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COVID-19: stay disciplined in uncertain times

Key take aways

- While uncertainty over near-term developments is high, we expect an economic recovery after a sharp recession (due to the shutdown of major centres) – once the spread of the virus is reversed and associated containment measures fade.
- Monetary and fiscal support across the globe is massive, but the ultimate cure is stopping the virus spread and/or a medical progress on a drug or vaccine.
- A disciplined and sequential (!) approach to moving back into risky assets is appropriate following sharp market declines and the potential for swift future market moves. At present, the best way to add risk is probably via equities.

01 Summary and implications

The COVID-19 crisis is at root a global health crisis but the economic impact is massive as has been the monetary and fiscal policy response to it. This unprecedented pattern is one reason for the sharp and volatile reaction of financial markets and helps explain the discomfort of investors. The ultimate solution will be found in the healthcare system's response and the containment of the virus.

These are uncertain times but we should not forget investment rules. As is usual in crises, investors can be distracted by short-term volatility and market "noise", but in the longer run it is the strategic asset allocation that matters along with the tactical shifts around it. We have been following a cautious portfolio approach over the course of this crisis. In this report, we now set out our future outlook (over three time horizons) and our investment response to it.

While we expect a severe recession as a result of the virus spread and the containment measures (very difficult to foresee a few weeks ago) it remains important to look through this and consider what the world could look like on a medium-term (6-12 months) time horizon. If the lock-down period currently in force in many economic centres does not need to be substantially extended, the effects of monetary and fiscal stimulus will start to yield results. We expect a strong initial economic recovery followed by a more muted growth as economies will need time to digest the longer-term consequences of this crisis.

As markets tend to anticipate such developments, market turns can be rapid with the risk of subsequent temporary setbacks. Following the recent strong market movement, this could be the time to start considering how to add risk to portfolios. Markets are going to remain unpredictable in the short term and adding risks on a staggered basis (i.e. in phases) in a disciplined way should help mitigate risks around market timing. Investors should try to plan out their investment route in this uncertain environment and act according to this road map.

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02 Nature of the crisis

Always remember that this crisis is being driven by the pandemic, not by economic factors. So while economic policy may – to some extent – ease the side effects of the crisis, it cannot provide the cure.

This unnerves financial markets. During previous recent crises (e.g. the Global Financial Crisis or the Eurozone crisis) markets eventually stabilized on a belief that a countercyclical fiscal impulse was underway, or that central banks would provide a credible backstop. But in a medical crisis central banks may not be able to provide a credible backstop. As result, markets may stay volatile until the end of the pandemic is clearly in sight.

What is also important is that crisis is affecting both supply (as production is impaired) and demand (as quarantined consumers shop less and companies with unclear future prospects invest less). This is not just a problem of fixing demand through monetary or fiscal policy. Instead, supply issues in particular may force fundamental reappraisal of how companies and economies work. We consider this at the end of the report.

03 Policy response so far

We titled our 2020 Outlook "The end of monetary magic?" and this crisis has suggested that its powers are indeed waning. However, very strong monetary intervention has yielded some initial results. This is despite policy interventions going beyond interest rate cuts to try and address possible credit and liquidity problems – and central banks signaling that they are willing to buy ever more assets.

With monetary magic fading, the focus is on fiscal policy. The response here has so far been insufficient in some countries but has gained traction in recent days. There are two reasons for the initial mixed response. First, governments (in most countries) are unused to delivering fiscal policy packages: this is a process that usually involves full democratic debate, not just a central bank committee. Second, it is unclear what the most effective fiscal response should be: conventional demand boosting measures (e.g. tax cuts) may not revive demand and could take too long to act. Instead the focus may have to be on targeted short-term measures to get businesses and individuals through their immediate difficulties.

The loss of faith in demand is underlined by the markets' response to the OPEC+ disagreement and subsequent increase in the supply of oil. In normal times, this would be a relief for consumers (via lower energy prices) but this time it adds to market stress due to greater fears about the impact of higher spreads in the high yield segment (Chart 1) especially regarding lower capex spending in the (U.S.) energy sector. Consumers are also focused on other topics than the oil price.

04 Future issues

Given the massive changes described above, we should already start thinking about what this means for the future. Again, the primary shorter-term driver in future will be the epidemic itself, not the policymakers' response to it. The hope is that social distancing will slow the spread of the disease (with Italy the obvious priority) and the evidence from Europe at present is that this should work – extrapolating current numbers suggest that those European economies most affected will follow China's path to containing the disease and widened spreads may ease (Chart 2). Markets need to keep faith with this analysis. Both containment of the virus and markets' digesting of the consequences of the virus's development take time though.

On the policy front, more monetary policy initiatives are likely, but the focus will not be on cutting rates. Instead expect measures on credit supply, liquidity, and some quantitative easing-type operations. The danger is that policy initiatives will continue to lag behind market developments (e.g. liquidity) and high market expectations. This is a question of belief and (as we noted above) markets' faith in monetary magic is indeed fading.

