For investment professionals only

Q2 Outlook: Safety first

We offer potential answers to three critical questions for investors about the economy and markets in the shadow of the coronavirus crisis – and explain why we remain cautious on risk assets.

Emiel van den Heiligenberg
Head of Asset Allocation

Emiel joined LGIM in August 2013 as Head of Asset Allocation, with responsibility for asset allocation, strategy and multi-asset macro research.

In our last quarterly **outlook**, we flagged our cautious posture on risk assets, taken due to a number of smouldering risks on the horizon. One risk we did not highlight, however, was that a pandemic would break out, causing untold human suffering and economic damage.

We are clearly now living through an extremely challenging period for society and the global economy, as the entire world is enlisted in efforts to combat the spread and impact of COVID-19.

In this outlook, and against this extraordinary backdrop, we offer answers to three key questions for investors: How much do we know about the virus? How much damage will it inflict on the world economy? And, how will markets digest the responses from policymakers?

Staying cautious

The answers to these questions inform our current positioning. Here, we remain wary on the outlook for risk assets like global equities, given the large uncertainty over the economic impact of coronavirus and our concerns over the knock-on effect for earnings.

On the economy, we are by no means certain that a V-shaped recovery is the most likely scenario. Indeed, our virus modelling suggests that the authorities will need to keep social distancing – and the associated restrictions on businesses – in place for at least several more months, otherwise further outbreaks are likely.

News flow about the pandemic may also deteriorate further in the weeks and months ahead. We have already received an initial glimpse at the massive rise in unemployment likely to come; defaults on debt could soon follow.

Legal & General
INVESTMENT MANAGEMENT

Risk-on-sentiment

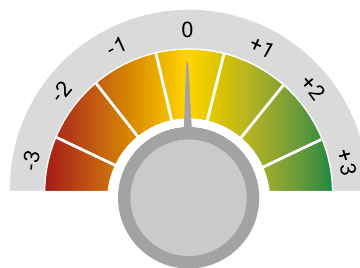
Yes, fiscal and monetary policymakers have undertaken truly impressive interventions around the world. But while these actions have made the tail risk of a truly systemic crisis much less likely, they cannot stop the virus nor erase the economic impact of those measures deployed against it.

Taken together, this is why we remain cautious, even amid rallies in risk assets.

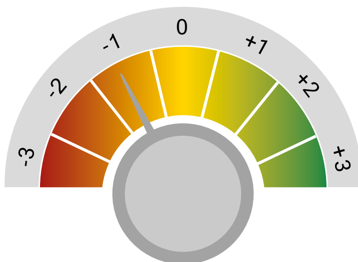
We know from experience that **sudden bursts** of risk-on sentiment, such as those we have seen recently, rarely endure during periods of severe economic disruption and weak company fundamentals. There will be a time when buying the dip is likely to be sustainably rewarded, but we don't think we are there yet.

Finally, I would like to wish you and those close to you good health during this uncertain and difficult period.

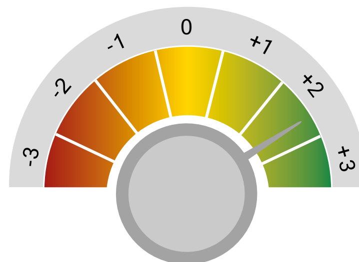
Summary of LGIM's asset allocation core view



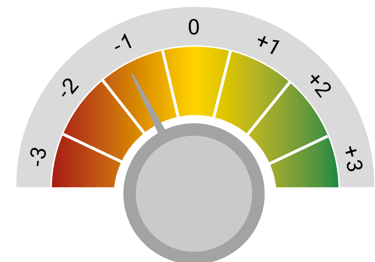
Neutral overall



Economic cycle
The Coronavirus pandemic has triggered a deep recession, but potential prospects for a rebound once virus fades



Valuations
Recent sell-off makes risk assets potentially more appealing



Systematic risk
Concern around interaction of recession and high global debt

These dials represent the medium term views of LGIM's Asset Allocation team as of April 2020. There is no guarantee that any forecasts made will come to pass.

