

On the Minds of Investors

April 2020

How bad will the COVID-19 recession be?

As COVID-19 continues to spread, the question has quickly shifted from whether there will be a global recession to how bad the recession will be. Will it be deep but short? Or deep and prolonged? As investors, the next question we need to ask ourselves is what is the market priced for. And will it be relieved, or disappointed?

In our view, the severity of the downturn will likely depend on three factors: the time it takes for the disease to be contained, the pre-existing vulnerabilities in the global economy, and the global policy response.

The hardest of these to analyse confidently is how long it will take for the virus to be contained and for the need for travel restrictions and social distancing to diminish.

China and South Korea, which were among the first to feel the effects of the virus, shut down their economies early and saw infection rates fall. As they return to work, infection rates have remained low. It is too early to absolutely declare victory, but so far so good. In these economies the shock has been sharp but seemingly short-lived.

Much of the developed world is a number of weeks behind these Asian economies, and remains in a period of economic lockdown, with little clarity about when that might end. It may ultimately depend on the scientists - either when a vaccine can be found, or when sufficient testing becomes available to establish whether swathes of the population have already been exposed and generated some degree of immunity. At this stage, it is unclear when the disease will be sufficiently contained for normal life to resume.

Was the economy in good shape when the virus hit? We believe the risk of this rapidly morphing into a credit crunch like the one we saw in 2008 is lower because the banking sector is more highly capitalised than a decade ago. And households, particularly in the US, have not overspent in this expansion, so balance sheets are in fairly good shape. Corporates, on the other hand, generally look more vulnerable in light of the rise in both listed and private leverage this past decade. The rapid increase in spreads, particularly in the high yield market, shows that investors are all too aware of these vulnerabilities.

This brings us to our final consideration. Are policymakers, and governments in particular, putting in place the right type and magnitude of stimulus? Will the economy be held in a state of suspended animation and able to quickly resume production once the disease is contained? Our verdict here is that governments have responded quickly, and in large part with the right type of policies. For example, in many European nations, very generous subsidies have been made available to companies to prevent them from cutting jobs. And a number of grants are available for small businesses. In our view, what is critical is that the government payments are gifts, not loans, since the loss of revenue is a solvency, not just a liquidity, problem.

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The central banks have also responded with admirable speed and vigour. The fiscal spending to support the economy will be enormous, which means governments will have to issue a lot of debt. Central banks have revved up their asset purchase programmes to absorb this, which has alleviated strains in the core government bond markets and kept yields low. Though specific policies differ by jurisdiction, central banks are also backstopping segments of the corporate bond markets in the US, Europe and the UK. At the moment, however, this extends only to the very highest quality credit and much of the problem debt does not therefore sit under the central banks' wings. Careful selection is therefore critical.

What type of recession is the market priced for? This is never an easy question. Economic forecasts generally look for a very deep contraction in Q2. It is certain that the normal data we track will, in the coming months, be truly disastrous, but the market may well shrug this off. A truly awful Q2 is a given. What is important is whether the strong bounce back in Q3 or Q4 is likely. If it is, this will set the stage for a strong recovery in earnings in 2021 (Exhibit 1).

The prospect for a bounce back is partly dependent on the path of the virus itself and the medical and scientific solutions. In the meantime, to assess whether policymakers have done enough to prevent second-round effects, we will be keeping a close eye on firms' employment intentions. We also have our US Economic Monitor (Exhibit 2) to track the severity of the recession in the near term.

EXHIBIT 1: REAL GDP FORECASTS AND US EARNINGS IMPLICATIONS

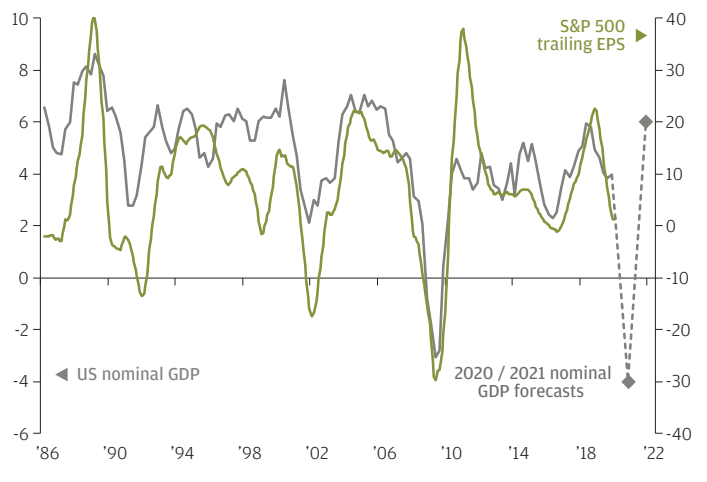
JPM Investment Bank real GDP growth forecasts

