

March 18, 2020

**Global Economics and Investment Analysis**  
**BNY Mellon Investment Management**

**Vantage Point Q2 2020 Preview**

The spread of the coronavirus is having a major global economic impact. Much of our analysis is devoted to trying to work out what that might be. **As regular readers will know, we don't deal in point forecasts – and a shock like the emergence of the coronavirus highlights the strength of the scenario-based, probabilistic approach we take on how the world economy may evolve in the next 12 months.** By mapping plausible scenarios, probability-weighting them and generating summary fan charts for key asset prices, **we can draw broad investment conclusions that we believe take account of the full distribution of likely outcomes.**

The main economic impact of the coronavirus is likely to be felt through the measures taken to contain it – travel restrictions, reduced working time, and quarantine. A number of countries have already gone into effective lockdown, including the US and much of Europe and this will have **a dramatic impact on GDP in the first half of the year and possibly beyond. Already, a global recession in 2020 looks more likely than not.**

To reflect the growing risks and quickly evolving developments from the coronavirus, we have revised our probabilities and lowered the likelihood of a V-shaped recovery by 5% to 35%. In our two downside scenarios, we see a greater chance of a U-shaped recovery and increased the probability to 35% and reduced the likelihood of a L-shaped recovery to 20%.

In economic terms it is **both a supply shock and a demand shock.** It cuts supply because working hours fall and supply chains are disrupted; and it hits demand because people can't go out shopping, buy services face-to-face, or go on holiday. Markets have reacted with shock – the S&P 500 fell close to 30% from peak – already the fifth largest post-war recessionary drop, in a fraction of the time it took the others to get there. **Central banks fear the demand shock more and the Fed has led the way with rate cuts and a relaunch of QE.** Financial market stresses have appeared and central banks have coordinated to supply the overwhelming demand for cash and dollars. Longer term, the situation could get more complicated should the substantial hit to global supply push up global costs and prices, especially if that impact endures because the spread of the disease causes de-globalization to accelerate.

This is a hugely uncertain situation and **we encourage readers to use the scenarios to test their own assumptions**, whether that's 'time to buy' or 'it's Armageddon out there', or anything in between.

**Our own broad investment conclusion, based on the return and risk expectations embodied in our fan charts, is that a more risk-averse stance may be prudent until we have more clarity. The potential for a strong bounce back exists no doubt but, it's not clear from our analysis that the expected gain in the best scenario outweighs the expected losses in the worst.**

**Scenario 1 – V-shaped recovery; coronavirus spreads but economic impact contained (35% probability)**

Disease peaks during the summer. Central bank liquidity provision is large enough to **prevent severe dislocation in financial markets** and the Fed in particular supplies enough dollars to overcome the dollar shortage and satisfy the global demand for cash. Large fall in Chinese GDP in China in H1 (around -10%), followed by a strong recovery during H2 2020 as inventories are rebuilt and services production/consumption resumes. The impact on Europe and the US lasts longer, with similarly large hit to GDP, but **global growth picks up gradually during H2 2020. Output recovers everywhere so that, by the first half of 2021, it is more or less where it would have been had the disease never emerged, so there is no permanent loss to output (hence the V-shape recovery).** Global monetary and fiscal policy remains loose. Other central banks may revert to unorthodox policy measures and closer coordination with fiscal authorities. **Global inflation remains subdued and interest rates remain low. Risk assets bounce back in Q2**, ahead of the economic recovery as investors learn that the long-term macro consequences of the disease will be limited.



## Scenario 2 – U-shaped recovery; financial market shake-out (35% probability)

**Coronavirus spread more persistent and widespread than scenario #1 but not as severe as scenario #3.** Nevertheless, this is the trigger for **widespread risk-off sentiment in the face of heightened uncertainty. Risk premia rise sharply**, equity and credit prices fall – **particularly in highly leveraged corporates**. Sell-off exacerbated by a **huge tightening of financial conditions as credit vulnerabilities are exposed in the US**. Non-China EMs suffer from China exposure and a withdrawal of liquidity and are limited in their policy tool-kit to stem the outflows. A further dramatic **flight to safety ultimately brings government bond yields to previously unthinkable lows** and even further into negative territory for certain regions. But preceding that, huge demand for cash causes some yields to rise temporarily leading to severe market dislocation as liquidity squeeze and dollar shortage worsens. **Unlike scenario #3, this is primarily a hit to global aggregate demand (rather than supply)**. Spill-over effects, such as in energy prices, make the situation worse. Global policy makers unable to put a floor on deteriorating sentiment in the short-term. **Sell-off triggers a slowdown not unlike that seen after the tech bust of 2000-1 followed by a U-shaped recovery.**

