Mid-year outlook 2020: Our view of the damage and the road ahead

The first wave of the COVID-19 crisis is passing. Now the skies are clearing just enough so that we can assess the damage and get a sense of where we’re headed.
PANIC GRIPPED THE MARKETS

On February 19, 2020, the S&P 500 reached an all-time high and the global economy seemed poised to accelerate. Just one month later, the question was not “Are we going to have a recession?” but rather “How bad is it going to be?” The COVID-19 crisis catalyzed one of the most severe global economic contractions and bear markets in 100 years. The last three-and-a-half months have contained years of market-moving events and historic occurrences. Here’s how the transformation unfolded:

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<thead>
<tr>
<th>January</th>
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<tr>
<td><strong>VIRUS</strong></td>
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<td>WHO reports cluster of pneumonia cases in Wuhan</td>
<td>Fed surprises with 50 basis points (bps) rate cut</td>
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<td>Wuhan goes into quarantine</td>
<td>U.S. surpasses 100 cases</td>
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<td><strong>POLICY</strong></td>
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<td>U.S. restricts entry for foreign nationals</td>
<td>10-year U.S. Treasury yield drops below 1.0%</td>
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<td><strong>VIRUS</strong></td>
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<tr>
<td>Italy confirms its first infection</td>
<td>Oil prices plummet after OPEC+ abandons agreement</td>
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<td><strong>MARKETS</strong></td>
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<td>Chinese stocks plummet</td>
<td>Italy locks down Lombardy region</td>
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<td><strong>MARKETS</strong></td>
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<tr>
<td>S&amp;P 500 closes at an all-time high</td>
<td>S&amp;P 500 triggers market-wide circuit breaker</td>
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<td>4.8% S&amp;P 500 YTD Performance</td>
<td>COVID-19 labeled a pandemic</td>
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<td><strong>VIRUS</strong></td>
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<td>Northern Italian towns close down due to virus cluster</td>
<td>NBA suspends all games</td>
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<td><strong>MARKETS</strong></td>
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<td>S&amp;P 500 enters into a correction</td>
<td>Stock markets have their worst day in decades</td>
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<td><strong>VIRUS</strong></td>
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<td>Infections peak in South Korea</td>
<td>ECB expands Quantitative Easing asset purchases</td>
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<td><strong>MARKETS</strong></td>
<td><strong>VIRUS</strong></td>
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<td>NYSE announces temporary move to full electronic trading beginning on March 23</td>
<td>China reports zero new local infections, U.S. surpasses 10,000</td>
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<td><strong>VIRUS</strong></td>
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<td>Italy surpasses China in virus deaths</td>
<td>White House declares national emergency</td>
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<td><strong>POLICY</strong></td>
<td>Fed cuts policy rates to 0%</td>
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<td><strong>MARKETS</strong></td>
<td>S&amp;P 500 posts third consecutive day of moves over 9%</td>
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<td><strong>POLICY</strong></td>
<td>White House embraces social distancing</td>
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<td><strong>POLICY</strong></td>
<td>California orders shelter-in-place</td>
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<td><strong>POLICY</strong></td>
<td>ECB announces Pandemic Emergency Purchase Program</td>
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THE RELIEF RALLY

When markets bottomed, there were only about 43,000 confirmed COVID-19 cases in the United States. Now, there are over two million cases in the United States (and almost eight million worldwide), yet the S&P 500 has rallied by almost 40%, the NASDAQ 100 Index has regained its pre-crisis peak, corporate and high yield bond spreads have tightened, and 10-year Treasury yields have traded in a narrow band.

Despite the virus case load and economic toll, the market panic has dissipated. The question is: Why?

As the market was rallying, the economic news wasn’t improving measurably. During the crisis, global business activity plummeted to levels well below those seen during the global financial crisis. In the United States, there have already been more than double the job losses experienced during the global financial crisis. Global demand for oil is at the lowest level since 1995. Half of small businesses in the United States are worried about their survival.¹ Large-cap earnings in the United States are set to drop by ~25% (and even further in the rest of the developed world).

THE JOB LOSSES DUE TO THE COVID-19 CRISIS ARE UNPRECEDENTED

Change from prior peak in total private non-farm employment (in millions)

During the crisis, global business activity plummeted to levels well below those seen during the global financial crisis. In the United States, there have already been more than double the job losses experienced during the global financial crisis.

