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Mid-year outlook: markets could rise more despite the recession

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The financial markets reacted to the coronavirus with an unprecedented first-quarter drop, then turned around quickly. This appetite for risk in the face of the deepest recession since the 1930s is quite unusual, but the markets are being driven by optimism about potential economic improvement down the road – so we can't exclude a further rise in equity prices.

For the market rebound to have staying power, four uncertainties must be addressed

During the first quarter of this year, the coronavirus caused the financial markets to drop faster than the average of all 11 bear markets since 1946. But despite unsettling economic fundamentals related to the pandemic, this bear market suddenly turned around far more quickly than its historical counterparts (see chart on next page). Investors seemed reassured by news of a possible peak in coronavirus infections and related deaths, by the prospect of vaccines and therapies, and by massive amounts of fiscal and monetary-policy stimulus.

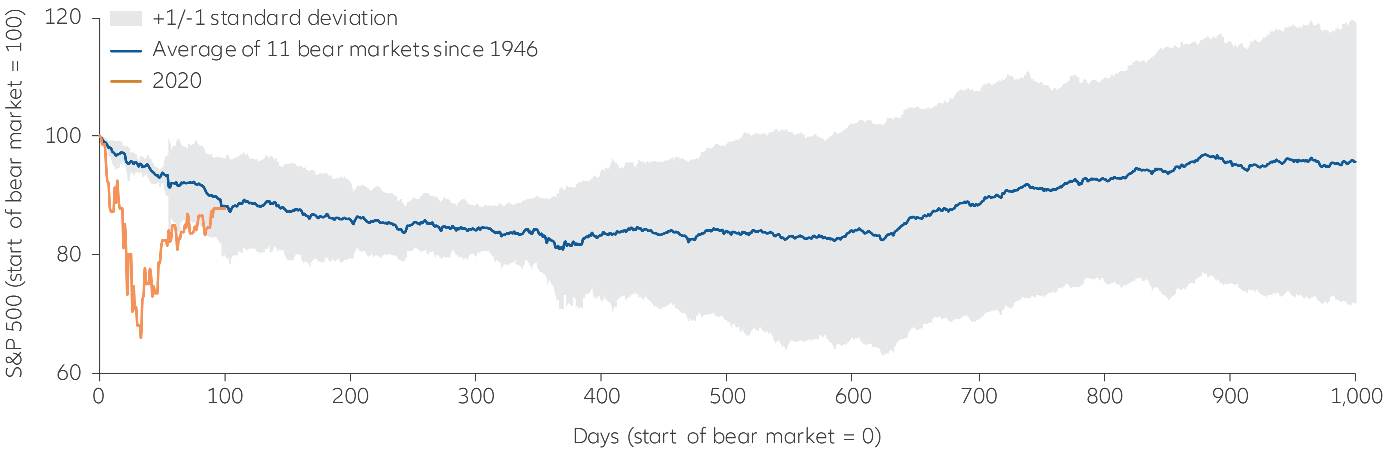
This market rebound occurred even as the economic picture deteriorated, highlighting the disconnect between market performance and the wider economic outlook. The question is: will this bounce last? While this recovery in equity prices is fragile, we think it may continue as long as investors embrace a better growth outlook on the back of massive monetary and fiscal stimulus, and they continue to see evidence that infection rates are past their peak. But the rally in equities would be on a much sounder footing if we were to see improvement in at least some of the following four areas.

Key takeaways

- Despite the market's confidence in a quick rebound from the recession, we think investors should be cautious and maintain a neutral allocation in the medium term – while remaining ready to take advantage of select opportunities
- We expect bond yields to remain low given the tremendous monetary-policy support from central banks, which represents a "reloading" of the financial repression policies triggered in response to the global financial crisis and subsequent European debt crisis
- We are neutral to positive on the credit sector overall, as continuing central bank intervention will likely provide substantial support for this sector
- Over the long term, we prefer equities over low-yielding bonds for investors in search of returns, even though investors seeking a "safe haven" have pushed up equity valuations in the US; valuations are more moderate in Europe and Asia
- Growth stocks – particularly the tech sector – may benefit from the fact that growth is scarce in this current recession, and from the greater demands being placed on the digital world in times of Covid-19

The coronavirus bear market fell farther – and has so far recovered faster – than the average bear market

(Current bear market vs average of all bear markets from 1946-2009)



Source: Bloomberg. Data as at 29 May 2020. Bear markets defined as periods in which S&P Index 500 falls by at least 20%.