## Scenario 3 – L-shaped recovery; globalization flatlines (20% probability)

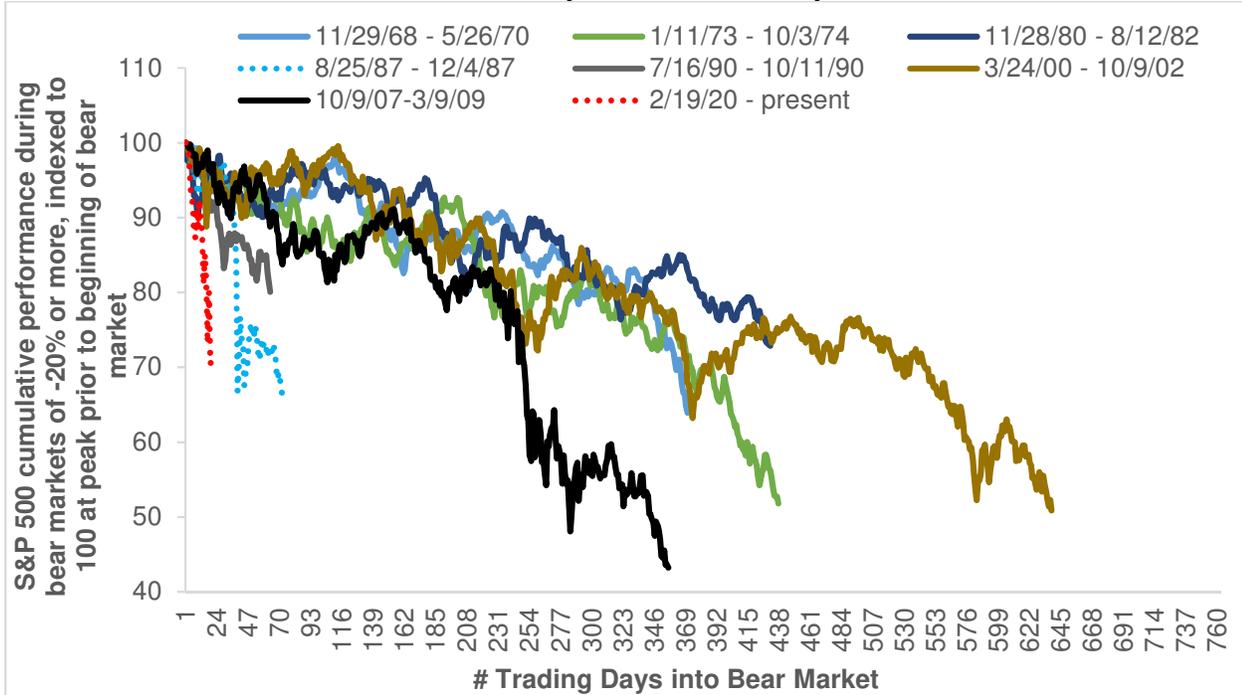
As contagion spreads outside China, developed countries are overwhelmed by the epidemic and economic activity in affected regions falls to a trickle. **With hits to demand and supply, the impact on Chinese GDP is massive--close to 18%--over the course of 2020, mostly in the first half of the year. Europe and the US see similar-sized GDP losses during the rest of 2020.** Ultimately, this adds pressure on firms to diversify supply chains over the longer term, **accelerating underlying de-globalization trends**. The impact on global GDP is large, mostly felt through the supply side. **Global costs rise** as businesses struggle to find alternatives to Chinese production. **US, EU and China respond with protectionist moves**, especially if China attempts to devalue the Yuan, further exacerbating the supply shock. **Central banks can accommodate to some degree, but there is only so much monetary policy can do** in the face of a negative supply shock. Fiscal policy is loosened globally, but insufficiently to offset global retrenchment and many businesses go bust. **Asset prices fall despite loose monetary policy stance**, since policy is still tighter than previously expected and confidence is hit hard by duration and spread of disease. In the longer term, **the liberal international trading/investment order is truly dead and** a new narrative takes hold: **the virus has accelerated an underlying trend in which re-shoring and nationalism means higher costs and lower growth for years**. Risk markets sell off big time, equities enter a prolonged bear market, and global yields dive further into negative territory.

