

Global Markets Overview

Asset Research Team

March 2020

How do you manage the implications from the highly unpredictable?

In our *Global Investment Outlook* – which takes a medium to long-term perspective on investing – we described three big uncertainties. First, less policy room for central banks to address a shock. Second, risks to corporate cashflows are higher than risks to economic growth. Third, politics and/or geopolitics could cause an “exogenous” market shock.

In the nearer term, we can add COVID-19 to this list of impactful shocks. COVID-19 has the characteristics of a “black swan” event, i.e., it is unpredictable, it could potentially have a very large impact, and after the event and with the benefit of hindsight it can be more easily explained.

Rather than comment in detail on the recent market moves we look forward and set out how to analyse and manage the highly unpredictable. We break it down into three parts.

1. Tracking the coronavirus (COVID-19)

The development of the disease – how it will spread and when it will peak – is highly uncertain, even for scientists. Therefore, we track the number of cases on a country-by-country basis (see page 2). Importantly, we’ve seen the number of new cases in China decline. Equally importantly, in South Korea and Japan the number of cases has been increasing at a constant rate rather than accelerating. In Europe – Italy, Germany, and Spain – and the US, the number of cases has been accelerating recently.

2. Assessing the macroeconomy and financial implications

It is not a surprise that recent developments have taken on a high level of importance for financial asset prices, equity prices especially. Our approach is to work backward from the longer-term outcome we expect – in this case over the next 1-2 years – and then assess the most likely paths in the near-term.

To build a fact-base for potential longer-term outcomes, we have looked at the GDP impacts of the major pandemics over the last 60 years. Three things are notable: first, the drag on GDP has only lasted 1-2 quarters; second, the average impact on GDP is around -4% to -5%. When we consider this impact, we need to account for most case studies being in emerging economies and these have had structurally higher growth rates. Therefore, the impact may be more severe than would be expected for a similar outbreak in advanced economies. Third, in any event, the GDP impacts in each case vary significantly.

Our economic judgement is that the direct impact on world and country GDP from COVID-19 is likely to be minimal by the end of 2021 – in-line with the historical outcomes from pandemics. However, the virus may be a catalyst for longer-term structural changes that we were predicting, especially given the political and/or geopolitical context we describe in our *Global Investment Outlook*. For example, an increased scale of government spending in Europe and/or the simplification of global supply chains through bringing production back to advanced economies. These specific examples could be positive developments for world productivity and output.

Moving forward to the possible impacts of COVID-19 on economic and market conditions in 2020, there are six main channels we need to consider:

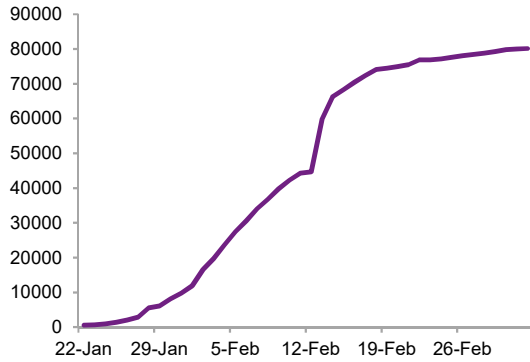
- The direct impact of the virus on China GDP, including the effects from monetary and fiscal stimulus;
- The impacts on other countries from reduced goods imported by China;
- The impacts on other countries from fewer Chinese tourists;

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Novel coronavirus (COVID-19): tracking the situation