Faith may be increasingly entrusted in fiscal policy. This has to address multiple issues, and on multiple time frames (immediate and longer-term). Obvious current priorities include health services financing, unemployment/wages support, and help for corporates to tide them over likely fall in demand. As can be seen policy here starts to overlap with more detailed monetary policy initiatives: some countries/regions will find it easier to coordinate this monetary/fiscal policy approach.

But medical progress on containing/reversing the outbreak is essential for economic policies to work. At present, the "best-case" scenario is that new Italian and other European infection rates start to flatten out within the next month, allowing output and demand to start to recover over Q2. The U.S. trajectory may lag behind this. China's new cases are already low. The basic aim remains to flatten the peak of pandemic to allow health services to cope with the situation. "Worse-case" scenarios involve persistence/reappearance or a second wave of the disease. Vaccine should be seen as an ultimate backstop but this is unlikely to be available for 12+ months; the other historic approach to pandemics "herd immunity" (the infection of a large proportion of the population so that the virus cannot spread further) is a not an option.

Given all this, it makes sense to anticipate more short-term volatility as the situation in Europe (in particular Italy) and the U.S. continues to deteriorate. There is unlikely to be a clear market turnaround until new cases flatten (or, perhaps, the growth in the growth of new cases shows signs of flattening).

Market recovery will likely be sustained only if there is evidence that previously implemented fiscal and monetary policy is gaining traction. Markets may recover swiftly if market participants are convinced the worst could soon be behind us. But economic recovery will take time and the economic impact will be significant. The Eurozone is in a recession which could last until H2; the U.S. will feel the economic impact in Q2 in particular; China has the potential to recover earlier but there is a concern here that consumer spending patterns may have changed and that export markets will be depressed for some time.

There will be a painful process of readjustment on many fronts. A deep recession (the length/extent of which will be determined by the duration of intensive social distancing measures) is weighing on risky assets and an additional problem is that company earnings expectations are lagging the reality – another reason why valuations should be treated with caution. Markets will take time to assess the economic damage and what it means, but will also welcome any brightening in the recovery outlook. The risk for investors who try to time the market perfectly is that they miss the point of trend reversal – which is why we think a disciplined and sequential approach is crucial.

05 Economic and investment outlook

The outlook may be best considered in three time frames:

1. Short term: a partial recovery

When the number of infections is decreasing and virus containment measures fade, an economic recovery is likely. Production of physical goods can recover, but the bulk of consumption foregone over the shutdown period (particularly of services) will be lost – and developed economies are more consumption-driven than many others e.g. China. Hence recovery in the developed markets could take some time. Economic weakness may last into H2 2020. Markets could remain volatile as long as uncertainty persists (Chart 3 illustrates recent volatility) but when they start anticipating a better economic environment, their readjustment process could be rapid. In order to mitigate timing risks a sequential, structured investment approach seems prudent. At present, the best way to increase risky assets in a portfolio is likely to be via equities, as they have not the same liquidity issues as other assets.

This will be not a short dip but a very severe recession. The unprecedented measures implemented to contain the virus have resulted in a sharp drop in consumption due to social distancing and closure of shops and restaurants, in addition to industrial production as factories are shut down. A pure V-shaped recovery is unlikely, but so is an L-shaped (i.e. very flat) recovery given massive fiscal and monetary boost and potential containment of the virus. Once people can start to consume again GDP is likely to rise, but the effects of the crisis could be difficult to digest. What we are likely to see is a strong upturn followed by a weaker economic development thereafter – the vertical mirror of a mathematical root symbol (√‾) – in other words, a fast initial recovery, but not full previous output, followed by rather flat or slow growth thereafter.

2. Medium term: role reassessment

Monetary policy is expected to remain loose. Debt levels will be higher as the numerator (debt) rises and the denominator (GDP) is lower. The role of governments will increase due, for example, to the nationalization of companies. Companies will question their business models.

