

Willis Towers Watson PODdfolio episode 2

Covid-19 economic and market scenarios

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DAVID HOILE: That there's no doubt different parts of the financial system and the credit system have experienced some strains. But we're nowhere near at the levels that we saw during the financial crisis.

SPEAKER 1: Welcome to The Portfolio, 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 portfolios.

LOK MA: Hello, and welcome back to The Portfolio podcast. My name is Lok Ma. And this is actually part two of my conversation with David Hoyle, an economist. So if you haven't checked out part one, that was about giving you an update on what's happened in the markets over the last four or five weeks since COVID-19 had started having an impact on investment markets. So if you haven't checked that out, please do go and listen to that first.

So this is now part two of this conversation. And we're now going into our main investment topic, which is around these COVID-19 scenarios. Where could we go from here, both in terms of the battle against COVID-19 and in terms of the implications for the investment markets.

So David, do you want to just give us an overview of the scenarios that you and your team has developed?

DAVID HOILE: In the interest of time, I won't go through all of the medical and economic assumptions and their impacts that we've worked on. And what I'll do is I'll summarize some of the key messages. We'll be publishing a detailed description of these scenarios and also producing a dashboard which tracks the important metrics around this. We'll be updating the dashboard weekly. And that will be freely available for everyone to see and to use.

What do the key messages look like? Well, us economists love our jargon. And so hopefully the only bit of jargon that I'll throw out today is that COVID-19 has all of the characteristics of a black swan event. What does that mean, which I'm sure you were just about to ask me?

LOK MA: [LAUGHS] Yeah, what is a black swan? Have you got one of those in your garden?

DAVID HOILE: No black swans. But in economic terms, it's something that's highly unpredictable, could have a very large impact, and is easier to reconcile or explain once you've been through that event and you have the powerful benefit of hindsight. And so if we look at COVID-19, it has all of those characteristics.

And what that means is that we need to think not only about risk, but also about unpredictability or uncertainty. And the best way of trying to deal with unpredictability is through the use of economic scenarios or stress tests. And the three scenarios that we've defined are, as I sort of alluded to a bit earlier in the call, a scenario in which we see

economic recovery in the advanced economies occurring in quarter three of this year, where China actually would be recovering earlier than that. It would continue its recovery in this quarter.

The second scenario is a deeper and more extended recession that lasts until quarter four in the advanced economies. And then the third scenario is something that looks much more financial crisis-like. So in other words, what we see is the economic supply and demand shock feeding through into the financial system, causing a major squeeze in credit, higher rates of economic defaults and economic disruption, and ultimately, a much weaker and protracted set of conditions that would last into early or mid 2021, and which would see a much more structurally weak recovery from that point on.

LOK MA: So these three scenarios-- normally, when you get three scenarios you think it's a kind of good, somewhere in the middle, and a bad scenario. Could I characterize the first scenario as-- I mean, it was obviously the most benign of the three. It doesn't sound like that's the same as, we get back to normal and kind of look back and thought, well, what a strange time, but it was mainly a blip. I don't get the sense that even the best scenario is we get back to where we were before.

DAVID HOILE: Actually, for the first scenario my answer is actually things are a little bit more positive than that. So in both of the first two scenarios, the recovery in quarter three or a more deeper extended recession, both of those are consistent with economies and the growth-related assets that our listeners will own moving back to previous levels.

Now, there'll be differences in composition in terms of, for example, different sectors, different businesses experiencing different rates of recovery. But the critical distinction between those two scenarios is the time that it takes. So for example, in the Q3 recovery scenario, we would get back to GDP levels that we had at the start of the year by 2021 in advanced economies. But with the extended recession, this would be pushed back to 2022.

So what that means for asset prices if we go back, say, to equity or credit markets, is under the recovery scenario you could expect a decent recovery-- a good recovery in asset prices towards the second half of this year, if that scenario plays out. I should add that that could well be from lower prices than we see today, given the scale of economic bad news still to come and the uncertainty that I mentioned. But nevertheless, I think that there is a positive story--

LOK MA: Positive scenario.

DAVID HOILE: [INAUDIBLE] there about asset return prospects. And even under the second scenario for a medium to long term investor, yes, you're likely to see further losses in equity and credit assets in the shorter term, by which I mean maybe the next quarter or two. And yes, they'll take longer to recover. But we would still expect them to recover over a sort of a two to three year type time frame under that scenario.

And so what's important for investment strategy at the moment is being able to distinguish your risk tolerances and the extent to which, while you are a long term investor, whether there are specific things in relation to your mission or objectives that mean that you should also be focused on shorter term market risks or losses.

LOK MA: Yeah, whether you can ride out the storm--

DAVID HOILE: Correct, yes.

LOK MA: --and how long that's going to take. Any thoughts on-- are these three equally likely scenarios in your view?

DAVID HOILE: Yeah, again. And I think that that's the critical question that I'm sure everybody is thinking about and asking us. And what I'd say is that the third scenario, that credit squeeze, wave of defaults, financial crisis, low, very slow growth in terms of recovery-- that, to us, still looks like highly impactful, but a low probability event. So there's no precision to this, so let's just say around about 10% to 15%.

And the reason we say that is not because we are blind to the potential risks. But it's because, at least for the moment, when we look at various liquidity and credit measures factoring in the very large scale of response by central banks that we've seen, that there's no doubt different parts of the financial system and the credit system have experienced some strains. But we're nowhere near at the levels that we saw during the financial crisis. And equally, the scale of fiscal and monetary stimulus to us looks sufficient with the expectation that there's likely to be further rounds of fiscal stimulus to help to offset or prevent us from tipping over to that sort of sustained negative self-reinforcing debt deleveraging environment.

