Where do we go from here?

A consideration of past equity market downturns

May 19, 2020

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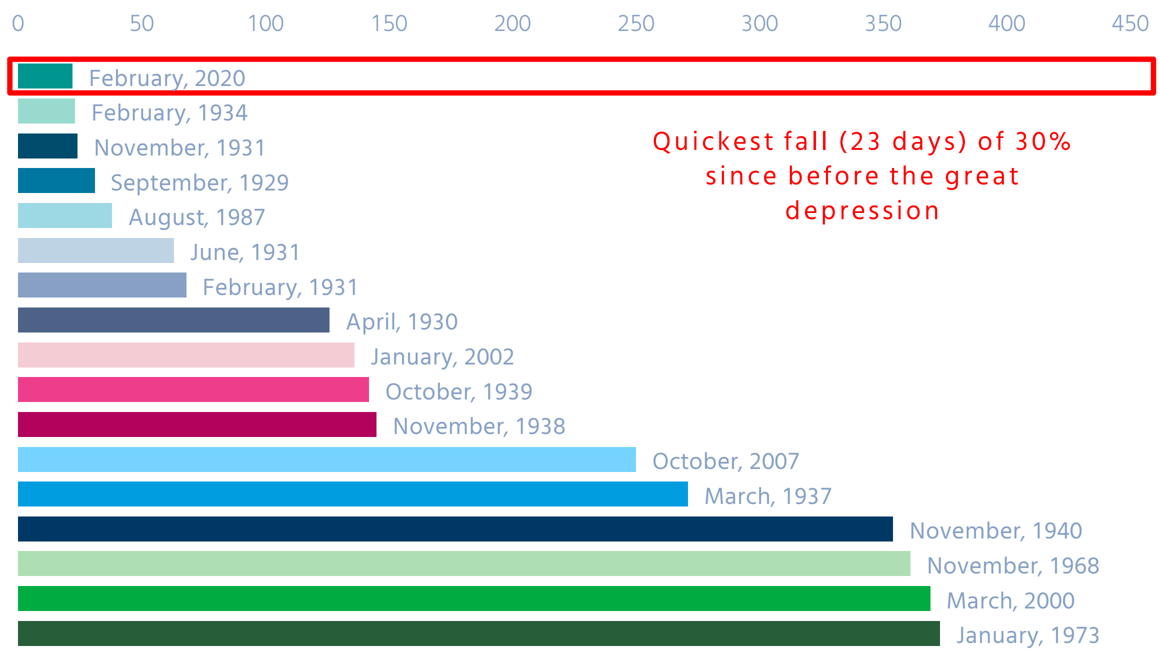
Introduction

The first half of 2020 has seen the rapid international spread of a newly discovered highly infectious disease, coronavirus (COVID-19). By the end of April, the number of confirmed cases surpassed 3,000,000 globally. This has led to large parts of the world economy halting in a bid to minimize casualties, and to avoid the collapse of healthcare systems. Initially, global equity markets were slow to respond to the risk. However, once they did, we witnessed the fastest-falling equity market of the last century.

Figure 1: Number of trading days for S&P 500 to fall 30%

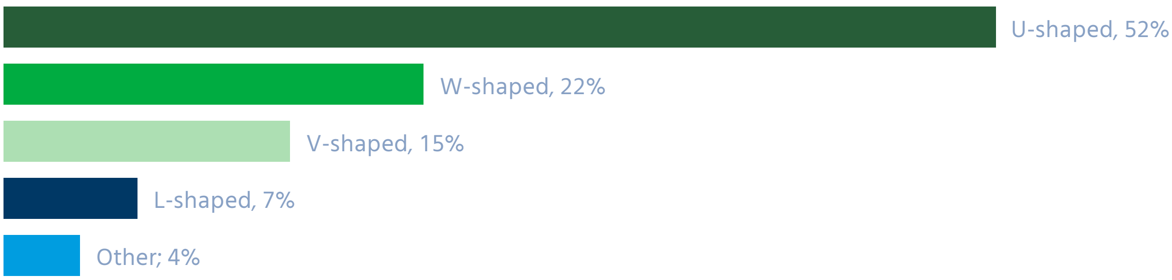


Source: BofA Global Research, Bloomberg. Months shown are when pre-crash peak occurred. S&P 500 used as proxy for market.

