Looking Beyond – Will We See a 'V' or 'U'-shaped Recovery?

April 2020

FULLERTON FUND MANAGEMENT

Executive summary

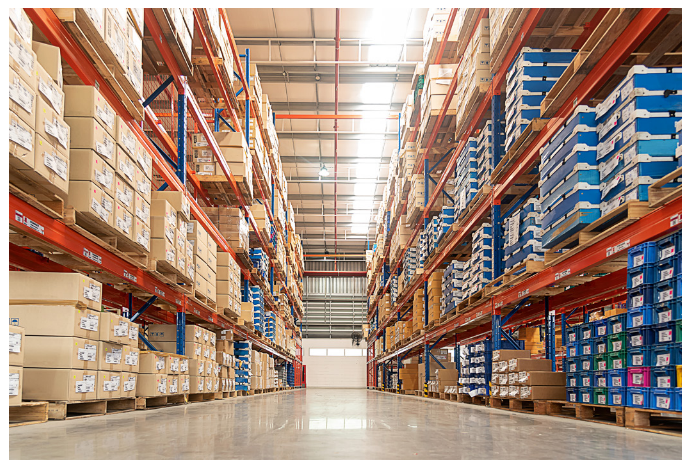
- The economic impact of the COVID-19 pandemic is likely to be more painful than the global financial crisis (GFC) from 2008-2009, and we will see a global recession.
- In the first scenario, if key countries, especially the US and Europe can contain their COVID-19 epidemics as successfully as China and South Korea have, then combined with the strong policy stimulus already launched, the global recession could be of a shorter duration than the GFC. A 'V'-shaped recovery could potentially unfold in 3Q 2020 or 4Q 2020.
- In the alternative scenario, the costs of containing COVID-19 are so great and an adverse spiral unfolds from very high unemployment rates, a sustained collapse in spending, a painful rise in corporate defaults and a credit crunch (especially in the US). These would result in a more prolonged recession, with a 'U'-shaped rebound happening some time next year.
- We are monitoring key signposts to determine which recession scenario is unfolding, assessing strategies for when to take more risk, and what assets to buy.
- Amidst the uncertainty, investors need to continue to protect portfolios from further potential downside risks and wait for appropriate opportunities to dial up risk in their portfolios.

China to lead recovery from global recession

Since our 1Q 2020 Fullerton Investment View was last published, governments in many parts of the world have put in place stringent lockdown measures to combat the spread of the COVID-19 pandemic, which has depressed global manufacturing, business investment, and consumer spending.

Global trade is falling, unemployment rates have surged, and the uneven containment of COVID-19, especially in the US and Europe, has increased the risk of a more protracted global recession and slower recovery.

Encouragingly, China seems to have contained the spread of the COVID-19 virus, and the 'sudden-stop' in its economic activity has reversed as factories have returned to work and increased their capacity. China seems well-placed to lead the global recovery while the rest of Asia, the US, and Europe, will lag. China's success so far has seen its equity market outperform most other countries. However, indicators suggest China's unemployment rate has also jumped significantly and it remains to be seen if the demand-side of the economy could still be depressed for some time, given very weak retail spending and imports.



Will we see a 'V' or 'U'-shaped recovery?

We believe investors should be prepared for two possible scenarios. First, if other countries in Europe, and especially the US, can replicate the success of China in containing the COVID-19 virus then economic activity and employment can rebound quite quickly – especially given the massive policy stimulus. While the global recession will prove very painful, a 'V-shape' recovery could potentially unfold over 3Q 2020 or 4Q 2020.

The alternative scenario is a more prolonged global recession, with a 'U-shape' rebound happening some time next year. In such a scenario, a stronger China alone is insufficient to drive a sustainable global growth rebound if Europe, and more importantly the US, are still struggling with COVID-19 controls and global trade remains very weak.

Against this backdrop, the key driver of a prolonged global recession would be if the US experiences an adverse spiral from very high unemployment rates, which translates into a sustained collapse in spending, a painful rise in corporate defaults, and a credit-crunch.

