

Willis Towers Watson PODfolio episode 1

10%, 4 weeks and two-thirds – Q1 2020 market update

DAVID HOILE: If we look over the longer term, this certainly is an extraordinary number relative to the economic conditions we've got used to in the last 50 or 60 years, but it isn't unprecedented.

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SPEAKER 1: Welcome to The Podfolio, Willis Towers Watson's investment podcast series where we'll give you an update on the latest developments across global markets and talk to expert guests on hot topics that matter to institutional investors and their portfolio.

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LOK MA: Hello, and welcome to The Podfolio. My name is Lok Ma. I'm an investment consultant and an actuary based in the UK, although we're very much going to be talking about global things here.

Our main topic of the day is going to be around a very significant movement in the investment market over the course of March and also over the first week of April, obviously movements related to the outbreak of the COVID-19 pandemic. And at this stage, I think most of us will have friends, family, and colleagues who have been affected by COVID-19 or the lockdown to deal with it. And of course, our thoughts go out to anybody who is suffering or struggling in this very, very difficult time.

Now, one of the pieces of advice that's going around at the moment is that, whilst we're all in isolation stuck at our homes, it doesn't matter how restless or even bored you might be feeling. You must never ever give in to that temptation of starting your own podcast. And obviously, we're not following that piece of advice here.

And that's because, if you're listening to this, then, like us, you are in some way involved in the world of institutional investment, if you like. And of course, we will have our responsibilities to various people. So for example, members of pension schemes will be relying on us to carry on looking after their savings and looking after their retirement.

And if we're all stuck at home, then maybe it just gives us a tiny bit more time to really look into some of these investment issues of today. And of course, a lot of those issues will be related to COVID-19 and where we might go from here. So we've called this The Portfolio.

And just to give you a sense at the beginning of this of where I'm recording this from, I'm home, obviously. I'm sat on my piano stool, which is the one part of the house that the children are guaranteed not to want to go anywhere near. So we'll see if they manage to stay out the way for the next 20 minutes or so.

And to give you a sense of the format of The Portfolio, in a typical episode we're going to spend 5 minutes or so giving you that market update just to catch everybody up on what's been happening. And then we'll spend maybe 15 minutes going into a specific topic with a

subject matter expert. But today, because this is the first episode, we're going to do things slightly differently.

We want to spend more time on that market update, just because there's been so much happening in the last few weeks up to this point. So if you're listening to this, you're listening to the first part of the recording, which is the market update. And hopefully at the end of this, we will move onto part two of the recording, which is around our main topic, the COVID-19 scenarios and where we might go from this point onwards.

So with me, we've got David Hoile. David is our in-house economist and head of the asset research team and, for me, just an all-round super interesting guy. I often wonder whether he is just so incredibly knowledgeable about every topic. I could possibly think of or whether he's just knowledgeable about the things that he happens to be talking about. But hopefully, you are with us, David. So can you hear me? And how are you?

DAVID HOILE: Yes. I'm very good. Thank you, Lok. And many thanks for the kind introduction.

LOK MA: Yeah, yeah. Your most welcome. Can you just give us a quick sense of your surroundings, kind of where you're recording this from?

DAVID HOILE: Yes, of course. I live in the countryside. And from my study window, I can often see a young family of small deer that have decided to set up their home in the corner of our garden.

LOK MA: Right.

DAVID HOILE: So working from home is feeling a little bit more like a Disney movie at the moment than Wall Street.

LOK MA: Yeah. I got you.

DAVID HOILE: But it definitely provides a different perspective on things.

LOK MA: Indeed, indeed. And [INAUDIBLE] your link to the topic of the day can be kind of, oh, dear, what's happening with the world and all that?

DAVID HOILE: Yeah. That would be a good one. I think my pretty tenuous link to some of the things I'll cover in the podcast is that taking a different perspective or taking a step back from the day to day analysis of COVID-19 cases and the market moves that we've seen is important. There's no doubt that tracking those things is a necessary thing to do.

LOK MA: Yeah.

DAVID HOILE: But it's also very important to consider the big macro implications for investor savings over the medium and long term. And there's certainly aspects of that that I'll pick up in the podcast.

LOK MA: [? Brill, ?] [? brill. ?] So let's start with a quick look at the markets. And I guess seeing as this is our first one, it would be good to kind of get your perspective of what's happened over the last maybe two or three weeks.

