Market Insights & Strategy

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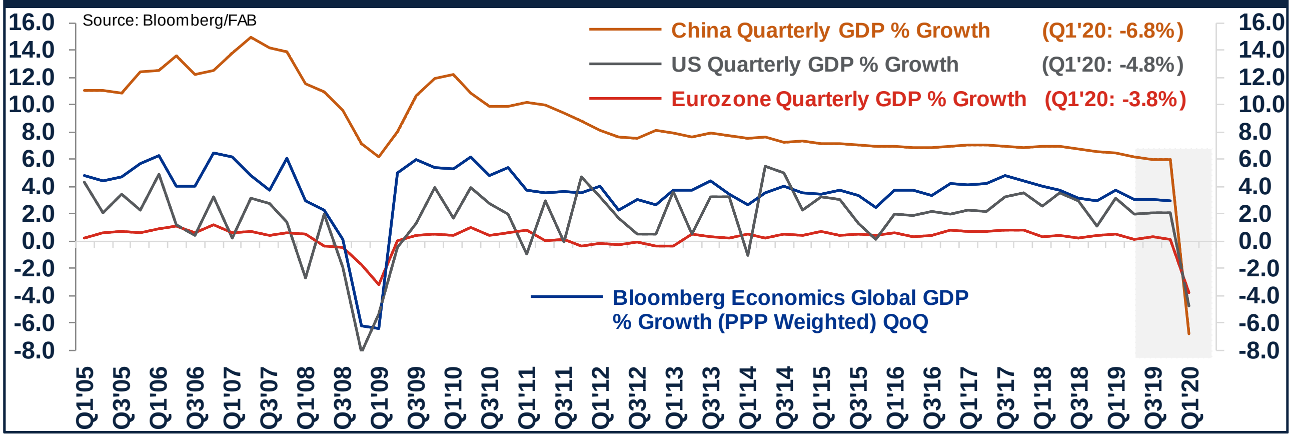
Alphabet Soup

- **The economic recovery debate is split between 'V' and 'U' scenarios, but it's not that simple**
- **Investment strategies in H2 2020 and H1 2021 need to look beyond the alphabet**
- **The pace at which restrictions are lifted will determine between success and second wave**

The letters 'U' and 'V' may be cordial neighbours in the alphabet, but when it comes to the outlook for the global economy over the coming months they sit much further apart. Indeed, we believe that distinguishing between the two letters over the coming months will be key to successful investment strategies during H2 2020 and into 2021. With the global economy having been floored by COVID-19 over the past few months there is now much debate and argument as to whether the trajectory of the aspirational global economic recovery over the coming months will be 'V-' or 'U-'shaped in nature, or indeed some other letter. As natural optimists, we dismiss the spectre on an 'L'-shaped economic future.

At the core of the debate are the economic lockdowns and public health measures that have been implemented on the global stage, in an effort to cauterise the spread of the virus. The consequent shuttering of industries around the globe and the newly imposed rules on social distancing and confinement of individuals to their homes have had a sharp negative impact on global economic activity. As a result global growth expectations have plummeted from consensus 3% trend growth being maintained through 2020, to now consensus expectation of a global recession for 2020 as a whole. Q1 GDP data has already looked miserable across many major economies and we forecast that Q2 GDP will look decidedly uglier. Meanwhile, labour markets have imploded.

Race to the bottom



This deterioration has been succinctly highlighted by the ECB's latest analysis of Euro area growth, which suggests that even in the most benign scenario, the Eurozone is expected to contract by 5% this year. Indeed, if a more severe outcome materialises, the ECB is braced for the region to shrink by up to 12% this year. Beyond the near-term downside potential though, the ECB does then assume – as we do – a degree of economic recovery during H2 this year as the containment measures are (gradually) lifted, which we hope will then continue into 2021. In aggregate though there is no denying that the speed and scale of recovery over the medium term remains highly uncertain, with some considerable downside risk.