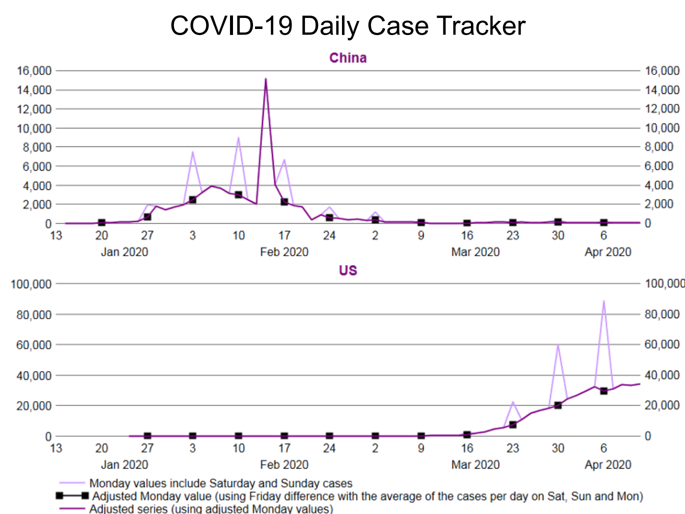
These adverse forces could be reinforced if consumers become much more cautious as they rebuild their lost wealth. Furthermore, even with successful containment of the global COVID-19 pandemic, consumption patterns may shift as people interact less and work from home more.

Monitor key signposts to determine length of recession, and when to dial up risk again

We have a set of signposts we are monitoring to try and understand which scenario may be unfolding and when investors should increase risk. China and South Korea appear to have contained COVID-19, and there are early encouraging signs that new US cases are slowing (as well as in Germany and Spain). However, the US mortality rate is likely to trend higher for a while. We have seen from China's example that these 'sudden-stops' in economic activity can quickly reverse when the COVID-19 lockdowns begin to ease.

Figure 1: US needs to replicate China's success in COVID-19 containment

COVID-19 Daily Case Tracker



Source: Refinitiv, Datastream, April 2020

We have also seen massive policy stimulus. While it is unlikely to be timely enough to prevent a global recession, it is a critical sign post to help stabilise financial markets and drive the eventual recovery.

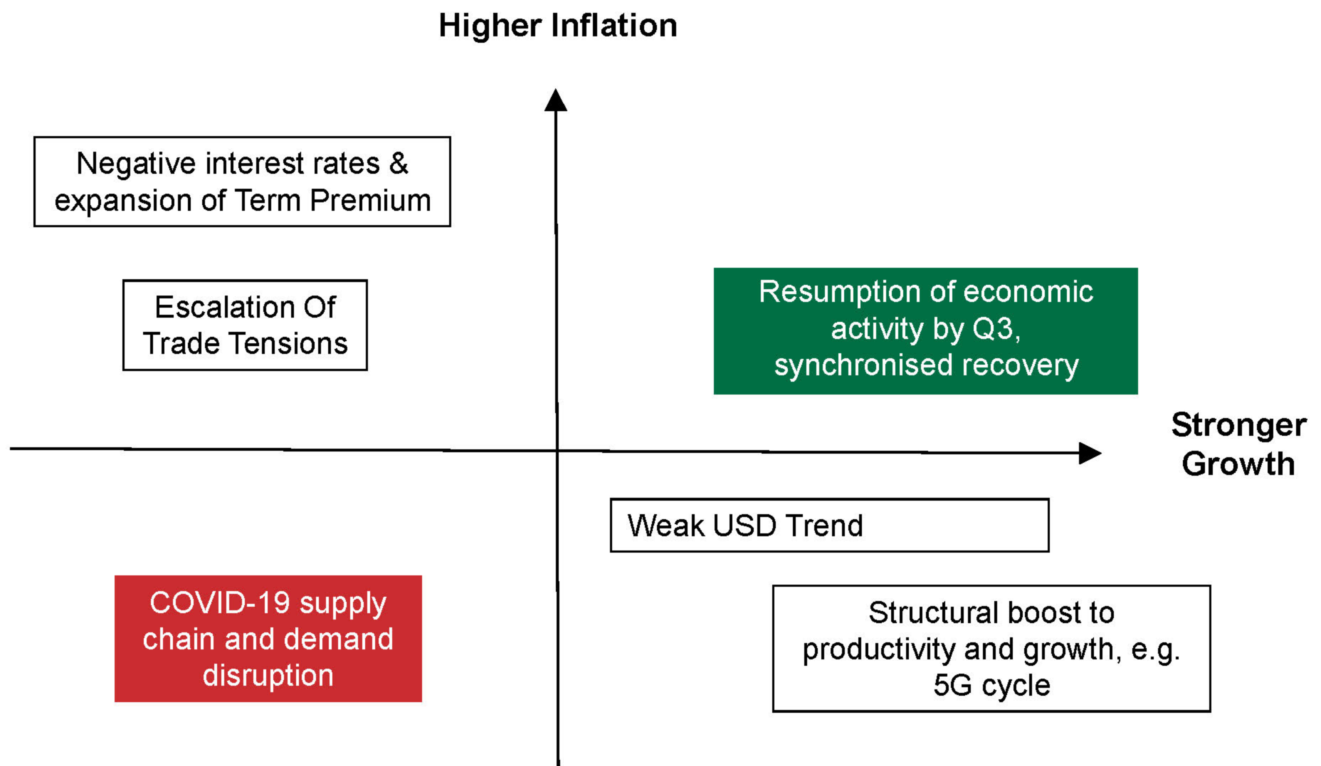
Globally, policymakers are committed to do whatever is necessary to support economies from the huge costs of trying to contain COVID-19. This pledge could already be contributing to the rebound we have seen in markets, especially US equities since late March, and the fall in risk aversion (as signalled by the drop in the VIX index).

