Many countries around the world are gradually reopening their economies as COVID-19 infection rates slow. While any progress toward normality will likely inspire a sense of cautious optimism, overall uncertainty remains high. Our Global Chief Economist and Global Head of Macroeconomic Strategy Frances Donald identifies five themes that inform her views on the market.

Market outlook: navigating the next chapter of COVID-19

Key takeaways:

- We believe the worst of the week-over-week decline in economic data is over, but we aren't out of the woods yet.
- The eventual recovery will be uneven across the global economy and the financial markets—which is likely to rebound well before economic growth resumes.
- The global and US economy are facing near-term deflationary pressures—short-term US rates can touch zero.
- Significantly higher fiscal spending globally will likely lead to inflation in the medium term—gold can continue to do well in this environment.
- Coming out of the global financial crisis, it was all about not fighting the US Federal Reserve (Fed); the equivalent this time around could well be "own what the Fed owns."

We're in the midst of the greatest economic contraction in modern history: Oil prices fell into negative territory, the United States lost over 30 million jobs since mid-March,[1] companies are pulling earnings guidance, and beneath it all, the lingering sense that a second wave of COVID-19 could take place soon. Concerns about a second outbreak in particular are severely restricting everyone's ability to time—or gauge the size of—the global economic recovery that we know *will* come.

On the other hand, global central banks are continuing to engage in the most expansive monetary policy response of our time, and governments worldwide are blowing out their fiscal deficits to levels that are typical of wartime. Every day, we hear about medical advancements related to potential COVID-19 vaccines and treatments, and how coronavirus case count curves are flattening. The narrative seems to have shifted gear rapidly as economies reopen. The S&P 500 Composite Index, for instance, retraced over half of its initial sell-off by the end of April.[1]

How should investors navigate the depths of market uncertainty and upside/downside risks in the months ahead? If we were in the midst of a baseball game, we're probably only in the second inning of a very long game, and it's still far from certain how long the game will last—or how it'll end. With that as a caveat, we present five key investment themes—a playbook of sorts—that frame our thinking and help us navigate uncertain markets. Naturally, as the situation evolves, so too will our thinking and focus.

Largest week-on-week dips in economic indicators are likely a thing of the past, but expect more turbulence ahead

Market implication

We're expecting risk assets to retrace some of their recent gains, although we don't expect the market to hit new lows. From an investment perspective, caution is still warranted; this doesn't feel like the time to make huge bets about which way the equity markets will go. That said, it makes sense for

[1] Bloomberg, as of 1 May, 2020.

investors with a longer investment horizon to gradually add risk back to their portfolios.

Most high-frequency indicators that we're monitoring suggest the worst of the economic fallout ended in mid-April; that is, it'll continue to worsen, but at a slower pace. Despite this, we continue to have several concerns:

- There's still pronounced uncertainty about how the COVID-19 virus could evolve. In particular, we cannot discount the possibility of a second wave of outbreak in the autumn or winter, which could lead to another round of shutdowns.
- COVID-19 infection curves in most major economies (although not all) have mostly flattened as of this writing, but the pace at which infection is falling appears to have plateaued. In other words, the number of new infections is still rising.
- With oil prices at current low levels, we find it difficult to dismiss the possibility of credit events materializing, even with support from the US Federal Reserve (Fed).
- While nearly a fifth of firms that have handed in their quarterly earnings managed to meet expectations,[2] we're concerned about the number of announcements relating to dividend cuts, a fall in share buyback programs, and a reduction in earnings guidance.
- Within the S&P 500 Index in particular, we note that movements in the index continue to be led by large-cap companies, and the index itself has failed to break through key technical levels, including the 50-day moving average.[2] History suggests another drawdown is likely before we see a sustainable recovery in stock prices. That said, given the speed of the recent bounce, we doubt we'll see markets retest recent lows.
- The upcoming US election will no doubt have an effect on market sentiment, which will likely become more pronounced as we get closer to election day.
- The market may need to contend with louder noise around the US-China relationship and what it may mean for supply chains, reminiscent of the rise in trade tensions in 2019.

[2] FactSet, as of 24 April 2020.

Any rebound will be uneven across economies, sectors, and markets

Market implication

We expect manufacturing activities in the global economy to recover faster than consumption and services—we're already seeing that play out in real time. From an investment perspective, this suggests the manufacturing/construction sector will likely outperform the consumer discretionary sector in the near term.

On a macro level, it also means that we're more likely to see a recovery in corporate earnings before we see a broader economic rebound. Based on data from previous recessions, we know that corporate earnings—on average—take 27 months to recover the lowest point it'll hit during the contraction. The equivalent recovery period for economic growth, by comparison, is 58 months.[3] For this reason, we have a more optimistic view of the equity markets in the medium term than the economic environment.