Since then, however, markets have recovered a significant amount of loss. This suggests optimism that the vast and various monetary and fiscal policy support offered across the world will be enough to stave off serious negative long-term economic consequences. Humankind has recovered from many adversities when standards of living were much lower and technology less advanced or non-existent — medieval plagues, civil wars, and the world wars being a few examples. This expectation of combatting COVID-19 and stimulating growth is thus in part due to the resilience the global economy —and corporations —have shown to challenges throughout recent history.

Mercer, along with many others, believes that we will ultimately see a recovery and resumption of economic activity. However, the shape of that economic recovery remains unknown. The general optimism of an immediate return to strong growth following an extremely poor period is clear in Figure 2 — although more than one in five expect further falls (W-shaped), and only 15% expect the most optimistic V-shaped recovery.

Figure 2: What shape do you expect the recovery (out of recession) to be?



Source: BofA Global Fund Manager survey, April 2020. This is a monthly report that canvasses the views of approximately 200 institutional, mutual and hedge fund managers around the world.

The expectations that investors form in relation to the recovery will shape the reaction in equity markets. As a result, it is important to understand the factors that might affect the shape of the recovery and the length of time it might take equity prices to reach new stable highs in the future.

Every downturn is different

A short, event-driven economic shock can turn into a longer structural decline if expectations and engrained consumer/business behavior (“animal spirits”[1]) turn negative enough. Ultimately, lower confidence results in reduced spending and investment, making recovery a lengthier process.

One challenge in assessing how COVID-19 might play out is the lack of precedent. There have been pandemics in the past, but each occurred in a different way, at a different time, in different locations, with different responses.

All figures in USD dollars.

[1] The phrase used by John Maynard Keynes to describe waves of optimism and pessimism that can drive or hinder economic growth. He famously said that markets are moved by “animal spirits, and not by reason.”

- In terms of some limited voluntary social distancing measures, the closest comparator to the current outbreak is the "Spanish flu" of 1919, even though asset markets were largely unaffected. However, at that time, the world was recovering from a brutal world war, where markets had already fallen by almost half since 1911, so the market impact was small.

- The 1957 Asian flu and 1969 "Hong Kong" flu are also comparable, and, with a global death toll of over a million for each, could yet remain much worse than COVID-19 in terms of fatalities. That said, today the world's markets, media and supply chains are more sophisticated and interconnected, making a comparison challenging.

- The HIV/AIDS pandemic did not necessitate a shutdown, while SARS, Ebola, and MERS were, thankfully, limited in virulence or by region.

