

# Our Scenarios

30 March 2020

## How do you manage the implications from the highly unpredictable?

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### **COVID-19 has the characteristics of a “black swan” event**

- It is unpredictable
- It could potentially have a very large impact
- After the event and with the benefit of hindsight it's easier to explain

### **How do we manage economic, business, and investment risk given such high unpredictability?**

To understand the range of the possible impacts of COVID-19 on economic, business and financial market conditions in 2020 we seek to manage unpredictability and uncertainty through using three broad economic scenarios

## Scenarios and forward-looking risk management

Assumptions and expected impacts			
	Global recovery in Q3	Extended global recession	Credit squeeze and defaults
<b>Most likely</b>			
<b>Epidemiology</b>	<ul style="list-style-type: none"> <li>Public health policy measures are highly effective – virus spread controlled by mid-Q2</li> <li>Social distancing measures eased in c. 2 months</li> </ul>	<ul style="list-style-type: none"> <li>Problem transmissions occur up to Q3. Public health policy is less effective; control of the virus and social distancing easing takes 4 months; with new cluster cases in localised areas</li> </ul>	<ul style="list-style-type: none"> <li>Problem transmissions occur up to Q3. Public health policy is less effective</li> <li>New cluster cases continue in localised waves through the northern hemisphere winter</li> </ul>
<b>China</b>	<ul style="list-style-type: none"> <li>Recovery in factory output is largely complete by early-to-mid Q2; consumer confidence recovers in Q3</li> </ul>	<ul style="list-style-type: none"> <li>Recovery in factory output is delayed until Q3; consumer confidence recovers only in Q4</li> </ul>	<ul style="list-style-type: none"> <li>Recovery in factory output is delayed until Q3; consumer confidence recovers only in Q4</li> <li>Slower recovery in export sectors</li> </ul>
<b>US and Europe</b>	<ul style="list-style-type: none"> <li>US and Europe have an acute contraction until mid-to-late Q2</li> <li>Highly effective government credit support for households / businesses</li> <li>SMEs are most affected; service sectors (aviation, travel, tourism) will be significantly affected</li> <li>Energy sector affected by lower oil price to Q3</li> </ul>	<ul style="list-style-type: none"> <li>Global recession over Q1 to Q3; US and Europe contract significantly throughout Q2 and Q3</li> <li>Acute, sustained and broad-based decline in corporate earnings in 2020</li> <li>Large-scale government credit support for households / businesses</li> <li>Consumer confidence does not recover until Q4</li> </ul>	<ul style="list-style-type: none"> <li>US and Europe contract through to Q1 2021</li> <li>A shock to employment, incomes, and global trade drives deleveraging given high debt levels</li> <li>Company funding and credit conditions are acutely affected leading to defaults</li> <li>Policy is insufficient or ineffective; economic recovery is weak from Q2 2021</li> </ul>

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### Overview

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
- Carefully thinking through and managing liquidity needs, will provide more resilient and, ultimately, more successful portfolios over time

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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 combined with an ineffectual public health and/or economic policy response would 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”, we expect a tightening of liquidity in financial and broader credit markets – we are tracking various market liquidity metrics;
- **Credit risk:** if liquidity strains in funding markets and the real economy start to emerge this can extend into credit or solvency risk – we are also tracking various metrics for funding conditions and policy responses;
- **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.

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