

CYCLE, FURTHER
INTERRUPTED



Global Market Outlook – Q2 update



Synopsis

The COVID-19 virus has stalled the mini-cycle rebound and made a global recession likely. While the duration of the virus pandemic is unpredictable, policy stimulus, pent-up demand and a lack of major imbalances argue for a solid upswing when the virus threat clears.

Key market themes

The containment measures being taken across the globe to combat the virus will have a large economic impact. Global gross domestic product (GDP) growth will likely be negative in the first quarter and will enter the second quarter at risk of contracting further. It is also possible that stresses in credit markets create a wave of defaults and liquidity issues that cascade across investment markets.

Provided the virus is transitory - perhaps contained in the second quarter - the global economy should be poised to rebound in the second half of 2020. The combination of monetary and fiscal stimulus on top of last year's global central-bank easing, in addition to the reduction in China-U.S. trade tensions, argues for a solid recovery when the virus threat recedes.

In Australia, the COVID-19 threat will likely accelerate the nation's slowing housing market and slipping consumer confidence. The Reserve Bank of Australia is likely to follow up its 25-basis-point cut in early March, with another similar-sized cut that will take the cash rate to 0.25%. The bank will then probably consider using unconventional policy, such as quantitative easing, for the first time.

In the U.S., the government's virus containment measures mean a technical recession - negative GDP growth in Q1 and Q2 - seems likely. Fiscal policy will be important in helping to offset the recession. The upcoming federal elections in November, however, complicate the political calculus around a bipartisan agreement on a stimulus package. In addition, the economic turmoil caused by COVID-19 means Democratic frontrunner Joe Biden may have a better chance of beating U.S. President Donald Trump in the November election, if he becomes the Democratic party's presidential nominee. A Biden-versus-Trump election would likely be neutral for markets.



We believe that the eurozone is likely to experience a deeper recession than the U.S., but should also experience a bigger economic bounce when the virus subsides. We think the region will be one of the main beneficiaries of the rebound in global trade. We currently see eurozone equities as very attractively valued and we believe the European stock market could be one of the best performers in a recovery.

In the UK, the COVID-19 declines have taken the FTSE 100 Index into exceptional value territory. It has a trailing price-to-earnings ratio of under 10 times, and a dividend yield pushing toward 7%.¹ We believe the UK economy has two main advantages over Europe. First, the Bank of England has been able to cut interest rates by 50 basis points, with the potential for a further reduction of 25 basis points before it reaches the zero-lower bound. Second, the nation has the ability to quickly implement fiscal easing.

In China, where the number of COVID-19 cases is on the decline, high-frequency trackers of daily economic activity show that economic activity is resuming. We also believe that government stimulus is coming. Local provinces have already announced infrastructure projects, and the People's Bank of China has cut interest rates and the reserve ratio requirement several times.

In Japan, the COVID-19 disruption has almost certainly pushed the nation's economy into recession, but stimulus measures are underway. Although the Bank of Japan has limited firepower, it has increased its purchases of government bonds, corporate bonds and equities via exchange-traded funds.

In Canada, the twin shocks of the COVID-19 outbreak and the collapse in oil prices have complicated what was already a lacklustre economic outlook. Economic growth is now at risk of falling below the 1.0% lower-end of our forecast range.

Economic indicators



CONSUMER & BUSINESS CONFIDENCE

The economic impact of the virus may turn out larger than expected. The shock to consumer and business confidence could generate a self-sustaining economic downturn.



FINANCIAL INDUSTRY

A re-run of the 2008 financial crisis seems unlikely. Tier 1 capital ratios² for large U.S. banks are significantly improved from 2007, and should cushion against the risk of a severe drawdown. Bank mortgage lending has also been prudent, and consumer balance sheets are reasonably healthy.



PANDEMIC IMPACT

The main uncertainties are around the duration of the virus threat and whether it will re-escalate when the extreme containment measures in many countries are relaxed. It's likely that markets will find a bottom when the daily number of new virus cases in Europe and the U.S. begins to decline.



CENTRAL BANKS

Central banks have limited firepower compared to previous recessions. The U.S. Federal Reserve and the Bank of England are close to the zero-lower bound. The Bank of Japan and the European Central Bank are already there.

Asset class views

Equities: Improved value

We believe equity value has improved after the large market falls. The cycle outlook is supported by the substantial amount of stimulus being implemented, even though our near-term outlook is for recession. The message from our composite sentiment indicator is that investors have panicked and herded into a pessimistic outlook, which supports taking a contrarian view. The equity markets that have been hardest hit by the COVID-19 crisis should be those that benefit the most from the eventual rebound.

Fixed income: High-yield credit attractively priced

We believe high-yield credit is now very attractively priced after selling off as a result of the COVID-19 shock and oil price collapse. The spread to U.S. Treasuries on March 19 was close to 900 basis points. This historically has been a good entry point into high-yield exposure, although there is obviously considerable uncertainty in the market and liquidity risk that investors will need to consider in deciding whether to take advantage. We see government bonds as universally expensive. They may rally further if the COVID-19 crisis escalates further, but are at risk of underperforming once the post-virus recovery is underway.

Currencies: Safe-haven rally in U.S. dollar should unwind once post-virus recovery phase begins

This would likely favour currencies such as the Australian dollar, New Zealand dollar, Canadian dollar and British pound, which have depreciated significantly and at quarter's end are significantly undervalued, relative to long-term purchasing power parity comparisons.

¹ Source: Refinitiv Datastream, as of March 15, 2020.

² Tier 1 capital is the core measure of a bank's financial strength from a regulator's point of view. It is composed of core capital, which consists primarily of common stock and disclosed reserves, but may also include non-redeemable non-cumulative preferred stock.



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IMPORTANT INFORMATION

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