3. Long term: structural shifts and stresses

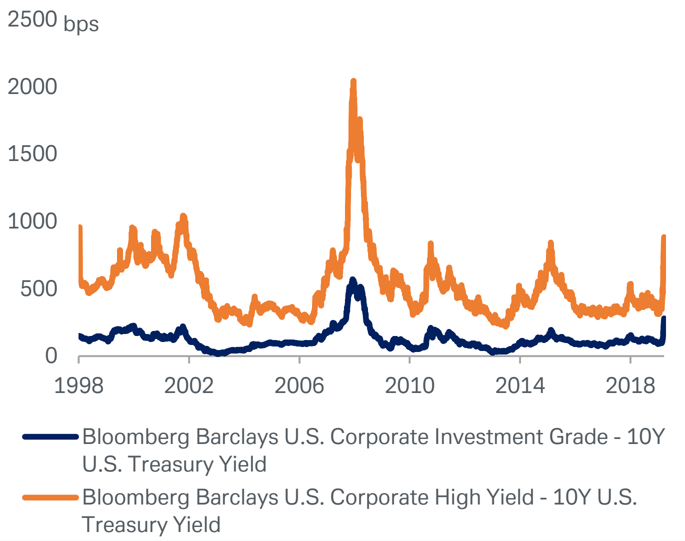
Structural change: there could be changes to how we all work, at all levels. Increased digitalization of work, will be accompanied by reconsideration of structural issues such as repatriation of production, questioning of global supply chains and globalization in general. All will be under review.

The bill will need to be paid: so financial repression will continue. As a result, we could see a world of “helicopter money”, where central banks further finance governments to stimulate growth (nominal or real) over the medium to long term. (See our “Peak debt” special report published last year.) Debt moratoriums may not be ruled out.

Geopolitical shifts: China’s influence globally may rise. The East Asian region is likely to recover faster than others. There will be challenges for the Eurozone, short and long-term. One problem is that some countries with the highest debt levels also, by coincidence, have the higher infection rates. In the long term, there may be the need for an internally-created European Marshall plan.

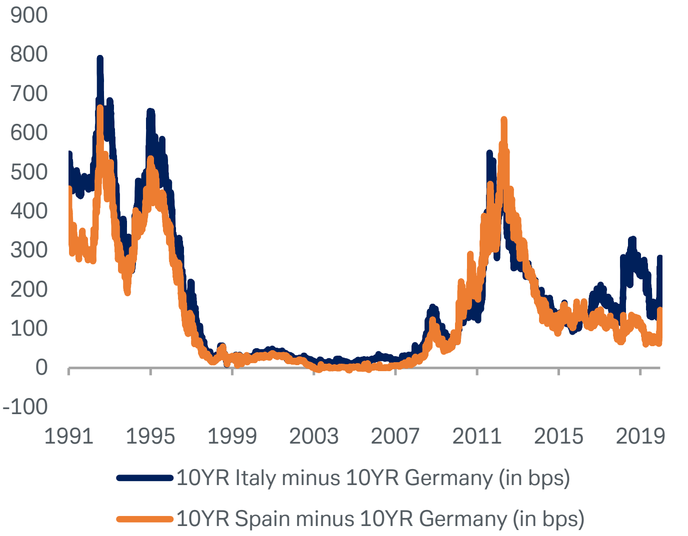
In summary, the world ahead could be a very different place. But the established rules of investment will still prevail. Follow a predefined strategy and stay disciplined in uncertain times. The likelihood of a “lower yields for longer” environment will add to the longer-term case for equities, once we can see a way through current volatility.

Chart 1: IG and HY spreads



Source: Datastream, Deutsche Bank Wealth Management; Data as of March 19, 2020.

Chart 2: Spain and Italy: spreads vs. bunds



Source: Datastream, Deutsche Bank Wealth Management; Data as of March 19, 2020.

Chart 3: S&P 500 index

Source: Bloomberg, Deutsche Bank Wealth Management, DB Global Markets; Data as of March 18, 2020.

Glossary

BTP (in full, Buonidel Tesoro Poliannuali) are Italian government bonds.

Bunds are longer-term bonds issued by the German government.

The DAX is a blue-chip stock-market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange; other DAX indices include a wider range of firms.

EUR is the currency code for the euro, the currency of the Eurozone.

The European Central Bank (ECB) is the central bank for the Eurozone.

The EuroStoxx50 Index tracks the performance of blue-chip stocks in the Eurozone and includes the super-sector leaders in terms of market capitalization.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

The Federal Reserve (Fed) is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

The G7comprises Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

High yield (HY) bonds are higher-yielding bonds with a lower credit rating than investment-grade corporate bonds, Treasury bonds and municipal bonds.

The global financial crisis (GFC) is the financial crisis that started in 2007/2008 and lead to a recession in many major economies, originating from an asset bubble in the U.S. mortgage market.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

An investment grade (IG) rating by a rating agency such as Standard & Poor's indicates that a bond is seen as having a relatively low risk of default.

JPY is the currency code for the Japanese yen, the Japanese currency.

The Organization of the Petroleum Exporting Countries (OPEC) is an international organization with the mandate to "coordinate and unify the petroleum policies" of its 12 members. The so-called "OPEC+" brings in Russia and other producers.

Quantitative easing (QE) is an unconventional monetary policy tool, in which a central bank conducts a broad-based asset purchases.

The Relative Strength Index (RSI) is a technical indicator that considers the speed and size of market price movements.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The StoxxEurope 600 includes 600 companies across 18 European Union countries.

Treasuries are bonds issued by the U.S. government.

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