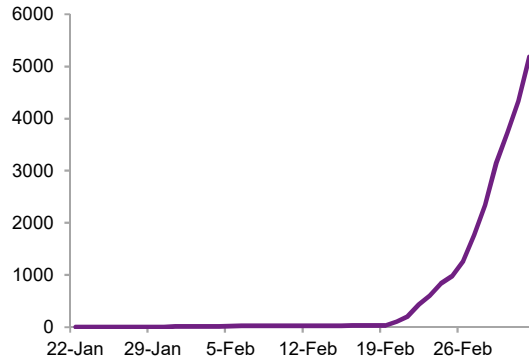
China

Cumulative number of confirmed cases



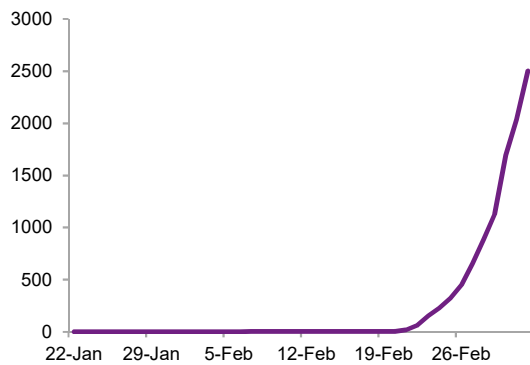
South Korea

Cumulative number of confirmed cases



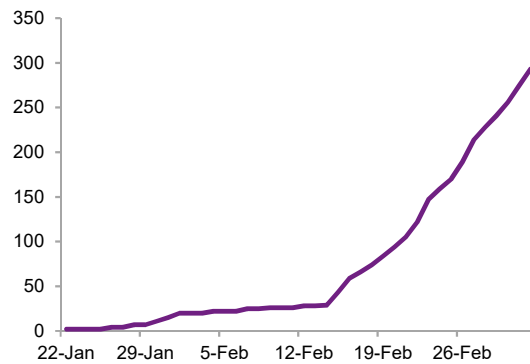
Italy

Cumulative number of confirmed cases



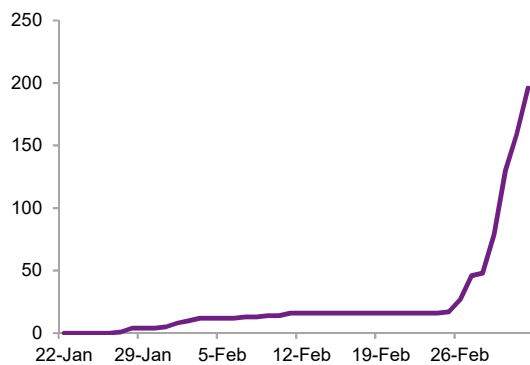
Japan

Cumulative number of confirmed cases



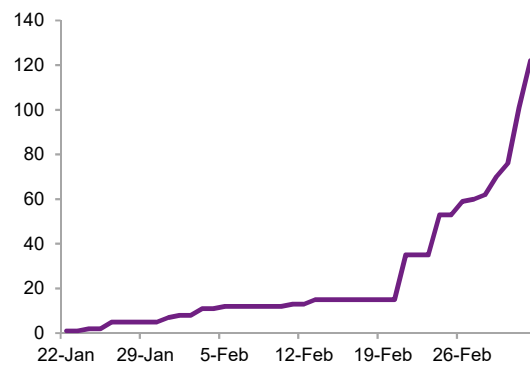
Germany

Cumulative number of confirmed cases



United States

Cumulative number of confirmed cases



Source: John Hopkins University (based on WHO and local health authority data)

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- Global supply chain disruptions, with a focus on those industries and countries that have high exposure to Chinese-produced intermediate goods in their production;
- The direct impact of the virus on other countries, especially the major advanced economies, including the effects from monetary and fiscal stimulus;
- The impacts on financial markets, the impacts from asset price changes and consumer and business confidence.

We will cover each of these channels in more detail in a forthcoming report. To summarise, when we net out the different impacts of each of these, we expect an economic contraction in Q1 driven by a contraction in economic activity in China due to the substantial shut-down in production facilities that has already occurred. Falls in import demand, lower spending from Chinese tourists, and supply chain disruptions will also affect Asian economies, e.g., we expect a contraction in GDP in Japan and South Korea in Q1. Our assessment for Europe and the US is that the economic impact has been more moderate, with the US currently affected less than Europe.

If we don't see large scale clusters of COVID-19 cases continuing to emerge in the next month in China and the major advanced economies, then we expect a sequential recovery in global economic activity in the remaining three quarters. This would be driven by a sharp recovery in manufacturing and domestic demand in China. This would support a gradual recovery in world trade and ease most supply chain pressures. Liquidity support and an easing of monetary policy by central banks and increased and targeted spending from governments will also add to demand. Thinking further ahead, we note that this will leave less room in the future for central banks to address another shock, e.g., the US Federal Reserve cut its policy rates by 0.5% on the 3rd March, which now leaves them at 1%-1.25%.

Equity markets have fallen significantly since the spread of the virus to advanced economies and daily volatility has been high, reflecting both the uncertainty and unpredictability of the risks. Bond

yields have also fallen sharply, in the US especially, due to policy rate cuts, lower short-term growth expectations, and negative sentiment. Therefore, relative to bonds, the fall in equity prices is clearly higher. Markets must be offering a higher equity risk premium. The impact on other growth-related assets, notably corporate credit and EM sovereign markets, has been moderate and the moves are not predicting system-wide risk (see pages 5 and 6).