The initial rally seems like more an expression of relief than economic rebound. When risk assets bottomed on March 23, COVID-19 represented an existential threat. Investors sold risk assets because they were terrified of the economic costs of a widespread lockdown and a devastating shortage of credit at a time when cash flows were likely to dry up. Then, the extent of the lockdown’s economic cost became clearer; new cases plateaued (with the exception of some emerging markets), the world economy started to open (from Foshan to Fort Worth, Milan to Miami), and policymakers offered robust support. Risk markets rallied.

In fact, the policy response has been so forceful that it may be misleading to rely on traditional economic indicators such as the unemployment rate and GDP growth. An estimated three out of every four workers in the United States who had been laid off received more in unemployment insurance than they did from their wages. Small businesses have taken out over $550 billion in loans from the Payroll Protection Program (roughly two months of payroll) to help keep them afloat. Many countries in Europe have similar schemes to replace incomes. Globally, policymakers have earmarked an astonishing $18 trillion in support, and central banks have cut rates 122 times. This support was designed to help keep business and household cash flows going during the lockdown so as to avoid a devastating wave of bankruptcies and business failures. It seems to be working.

The Federal Reserve fixed the troubling volatility in Treasury markets, and reduced spreads across issuers and maturities by providing a funding backstop for many types of borrowers. The mere willingness of the Fed to intervene has allowed borrowers of all types to access markets. Indeed, the numerous facilities the Fed established for direct lending have hardly been used. Traditional corporate debt issuance is occurring at a record clip. Credit is oxygen for the economy, and its flow seems healthy.

> Markets faced less uncertainty and knew they were getting robust policy support. Sometimes that is all it takes.

WHAT’S PRICED IN NOW?

While no one can know what will happen during the next year or two, we do know that the answer lies in the way governments, public health officials, scientists, economic policymakers, corporations and individuals respond to the virus threat.

So far, their responses are offering hints—and markets are taking notice.

The virus, clearly, is the hardest variable for market strategists to project (and we have enough trouble with our own specialty). An effective treatment or a vaccine would be a silver bullet, but drug and vaccine development and mass production take time.

So far, reopening has not come with a resurgence in new cases in Asia or Europe. In the United States, official “stay at home” orders and other measures designed to contain the virus were relaxed before it was clear certain jurisdictions had reached their peak of new cases. For the country as a whole, we seem to be past the peak, but a recent rise in cases in places like Texas, Arizona and Utah is concerning. We believe that policymakers will be willing to tolerate stable to slightly rising new infection curves in exchange for reopening the economy as long as the healthcare system has excess capacity. The bottom line is that the virus remains the key risk for markets.

From an economic perspective, the recent data on consumption and labor markets have been encouraging. In fact, it seems very likely that the recovery has already begun, albeit from very low levels.

So, stimulus has clearly helped prevent a continued negative economic spiral, and we seem to be past the trough. But the market is only 10% below all-time highs, and the economy still has a long recovery ahead. Are markets completely disconnected from reality?

In our view, markets are not waving the “all clear” signal.

Many sectors and asset classes are still suggesting weak future economic growth (market data listed below is through the end of May):

• Small-cap stocks have underperformed large-cap stocks by 10% so far this year (the widest gap since 1998)
• More than 163 S&P 500 stocks are down more than 20% on a year-to-date basis
• Bank stocks in the United States are down more than 30% from their 52-week highs
• Emerging market equities are still more than 25% below their January 2018 highs
• Ten-year Treasury yields are still below 1%, which signals that bond investors expect low future growth and inflation
• High yield bond spreads are still indicating a default cycle similar to the global financial crisis of 2007-2008
• Gold, a traditional safe haven, has rallied along with the U.S. dollar and the Japanese yen
• Industrial metals and crude oil have both sold off to levels consistent with the commodity super-cycle collapse of 2015 and 2016
These assets have rallied recently, but we still think they could appreciate further if the current trajectory continues.

However, there have been notable “winners” that are linked to some underlying—and accelerating—trends:

• The global technology sector has returned over 6% this year
• Home improvement companies are up over 11%
• Biotech stocks are up almost 10%
• Companies linked to e-commerce are up more than 14%
• The most well-known technology companies have returned over 22%

The COVID-19 crisis has increased the divide between the physical and digital economies, and the market is reflecting it. It also seems that many people realized their houses were due for some upgrades (or boredom is really kicking in)!