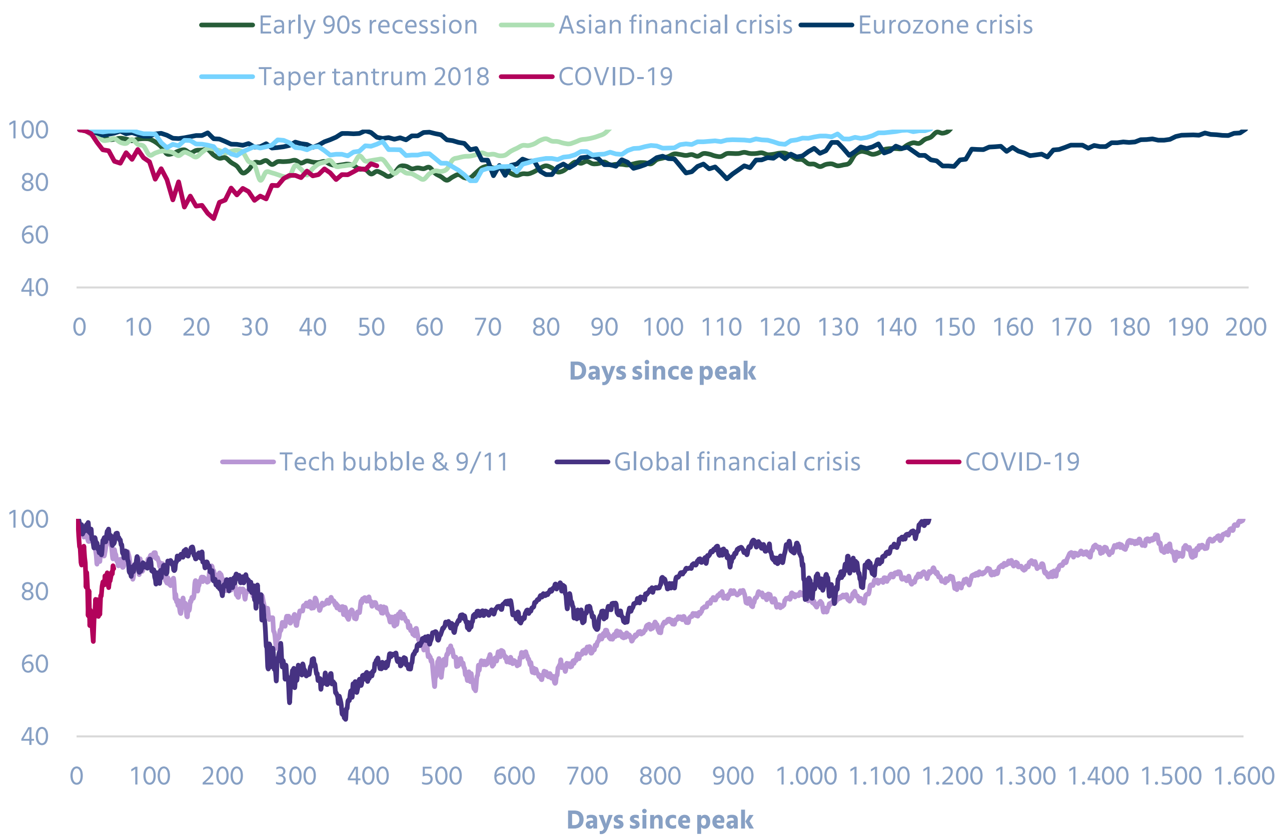
While COVID-19 has little precedent, market downturns do. Every market shock has a unique origin and evolution, but the same reason for falls (fear) and recovery (greed), so comparing recent (last 30 years) downturns may be informative.

Figure 3: COVID-19 vs previous downturns – statistics (S&P 500: 1990–2020)

Event	Peak date	Cause	Peak to trough	Max down	Recovery
Coronavirus	February 2020	Coronavirus	?	-33.8%	?
Taper tantrum 2.0	September 2018	Federal Reserve tightening — "perceived policy mistake"	95 days	-19.4%	109 Days
Euro sovereign crisis	April 2011	Risk of collapse of euro area	157 days	-18.6%	123 Days
Global financial crisis	October 2007	Risk of global financial failure	517 days	-55.3%	1,117 Days
Dotcom bubble & 9/11	September 2000	Tech bubble & middle eastern instability	768 days	-47.4%	1,475 Days
Asian financial crisis	July 1998	Investors dumping overleveraged Asian companies and overvalued currencies	45 days	-19.2%	84 Days
Early 90s recession	July 1990	Middle East instability, oil price spike	87 days	-19.2%	123 Days

Source: S&P 500 Total Return Index. Thomson Reuters Datastream. Days are calendar days. Recovery is the length of time for total return index to return to previous peak.

Figure 4: COVID-19 vs previous downturns – time series (S&P 500: 1990–2020)



Source: S&P 500 Total Return Index. Thomson Reuters Datastream. Days are calendar days. Recovery is the length of time for total return index to return to previous peak.

