Las empresas en la era de la globalización son muy interdependientes a través de la integración económica y las cadenas de suministro globales. Debido a los bloqueos concomitantes de la pandemia, las empresas globales experimentan interrupciones en las producciones, suministros, transportes y ventas. Estos resultan en fuertes disminuciones de los ingresos y en quiebras de varias empresas. Los precios de las acciones reaccionan rápidamente a estos choques. Pero no todas las acciones de la empresa reaccionan de la misma manera. Por lo tanto, separamos los impactos en dos grupos. Analizamos el impacto del coronavirus en los mercados financieros desarrollados y emergentes. Los mercados financieros desarrollados representados por los mercados de EE. UU. Y Europa son capaces de gestionar de manera justa las turbulencias iniciales en los mercados de acciones y bonos. Los bancos centrales de estas economías pueden responder de inmediato recortando las tasas de interés, aunque estas acciones no estabilizaron el mercado de manera adecuada. Los mercados emergentes representados por China, India, Brasil, México, Rusia, Indonesia y Turquía sufren en mayor medida el virus en forma de trastornos económicos, devaluaciones monetarias y altos aumentos del desempleo. Este documento destaca los impactos del virus en los dos grupos de mercados financieros de forma cualitativa. Los hallazgos sugieren que los responsables de la formulación de políticas, las autoridades reguladoras y los inversores deben tomar medidas para mantener los mercados financieros funcionando de manera eficiente en estos tiempos.
ABSTRACT

Just after the agreed Phase One trade deal between the US and China, the world becomes gripped in a major pandemic of coronavirus infection. The coronavirus has affected almost all sectors of life, including all sides of the economy and financial markets. It has caused sharp decreases in demand and greatly slowed down economic activities. The virus outbreak has become one of the biggest threats to the global economy and financial markets.

Companies in the age of globalization are very interdependent through economic integration and global supply chains. Due to attendant lockdowns of the pandemic, global companies experience disruptions in productions, supplies, transportations and sales. These result in sharp decreases in incomes as well as bankruptcies of several firms. Stock prices react to these shocks rapidly. But not all company stocks react the same way. Thus, we separate the impacts into two groups. We analyse the impact of coronavirus on developed and emerging financial markets. Developed financial markets represented by the US, and European markets are able to fairly manage the initial turbulences in stock and bond markets. Central banks of these economies are able to immediately respond by cutting interest rates, though these actions did not stabilize the market adequately. Emerging markets represented by China, India, Brazil, Mexico, Russia, Indonesia and Turkey suffer greater from the virus in the forms of economic disruptions, currency devaluations and high increases in unemployment.

This paper highlights the impacts of the virus on the two groups of financial markets in a qualitative way. The findings suggest steps to be taken by policy makers, regulatory authorities and investors to keep financial markets operating efficiently in these troubled times.

Keywords: Coronavirus, financial markets, emerging markets, developed markets

1 INTRODUCCIÓN

The world continues to experience a major pandemic of coronavirus (Covid-19) infection. The new pandemic began in Wuhan, Hubei, China, in late 2019. It was originally called 2019-nCoV and renamed COVID-19 by the World Health Organization (WHO) on February 11, 2020. The WHO, on March 11, declared COVID-19 a pandemic, pointing to the over 118,000 cases of the virus infection at that time in over 110 countries and territories around the world and the potential risk of further global spread.

By late January 2020 Chinese authorities confirmed that the virus had killed 80 people and infected almost 3,000 more. They warned that its spread could accelerate still, with the millions of people traveling all over the country for the Chinese Lunar New Year celebrations. These trips could spread the virus abroad. The outbreak of Coronavirus has caused a pandemic of respiratory diseases for which vaccines and targeted therapeutics for treatment are unavailable (Wang et al. 2020). The coronavirus has affected almost all sectors of life, including economies and financial markets. The
virus outbreak has now become one of the biggest threats to the global economy and financial markets. Even though the novel virus outbreak started in December 2019, financial markets did not react immediately as there was little information on how long it might last, whether China would be able to quickly contain it and prevent it from spreading to other countries, and the risks that a spread would pose for the global economy.

There are several papers in literature studying impact of epidemics and a few specifically of Covid-19 on the economy and finance. Chen et. al (2007) examine the impact of the SARS outbreak on Taiwanese hotel stock performance. They find Taiwanese hotel stocks show significantly negative cumulative mean abnormal returns, indicating a significant impact of the SARS outbreak on hotel stocks performance. Yang et al. (2020) study the impact of the coronavirus outbreak on tourism. Employing dynamic, stochastic general equilibrium (DSGE) models, they report that the coronavirus outbreak hinders tourism, consumption, and healthcare systems, and induces welfare levels decline. To facilitate post-crisis tourism recovery, they propose stimulus vouchers for residents to support tourism. Kim et al. (2020) research the impact of infectious and macroscopic epidemic disease outbreaks on financial performance of the restaurant industry. They find negative influence of epidemic disease outbreaks on the restaurant industry, and identify firm characteristics that serve as risk-mitigating factors.

