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Coronavirus outbreak update

Investment implications

March 18, 2020

Introduction

COVID-19 has continued to spread at a rapid pace around the world and has now been declared a global pandemic by the World Health Organization. This will cause a severe shock to the global economy, pushing it and most economies into a deep recession. Financial markets have responded with huge falls in equities, a rise in credit spreads and a flight to the safety of government bonds. Central banks have responded by cutting interest rates and providing liquidity to the financial system, while governments have announced unprecedented measures to support businesses. Governments and central banks have made broad statements, indicating they will do whatever is necessary to support the economy over the next few months.

The economic shock

Governments have taken a number of steps to contain the outbreak, such as canceling sporting and other large events and in some cases shutting down all non-essential activities. An increasing number of countries have also closed or restricted arrivals from other countries. Individual behavior has also changed with people going out and traveling less, while businesses have encouraged staff to work from home where that is possible. These measures have been extended widely across the world.

For some businesses, such as airlines, the impact has been catastrophic, while tourism, entertainment and a number of other sectors will see a sharp decline in revenue. Business and consumer confidence is also likely to fall sharply, leading to less spending and investment across a broad range of activities.

Adding to the challenges facing the global economy and financial markets has been the collapse in the oil price to below $30 per barrel. Demand for oil has obviously fallen, but it was the inability of Russia and Saudi Arabia to agree to production cuts that led to a collapse in the oil price. While this fall is positive for energy consumers, it raises concerns about the viability of energy producers.

Economic growth forecasts for the first half of 2020 have been cut sharply everywhere, with these forecasts acknowledged to be little better than educated guesses. The low point for most economies will likely come in April, May and June although in Asia and especially China the peak impact will be somewhat earlier. A severe short recession is most forecasters' best guess.

Most forecasters assume a sharp recovery in the second half of the year as the virus is contained and activity returns to normal, bolstered by ongoing support from governments and central banks. Many point to China, which was where the virus first emerged and where it now appears largely contained. Chinese economic activity collapsed in February as the government put the country into lockdown. However, with new domestically generated cases falling to about 10-30 per day, these restrictions have loosened and some expect activity to return to something approaching normal by the end of March.

Forecasters hope that other countries will see a V-shaped trajectory of a sharp fall followed by a modest recovery. While we expect a return to normality at some point, we fear it may be slow and uneven as some industry sectors recover more quickly than others.

The policy response

After some initial inertia in some countries, policy makers have responded aggressively to support the economy and markets. More stimulative measures are likely, both to boost government spending and support the provision of liquidity to affected sectors. Central banks have cut interest rates and governments have announced increased spending, and have pledged to support banks and businesses by supplying credit. Small and midsize businesses are especially vulnerable, while airlines are facing an unprecedented shock. Governments and businesses in most countries are in urgent discussions across multiple sectors regarding if and how governments can lend support.

As part of the massive economic stimulus package, the US administration is now pledging to send direct cash payments to citizens to help contain the economic fallout.

The goal of policy makers is twofold:

- First, to provide businesses and consumers a financial bridge to see them through the next few months so they are able to stabilize the economy until the recovery becomes self-sustaining.
- Second, to ensure the financial system remains functional and that the economic, public health and confidence shocks don’t turn into a financial crisis as well. Central banks are aware that lower interest rates will not suddenly get people spending if the virus is not under control. However, the cuts may support financial markets and give investors hope that when the recovery comes, it will be robust.

What could go wrong?

In the near term, many foresee two key risks to the V-shaped recovery that some have as their central expectation. The first is that the virus is not contained over the next few months and the economic disruption continues longer than expected. It is difficult to know how likely this is.

The second is that policy makers will be unable to stabilize the financial markets and the banking sector. When combined with the economic pressure from the virus, this could lead to a wave of bankruptcies and much higher unemployment. We note that banks are generally well capitalized, and governments will aim to do whatever it takes to protect the corporate sector. With interest rates very low, governments will borrow much larger amounts of money if they have to. Despite these interventions, much will depend on how long economic activity is severely curtailed.

Another concern is fiscal pressure on highly indebted countries that are heavily affected by the pandemic, such as Italy. Its debt to GDP is among the highest in the world and Italian spreads over German bunds have risen 100 basis points over the past month. In contrast to the European debt crisis of 2009, forecasts expect that there will be less resistance from other euro-zone countries in terms of loosened borrowing restrictions or further debt monetization by the European Central Bank.

What could go right?