The speed of decline is again noticeable. Why did markets discount stocks so heavily, given that stock prices reflect an estimated earnings stream over a significant timeline, not just the next quarter or the next year?

- **Market ecosystem**. While participants should act together to allow market prices to reflect relevant data, markets are more chaotic in reality. Liquidity in general is important: if an asset price is lower than its expected return, it could be because no one has the cash to buy it.

- **Fragile firms**. Few companies maintained cash reserves to cover a macroeconomic event risk such as a pandemic, and few had insurance. For these companies, two quarters of lost earnings could mean that without sufficient government or central bank support, they will have to wind up. Such occurrences would make a recovery more complex.

- **"Fair weather" prices.** Prior to the pandemic, equity markets were pricing a lot of fair weather on the horizon. Years of monetary stimulus, low inflation and interest rates had engrained expectations of these "goldilocks" conditions continuing, making any negative deviation potentially shocking.

- **Immeasurable risk.** COVID-19 took markets completely by surprise, despite a pandemic being cited as one of the largest existential risks to world economies over a number of years in the Global Risks Report.[2] The prospect of the global economy shutting down has brought a huge amount of uncertainty, as investors tried to assess what the damage might be.

- **Policy support.** Investors have questioned what the most effective monetary support policy might be able to offer should a market shock occur, given interest rates had never returned to "normality" following the global financial crisis (GFC).

The final bullet offers reasons that may explain the recovery in asset prices since the mid-March lows. A large part is investor positivity that the "whatever it takes" attitude of central banks and governments to support parts of the economy affected by COVID-19 will be effective. The markets received positively the announcement of unlimited monetary support (colloquially named "QE infinity") by the Federal Reserve and ECB, among others, which allowed government debt creation while keeping sovereign and corporate interest rates low. Most economies have seen strong combined commitments of support issued in the form of both unorthodox monetary and fiscal policy.[3] A number of technical reasons (short closing, rebalancing) may also partly explain the recovery.

As a reminder of what can happen in challenging times, during both the tech bubble and the GFC, the S&P 500 saw declines followed by rises (as shown in the tables below), reminding us that markets "rarely rally in a straight line".

Tech bubble	
September 1, 2000 – April 4, 2001	-27%
April 4, 2001 – May 21, 2001	+19%
May 21, 2001 – September 21, 2001	-26%
September 21, 2001 – March 19, 2002	+22%
March 19, 2002 – October 9, 2002	-33%

Global financial crisis	
October 9, 2007 – March 10, 2008	-18%
March 10, 2008 – May 19, 2008	+12%
May 19, 2008 – November 20, 2008	-47%
November 20, 2008 – January 6, 2009	+25%
January 6, 2009 – March 9, 2009	-27%

Source: Howard Marks, "Calibrating" memo, April 6, 2020

[2] https://www.weforum.org/reports/the-global-risks-report-2020, published January 15, 2020

[3] For example, the Federal Reserve has announced further programs of bond buying in both sovereigns and corporates, including recently downgraded issues that are technically high yield now. The US government also committed to a payment of $1,200 to all adults in the country during the lockdown.

While the February 2020 drawdown was large, it was small in comparison to the falls post-GFC and the tech bubble. Given where valuations started, and the levels they have returned to, there is always the chance of further stock market falls. This is particularly likely if a second wave of COVID-19 infections occurs, or if reinfections occur, making immunity — and therefore a successful vaccine — more difficult to achieve. Moreover, the damage to the global economy would be more widespread and the ensuing recovery period even longer.

What are the possible paths from here?

In short? It depends. Stock market positivity remains out of sync with the real economy, where it is becoming clear that the announced monetary and fiscal programs will not be enough to stave off one of the largest falls in economic activity ever seen.[4] The S&P 500 has seen predicted Q1 2020 year-on-year earnings growth of 4.3% (at December 31, 2019) turn to actual earnings growth of -13.7% as at May 1, 2020[5], and the number of new jobless claims in the US since mid-March has already surpassed the number of jobs created since the depth of the global financial crisis[6]. Indeed, the beginning of May also saw some volatility return, as COVID-19 related tensions flared between the US and China, amid ongoing poor economic statistics.