HOW ARE WE POSITIONED?

Markets have recovered rapidly, but there are still many uncertainties on the horizon. So what should investors do?

While it may be tempting to aggressively allocate to the down-and-out sectors in the hope of an economic rebound as the virus dissipates, we remain prudent in our approach, focused on navigating volatility and downside protection. At the same time, we believe the policy response from central banks and governments is enough to avoid the worst-case scenario.

Still, the path to economic recovery is murky. Business models have been forcibly disrupted. There are questions regarding the long-term viability of the corporate real estate sector. The evolution of the virus is still an unknown. Amid this backdrop, valuations seem full. That is why we maintain a modest underweight to equities relative to our strategic benchmark. Further, we still believe that core fixed income can provide an important balance against other risk assets.

However, a recovery will come, and may already have started. The contraction has been severe and painful; it will lead to lasting consequences. But there is reason to believe this recovery could happen faster than the one after the global financial crisis. It will also likely be quite similar in many ways: low and stable inflation, low interest rates and rising earnings. We also expect certain trends to accelerate: geopolitical tensions, digitization, healthcare innovation and widening gaps in wealth and income.

We have started a deliberate and thoughtful approach to rebuilding a “pro-cyclical” tilt in portfolios (i.e., overweights to equities and risk assets). The first step was to allocate to high yield bonds, which we believed presented an attractive risk-reward profile relative to stocks, given that spreads were still suggesting a significant default cycle. Recently, we have been adding to assets that have exposure to the physical economy if the recovery continues to surprise to the upside.

One thing we got right in the 2020 market outlook (published at the start of the year, before the crisis hit) was that digital transformation and healthcare innovation can offer compelling secular opportunities, and could be less sensitive to the cyclical business cycle. This thesis is playing out, and we expect it to continue. In fact, the COVID-19 crisis has probably accelerated the move toward a digital-first economy, and healthcare innovation could literally provide the resolution to the pandemic.
INVESTING WITH INTENT

The COVID-19 crash has been a stark reminder to expect the unexpected. Not one investment outlook issued at the start of 2020, ours included, predicted a new pandemic would cause the global economy to effectively shut down and equity markets to go through one of the most severe bear markets in history, and then rally over 40% in 50 days from the bottom. That is why we rely on diversification to help us weather unexpected storms. Stocks may be down 8% so far this year, but bonds are up 5.5%.

As we look forward, the range of possible outcomes is wide. The opposing tail risks of a second wave in the fall (clear negative) or the development of an effective vaccine or treatment (clear positive) illustrate this dispersion. Diversification is critical in this environment.

Ultimately, investors need to focus on what they can control: articulating a specific intention for their investments. Whether it is saving for retirement or a new house, or building generational wealth, we can build portfolios together that offer a higher probability of success, even in the face of the next event that might cause the next 30% sell-off in equity markets.

One way to achieve your individual financial goals is through proper planning and precise portfolio construction. The COVID-19 crisis is not the first event to roil stock markets. The recession that containment strategies have created isn’t the first setback for the global economy. Workers will be rehired, consumers will gain confidence, revenues will grow and asset prices will rise. It isn’t a question of if, but a question of when.

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KEEP WATCH

While we’re on this road to recovery, you may want to keep an eye out for some possible risks that may arise.

POTENTIAL DOWNSIDE RISKS:

- “Second wave” of virus infections around the world that necessitate more restrictions
- Small business failures compound into problems across the economy
- Tepid consumption activity even after restrictions are lifted
- Reduced corporate capex as balance sheets are constrained by excess debt
- Higher corporate and individual tax rates
- A return to fiscal austerity around the world due to concerns about growing government debts
- Spiraling geopolitical tensions and a resumption of the United States-China trade war

POTENTIAL UPSIDE RISKS:

- A COVID-19 vaccine or other medical solution becomes available by the end of 2020
- Consumer demand bounces back rapidly after restrictions are eased
- Robust fiscal and monetary support catalyze a rapid economic recovery
- Low bond yields incentivize a return to “there is no alternative” investor mindset. This could lead to well above-average equity valuations
A GLOBAL PERSPECTIVE

It also can be helpful to see how regions of the world are experiencing this crisis. Our in-country teams offer these reports:

ASIA

Asia is now a tale of two extremes: Many parts of the region remain in lockdown with the worst economic fallout still to come. Other parts, particularly East Asia, have contained their viral outbreaks and moved into the recovery phase.