We have seen China, South Korea and some other Asian countries bring the spread of the virus under control and thus allow a degree of economic normality. Signs that the measures in Italy, for example, were working would engender hope that other countries would be able to contain the virus as well. There is also a possibility that treatments, vaccines and the large-scale production of home testing kits will bring the virus under control in the not too distant future. Scientists, pharmaceutical companies and governments are spending huge amounts of money developing these. The onset of spring weather in the Northern Hemisphere may also alleviate seasonal demand on healthcare systems, making it easier to fully concentrate on COVID-19 patients while people’s immune systems are also stronger, given greater exposure to sunlight by being outdoors.

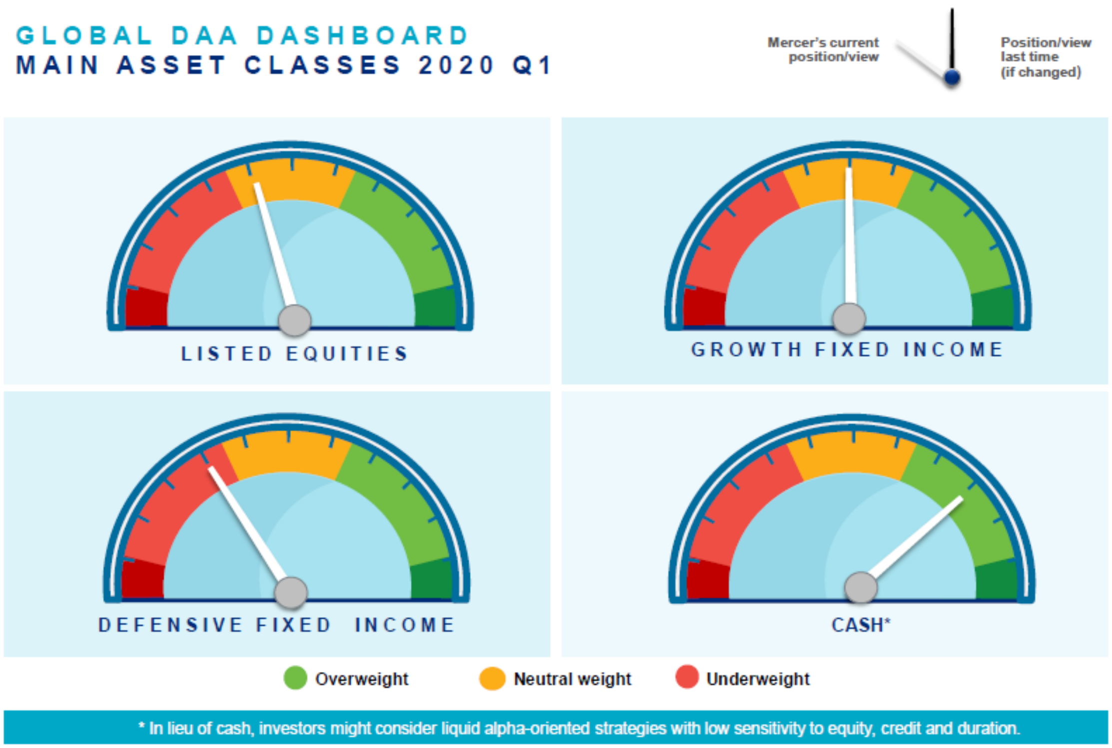
Mercer's dynamic asset allocation view

The economic outlook has deteriorated significantly in recent days and weeks, and a deep recession in most parts of the world is likely. How deep and when the recovery will come are uncertain at this point and will largely depend on when the pandemic is brought under control.

On a positive note, governments and central banks will attempt to do whatever it takes to provide businesses and consumers with a bridge to the other side of the pandemic, so that both can take part in and contribute to a strong recovery. Whether these efforts succeed and how quickly the pandemic is brought under control will largely determine the path for financial markets.

We continue to monitor the situation, but at present, we do not have any strong views on the timing of any recovery, or even when this current volatile environment will end. We therefore remain neutral on risk markets in general, with a preference to hold cash, or cash-like investments, relative to defensive assets, as we deem traditional safe havens such as government bonds to be extremely richly valued at present. Our current global dynamic asset allocation dials are in the appendix.

Appendix



GLOBAL DAA DASHBOARD
MAIN ASSET CLASSES 2020 Q1
Mercer's current position/view
Position/view last time (if changed)
LISTED EQUITIES
GROWTH FIXED INCOME
DEFENSIVE FIXED INCOME
CASH*
Overweight
Neutral weight
Underweight
* In lieu of cash, investors might consider liquid alpha-oriented strategies with low sensitivity to equity, credit and duration.

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