Economic cycle	Valuations	Systemic risk
Likely temporary, but deep recession	Risk assets historically cheap versus government bonds	Huge uncertainty around coronavirus
Disinflationary shock	Equities pricing a fall in earnings and average multiples	Recession could expose the areas of excessive debt
Pre-emptive policy response	Credit spreads have significantly widened	Lack of conventional monetary policy space

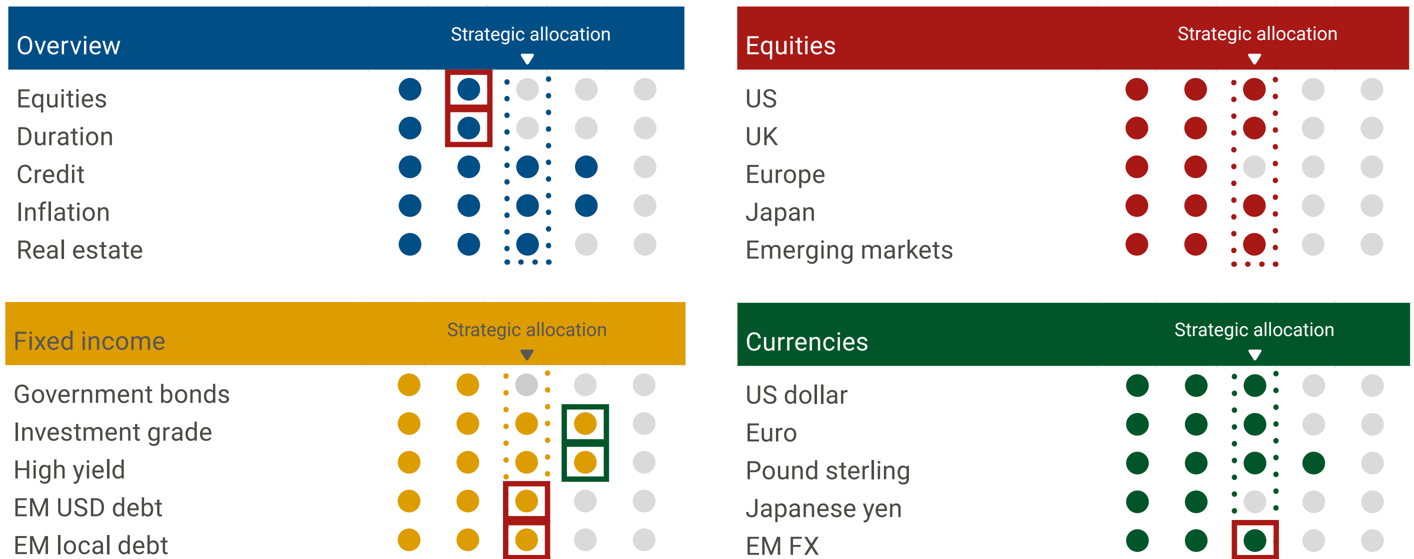
Source: LGIM. Our core view on risk assets, as illustrated by the big dial, may move in either direction going forwards; and our certainty over the expected direction of travel and timeframe for this next move has decreased in reflection of the uncertain geopolitical environment.

Our views at a glance:

Negative in the short term on equities – in our view, the market is underestimating the impact of measures required to contain COVID-19 and the downgrade to corporate earnings. Over the medium term, however, we are neutral as we believe valuations have improved significantly.

Neutral on duration in the short term – we expect central banks to keep yields low as they seek to prop up economies. Over the medium term, we expect yields to possibly rise as the world returns to 'normality'.

Neutral on investment grade credit and positive on global high yield – we are upgrading our stance here after spreads widened substantially. Though we expect defaults to pick up, support from policymakers may help cushion bond-holders, while carry is appealing.



Source: LGIM

This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of April 2020. The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point. A box indicates a positive or negative change in view, a green box being positive and a red box being negative. The tactical score for equities has been made more negative, whilst the medium term view is upgraded to neutral.

Erik Lueth
Global Emerging Market Economist

How much do we know about the virus?

News coverage of the virus by far exceeds that of the euro crisis, Brexit or the US election. But, sorting the wheat from the chaff is not always straightforward. Here we present the overwhelming scientific consensus so far.

The coronavirus is not simply another form of flu. The mortality rate is estimated to be somewhere between 0.5-1% which makes it five to 10 times more deadly than the seasonal flu. The mortality rate cannot be readily observed, as the number of reported cases is typically underreported and deaths follow infections with a three-week lag. But, natural experiments like the outbreak on a cruise ship, as well as mass testing in a number of countries, allow for reasonably precise estimates.

The importance of the mortality rate was cast into stark relief by a recent study by Oxford University. This claimed that the disease had peaked in the UK, as more than half of the population had already become infected – and immune – by now. This was inferred from the number of deaths by assuming an implausibly low mortality rate, in our view. The study was quickly dismissed by the scientific community and some **investment professionals**.