1 The world must make more progress in fighting the virus

The battle against the coronavirus is first and foremost a humanitarian crisis, and second an economic one. But there is clearly a link between the health of populations and their economies, and investors will therefore be watching closely for signs of success in the ongoing struggle. Lockdowns and social distancing are currently the most effective tools in the global arsenal, but as the threat from the virus recedes and people dare to venture outside, the outlook for the economy should improve.

What the world needs most are effective treatments and, ultimately, vaccines. Some progress has been made on this front, and the markets have reacted well whenever there is positive news, but it may be a year or more until treatments and vaccines and mass-produced antibody tests are widely available. Until then, testing and contact tracing can limit the virus's spread and help people return to work, so the markets will likely continue to cheer positive headlines about these areas. Still, the coronavirus will be a major risk factor for the foreseeable future, and investors should be prepared for continued market volatility.

2 Economic data need to rebound – which requires a robust private sector

Around the world, economies have initially reacted positively when lockdowns are ready to be eased. But the private sector is the key: it must enjoy a robust recovery if there is to be long-term growth. Fiscal support from governments and monetary support from central banks can only do so much – mainly providing enough liquidity to the private sector to spark initial activity. But that's very different from sustained growth. We'll be able to see proof of this when we see lasting improvement in cyclical data – such as PMI (purchasing managers' index) numbers, employment, housing, consumer and small-business confidence, and ultimately GDP. While some of these data are showing the first signs of improvement, the level of activity remains – so far at least – significantly below normal.

3 The risk of financial contagion must be contained

The overall amount of global debt – including US dollar-denominated debts held outside the US – was at record levels before the coronavirus, and it has increased further since then. We expect global leverage to rise from almost 300% of GDP at the end of 2019 to around 320% by the end of this year. Government debt in developed markets, in particular, is at post-second world war highs, and this situation will need to be addressed in the coming years.

But we are also concerned about debt in the private sector. Companies have added more debt to their balance sheets as they secured liquidity lines offered by central banks and governments. If the economic recovery is only gradual, today's liquidity problems may become tomorrow's solvency issues. The non-bank financials (including insurance companies, pension funds, ETFs and hedge funds) are a particular source of concern. They have used the credit market to grow and have gained share in the credit markets from banks. But the banks are now much more stable because of tighter regulation following the financial crisis, whereas these non-bank institutions don't get direct access to central-bank funding and we know little about how they respond in times of stress. This helps explain why spreads (excess yields of "risky" bonds over "safe" bonds) and other indicators of financial stress rose at the beginning of the coronavirus crisis.

The decision by central banks to offer liquidity to the private sector – notably via purchases of investment-grade bonds and "fallen angels" (investment-grade companies that have been downgraded) – has caused spreads to tighten again. However, the post-financial crisis experience tells us that it is ultimately the medium-term growth outlook that will determine the direction of spreads. Purchases by price-insensitive central banks can only help so much.

4 Valuations need to be more attractive in some markets

Valuations are helpful in gauging the long-term risk-reward ratio for the markets overall, but they don't predict the market's direction in the short term. Still, we find US equity valuations to be quite high in a historical context, with cyclically adjusted price-to-earnings (CAPE) ratios near 27 in May. (By comparison, the US CAPE ratio was 12 in early 2009, and the 50-year average is 20.) Massive monetary and fiscal stimulus measures – and the expectations of a swift economic recovery – largely explain this expansion in earnings multiples. Moreover, the US stock market, in particular, has benefited from the fact that it has a higher exposure to technology and healthcare stocks, which are perceived to be the long-term beneficiaries of the coronavirus crisis.

Equity markets in Europe and Asia are moderately priced, but not at rock-bottom levels either. Stocks overall are trading at higher multiples than they were in the wake of the financial crisis, even though today's recession looks like it will be much deeper (though it may ultimately be shorter). In the fixed-income markets, yields are still low and bonds are not cheap, so investors will need to continue to broaden their horizons in the hunt for income.

What should investors do next?