Other event signposts we are watching closely – for the risk of a more prolonged global recession – are how much of the surge in US unemployment will be sustained and whether this demand stress could trigger a credit-crunch for corporates and a very painful deleveraging process. While servicing costs are low, US corporate leverage is at record highs and firms that suffer significant drops in earnings may be forced into painful asset liquidation and debt reduction. This risk is one key reason why the US Fed had been quick to launch another large stimulus package to directly support US corporate loan growth (and especially for Small and Medium Enterprises) on 7 April 2020.

If signs of an adverse feedback loop start appearing, especially in the US, then the risk of our alternative scenario rises and markets could experience another leg-down. In such a scenario, investors would need to de-risk further and wait longer for investment opportunities to come back into play.

There is also the obvious risk that the US may not be able to control the COVID-19 pandemic in a timely fashion, perhaps because lockdown restrictions are sub-optimal or are relaxed too soon. Likewise, there is also the possibility that "peak virus" does not equate to "peak lockdown" – containment success across countries like China and South Korea could unwind with re-infection waves, which would then make finding a vaccine absolutely critical.

Figure 2: Two possible scenarios – a very painful recession that is short (green box) or long-lasting (red box)



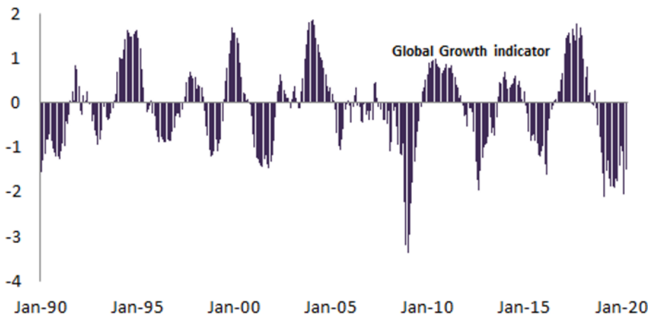
Source: Fullerton, April 2020

Figure 3: Check-list: Key signposts for a painful, albeit short, global recession

- [x] China successfully contains its COVID-19 epidemic
- [x] China's supply-side rebounds as lockdown restrictions ease
- [x] Huge and well-targeted policy stimulus from global policymakers, especially the US and Europe, is launched
- [ ] China's demand-side rebounds without a further leg-down (given weak external demand and rising unemployment)
- [ ] The US successfully contains its COVID-19 epidemic. There are early signs that US' new cases are slowing (but the lagging mortality rate is likely to trend higher for a while).
  Success in China followed by the US will be good news for all countries in showing that the global COVID-19 pandemic can be defeated. That said, set-backs could arise if there are waves of reinfection which will then make finding a vaccine absolutely critical.
- [ ] The US avoids an adverse spiral from the surge in its unemployment resulting in a sustained collapse in spending driving a painful corporate credit-crunch and high default rates