The recovering
In China, production activities recovered quickly after the government started easing restrictions in mid-March. Still, sluggish consumer demand is restricting growth. Elsewhere, Korea’s consumer sentiment is rebounding, and Japan is lifting its state of emergency. From a policy perspective, Japan, South Korea, Singapore and Hong Kong have launched sizable fiscal packages in response to the pandemic. China’s stimulus approach has been more conservative, due to concerns about structural challenges and high debt levels.

Looking ahead
Three broad factors will determine how well the Asian economies ultimately weather the COVID-19 storm:

1. Controlling the virus—This factor is particularly pertinent in those countries where cases are still rising, but also important in countries that now need to prevent a second wave.

2. The structure of the economies—Exporting economies and those more reliant on services and tourism will likely suffer in the second half of 2020 amid global weakness. But countries with large consumer bases and manufacturing industries (such as India and China) should fare better.

3. Policy responses—Hong Kong and Singapore have provided significant fiscal support, while other countries such as India and China provided relatively less.

The suffering
One key economic risk will be the ability of ex-East Asia emerging market economies to contain the virus’s spread. They may not be able to, given that: Despite extensive lockdowns, new case numbers keep rising; these countries often have fragile health systems and weaker governance capacities; and in many, especially those reliant on tourism, it seems likely that if the virus is an issue somewhere, it will continue to ripple across the region.

The East-West divide
For investors, one significant overhang is escalating United States-China tensions. Relations between the two countries appear to be at their lowest point in decades. There was a short period of calm after the “Phase one” trade deal was signed on January 15, but the COVID-19 crisis seem to reignite tensions.

Still, the trade deal is safe, for now. Both countries recognize the detrimental impact of tariffs and are unlikely to escalate tariffs while working to recover from the COVID-19 recession. So far, China seems committed to honoring its purchase agreements, though it’s highly unlikely to be able to meet the agreement’s targets.

Overall relations are likely to keep deteriorating, however, with both sides continuing to decouple their economies from each other.

Alex Wolf
Head of Investment Strategy, Asia
EUROPE

As Europe deals with the COVID-19 crisis, the continent is on the brink of systemic change.

BREXIT

The year 2020 was always going to be difficult, given the tight timetable for Brexit negotiations seemed bound to cause tensions and undermine economic confidence.

One might have thought the pandemic would persuade both the United Kingdom and the European Union (EU) to shelve difficult decisions until calm was fully restored. That is not the case, at least not yet. As we write this report, there is no agreement to delay the year-end expiration of the “transition period,” in which the United Kingdom remains bound to EU rules as final details are hammered out. Furthermore, as feared, there is no progress in reaching an agreement on the shape of a post-Brexit economic and security relationship.

Instead, the second half of the year looks likely to bring more Brexit drama and volatility. It is still possible to reach a deal that will avoid the worst possible economic fallout. However, it is also possible today’s politicians will ignore one of the past’s most painful lessons: Economic barriers often worsen, and extend, economic depressions.

Historic financial proposal

But despair not. Some of the current, potential changes are constructive, particularly the EU executive’s proposal to borrow to finance an EU-wide recovery plan.

As the COVID-19 crisis began to unfold, the European Central Bank (ECB) stepped up its stimulus efforts. Many questioned whether the ECB’s actions were within its remit. It was not long before the German Constitutional Court raised fundamental objections—which at a minimum might, if successful, place constraints on the ECB not felt by other central banks.

Spurred by the need to find other ways to stimulate the economies of the EU countries, support the nations hardest hit, and prevent uneven recoveries from undermining EU stability, Germany and France agreed on a landmark proposal: The EU itself would borrow in the capital markets and distribute grants to its weakest regions and sectors. This kind of fiscal unity seemed like a pipe dream for years. If implemented, it could be a boon for European assets.

At the time we are writing, it is not yet clear whether all 27 EU members will agree to finance a response to the crisis. However, if the core of this proposal becomes operational, 2020 will be remembered not only for the COVID-19 crisis, but also for laying a historic foundation for the EU’s ongoing economic stability.