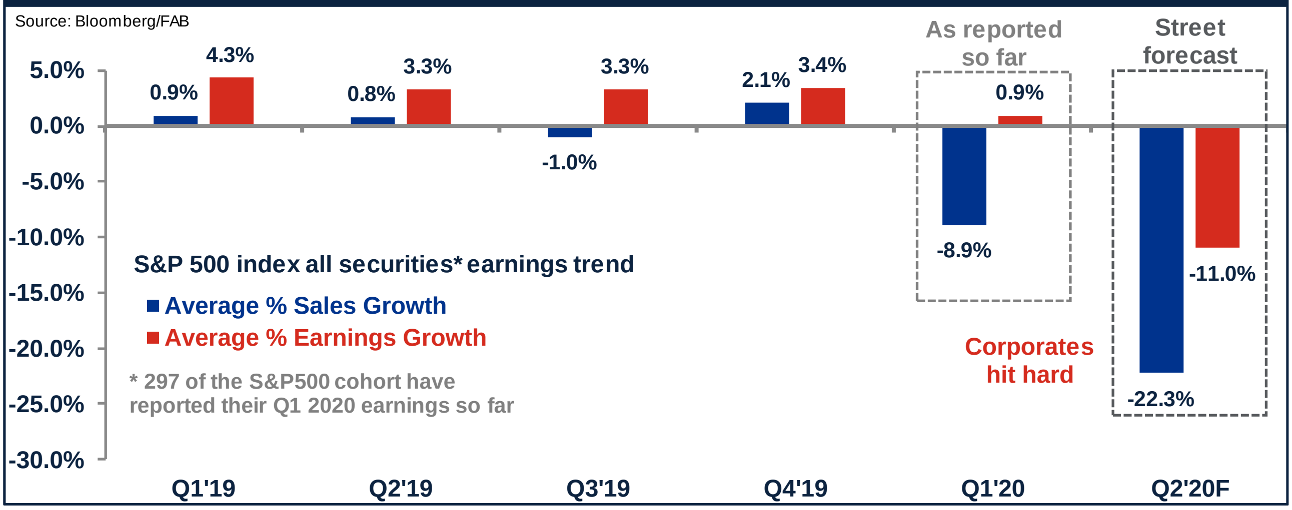
So central banks and governments are now left to balance the delicate options between lifting the restrictions to allow economic activity to resume, versus leaving the restrictions in place long enough to ensure we do not suffer from a second, more costly outbreak of the pandemic. No pressure then!

There's no 'v' in 'likely'

We have heard much about expectations of a V' shaped recovery emerging in the wake of the economic implosion and recessionary pressures that have built over the last couple of months. The assumption for such optimism is that the abundance of government and central bank stimulus deployed in the short-term, to offset the sharp contractionary effects of economic lockdown, will soon feed through to a similarly sharp rebound in market sentiment fuelled by pent up demand. Thus the trajectory followed by risk markets tracks a 'V' shape.

Increasingly though, such optimism may now look increasingly fanciful. Not only does the corporate earnings space, in terms of latest results and forward guidance, paint a very fragile outlook at best, but the renowned Warren Buffett also seemed to pour cold water on the 'V'-shaped recovery idea last week. The Sage of Omaha stated that he currently sees few compelling investment opportunities and that he is currently increasing his cash allocation. Buffett's cautious rhetoric may persuade others to view the market with similar apprehension, all of which will dampen market performance potential.