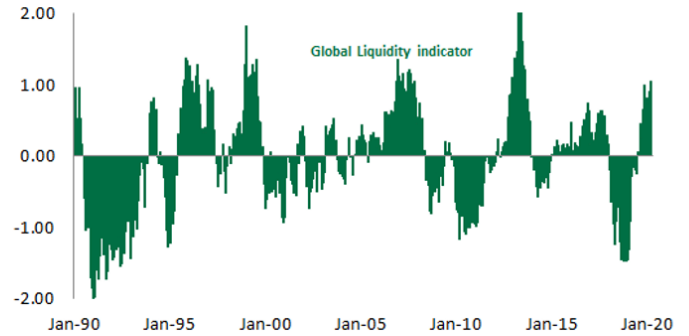
Source: Fullerton, April 2020

Figure 4: Our global growth indicator is very weak, but it could prove short-lived once lockdowns ease



Source: Fullerton, April 2020

Figure 5: Our global liquidity indicator remains strong and will be boosted further by policy stimulus

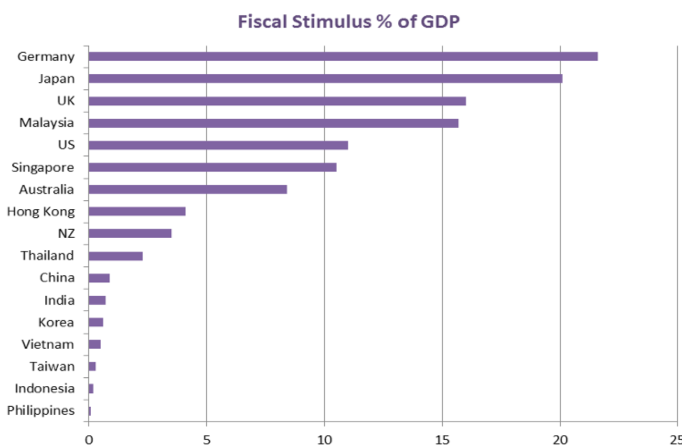


Source: Fullerton, April 2020

Key policy actions are critical signposts to help stabilise markets and drive recovery

Policy actions are unlikely to be timely enough to stop a global recession but they are critical signposts to help stabilise markets. The scale of fiscal stimulus alone has already been much greater than the responses during the GFC – across the US, Europe, Japan, and Asia (see Figure 6). Closer to home, because Singapore is such an open-economy (i.e very sensitive to weak global demand and trade), and with many of its SMEs under stress with lockdown restrictions, the Government has launched unprecedented supports (i.e the 'Resilience Budget' which totals around 11% of GDP to support households, firms, and to save jobs).

Figure 6: Tracking global fiscal stimulus



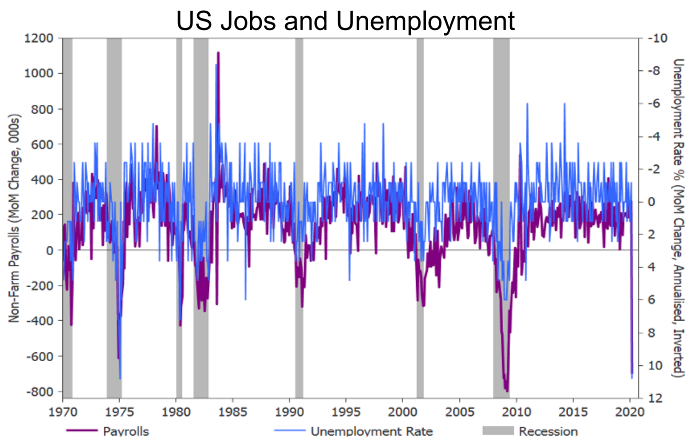
Source: JPM, Fullerton, Refinitiv, 7 April 2020