David Stubbs
Head of Market Strategy & Advice, International Private Bank, EMEA
The year began with such high hopes—invigorated by the assumptions that the trade truce between the United States and China would hold and supportive monetary policy would endure.

Expectations were that Latin America’s economic growth would strengthen somewhat from its soft 2019 levels. The whole region seemed about to get a boost from the two giants that account for 60% of the region’s economy: Brazil, where an economic recovery was underway, and Mexico, where an economic recovery was not yet seen but presumed. It was thought Latin American growth would go from 2019’s meager 0.6% to 1.5% in 2020. That would have been a welcome change, though still be shy of an estimated potential of 2.5%.

Then, suddenly, the deadly coronavirus brought the global economy to its knees. Most countries around the world imposed containment protocols that abruptly halted economic activity. And, when the global economy stopped spinning, so too did the Latin American economies. The region plunged into an unprecedented recession.

Now, six months into the year, Latin American countries have a variety of monetary and fiscal stimulus programs in place, but are still struggling to keep their populations safe and their economies afloat:

- Countries like Chile and Peru, and to a lesser extent Colombia—after many years of fiscal discipline—had greater leeway to shield their economies from the crisis
- Others, like Argentina, threw their more limited resources into the fight against the pandemic
- Still others, notably Mexico and Brazil, downplayed the pandemic’s risks and kept their initial responses to a minimum. Brazil later eased this hard line, forced by internal politics. But the Mexican government refused to budge. As a result, Mexico—despite its fiscal firepower—has allocated the region’s least amount of financial resources to combat the crisis

A risky reopening?

At mid-year, many Latin America countries are following the lead of the world’s superpowers and partially reopening—even though many here think this move is premature.

We’ll see the results in the second half of the year. As it stands now, the region is expected to contract by more than 7% in 2020. But this number assumes that lifting rules for social distancing does not spark a second wave of contagion that sends everyone back home and paralyzes economic activity yet again.

Even if a relatively benign scenario plays out and a degree of normalcy resumes, Latin America will have to contend with the fiscal deterioration and mounting levels of public debt that its defensive policies are likely to produce.

But that’s the challenge to be tackled tomorrow—after (we hope) renewed economic stability and growth are secured today.

Franco Uccelli
Head of Client Investment Strategy, Latin America
UNITED STATES

As 2020 began, the U.S. media seemed to expect that the U.S. election would dominate the national dialogue. Then the COVID-19 crisis hit and consumed our attention. But the more the country is able to move into a “new normal” and the closer we get to November, the more the U.S. presidential and Congressional elections are likely to come into focus.

While the COVID-19 crisis was intensifying, so too did the Democratic nomination process. Before presidential candidate Joe Biden decisively won the South Carolina primary on February 29, betting markets were giving him only a ~10% chance of becoming the Democrat’s choice. His Super Tuesday turnaround could have been the story of the spring, but alas.

From the perspective of the markets and the economy, having Biden as the presumptive Democratic candidate likely avoids more potentially transformative outcome. Biden’s last viable opponent for the nomination, Senator Bernie Sanders, offered a platform that sought meaningful change to the way American capitalism operates. In contrast, former Vice President Biden embodies the left’s more traditional approach: higher tax rates on corporations and the wealthy; more regulation; greater spending on public healthcare and infrastructure.

Election risks?

As investors, we have to assess how policy influences the economy and financial markets. We will be watching the outcome closely to see if there is increased likelihood of higher corporate or individual taxes, or less willingness to enact further fiscal support for an economy that is still recovering from the COVID-19 lockdown.

Consistency

No matter how the election goes, we expect the process of economic decoupling from China to continue. The “tough on China” approach is now quite bipartisan; there is broad support among federal lawmakers to rein in China’s rise. The recent national reckoning with systemic racism could also influence the tenor of the election.

The good news for long-term investors is that markets know how to deal with elections. They happen every four years after all. Historically, they matter for markets in the near term, and result in shifts at the industry and asset class level. Still, we believe that linking political outcomes to the business and economic cycle is the most important factor that drives our asset allocation process.

Jacob Manoukian
Global Market Strategist

STAY IN TOUCH

Speak with your J.P. Morgan team about how the markets’ recent movements and expectations may affect your portfolio and plans.
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