Financial markets have reacted to recent unpredictability in economic activities with large drops, triggering circuit breakers on US exchanges four times in March 2020. This safeguard mechanism pauses trading for 15 minutes in hopes that the market will calm down. The U.S. Securities and Exchange Commission mandated the creation of market-wide circuit-breakers to prevent a repeat of the Oct. 19, 1987 market crash, in which the DOW plunged 22.6%. Since then, circuit-breakers have only been triggered once in 1997 before the four times in March 2020.

2 IMPACT OF OUTBREAK ON THE DEVELOPED MARKETS

US tech companies rely heavily on China to manufacture their products, so it’s no surprise to see supply chain disruptions severely impact tech giants like Microsoft, Apple, HP and etc. Microsoft’s shares fell in February 2020, and so did those of chipmakers Intel and AMD, two of its major suppliers. Then again, late February 2020 saw the four consecutive days of virus-related declines for the whole of the US stock market. And as if to add fuel to the fire, new data arrived showing US factory orders for big-ticket items (like cars and appliances) falling in January – even before the worst of the virus had emerged. On Monday, February 24, 2020, the DowJones Industrial Average and FTSE 100 dropped more than 3% as the outlook for the spread of coronavirus worsened.
substantially outside China over the weekend. This was followed by benchmark indices falling sharply in continental Europe after steep declines across Asia. Developed market indices such as DAX, CAC-40 and IBEX 35 each fell by about 4% and the FTSE MIB fell over 5%. There was also a large decrease in the price of oil and a large increase in the price of gold to a 7-year high. On 27 February 2020, due to mounting worries about the coronavirus outbreak, various U.S. stock market indices including the NASDAQ-100, the S&P 500, and the Dow Jones Industrial Average, posted their sharpest falls since 2008, with the Dow falling 1,191 points, its largest one-day drop since the 2008 financial crisis. On 28 February 2020, stock markets worldwide reported their largest single-week declines since the 2008 financial crisis. Following a second week of turbulence, on 6 March 2020, stock markets worldwide closed down (although the Dow Jones Industrial Average, NASDAQ Composite, and S&P 500 closed up in the week), while the yields on 10-year and 30-year U.S. Treasury securities fell to new record lows of under 0.7% and 1.26% respectively. U.S. President, Donald Trump, signed into law an Emergency Appropriations and Pandemic Countermeasures Bill including $8.3 billion in government spending.

On another front, OPEC and Russia failed to agree on oil production cuts on 5 March 2020. On 10 March 2020, Saudi Arabia announced an increase in its oil production while Russia planned to increase its oil production as well. On 7 March, oil prices fell by about 25 percent hitting a multi-year low since 1991.

Figure 1: S&P500 and FTSE100 index returns
On the morning of 9 March 2020, the S&P 500 fell 7% in four minutes after the exchange opened, triggering a circuit breaker for the first time since the financial crisis of 2007–08 and halting trading for 15 minutes. At the end of trading, stock markets worldwide saw massive declines (with the STOXX Europe 600 falling to more than 20% below its peak earlier in the year), with the Dow Jones Industrial Average eclipsing the previous one-day decline record on 27 February by falling 2,014 points (or 7.8%). The yield on 10-year and 30-year U.S. Treasury securities hit new record lows, with the 30-year securities falling below 1% for the first time in history. On 12 March 2020, Asia-Pacific stock markets closed down (with the Nikkei 225 of the Tokyo Stock Exchange also falling to more than 20% below its 52-week high), European stock markets closed down 11% (their worst one-day decline in history), while the Dow Jones Industrial Average closed down an additional 10% (eclipsing the one-day record set on 9 March 2020), the NASDAQ Composite was down 9.4%, and the S&P 500 was down 9.5% (with the NASDAQ and S&P 500 also falling to more than 20% below their peaks), and the declines triggered the trading curb at the New York Stock Exchange for the second time that week. Oil prices also dropped by 8%, while the yields on 10-year and 30-year U.S. Treasury securities increased to 0.86% and 1.45% respectively. On Sunday 15 March 2020, the Fed cut its benchmark interest rate, the Federal Funds rate, by a full percentage point, to a target range of 0 to 0.25%. However, in response, futures on the S&P 500 and crude oil dropped on continued market worries.

As soon as the Fed cuts interest rates to near zero, everyone in the market panics and thinks that the pandemic will be worse than expected, and begins to withdraw money from the market. By mid-march investors had withdrawn $50-60 billion from the money market. This means that these funds need to sell short-term risk-free bills in order to pay money back to investors. But there are no buyers in the market. These bills are very short-term government securities and commercial papers of large companies. Companies and pension funds invest in these funds to be very liquid and to sell quickly when needed. But the fact is that now there are no buyers, and the funds could not sell their bills and commercial papers to return money to investors. To sell too cheaply is to return money to those investors at a loss. But money market mutual funds are not supposed do that. One of the main problems is that banks cannot buy these bonds due to the standards set for them (which were set after 2008). It is against capital rules to buy those securities, which are traditionally of very low risk, but now facing increasing risk, and doing so rapidly. Banks’ hands are tied to protect their accounts in accordance with the rules.