- Industrial, consumption, and traffic data from China provide an imperfect but valuable road map to understanding what's likely to happen when an economy emerges from a lockdown. From what we've seen, the key takeaway is that even as the supply side of the economy reopens for business, confidence channels will slow the return to discretionary consumer spending quite substantially.
- This recession is *services led* and therefore is likely to incur a substantially larger number of job losses than traditional manufacturing-led recessions. Whereas it's often mentioned that services make up two-thirds of the US economy in terms of monetary value, the sector accounts for 86% of the US job market.[4] We expect the US unemployment rate to rise to near 20% in the next two months, and while a significant amount of the job losses will be unwound as the economy reopens, not all positions will be recouped. It's also important to note that recent recessions have seen payroll gains lag

[3] National Bureau of Economic Research, Fundstrat, 24 April 2020.
[4] Bureau of Labor Statistics, 3 April 2020.

economic growth by several *years*. For example, after the global financial crisis, US GDP recovered by 2011, but the labour market didn't hit new highs until 2014.[1]

- An important takeaway for us is that the services-based nature of this recession also suggests that most job losses will come from lower-paid positions. Of the 701,000 jobs lost in March, nearly 60% were from the food services industry, where the median annual income is just under US$24,000.[4] While we're likely to see the largest job losses in modern history in absolute terms, the top 20 industries that have shed the most number of jobs make up a smaller percent of total income (14%) than what the headline numbers suggest,[5] limiting the aggregate impact on growth even as it remains particularly painful for a significant and important segment of the population.

A near-term deflation ahead; front-end yields can touch zero

Market implication

We're facing near-term (but short-term) deflationary pressures. We believe the Fed will seek to pin down the front end of the curve and may engage in yield curve control, or YCC, a policy that the Bank of Japan introduced. We think yields on the front end of the US curve can fall to zero.

- We see a variety of deflationary forces ahead and expect *outright* month-over-month deflation in April and May.
- The sharp decline in oil prices is profoundly deflationary and is likely to weigh on year-over-year comparisons through to April 2021.
- In addition to the substantial widening of output gaps—the difference between the actual output of an economy and its potential output—US dollar (USD) strength will continue to be deflationary, particularly in the United States.
- Note that we expect near-term deflationary pressures to be *services led*, which is problematic because the bulk of inflation in both the United States and Europe has been driven by the services sector (especially housing)—goods inflation in the United States is already negative.[1]
- We don't think the Fed is overly concerned about near-term price pressures—it's more focused on preventing a credit crisis. Yet, in addition to near-term deflationary pressures, the Fed's extraordinary emphasis on keeping near-term rates low can, in our view, push short-term rates to zero.

[5] Fundstrat, 24 April 2020.

Fiscal packages are powerful and (longer-term) inflationary

Market implication

- As much as near-term deflationary pressures are important, we believe it makes sense to add to inflation protection from a longer-term perspective. Fiscal packages announced by governments worldwide so far are huge and powerful, and will ultimately lead to higher levels of inflation in three to five years' time. In our view, gold can be particularly useful as a short-term risk-off hedge in addition to being a longer-term inflation hedge.

- The global level of fiscal stimulus means that fiscal deficits, particularly in the United States, will likely be on par with wartime levels. As we've mentioned previously, monetary policy's effectiveness at supporting growth and inflation has weakened post-1995; in contrast, the effectiveness of fiscal policies has probably strengthened. Research has suggested that at this juncture every dollar of US government spending could contribute as much as US$4 to US GDP four years down the road.[6] In other words, today's fiscal spending is likely to translate into inflationary pressure in three to five years. In our view, the timeline differentiation of near-term deflation and medium-term inflationary pressures is important.

[6] "Aggregate Effects of Budget Stimulus: Evidence from the Large Fiscal Expansions Database," Peterson Institute for International Economics, July 2019.

- From an investment standpoint, we expect gold to do well. There are various reasons why we like the precious metal: It can serve as a hedge against volatility in the short term and inflation in the longer term; the typical negative correlation between the USD and gold has broken down as a result of their safe haven status, meaning we're likely to see strong and persistent investment demand from both investors and central banks.

Own what the Fed owns … but beware some central bank pushback

Market implication

In our view, owning what the Fed owns could be this decade's equivalent of "not fighting the Fed"—a prominent investment mantra within the investment circles in the aftermath of the global financial crisis. From an investment perspective, we prefer US corporate credit over US Treasuries. However, even if the Fed were an important buyer of US corporate credit, we still have lingering concerns about cascading credit events.

- Most credit markets that were exhibiting significant stress in mid-March are normalizing, thanks to aggressive central bank action. As a result, we're seeing improvements in the Treasury market, the commercial paper market, the municipal bond market, and, perhaps most importantly, the US corporate bond market.
- The Fed has begun dipping into the high-yield (HY) market (slowly) by saying it may purchase "fallen angels," which were rated investment grade (IG) pre-COVID-19, but were subsequently downgraded. Our base case expectation is that the Fed won't need to step into the HY market more aggressively. Indeed, we believe the Fed will want to ensure that the market understands its role isn't to support "zombie" companies. There is therefore scope for some near-term market disappointment as Fed Chair Jerome Powell begins to delineate what he is and isn't willing to do. That said, it's clear that there is a far greater likelihood that central banks globally will extend their purchases of IG and fallen angels into the HY space rather than into the equity space over time.
- We continue to expect YCC to be an important next policy move from the Fed and believe the US central bank will target the shorter end of the yield curve (two years and below).
- The Fed has been *tapering* its Treasury purchases in the last two weeks—the rationale behind that decision is that the US Treasury market is now functioning properly and therefore requires relatively less support. We can't help but note that the Fed's initial decision to purchase US$75.0 billion per day (or US$19.5 trillion a year) was unsustainable—there're only US$18.5 trillion in US Treasuries outstanding.[1] We think it's important to acknowledge that there's scope for the Fed to disappoint in the weeks ahead.

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