DAVID HOILE: Yes, of course. The number I'd like to start with is 10%. And that's our expectation for falls in the level of real GDP in the US and Europe--

LOK MA: Yikes.

DAVID HOILE: --by the end of quarter two. It's factoring in what we've already seen and known in terms of the short term activity metrics that we track, but also embedding our expectations for the scale of impact associated with the economic shutdown that's in place in the major economies and that we expect to see maintained for quite a lot of this quarter ahead.

LOK MA: So 10%, I mean, it sounds humongous, obviously. Can you just put it into context for us? I mean, how big is 10% in the kind of history of things?

DAVID HOILE: If we looked at the financial crisis in 2008, 2009, that had a GDP fall of about minus 5%. So we'd be looking at something two to three times worse than that and which is happening much more quickly. If we look over the longer term, this certainly is an extraordinary number relative to the economic conditions we've got used to in the last 50 or 60 years, but it isn't unprecedented. So the 1930s, the US Great Depression, mid-1940s in the World War II period saw bigger and longer lasting falls in GDP.

LOK MA: So I mean, that's very useful to understand the scale of what's happening. I think the bit that feels slightly unprecedented to me is the speed at which things have happened. And I'm slightly trying to find a kind of silver lining to all this.

I mean, let's get this out the way. I mean, is there any scope that this is a blip, and so it's a very, very steep and fast fall? But you know, is there a scenario where we come out of this on the other side and actually demand picks up?

Because it's been pent up, because people haven't been able to do stuff. And then the demand picks up. And in some way, we can hope to claw back a bit of that fall in activity?

DAVID HOILE: Yes. And actually, just to give you another number, but the number this time is 2/3. Now, that's not a very exciting number, but it is a pretty important one to answer your question. And 2/3 is how much, roughly speaking, Chinese production and consumption have recovered from their acute decline in January and February.

So China is pretty much, let's call it, four weeks ahead of the experience in terms of number of cases and the implications of wide scale economics shutdowns and closure of key economic sectors. And so what we've seen in China is an even more acute fall in January and February in terms of economic activity than we're expecting in the US and Europe, but a very quick bounce back in March. And so China is going through that very sharp sort of almost classic V-shaped recovery. And our best guess is that that can continue.

So I'm not saying that's the automatic playbook for the US and Europe, but it certainly gives an indication of what is both possible and plausible. But certainly, in terms of not forecasting,

but tracking the number of cases and the death rates of associated with COVID-19, looking at the economic lockdowns in place and slowing of local transmission of the disease and also looking at the ramping up of test cases, all of those things were things that were implemented by China and other countries in Asia, like South Korea, that have successfully, as the media will call it, flattened the curve in terms of the number of cases or, in other words, just brought the virus under control.

And so the indications are that we could follow a similar sort of pattern over the course of April and into early May. And so that would then suggest that that would set the scene for the start of an economic recovery towards the end of the second quarter, so in a couple of months time, and set the scene for a rebound in Q3.

LOK MA: Anything else you want to talk about in terms of market movements?

DAVID HOILE: Yes, so I think it's-- as we've talked about economy, and I think it's also important to talk about markets. It's obviously going to matter much more for all of our listeners. And it may have felt in recent weeks that market moves, let's say equities, have been as severe as that expected change in growth.

LOK MA: Right.

DAVID HOILE: But that's not the case. So certainly, some of the daily or weekly moves in equity prices have been record breaking. But if we look at the last two months as a whole, I would say that the peak to trough fall in equities that we've seen, they bounced back a little bit in the last week or so. But the peak to trough fall of equities of about 35% is well within our expectations both in terms of typical value at risk assumptions, but also in terms of history.

LOK MA: So value at risk, as in this is the kind of [INAUDIBLE] thing that you might see kind of one year every 20, that kind of thing.

DAVID HOILE: Yes, exactly. Yes, exactly. So value at risk is a statistical measure that would be based on a prudent assessment of the sort of outcomes that we've seen historically. And it wraps the probability around them. History is probably the more intuitive thing to talk about.

And so looking back from, say, the early 1920s, there have been nine event driven or cyclical economic and equity bear markets. And so a bear market is where equities fall by more than 20%. And if we looked at those nine historic periods, on average equity falls had been around about 30%. So actually, the 35% peak to trough we've seen recently would be the worst of those, but, as you rightly mentioned, by far and away the quickest.

