Tactical Asset Allocation (March Update): The Case of Investing in a Global Pandemic

Almost exactly when a public market in Wuhan, China was identified as the starting point of the coronavirus outbreak, infectious diseases were classified by the World Economic Forum (WEF) as one of the top risks in terms of economic impact in its latest Global Risk Report. The WEF says population growth, urbanization and climate change lead to a higher frequency of epidemics and pandemics.

As we are able to witness, globalization facilitates the spread of the Covid-19 and magnifies the adverse impact on the economy and financial markets. The human cost is steep. As of writing, more than 100K people worldwide have contracted the coronavirus. More than 3K people have died. Equity indices registered their largest declines since 2008 and U.S. and Canadian benchmark bonds rallied at a pace unseen since 2008 as well. Ultimately, we registered a slight portfolio underperformance relative to the 50/50 benchmark in February because of our underweight position in bonds. However, we managed to protect part of the portfolio because we added a 4% cash allocation and turned neutral on equities when we published our previous Tactical Asset Allocation report a month ago.

Before this March 9th collapse in stock markets around the world, market sentiment, equity valuation and earnings fundamentals were looking better than during the global financial crisis. The S&P forward P/E to VIX ratio for instance, a measure of market complacency, stood at its lowest level since December 2018. The CBOE equity put-to-call ratio reached its highest point since August 2019. The bull-to-bear ratio displayed in the *American Association of Individual Investors* survey improved during the first week of March, supported by the Federal Reserve emergency's 50bps cut of March 3rd.

From a valuation perspective, as per our fair value model, the S&P500 is now undervalued for the first time since January 2019. The difference between the S&P500 index and the Barclays U.S. Treasury 7-10 years index is back to October 2019 levels but nowhere near the ultra-low bottom of 2008-09. As for fundamentals, they have not significantly deteriorated yet although more earnings revisions will come. The net number of companies revising down their earnings is still below the lows of 2019. Labour market conditions were also extremely solid in both Canada and the U.S. before the Covid-19 outbreak but pre-emptive health measures will depress, at least temporarily, the number of hours worked and labour income.

Covid-19 Economic Impact: China in recovery mode; March bottom for North America and Europe?

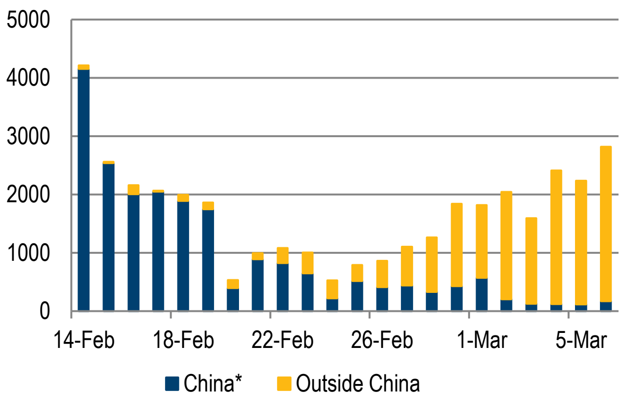
The OECD sees the coronavirus as the biggest threat to the outlook since the global financial crisis of 2008-09 because of its multifold supply and demand-related shocks: public health threat, containment measures, global supply chain disruption, decline in commodity prices, deterioration in consumer and business confidence and repricing of risk by investors.

In China, the epicenter of the virus, economic activity slipped at a record pace in February according to the latest PMI figure. The shutdown of the highly integrated global supply chain led to an all-time low in Chinese manufacturing activity in February and a stagnation in manufacturing output in the rest of the world. Demand for services in China tanked to its lowest level on record due to weak consumer confidence and quarantines. Furthermore, car sales fell by

80% m/m in February. Since household spending counts for a greater share of Chinese GDP than in the past, China real GDP Q/Q growth inevitably slipped into negative territory during 2020Q1.