We expect financial market volatility to continue in the short term driven by any deceleration or acceleration of the number of virus cases and short-term economic activity statistics. However, if we are right that world and country growth will sequentially recover over 2020/21, we would expect those growth-related assets that have sold off the most (i.e., equities) to also recover. However, it is entirely possible that this is from a lower price level than today.

The big uncertainties from COVID-19 are twofold:

- The number of cases in China could flare up as activity normalises (as SARS did in Canada in 2003) and/or the virus could spread much more widely in advanced economies. In both cases, the economic and growth-related financial asset impacts would be worse than our expectations for 2020;
- The “exogenous” risk is also heavily linked to fear, i.e., does virus-related news flow appear to be getting worse and how impactful is this for real economy spending by households and businesses;

However, it is important to emphasise that in *most cases* we would still expect economies and markets to significantly recover by the end of 2021, even under these downside risks. From a COVID-19 specific perspective it is also most likely that a vaccine will be developed in this timeframe. The exception to this outlook is if the downturn becomes self-reinforcing and deflationary, driven by high debt levels, where policy tools turn out to be highly ineffective.

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3. Managing the risks from the highly unpredictable

When faced with a risk that is unpredictable, multi-faceted and potentially large, we suggest using an approach that considers the various risks in an integrated way. Different risks will be more important for different asset owners. For example:

- **Operational risk:** are there established processes for decision-making, implementation and administration if many workers are ill?
- **Liability risk:** the virus may have an impact on liability profiles and ability to trade longevity risk;
- **Covenant strength:** a downside scenario of a severe global spread of the virus and a big sequential contraction in world GDP in Q1 and Q2 could have a large direct effect on the credit strength of any sponsoring company;
- **Investment risk and opportunity:** consideration should be given to three main areas –
 - **Liquidity risk:** while central banks around the world have committed to do “whatever it takes”, a downside scenario of a global recession would likely cause a tightening of liquidity in financial and broader credit markets;
 - **Credit risk:** if liquidity strains in the real economy start to emerge this can extend into credit or solvency risk. In our *Global Investment Outlook*, we highlight that rising levels of corporate debt and a loosening of lending standards in some credit sectors (US especially), means that a negative shock would likely be more disruptive to the corporate sector and asset prices than the real economy. We are monitoring private lending activity and funding conditions for small-to-medium sized enterprises to see if such strains are occurring;

- **Market risk:** what can investors do?

Reassessing risk tolerance or risk appetite is one course of action. More directly, we recommend rebalancing as the default course of action unless you think that there has been a long-term change and markets do not recover in the next one to two years. Finally, ensuring you have appropriate geographical and asset class diversification will help to manage the risk from a COVID-19 downside shock, given the virus would have a very specific geographical effect.

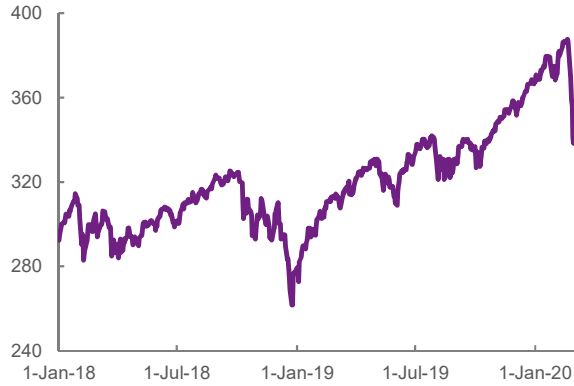
Recent market moves have been severe but, in our view, provide a reminder about the regular actions investors can undertake. We will always face systemic risks, whether they are economic, societal (such as COVID-19) or environmental. Thinking carefully about the level of risk one can tolerate, maximising the amount of diversity, removing unrewarded risks, and carefully thinking through and managing liquidity needs, will provide more resilient and, ultimately, more successful portfolios over time.

Most importantly, we extend our sympathies to the communities and families that have been affected by the virus.

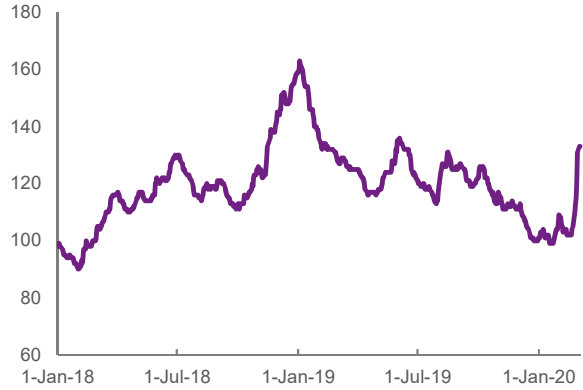
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Equity and corporate credit price moves by country