Now, it's also worth highlighting for additional context that there have also been a smaller number of structural bear markets. So those-- a set of conditions more consistent with banking or extended financial crises. And in those we tend to see equity falls of about 50% to 60%, so meaningfully worse than what we've seen. And so we talked a little bit about the possibility of cases stabilizing and economies starting in advance, economies starting to recover in Q3, that there is an alternative set of risk considerations where falls in asset prices could still be very significant if economic and financial system conditions were to get worse.

LOK MA: Understood, understood. So that's kind of world equity markets. I've also noticed bond prices, but I'm thinking mostly in terms of government bond prices. They've kind of been all over the place in the last couple of weeks.

And kind of very naively, I think, when everything's going wrong, there's this kind of idea of flight to quality. And so you move into safer things, like government bonds. And that seems that you would expect it to be one-way traffic. Well, it's just moved around hugely. Have you got any thoughts on that?

DAVID HOILE: Yes, so I completely agree with you. And if we look at where we've ended up, then central banks have cut interest rates. They started printing a lot of money again and making asset purchases.

And you're right, Lok, to highlight the demand for high quality assets. Advance [INAUDIBLE] government bonds increases as uncertainty and economic risk rises. And so we have seen that now in the form of lower bond yields.

There are many reasons for the volatility of bond yields, but the main one we would point to has been the massive demand for cash. And that makes sense. So in an environment when earnings and asset values are falling swiftly, businesses and investors need capital.

And to raise that capital quickly, you typically sell the assets that are most liquid or easiest to sell. And that includes government bonds. So what you've had is this enormous global squeeze for cash and, in particular, cash that can be converted into US dollars to pay and dollar linked borrowing liabilities.

LOK MA: So there's kind of two different forces. There's money flowing into government bonds, because of this kind of uncertainty. And then there's other people selling those bonds, because they need to raise cash. And those two things was what's swinging the market then.

DAVID HOILE: Exactly. And so what you saw in the early stages was that massive demand for cash was the dominant force. And that was pushing up bond yields. And then what we've seen is that that has now been stabilized and reversed both by private sector buying, but more importantly by equally massive liquidity provision and from central banks.

LOK MA: Right.

DAVID HOILE: So the US Federal Reserve has announced effectively unlimited buying of US treasuries. And that policy also makes sense. So if you're in an environment where there is both an acute economic contraction and the response of governments, as we've seen, is to engage with large scale borrowing and government spending, what you don't want is that higher government borrowing to start pushing up interest rates. Because what you're doing is increasing the borrowing costs for the private sector.

And so central banks will do everything, we expect them to do everything, they can to keep those government bond yields low despite the scale of government borrowing and, therefore, to keep borrowing costs in economies low. And by the way, the US, as well as buying US treasuries to keep borrowing costs low, has also announced that it's going to buy the bonds of investment grade companies as well. So again, you can see that focus in targeting on

providing liquidity to parts of the economy where it's needed and to prevent liquidity problems turning into solvency problems.

LOK MA: Anything else about the markets, David, worth mentioning?

DAVID HOILE: No, I think less markets. Just to give you a sort of scale of the large numbers that we're looking at--

LOK MA: Yes, please.

DAVID HOILE: --the US government has announced \$2 trillion fiscal package of loans and transfers to households and businesses. That's 10% of US GDP. And I talked about the Federal Reserve's liquidity and loan measures. And ultimately, we think those could double the size of the Federal Reserve's balance sheet from \$4 trillion to \$8 trillion. That's 40% of US GDP.

LOK MA: And just to be clear, this is trillion as in 1,000 billion.

DAVID HOILE: That is--

LOK MA: There is the other definition, which is a billion billion, which I think is not what we're talking about.

DAVID HOILE: No, so this is 1,000 billion, but no less the large for it.

LOK MA: Yeah.

DAVID HOILE: And I think that at the start of the podcast I said that we'll cover these shorter term day to day events and responses. But as we'll come to, these are also going to have very important longer term implications for the businesses and for investors. And so we'll definitely come to that in terms of our thinking around that.

LOK MA: Thank you very much, David. So that was the market update of what's happened over the last few weeks. We're now going to pause the recording here. Please now head on over to part two of this episode where we're going to go into the main investment topic with David again.

So he and his team have developed a number of scenarios around how things might develop from here both in terms of the control of the COVID-19 pandemic and also the possible implications for the investment market. So please, do head on over now to part two to carry on listening. Thank you.

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