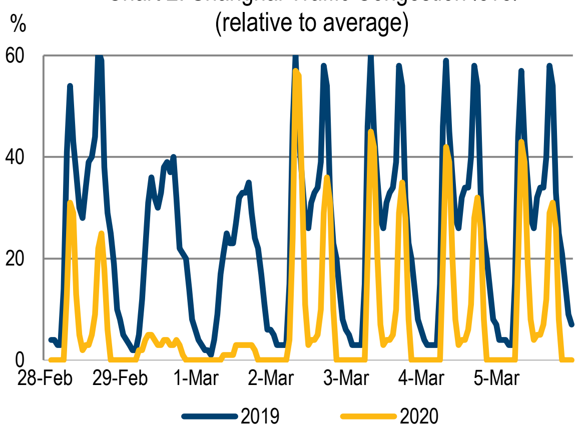
The good news is that quarantines are efficient as the number of new cases in China rapidly declined, although not to zero (chart 1). The WHO reported that 20 out of 31 Chinese provinces have downgraded their coronavirus risk assessment during the first week of March. In turn, Chinese factories gradually restarted operations and coal consumption rebounded softly. Migrants also returned to cities. As per Tomtom GPS maker, car traffic in cities increased over the past week although volumes remain well below average (chart 2). As employees return work, we will find out if the country can avoid a new wave of infections. All in all, China real GDP Q/Q growth could turn positive in 2020Q2 although it is too early to have a firm view on the magnitude and persistency of the rebound.

Chart 1: Daily confirmed cases of COVID-19



* Includes cases from Hong Kong, Macau and Taipei.
Source: WHO and ECDC.

Chart 2: Shanghai Traffic Congestion level (relative to average)



Source: TomTom Traffic Index.

The relatively encouraging evolution of Covid-19 in China and the pick-up in economic activity observed during the last few days are not sufficient to call for a bottom in bond yields and equities because the number of new cases is increasing at a faster pace globally (chart 2). New clusters have developed in Italy, Iran, South Korea and a few U.S. States. In response, drastic containment rules such as having a quarter of Italy's population in isolation are the lesser of the two evils. They reflect the uneasy health/economic outcomes trade-off authorities have to deal with. Leisure, tourism, accommodation, travel and educational companies are particularly hit hard. The J.P. Morgan Global Service Composite PMI has slumped to its lowest reading in almost 11 years in February and is expected to worsen in March. Also, the February U.S. PMI figure shows a contraction in services business activity for the first time in four years. In our view, U.S. real GDP will contract at a much steeper pace in March due to the weakening business and consumer confidence channels. For instance, the Morning Consult Daily Consumer Confidence Indices fell abruptly in late February and declined further in early March. Consumer confidence also deteriorated during the same period in Canada according to today's release of the weekly Bloomberg Nanos Canadian Confidence Index. The U.S. Michigan consumer sentiment for February, to be released on March 13th, is another key gauge investors will look into. Typical consumption patterns are clearly distorted: individuals buy emergency supplies such as masks, empty supermarkets shelves but delay big-ticket items purchases. The contraction in U.S. economic activity in March won't be enough to bring real GDP growth in negative territory in 2020Q1 because the U.S. economic momentum was strong before Covid-19. Unfortunately, the same cannot be said about Canada. In our view, Canadian real GDP fell in February and will contract even more in March, bringing down Q/Q growth in 2020Q1 into negative territory.

Covid-19: Odds of a constructive outcome appear higher than a severe scenario

Health experts debate on the virus spread and the effectiveness of preventive measures that are being taken. Under the most likely case that the coronavirus outbreak abates and eventually ends, scientists and doctors tend to consider the following scenarios:

1. The virus burns itself out once susceptible people are infected;
2. A vaccine is found but it will take some time to manufacture at the global level;
3. Efficient public health interventions bring the basic reproduction number (R_0) below the key threshold of 1 this Spring: an infected person passes the virus to less than 1 other person on average, leading to a decline in new cases.
4. Warmer weather in the Northern Hemisphere slows down the virus although we do not know if it will comeback this fall like the seasonal flu.