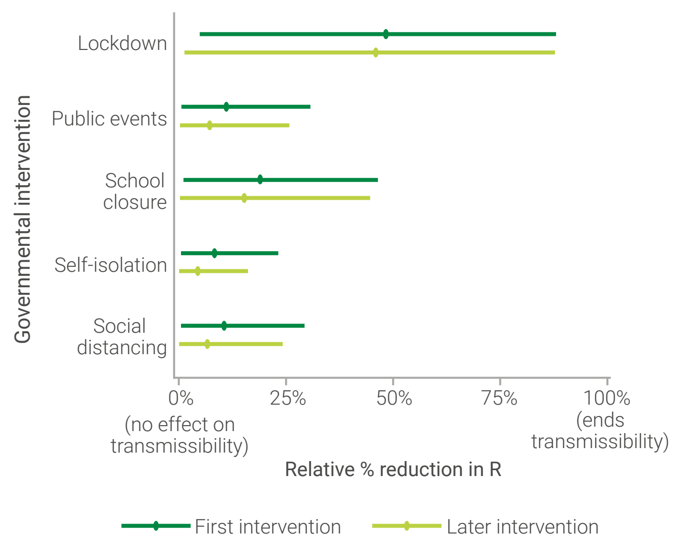
Waiting on the weather

Many hope that warmer summer weather will finish off the virus. This remains a largely unproven thesis. Estimates from various studies suggest that in warmer European countries, this could slow the natural spread of the virus by around 20%, although in the UK its effect would be less significant. What is certain is that it will not eliminate the virus, so is not a solution.

Most promising for the long term would be a vaccine. The intensity of research here is, of course, encouraging, but we have not yet found a credible source that claims a vaccine will be available within a year.

For the nearer term, some established antiviral drugs are being shown to have some effect on treating symptoms for those suffering from the disease. If they are proven to be reliable, and production bottlenecks can be overcome, such medication may at least reduce the pressure on intensive-care beds in hospitals and reduce the mortality rate of COVID-19.

Effectiveness of government interventions



Source: Imperial College London, LGIM, 30 Mar 2020.
There is no guarantee that any forecasts made will come to pass.

Finally, the disease's reproductive rate, R, has become a matter of collective consciousness. And, any smart 14-year old will tell you that the disease has peaked when the number of people a sick person infects falls below one.

So where do we stand? Again, reported cases cannot be trusted; hence, we derive R from the mortality dynamics. From this it looks like the disease has peaked in China, Korea and Taiwan. In Europe, Italy and Spain have passed the peak and Germany and the UK are on their heels. The US is not yet close to peak and some Asian countries are seeing infections accelerate again.

Tim Drayson
Head of Economics

How much economic damage will the outbreak cause?

The decisions by many governments to lock down their economies, by forcing non-essential businesses to close and people to stay at home, will have significant economic – not to mention social – consequences.

IIt is now inevitable that second-quarter GDP numbers around the world will confirm a massive near-term contraction. In our view, there are three potential scenarios for what comes after that.

Scenario 1: A speedy rebound

In this scenario, aggressive containment brings the virus quickly under control. These measures nevertheless still result in a year-on-year fall of around 10% in global output for the second quarter of 2020. This would be more than twice as bad as during the financial crisis; most stimulus efforts will be transfer payments, felt only later in the year, so can't stop this initial collapse in GDP. The huge response from monetary and fiscal policy that Chris describes on page 6 – crucially assuming no new major outbreaks – acts as a harness to limit the damage and then slingshot the economy forwards.

Overall, under this scenario, global growth may be around -3% in 2020 (roughly the same as during the financial crisis for the year as whole) and potentially +8% in 2021.

Scenario 2: Renewed outbreaks

This scenario is less positive. Containment strategies are lifted too early and have to be aggressively re-introduced to tackle renewed outbreaks. The damage would already have been done in terms of a significant rise in unemployment and bankruptcies. We then either learn to cope with seasonal outbreaks or a vaccine is found in 2021.

Under these conditions, global growth could be around -10% in 2020 – a contraction more than three times greater than in the financial crisis for the year as a whole – but there may be a partial snap back in 2021 of +8%.

Scenario 3: Scant recovery

This is the most concerning scenario. Heavy restrictions on individuals and businesses remain in place through 2020; any attempt to relax them is quickly reversed as the virus flares up again and has a higher mortality rate than expected. A huge rise in unemployment and bankruptcies would undermine confidence, while monetary policy is exhausted and fiscal authorities become reluctant to add further to their already massive deficits. There would be no significant recovery in 2021, no vaccine, and no herd immunity. Needless to say, this scenario would have many other negative social, financial and political consequences.

Economically, we would associate this with a year-on-year fall in global output in excess of 20% and an annual average contraction of 15-20%.

We believe scenarios 1 or 2 are more likely, but there is a non-trivial risk of us possibly ending up in scenario 3.