Under the weather with the virus



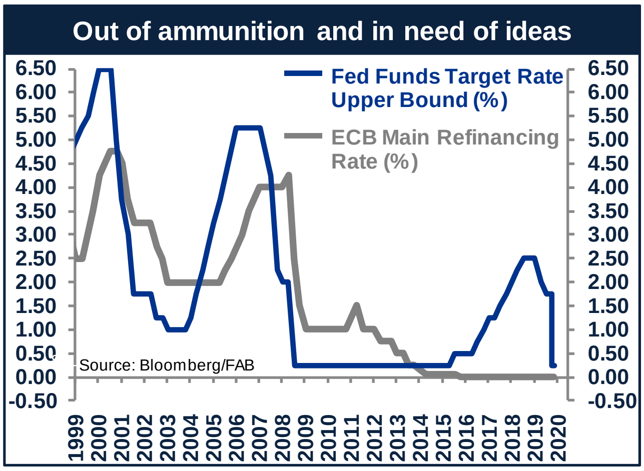
Why would a 'V'-shaped recovery be good?

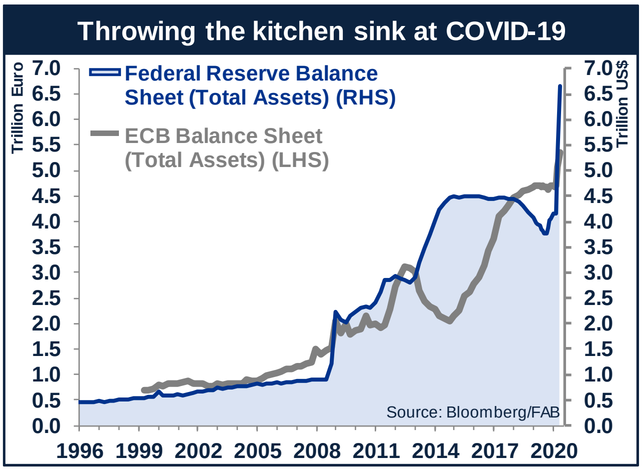
After the sharp contraction in growth metrics in recent weeks and the consequent drastic deterioration in employment conditions as social distancing and public health measures have been implemented, the obvious, natural hope was that the weakness would be short-lived, that COVID-19 would be swiftly contained, that recessionary pressures would then ease and that life would return to 'normal'. As such, the economic 'V' would fall from peak to trough and then back to peak again, just as quickly. This scenario of course would require coronavirus to prove transitory and to be contained, albeit after a recognised (brief) period of economic pain and social disruption.

The overall positive from such an outcome of course would be that the global economy suffers only a limited hiatus. Defensive investment strategies and a solid haven bid, helping to anchor rates as we are currently witnessing, would then give way to improving levels of risk appetite. As economic growth forecasts recovered, rates would sell off again and risk appetite would regain momentum.

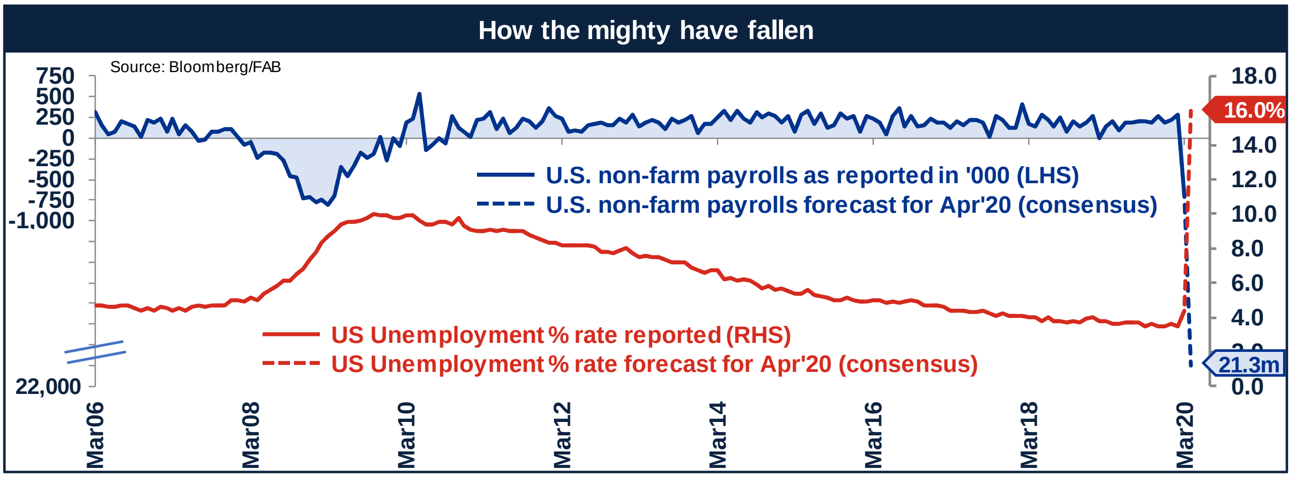
But would 'V' be ideal?
While we appreciate that industrialists, consumers and economists alike are desperate for current lockdown conditions to ease and for economies to 'open up' again, we would suggest that the only sustainable way forward from here will require us to affirm that lessons have been learned from the pandemic. Worst case scenario for us would be to see a quick and extensive easing of economic and social constraints that then raise the risk of second wave of the pandemic. With rates at zero and the global fiscal stimulus armoury already largely deployed in many regions, authorities' ability to respond to an aforementioned second wave of the virus would surely be limited. As a result, the impact of a second outbreak could prove more costly than the first.

