

Four scenarios on Covid-19 and its investment impact

By the BNY Mellon Global Economic and Investment Analysis team

*The situation with the Covid-19 coronavirus is evolving rapidly and markets have begun to price in a larger and more widespread hit to global growth, which we believe will likely last well past the first quarter. Here we outline our **four forecast scenarios** for the next 12 months, three out of four of which look at the economic impact of the coronavirus.*

In our single **most likely (but odds against) scenario** (40% probability) we see a sharp fall in Chinese GDP for one to two quarters, followed by a V-shaped recovery, with relatively small economic impact outside Asia. Our two downside scenarios highlight different channels through which the virus could impact the world economy more meaningfully: the first (25%), through trade and real economic activity; the second (25%) primarily through financial markets.

In our view, the first scenario remains the **single most likely outcome, but the risks of the second and third are rising rapidly** and should be taken into account in portfolios. We believe these downside scenarios are not unreasonable given the **lack of information, rapid contagion, some panic by governments and supply chain disruptions**. From an economic point of view, the **virus' initial impact comes through the supply side of the economy – as fewer working hours feed through to lower output and supply chains are disrupted**. But demand will likely be impacted too – particularly for services – though some final demand for goods/parts can be met through inventories for a short period of time. **At a minimum, we would expect repercussions to persist for the first half of the year**. This event is also likely to add pressure on companies to diversify supply chains over the longer term and it could **accelerate underlying de-globalization trends**.

Market concerns over the coronavirus have resulted in risk-off trades, which have slashed stock prices and Treasury yields over the past week. In a **richly-priced** environment, the market is fearful the hit to the global economy will not be a **V-shaped one—but a U-shaped one** (i.e. a period of lackluster growth before the eventual bounce back from the hit to economies due to contagion from the virus). Remember, economic uncertainty due to the **exogenous virus shock** comes at a time when the **unsettled race between the Democrats for the 2020 presidential election** is still top of mind.

At minimum, earnings estimates for 2020 will likely go lower as a result of the impact to the businesses. If the risk-off period lasts for more than a few days, we should see the US dollar assets as a safe haven trade.

Scenario #1: Virus contained (40% Probability)

Spread of Covid-19 is limited. Big hit on China for one or two quarters but minimal impact on the rest of the world. Strong China bounce back in H2 as inventories are rebuilt and services production/consumption resumes. Monetary and fiscal policy unchanged outside Asia. US/China trade agreement provides boost to global manufacturing. Growth picks up gradually, inflation subdued, interest rates low, risk assets progress. Same as our previous 'Turning a Corner' scenario, but with lower growth in Q1/Q2, faster in H2.

Scenario #2: Globalisation flatlines (25% Probability)

The containment efforts in China prove to be ineffective and the virus spreads within and outside China. Quarantine restrictions in China are left in place for several months as contagion continues with the active



labor force measuring a fraction of its size in January. As contagion spreads outside China, developed countries are affected and economic activity in affected regions draws to an effective halt. Millions are infected although the mortality rate decreases. With hits to demand and supply chains, the impact on Chinese GDP is massive--close to 10%--over the course of 2020, much of it concentrated in the first half of the year. Ultimately, this is likely to add pressure on firms to diversify supply chains over the longer term and accelerates underlying de-globalization trends.

The huge disruptions to supply chains affect output in a number of countries importing parts (intermediate goods) from China and also exporting parts to China. The impact on global GDP is large, but is predominantly felt through the supply side. As a result, global costs rise during the time alternatives to Chinese production can't be found. Even when they are eventually found, they are likely to be higher cost. Rising costs hit global output and demand over a period of years. Supply side shocks exacerbate de-globalization as US and EU respond to increased costs with protectionist moves, especially if China attempts to devalue the Yuan. Central banks can accommodate to some degree. Fiscal policy is loosened globally, but insufficiently to offset global shock. 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 crippled 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 (whether true or not). Risk markets sell off, global yields dive further into negative territory.

Scenario #3: Financial market shake-out (25% Probability)

Virus spread is more persistent and widespread than under scenario #1, though perhaps not as severe as scenario #2 and largely confined to China/Asia. Nevertheless, this is the trigger for widespread flight from risky assets in the face of an uncertain future. Risk premia rise sharply, equity and credit prices fall, bond prices rise – the US 10y yield rallies sharply. Sell-off is exacerbated by elevated initial valuations, a huge tightening of credit conditions and a sharp turn in animal spirits. Sell-off is global and tighter financial conditions trigger a slowdown not unlike that seen after the tech bust of 2000-1. Risk of full-blown financial crisis risk is greatest in China, where tighter financial conditions, falling capital productivity and lower property prices could initiate a collapse of shadow banking and a big rise in bad loans. Liquidity squeeze on Chinese banks morphs into solvency crisis and a need for widespread recapitalization, mitigating any recovery even if the disease is brought under control. China loosens policy, both fiscal and monetary, but reinforces capital controls in an attempt to put a floor under the Yuan. The Fed refuses to come to the rescue, perhaps cutting rates a little but refusing to extend dollar swap lines, exacerbating crisis as global dollar shortage intensifies. Unlike scenario #2, this is primarily a hit to global aggregate demand (rather than supply). Fall in global growth and inflation, global rates fall to zero, even larger share of global bonds starts to yield negative, dollar rises sharply. Big fall in global equity and credit prices, risky assets everywhere (e.g. peripheral EZ bonds) sell off too as 'search for yield' turns into 'flight for safety'.

Scenario #4: Inflation returns (10% Probability)

As above but with an added international twist. Source of the shock is US inflation, not China. US tightens as China/others are weakening – Fed does not act as 'world's central bank' but on basis of 'America first'. Implications for global financial stability similar to second half of scenario #3 above, but main transmission mechanism is international financial markets rather than Chinese banking. Replay of 2015-16, but bigger. Dollar shortage reappears and capital flight from EMs, particularly Asian EMs. Dollar reserves are depleted much faster than expected and a number of dollar pegs (including yuan) come under severe pressure. Collapse in short-term dollar financing affects investment and output in key dollar-exposed EMs, which domestic monetary policy can only ameliorate slightly. China, Asia and other EMs hit hardest, but knock-on effects to developed economies, notably euro zone.



NB: *None of the scenarios above take into account all kinds of idiosyncratic 'black swan' or geopolitical risks, which have the potential to vastly alter any of the outcomes.*

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