Christopher Jeffrey
Fixed Income Strategist

How will markets digest the policy response?

The primary policy response to the virus by authorities worldwide has, of course, been measures to protect public health. However, financial markets have understandably focused on the litany of economic policies also rolled out in response to the crisis.

Tackling the virus has led to an unprecedented shutdown in large parts of the economy. The overall policy response, outlined below, can be characterised as an attempt to alleviate hardship during that shutdown, while providing bridge financing to get corporations and households through to the other side.

Fiscal stimulus

Efforts to alleviate the shortfall in demand by cutting taxes, providing direct hand-outs to companies and households, and increasing government spending fall into this category – as do wages subsidies, augmented unemployment benefits and targeted tax forgiveness. Initiatives vary, but in aggregate, we are looking at a stimulus of roughly 5% of global GDP enacted thus far. With the exception of China, such stimulus measures are of the same order of magnitude (or bigger) to those seen in the 2008-2009 crisis.

Fears about public debt sustainability are, in our view, misplaced outside of certain corners of Europe and emerging markets. In an environment in which private sector spending is collapsing, markets will continue to welcome governments stepping into the breach to mitigate the size of the decline in output.

Government guarantees

These are attempts to keep lending channels flowing by underwriting credit creation. The details are still emerging, but partial government guarantees of loans made to small businesses are a key plank of the response in the UK, Eurozone and the US. This implies more contingent liabilities on sovereign balance sheets, and relies on traditional credit origination channels through existing high street lenders.

In principle, this policy response is the most powerful in reducing the risk of widespread corporate defaults, but speed is of the essence. Surveys reveal that around a quarter of small businesses face a cashflow crunch unless they receive some kind of assistance within a matter of weeks. Regulators are doing all they can to grease the wheels (reduced capital burdens, extra liquidity programmes), but operational challenges in the banking sector due to the virus are slowing the distribution of cash.

Direct market interventions

Here we see attempts to prevent an aggressive tightening of financial conditions from augmenting the underlying economic shock. Measures in this category have seen central banks assume 'lender of last resort' responsibilities on a scale never seen before, with a particular onus on the Federal Reserve (Fed) given the US dollar's status as the world's reserve currency.

'Conventional unconventional' policy easing also is happening at a furious pace. Over the space of three weeks, for example, the Fed will have purchased more than $1 trillion of US Treasuries. That is more than the central bank bought in the worst 12 months in the aftermath of the 2008/9 crisis. The primary responsibility here is to prevent an illiquidity-driven financial accident, hence the backstops to corporate bond and commercial paper markets.

The secondary (and typically unstated) responsibility is to facilitate the wave of public debt issuance that is an inevitable consequence of the two initiatives listed above. In addition, by facilitating liquidity in these core markets, the hope is to short-circuit fire sale dynamics elsewhere.

Will this be enough?

As a three-pronged approach to tackle the economic fallout from the virus, it is definitely a coherent plan. It adds up to a policy framework that is comprehensive enough to prevent a snowball effect of cascading defaults in the short-term.

Over the longer term, its effectiveness will be a function of the length of the restrictions to everyday life that are integral to the public health response to the virus – and in which of the scenarios listed by Tim we find ourselves.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

Important information

Past performance is not a guide to future performance. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested. Views expressed are of Legal & General Investment Management Limited as at March 2020. This document is designed for the use of professional investors and their advisers. No responsibility can be accepted by Legal & General Investment Management Limited or contributors as a result of information contained in this publication. The information contained in this brochure is not intended to be, nor should be construed as investment advice nor deemed suitable to meet the needs of the investor. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be solely relied on in making an investment or other decision. The views expressed here are not necessarily those of Legal & General Investment Management Limited and Legal & General Investment Management Limited may or may not have acted upon them. This document may not be used for the purposes of an offer or solicitation to anyone in any jurisdiction in which such offer or solicitation is not authorised or to any person to whom it is unlawful to make such offer or solicitation. No party shall have any right of action against Legal & General in relation to the accuracy or completeness of the Information, or any other written or oral information made available in connection with this publication. As required under applicable laws Legal & General will record all telephone and electronic communications and conversations with you that result or may result in the undertaking of transactions in financial instruments on your behalf. Such records will be kept for a period of five years (or up to seven years upon request from the Financial Conduct Authority (or such successor from time to time)) and will be provided to you upon request.

© 2020 Legal & General Investment Management Limited. All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, including photocopying and recording, without the written permission of the publishers. Legal & General Investment Management Limited. Registered in England and Wales No. 02091894. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised and regulated by the Financial Conduct Authority, No. 119272.

CC17342020