% change quarter on quarter, seasonally adjusted annualised rate

	Q1 '20	Q2 '20	Q3 '20	Q4 '20	2020*	2021*
US	-10.0	-25.0	11.0	7.0	-5.3	4.5
Eurozone	-15.0	-22.0	45.0	3.5	-3.4	4.7
China	-40.8	57.4	23.9	5.5	1.1	9.8
UK	-10.0	-30.0	50.0	2.5	-3.7	4.1

US nominal GDP growth and earnings growth

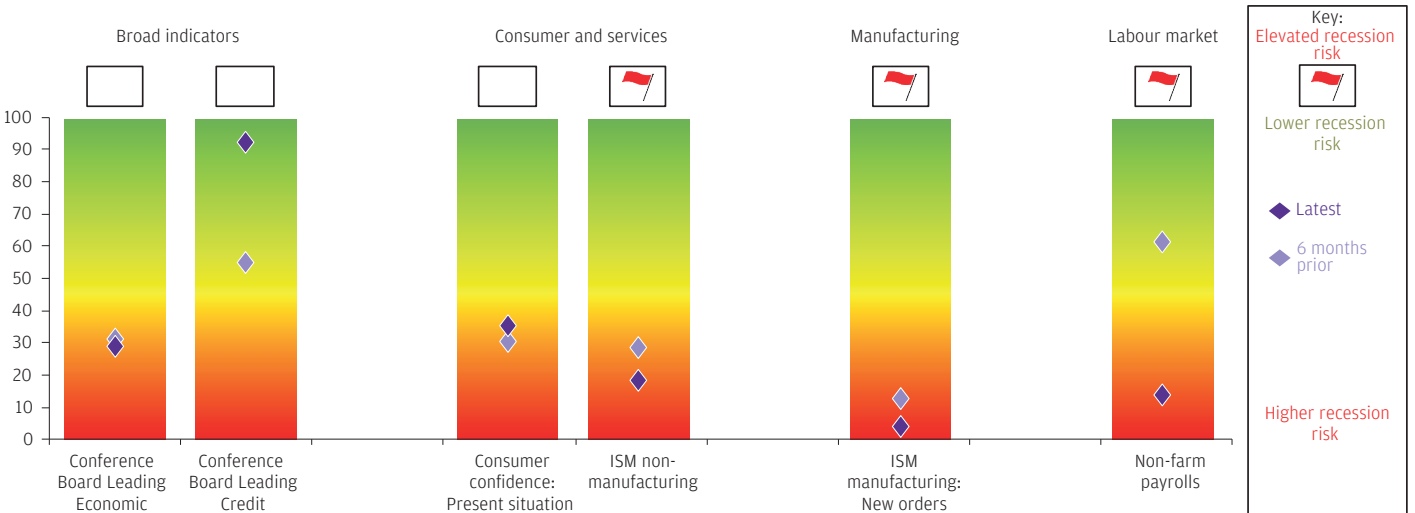
% change year on year



Source: (Top) J.P. Morgan Securities Research, J.P. Morgan Asset Management. *2020 and 2021 figures are the annual growth forecast for the full year. (Bottom) BEA, IBES, Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management. Earnings data is a three-month moving average of last 12 months' earnings per share. Nominal GDP forecasts are from J.P. Morgan Securities Research. Past performance and forecasts are not a reliable indicator of current and future results. Data as of 31 March 2020.

EXHIBIT 2: US ECONOMIC INDICATORS

Percentile rank relative to historic data since 1990



Source: BLS, Conference Board, ISM, Refinitiv Datastream, J.P. Morgan Asset Management. Elevated recession risk flags are shown when the underlying indicator is at a level consistent with the onset of any of the past three US recessions, as determined by NBER. Transformations used for each of the indicators are: % change year on year for the Leading Economic Index and consumer confidence present situation, index level for Leading Credit Index, ISM non-manufacturing and ISM manufacturing new orders and three-month moving average of monthly absolute change for non-farm payrolls. Data as of 31 March 2020.

Conclusion

Overall, our conclusion at this stage is that the recession is likely to be a little more prolonged than currently anticipated. However, we acknowledge that this answer is partly based on our assessment of the outlook for the virus itself, and we should be humble about our conviction here. This leaves us slightly on the bearish side of neutral, with a focus on diversification. Diversification by asset class because we still believe core bonds will go up in price if the situation becomes materially worse and stocks fall, and diversification by region because some countries may fare better than others. In particular, given the US seems to be the laggard in its health and policy response, clients with a large overweight to the US might wish to rebalance.

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