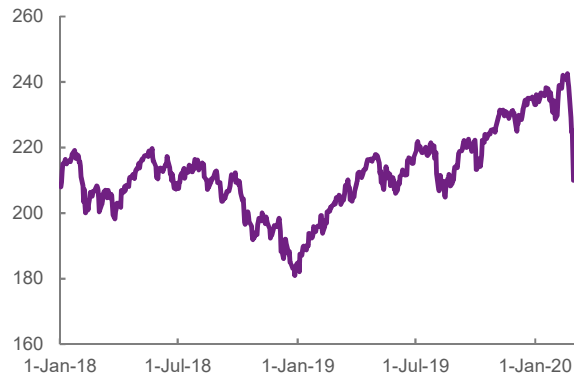
United States equity price moves
MSCI USA total return index



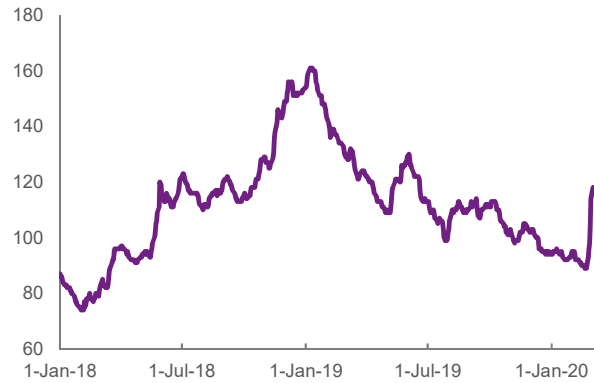
United States corporate credit spread
ICE BoA US corporate option-adjusted spread, bp



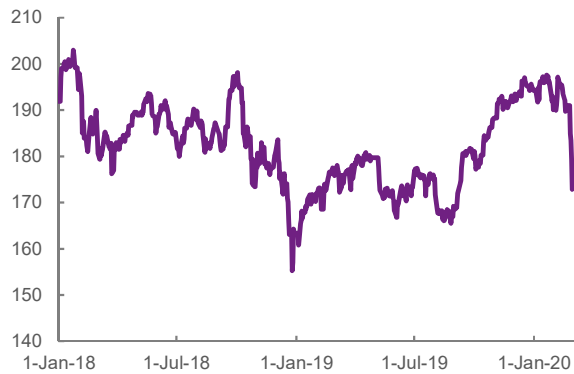
Eurozone equity price moves
MSCI Euro total return index



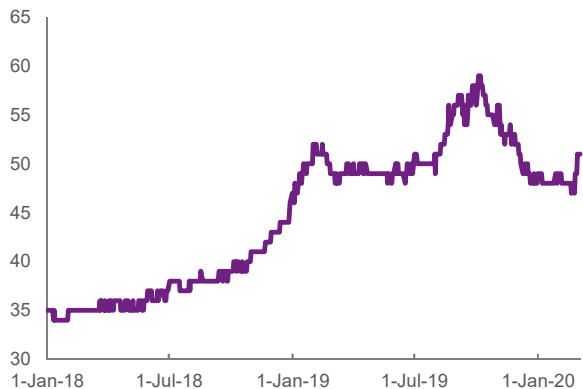
Eurozone corporate credit spread
ICE BoA Euro corporate option-adjusted spread, bp



Japan equity price moves
MSCI Japan total return index



Japan bank corporate credit spread
ICE BoA Japan corporate option-adjusted spread, bp



Source: FactSet

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Equity and corporate credit price moves by country

China equity price moves

MSCI China A-shares total return index



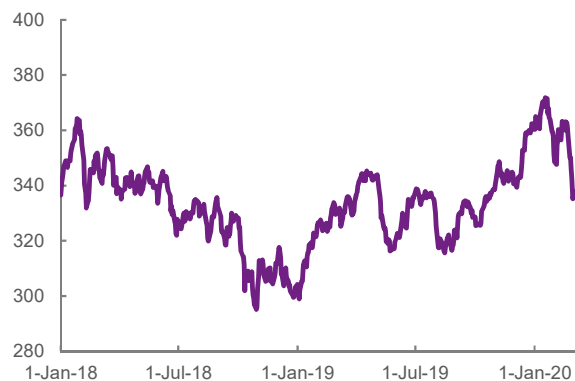
South Korea equity price moves

MSCI Korea total return index



Emerging markets equity price moves

MSCI Emerging Markets total return index



Emerging markets debt sovereign credit spread

Bloomberg Barclays EMD Sovereign USD OAS, %



Source: FactSet

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