## Scenario 4 – US-led inflation returns (10% probability)

Growth fears are overdone in the US as the coronavirus is contained. The economy remains resilient, resumes its upward trajectory prior to the coronavirus, and activity rebounds sharply in 2H as rest of world weakness lingers. Ultimately, the US economy is more resource constrained than anticipated. Inflation rises more than expected and breaches the Fed's 2% target in early 2021. Inflation expectations quickly and sharply adjust higher, forcing the Fed to tighten as China/others are weakening. Higher rates and dollar prompt capital flight from risky assets, particularly in emerging markets. Financial instability and dollar shortage ensues yet the main transmission mechanism is international financial markets. Replay of 2015-2016 but bigger.

## S&P 500 Performance through 20%+ Bear Markets Since 1970\*

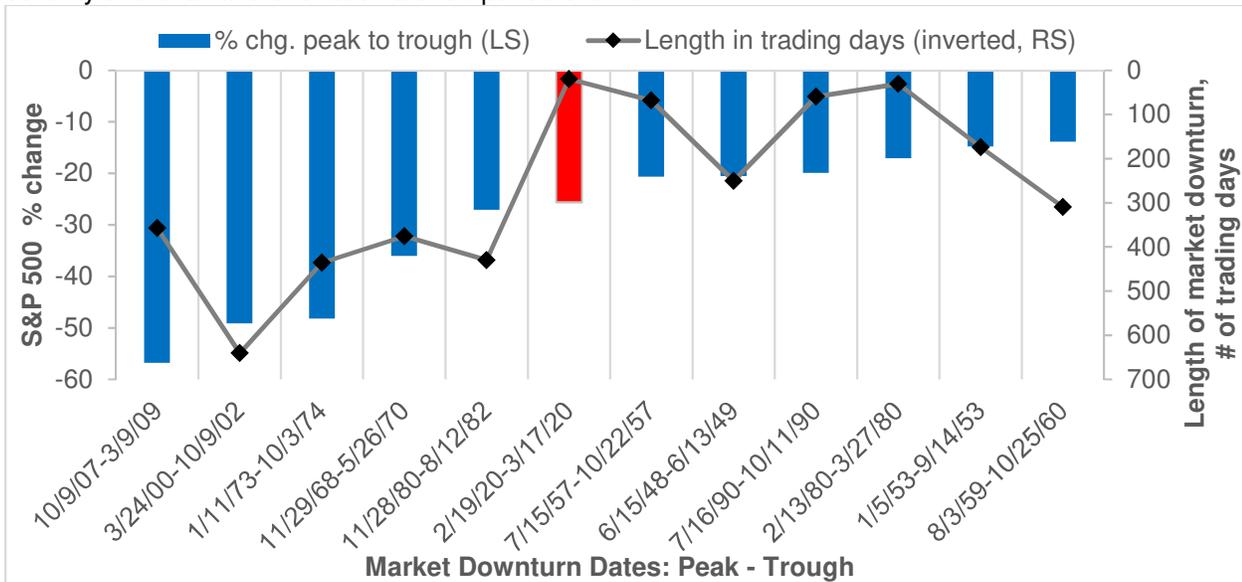
The S&P 500's descent into bear market territory has been historically swift



\*Dashed lines correspond to non-recessionary bear markets, all others correspond with recessions. Recessionary dates used by NBER (National Bureau of Economic Research). Data as of March 17, 2020 close. Source: BNY Mellon using data from Bloomberg.

## S&P 500 Market Downturns in Post-World War II Recessions\*

When compared to market downturns in post-WW II US recessions, the latest move stands out both for the severity of the fall and over such a short period of time



\*Sorted from left to right by highest to lowest downturn in percentage terms. # trading days calculated assuming 252 trading days per year. Data as of March 17, 2020 close. Source: BNY Mellon using data from Bloomberg.

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