So then of the other two scenarios, I would say that, very roughly speaking, we're sort of equally weighting the two of them. So you could say 40%, 40%. And I think it will become-- what I would say is that it will become a little bit clearer as we go through the next few weeks and we see the various medical information around number of cases, and number of deaths, and number of tests, and all of those types of medical metrics. If we start to see those stabilizing in a way that's consistent with what we saw in a number of countries in Asia, then that would move us, I think, a bit closer to the first scenario rather than second.

Obviously, if those continue to deteriorate, then that would move us to the second scenario.

LOK MA: Right. So you know, I'm feeling a bit more positive after speaking to you, which happens a lot of the time, David. But if I'm thinking a good, medium, and bad scenario is 40, 40, 20, maybe even a little bit less than 20% likelihood for the really bad one-- I'd kind of take that. And also, I mean, the other thing I'm getting from what you're saying is that we could look for the signs of whether we're leaning more towards the first scenario, the second scenario, by looking at the kind of medical numbers coming out and seeing whether we are turning the corner or not. So that would be like the kind of green shoots of recovery that we're looking for. And then we could translate that into these economic scenarios.

DAVID HOILE: Yes, I think that's actually right. So one of the things I mentioned earlier on the call is we're setting up a dashboard of medical and economic metrics to track. And so I've covered the medical metrics around the rates of change of cases and the test counts per millions of people, things like the de-utilization of hospital beds, any evidence of virus seasonality. All of these things, we can draw on best practice current scientific analysis and data and thinking. And so without just trying to forecast where things are going, we can build a good sense of where things are and where things look most likely to go to.

We can do exactly the same on the economic side as well. And so we can look at various economic metrics that give us a good gauge in terms of how deep the fall in GDP is likely to be. And that's very much related to economic constraints around social distancing and the shutting down of key parts of the economy and the potential for those to gradually open up.

We can also look at a whole host of activity data related to measures of confidence or traffic congestion. We can look at latest data in terms of footfall in online retail shopping, claims related to unemployment benefits. All of those types of metrics are relatively high in frequency and we can track.

I think one of the most important areas that we're looking at very carefully are economic metrics that showcase whether the sort of fiscal and monetary stimulus that I've highlighted is flowing through to mid and small size companies. I think that's absolute-- that's one of the critical factors for whether we are in scenario one or scenario two.

LOK MA: This is absolutely fascinating. I think it's a sort of grim fascination. But I mean, I look at the papers. And there's all the-- I guess the kind of case load indicators, the spread of disease and the control. But what you're doing here is you're linking it to the wider economy, GDP levels, and also linking that to possible scenarios to the future market movements, which isn't something that I've seen before. So I mean, I find this very, as I said, a sort of grim fascination, I guess. This dashboard then, is it imminently available? Is it already available?

DAVID HOILE: So we expect that to be available next week--

LOK MA: For real?

DAVID HOILE: --for our clients. And it'll also be on the [? WTW ?] website as well.

LOK MA: Yes, and just to say, I mean, this paper outlining scenarios we're going to make available as an accompanying piece to this podcast as well. So we really encourage people to have look in that. I've had a look at the stuff. It's really just very interesting how you link all the different things that are going on right now.

And one final, final question, David. We've talked a lot about the economic side of things. Also kind of interested in the future pass of the investment market. When we come out the other side of this, whenever it could be-- and it depends on which scenario that we're going down-- are we really in a different world in the investment sense?

DAVID HOILE: Yes, that's an excellent question. It's a very difficult question to answer. But really for any institutional investor that medium to long term context is absolutely key. So what does the next normal look like when we do start to recover? We have started looking at that. And we'll be publishing our views on that soon. And I should say up front that the big picture long term implications may start to become a little bit clearer over the next few months as we get to see which scenario we're following.

But here's a few things that are top of our minds at the moment, and you can expect to hear quite a bit more from us on. So from an investor lens, there's no question that asset-to-risk premia are higher. And risk-free rates are lower-- government bond yields-- are expected to remain so for quite some time. And so that's going to have implications for investment

strategy, and looks like a different strategic world than the one of lower for longer that we were emphasizing, at least in relation to growth-related assets.

Second, I've spent quite a bit of time talking through the government and central bank stimulus. And so the much higher levels of government debt that we're facing and much larger central bank balance sheets to facilitate that government debt has important implications for the way that markets operate and set prices. And that's going to have natural implications for those assets that will potentially benefit from that over the medium to long term.

And then similarly, on the equity side or the business side, there were things that were already underway-- simplifying global supply chains, trade-related tensions, and channel shift to online retail away from bricks and mortar-- all of those things may be amplified, and therefore, have implications sector by sector, company by company. And then similarly, as we saw post the financial crisis, large scale government involvement and bailouts of sectors can shift the regulatory environment. And so we've yet to see the sort of conditions that might be attached to businesses for the loans or the bailouts that are to come.

And so that's going to have important shifts in terms of the sectoral landscape. And obviously, then, that naturally has implications for returns from equity and from credit assets.

LOK MA: Thank you very much, David, for your fascinating insights. And hopefully, our listeners now get the same sense that I do, which is that you just seem to know way too much about everything. So we hope our listeners enjoyed this episode. If you did, please do tune in to future episodes. We're going to make this a fairly regular thing.

In the meantime, please do check out David's paper on the various scenarios for how COVID-19 could develop. We're also hoping to get David back in future episodes just to give us an update on how the markets have moved and also tying things in with his COVID-19 dashboard as well.

And in the meantime, do take care of yourselves. And we look forward to welcoming you back for the next episode.

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