The impact extends to real estate funds holding mortgage bonds. On 15 March 2020, the Fed announced it would purchase at least $500 billion of Treasury securities and at least $200
billion of mortgage-backed securities. But this was a very moderate amount. Since these funds also invest in debt, if a margin call takes place (the demand to sell their assets as interest rate increases), the price of the assets to be sold falls, and the margin call situation re-emerges in a spiral. This scenario puts many real estate funds in problematic situations.

The problem also affects municipal bonds. As the outbreak of covid-19 worsened, investors started to view municipal bonds as riskier than previously thought. Investors began withdrawing from municipal mutual funds. These withdrawals are followed by sharp increases in the interest rates borrowers were required to pay.

The closure of schools also affects the situation, and many city-municipal-schools receive temporary loans from local banks. Meanwhile, brokers and dealers have to think about the situation of their clients experiencing margin call problems and calculate how many will declare bankruptcy at the end of each day. At the same time, volatility traders face an increasingly worse situation.

The Chicago Board Options Exchange (CBOE), temporarily closed its local trading pits to avoid the spreading of the deadly virus. Volatility index is rising so much that several large stocks are losing close to half of their values, sometimes even three-quarters of their values in one day. There are also huge problems with closed-end funds. The money management department of a large German insurance fund is facing a problem in the options market. The company’s strategy was to sell short-term crisis insurance and buy long-term crisis insurance. A strategy that has worked well in the past but so far no longer works. The company loses more than $2 billion in a week. Compared to the beginning of the year, the company suffered a loss of 97 percent of its value.

As can be seen, the impact of the pandemic on financial markets is spreading with domino effect. Therefore, the Fed has to intervene in the market comprehensively and act as a buyer in a non-buyer market and as a seller in a non-seller market. In a speech on 9 April 2020, the Fed chairman, Jerome Powell, outlined important ways the Fed can contribute by providing a measure of relief and stability during this period of constrained economic activity and by using Fed tools to ensure that the eventual recovery is as vigorous as possible. He declared: “We are deploying these lending powers to an unprecedented extent, enabled in large part by the financial backing from Congress and the Treasury. We will continue to use these powers forcefully, proactively, and aggressively until we are confident that we are solidly on the road to recovery.”

3 THE IMPACT ON THE EMERGING MARKETS

In early March 2020, oil prices stood at around $50 per barrell. Then prices fell to $20 as a result of the low demand brought by the pandemic. Low oil prices have severely affected the
economies of oil-exporting countries such as Russia, Qatar, Azerbaijan, and Saudi Arabia, especially where the economy is predominantly oil-dependent. In this context, coronavirus affects many countries, developed as well as emerging markets. The serious decline in oil prices caused by the coronavirus outbreak has turned the world oil market upside down. The decrease in energy prices may reduce inflation. In particular, this situation seems favorable for a country like Turkey because it is dependent on foreign energy. The cut in interest rate by the Fed provides a welcome relief on the foreign currency debt of a country like Turkey. Due to the coronavirus, many foreign investors initiated million of dollars outflow in the bond market of Turkey, according to the January-February 2020 data. Turkey, a country with significant tourism sector, has already began to record losses in tourism. In addition, the decrease in tourism is causing Turkish Airline’s shares to fall. These global developments portend hard times for Turkey’s economy as well as those of many developing economies in the future.

Among emerging markets, and in terms of the infection curve, Turkey, Brazil and Russia appear to be most affected, followed by India and Peru. Having said this, at this point, it is instructive to note that the death toll is still low in comparison with the levels experienced in developed countries. With regard to potential second or third outbreak, the good news is that emerging markets and frontier countries can benefit from best practices put in place by countries that have already been affected by the pandemic. On the other hand, the bad news is that most emerging markets do not have well-equipped and robust health care systems to confront the kind of severe outbreak seen in already hard hit developed countries.

On the economic front, it is safe to state that no country will be spared of the consequences of the pandemic. The combination of a domestic outbreak and the related lockdown measures implemented to contain it, along with external shocks arising from weaker demand from abroad and weaker tourist flows, will push emerging markets into recession, the depth and length of which will mainly depend on infection curve dynamics, lockdown duration, and the availability, on a global level, of treatments for the virus and/or a vaccine. Domestic demand struggles will be amplified in the most open economies, the ones well-integrated into the global supply chain, or the commodity exporters, as well as the small ones highly dependent on tourism flows.

4 CONCLUSION

The Coronavirus has affected almost all sectors of life, including financial markets and the general economy. The virus outbreak has become one of the biggest threats to the global economy and financial markets. Even though the novel coronavirus outbreak started in December 2019,
financial markets did not react immediately as there was little information on how long it might last, whether China would be able to quickly contain it and prevent it from spreading to other countries, and the risks that a world-wide spread would entail for the global economy. But now it is clear that the virus is very contagious and it is very difficult to control. The impact is significant on both developed and emerging markets. Following the greatest lockdowns ever in the world, countries now are preparing to reopen their economies under cautious conditions. We hope these openings are carefully planned and the quest for vaccines is accelerated to ensure gradual economic recovery. Nevertheless, the global economy will feel the impact of covid-19 for a long time to come.

REFERENCES