So, let's not lay all our hopes on a 'V'-shaped recovery materialising. V's alphabet neighbour – or a relative thereof – may be far better company in the long-term.





A 'Hybrid U'-shaped recovery is our preferred outcome
Rather than 'V', we believe that a form of 'U' may be far more appropriate both in terms of describing the recent collapse in economic metrics as well as forecasting the direction of travel from here. For us the initial down leg of the 'U' better represents the extent of the recent collapse in economic conditions, particularly in terms of employment (U.S. unemployment rate forecast to spike from 4.4% in March to 16.0% in April) and GDP (IMF forecasting a plunge in global GDP from +3% last year to -3% in 2020). Moreover, as alluded to above in terms of the pace of recovery, we believe that the more gradual path on the way through the nadir of the 'U' may be more appropriate and sustainable.



But even a 'U' may not be perfect. There can be no rapid return to normal. Even as coronavirus infection and mortality rates hopefully continue to recede over the coming weeks and months, the global economy will still have to adhere to new ways of living and interacting. There can be no quick fix from where we find ourselves today. As a result we would advocate pursuing recovery strategies that follow a shallower upward trajectory on the way back up the right side of the 'U'. The latter will prove to be the lower risk and more sustainable strategy in the medium-term.

Bottom line

In the 'V' versus 'U' recovery debate we sit on the 'U' side, albeit with the recognition that reality will likely produce a 'shallow U' over the coming quarters. While on the left side of the 'U' there is certainly no disputing the near-vertical drop in economic conditions over the past 2 months, we expect the right-hand side exit to be more gradual and cautious. Yes, we appreciate the increasingly widespread hope that we will soon be able to label COVID-19 as a seasonal, transitory virus and that this will be the medical game-changer in the pandemic story, but at same time we are cognisant that a vaccine or proven treatment for the disease is probably still many months away, a fact that will continue to anchor the gradient of the recovery.

With COVID-19 infection rates beginning to improve already and mortality rates thankfully coming down around the globe we do expect the macro outlook to begin process of stabilisation as Q2 evolves and as we head through H2. The economic costs of the pandemic have been crippling in the near-term however, and so any meaningful global growth recovery is unlikely to feed through into hard data until early 2021.

There is light at the end of the tunnel, but we must remain realistic and pertinacious for now. Ease economic restrictions, but only at a pace that allows stabilisation to be followed by modest sustainable recovery over the coming quarters. This will create the foundations for the forecast rebound in global GDP growth in 2021 toward the +3% level. But, rush headlong toward the light too quickly, lifting all restrictions in short-order, and it could turn out to be a second wave outbreak coming back towards us with full beam on, in which case we will soon find ourselves back on a contractionary path and the V versus U debate will be irrelevant.

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