So far this year, the financial markets have shown surprising confidence that the economy would rebound from the virus-triggered recession. Based on all the evidence we have presented, investors should be cautious while remaining ready to take advantage of opportunities. Here are the key ideas investors should keep in mind for the rest of the year.

Amid continued low bond yields, keep up the hunt for income

- We expect bond yields to remain low given central banks' tremendous support so far and their commitment to do more if necessary. This is "financial repression reloaded" – a continuation of the policies implemented a decade ago (including low interest rates and increased regulations) to help countries grow their way out of debt.
- Monetary and fiscal support may generate higher inflation in the medium to long run, but we don't expect inflation to be a major factor in the pricing of nominal bonds. Still, we are finding value in some inflation-linked bonds.
- We are neutral to positive on the credit sector overall. While valuations are not overly attractive and global indebtedness is at record levels, central banks are price-insensitive buyers, and they will continue to directly intervene in investment-grade bonds and, to some extent, high-yield bonds. This will likely provide substantial support for this sector.
- "Fallen angels," in particular, could be attractive in this environment. Convertible bonds are also interesting, since they have historically performed well in times of volatility and offer potential upside from their equity-like characteristics.

Consider growth stocks for the long haul, while staying cautious on equities in the short term

- Given the impending recession and widespread uncertainty, we think investors should still be somewhat cautious about equities in the short term, at least for now. We recommend a neutral position in equities at this time. We would be ready to change our view and become more constructive when some of the four factors mentioned above – including positive news about containing the virus and robust private-sector growth – show progress. On the other side, we might suggest less exposure to equities if the growth expectations anticipated by the markets turn out to be too optimistic, or if we see signs of a second wave of the virus.
- Despite our short-term caution, we have a clear preference for equities over bonds for investors with a long-term investment horizon – particularly given that many real (after-inflation) bond yields are negative.
- Among equities, we still prefer growth stocks at this time – notably those in the tech sector – in part because growth stocks have historically done well in times when growth is scarce. In addition, the coronavirus crisis has shown that there is a structural demand to further build out the digital world. Over the longer term, investors should also consider balancing tech holdings with healthcare and cyclicals. As progress is made towards re-opening and stabilising the global economy, markets may favour areas like pharmaceuticals, biotechnology, and even parts of energy, financials and industrials. These areas may offer compelling risk-reward opportunities.
- Emerging-market equities could also be an attractive source of growth potential for long-term investors. China A-shares (companies listed on stock exchanges in Shanghai or Shenzhen) are one such example. These securities give foreign investors a direct way to participate in China's long-term growth story – which we believe is still compelling despite US-China tensions.

Use sustainability as a lens to spot weaknesses and strengths

- The coronavirus pandemic has exposed shared vulnerabilities in our economies and the systems on which we all rely. Amid so much interconnectivity, investors will increasingly need to be selective among sectors and individual names, rather than rely on broad market performance. Environmental, social and governance (ESG) factors can be a helpful lens for highlighting major global risks and test the resilience of businesses and systems. Look for partners with experience conducting in-depth research into sustainability issues and engaging with management teams to improve practices.
- Corporate governance will be critical as the private sector navigates a deep recession. We expect more attention to be paid to how companies allocate capital overall – particularly on share buybacks and dividends. But these practices need to be addressed on a case-by-case basis, since retail investors and pension savers also benefit from higher stock prices and dividend payments. We also expect to see growing interest in aligning the performance and remuneration of management with the interests of all the companies' stakeholders.
- The coronavirus will likely result in people demanding sound healthcare systems and better access to high-quality care, which could have positive implications for the healthcare sector. And over the long term, we expect to see a trend towards simpler, more "local" supply chains that are easier for firms to control.

Stay active to help distinguish winners from losers in this environment

– Financial markets during times of crisis lend themselves better to active strategies, in our view, and this pandemic is no exception. Active investing can help add a layer of risk management to portfolios by seeking to mitigate declines when markets fall, and aiming for the most attractive opportunities when markets rise.
– Markets today are being driven by sector-specific performance rather than the broad market returns (beta) that passive investors relied on in recent years. There will certainly be winners and losers during this crisis, even within sectors, and the divergences could be quite pronounced. Some companies may not survive. Passive and index investments – which can be useful in certain environments – could expose investors to potential underperformers or even defaults.