Stocks will rise or fall as it becomes clearer what scenario will play out. This is why in most recessions a stock market recovery happens in advance of an economic recovery. Our internal base case is below, presented against what we term an "upside" and "lingering recession" scenarios:

Upside
1. Virus quickly contained.
2. Global economy recovers sharply post-virus driven by stimulus packages.
3. Initial discussions on winding back stimulus (particularly QE) before year-end and interest rates begin to normalize as inflation picks up.

[4] It is hard to predict how large these programs will need to be before knowing the true spread of COVID-19, or how badly hit businesses and consumers are. The low availability of proper testing in many countries is also severely impairing assessment.

[5] From 55% of companies that had reported by 1 May 2020. Factset Earnings Insight

[6] US Department of Labor Statistics

Base case	
1.	Virus largely contained.
2.	Economy suffers sharp fall, but further stimulus leads to GDP recovery to 90% capacity by the end of 2020, and 100% of 2019 levels by the end of 2021.
3.	Global growth recovers to pre-virus expectations, but there is ongoing concern related to debt levels and enhanced event driven volatility.
Lingering recession	
1.	Virus not contained or mutates[7] and concerns linger into Q3, particularly in Europe, the UK and US
2.	Global growth sluggish, with early signs of economic recovery in late 2020.
3.	Economy recovers up to 60% capacity by year-end.
4.	Stimulus constrained due to debt levels.

So, what should investors do?

There are steps investors can take to ensure their portfolios remains as robust as possible, including ensuring portfolio allocations that have moved far from pre-defined strategic allocations be rebalanced.[8] Given the implicit costs in rebalancing, particularly with volatility still high, we believe investors should try to rebalance at least 50% back toward benchmark, in liquid asset classes.[9]

Risk appetite and scenario testing inform opportunistic investor decisions. For investors looking to reposition a growth allocation, Mercer sees an investment opportunity in the high yield and investment-grade credit space, where spreads have widened.[10]

Mercer's Q2 2020 global dynamic asset allocation report noted a repositioning from cash to growth fixed income (in particular high yield, where we believe valuation levels are compensating enough for the apparent risks). Due to the large potential volatility in the outlook for earnings (a key driver of equity performance), we remain neutral on equities, not seeing a clear risk-adjusted attraction to recommend being overweight.

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[7] While "successful" mutations typically tend to reduce lethality, if we are unlucky, a mutation could happen that makes the virus both more transmissible and ultimately lethal at the same time. We have already seen three lineages of the virus emerge.

[8] Regardless of market risk, this action will reduce the risk that you severely underperform your benchmark allocation by being underweight equities when markets recover.

[9] https://www.mercer.ca/content/dam/mercer/attachments/north-america/canada/ca-2020-rebalancing-in-troubled-markets.pdf

[10] https://www.mercer.ca/content/dam/mercer/attachments/north-america/canada/ca-2020-investments-time-to-buy-high-yield-debt.pdf

However, there are always risks to investing at the start of an equity or credit downturn. Regardless of expectations, stock market volatility is still high, and liquidity remains lower, meaning that further negative shocks might occur. The steep fall in February 2020 and comparisons with the path of previous recovery periods serve as a reminder of this. Investors should be mindful that we may see further mark-to-market losses (as we have shown in our analysis), but the significance of these will be naturally reduced over longer investing horizons.

While we ask investors to remain aware of the potential negative risks from here, our base case continues to be cautiously optimistic. The road to recovery seems long, but with some countries beginning to reduce lockdown following periods of plateauing or falling deaths, and countries undertaking historic levels of monetary and fiscal policy support, we see reason to be hopeful.

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