Monetary policy has also been very active with the Federal Reserve, the European Central Bank, and the People's Bank of China, all providing significant QE-related and liquidity support. Most recently, on 7 April, the US Fed launched a $2.3 trillion package (around 10% of US GDP) to support US local government debt and free-up their balance sheets so they can increase state-targeted spending. The Fed will also use almost three-quarters of the package to work with banks to give more loans to US firms, and especially SMEs. So the focus of Fed policy actions has shifted from lowering real interest rates and boosting liquidity toward helping the corporate sector with credit to navigate the recession. The Fed said it would monitor the financial performance of local governments closely to see if more help is needed, and that it was critical that US policymakers keep firms and households "financially whole" until recovery begins.

Monitoring global labour market stress and US corporate leverage

Based on the collapse in employment, the US unemployment rate is likely to reach a post-war record of 10-15% by mid-year (Figure 7). Many US job losses will prove to be temporary layoffs given the COVID-19 control measures, and unemployment benefits have been increased sharply to try and support household spending. But even when COVID-19 restrictions ease – given the significance of the containment cost – there is the risk that an adverse spiral unfolds where weak demand is sustained, in turn stressing corporate revenues and resulting in greater defaults. Firms would struggle to re-hire and consumption would then fall further.

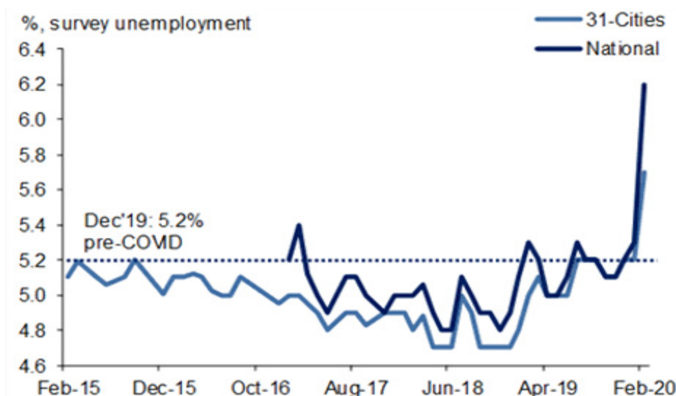
Figure 7: Indicators of US unemployment



Source: Refinitiv Datastream

Indicators suggest China’s unemployment rate has also jumped significantly and it remains to be seen if the demand-side of the economy could still be depressed for a while given very weak retail spending and imports (Figure 8). A key sign-post that would make investors much more confident about China’s post-COVID-19 recovery will be more fiscal stimulus which could be forthcoming after the National People’s Congress meets (likely in May).

Figure 8: Indicators of China’s unemployment and domestic demand



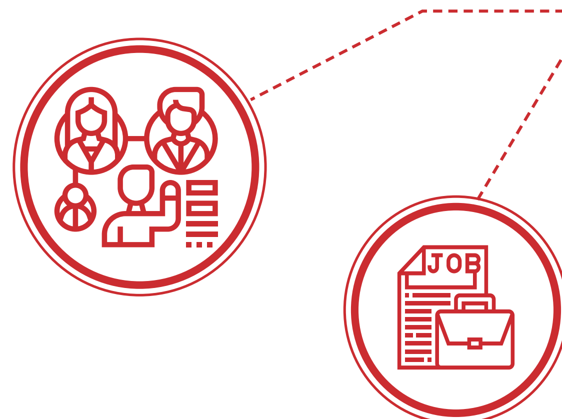
Source: Fullerton, CEIC, April 2020

Source: Refinitiv Datastream

All previous recessions have seen US corporate leverage fall significantly (even in the GFC, which was a household/financials driven crisis and a time when policymakers worked hard to cut funding costs. See (Figure 9). With US corporate leverage at a record high today, and the surge in US unemployment, it is important the US does not slide into an adverse spiral of a sustained collapse in spending, in turn driving a painful corporate credit-crunch, in order to avoid a prolonged global recession.

Figure 9: Monitoring US corporate leverage

Source: Refinitiv Datastream



Still positive on fundamentals in the longer term; Recovery will create buying opportunities

Risk assets across the board have suffered significantly from recession fears and as investors build liquidity and try to defend their wealth. But underlying fundamentals should remain robust once the recovery takes place because this is a health crisis, and not a financial crisis (like the GFC) that is driven by large macro imbalances.

The recovery will create buying opportunities but investors will still have to be cautious and selective given the risk that the post COVID-19 environment is fundamentally different with potentially less globalisation and more social distancing (resulting in lower spending on tourism and discretionary retail, and more spending on utilities, health care, technology, and consumer staples).

Defensive on global equities for now

We are defensive on global equities until we see key sign-posts trigger to give clarity on the duration of the recession, and we can think about positioning for what the post COVID-19 environment will be like. What this means is that investors need to continue to protect portfolios from further potential downside risks but also start thinking about opportunities with the recovery

China’s equity market likely to remain a strong relative performer, especially in Asia

Strong liquidity and fiscal stimulus will support the eventual recovery from global recession. However, risk appetite will take time to strengthen and falling economic activity will drag on earnings for a while. Asian equity markets will get support from the recovery in China, but more export dependent markets, like Korea and Taiwan, will struggle. Valuations are less attractive when earnings downgrades to come are factored in, especially across Asia.

Given China’s success in containing COVID-19, and the significant rebound in its manufacturing and supply-chains as lockdown restrictions have eased, we believe its equity market is likely to remain a strong relative performer (especially across Asia). However, investors will still be cautious to see how the demand-side of China’s economy rebounds and how much its unemployment rate rises by. US markets will also suffer from weaker earnings until economic activity rebounds, but should still outperform Europe.

Technology, on-line services and healthcare stocks are among the winners

Sound ‘bottom-up’ stock selection, focusing on fundamentals, remains critical. Some sectors could suffer from depressed earnings growth for a while after the recession such as tourism, transportation, recreation & sports, and consumer discretionary spending (especially big ticket items). Other sectors like technology (especially 5G related roll-outs), on-line services, heath care, utilities and consumer staples should perform strongly.

The energy sector could also take time to rebound given the greater likelihood of less fuel demand and difficulties for oil producers to ensure sufficient, and credible, output cuts to boost oil prices. In addition, especially in the US, the High Yield (HY) segment of the industry is highly leveraged.

More benign outlook on Investment Grade credit given stronger balance sheets and fundamentals

Ultra low and negative government bond yields, across much of Developed Market space, reduce the attractiveness of fixed-income investments. However, in the US, bond demand will be supported by the Fed's significant policy stimulus, and so we are neutral-to-positive on duration.

As the global recession unfolds default rates will rise, and therefore we are more cautious about HY credit exposures than Investment Grade (IG) – which have stronger balance sheets and fundamentals. This is especially the case across Asia, where China's economic activity may recover quickly but countries more dependent on global demand and trade will lag such as Taiwan, South Korea, and ASEAN.

Metal prices likely to rebound, oil prices might continue to struggle

Metal prices, especially copper, can rebound when China's demand recovers and markets are confident the US can avoid a prolonged recession. If the USD can resume a depreciating trend then this can help support oil prices (i.e if USD falls relative to an oil buyer's currency then purchasers need less of their own currency to buy. As oil becomes less expensive demand for oil increases bidding up oil prices). However, on balance, oil prices will likely struggle for a while given significantly less demand for fuel (in transport, especially jet) and difficulties for global oil producers to ensure output cuts get credible traction to boost oil prices.

USD likely to see short-term strength; Gold prices could see further upside

The USD could prove stronger than we expect over the short-term given greater funding stress and safe-haven flows. But as we have said before, the USD should depreciate given significant monetary policy stimulus from the Fed and weak economic activity. The GFC experience saw the USD appreciate for the first six months or so of the recession before depreciating steadily into 2009 (after significant US policy stimulus).

Despite high risk aversion, and with the sharp fall in markets, gold prices also suffered as investors de-risked across the board to raise cash. However, looking ahead, gold prices can potentially rally given very low interest rates and the likelihood of a weaker USD. There is likely more upside to gold prices, than downside, until there is strong evidence that the US has successfully contained its COVID-19 epidemic.

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