It is difficult to assess probabilities to these four events because there are other possibilities regarding the virus transmission. Nonetheless, the characteristics of the coronavirus should lead investors to favor a relatively optimistic base case scenario. Indeed, the basic reproduction number R_0 currently stands at around 2.0-2.5, lower than SARS (2.8) but higher than Ebola and the seasonal flu (between 1 and 2). The mortality rate, estimated between 0.5%-2%, is significantly lower than most viral diseases (SARS: 10%, MERS: 35%, Ebola: 50%). A weakening in the number of new cases globally, particularly outside Asia, could occur within the next month and a half if the spread pattern observed in China and South Korea repeats itself in Europe and North America. While several mild cases are undetected, some experts argue that industrialized countries such as France, the U.S., Canada and Italy could curb contagion faster than in China because authorities are generally better prepared. South Korea particularly succeeded in containing the virus due to its very efficient lab testing capabilities.

Central banks and governments to the rescue

Macro policy makers are generally proactive and are starting to make announcements to support economic growth. The IMF announced that $50B is available through its emerging financial facilities for low-income and emerging markets. The World Bank announced up to $12B in immediate support to countries dealing with the outbreak. Furthermore, the Federal Reserve never ends an easing cycle with a 50bps cut. Historically, an unscheduled emergency 50bps cut, like the one announced on March 3rd, is usually followed by a 50bps cuts in the following scheduled meeting. Thus, we forecast at least a 50bps cut by Fed Chair Powell on March 18th, acknowledging a coordinated move with other central banks including the Bank of Canada could occur before. A week ago, we were saying U.S. and Canadian benchmark rates could go to zero. North American yield curves close to the lower bound (of 0% or slightly negative) restrain the effectiveness monetary easing as we know it, a new challenge for the TSX and the S&P500. The Federal Reserve and other central banks could be forced to change the definition of "unconventional" monetary policy and start buying corporate debt and equities to ease the pain like the Bank of Japan has been doing for a decade. The BoJ is a top-10 shareholder in several companies of the Nikkei index. Also, additional automatic stabilizers to protect workers and companies are likely in the coming weeks. Media reports the safety net in the U.S. and Europe could include sick-leave pay Japan offers US$16B in special financing for SMEs. Once the virus is contained, other fiscal measures could be announced to lay down the foundations for a persistent rebound in global economic growth.

Despite the cracks appearing in the economy, we favor a constructive scenario

The multifaceted and proactive responses from health authorities, central banks and governments, combined with the characteristics of the virus, support the Economist Intelligence Unit and the OECD's constructive base case scenarios that the number of new daily cases could peak globally in late March or in April.

Given the viral-led slowdown, we prefer to use a pragmatic approach when it comes to the economic and investment outlook. For simplicity, we decided to transform the multiple Covid-19 scenarios in two economic scenarios. In our constructive base case scenario, the world economy goes through a brief and distorted V-shaped form where the bottom in GDP occurs in March, followed by a gradual recovery beginning in April. The second scenario is a recession of an unknown shape because too much financial vulnerabilities exist to pinpoint what could be the next shoe to drop. Indeed, even if the virus abates in a month from now, several things could go wrong. First, quarantines and isolation measures could hit financial hubs like Toronto, NYC and London, shutting down financial markets similar to 9/11, which led to a "flash recession". Second, the world could go through an intense episode of financial stress. The coronavirus market fears unambiguously increased the odds of a credit crunch: the jump in corporate credit default swaps and the widening in the Forward-Rate Agreements/Overnight Index Swaps spread observed during the first week of March reveal challenges in the corporate bond universe and U.S. money market. Other financial stress events such as the collapse of UK airline Flybe will hopefully be contained to relatively small, weak balance sheets companies and to small segments of sectors directly hit by Covid-19. Third, depressing cash flows and higher financing costs could lead companies to announce permanent layoffs, leading to a more classic recession including an increase in unemployment.

Overall, we peg the odds of our base case scenario at 55% given the wide range of possibility in terms of economic damage. In a new reliable study from the Australian National University, authors estimate that a global recession could occur in the softest of their seven Covid-19 hypothetical scenarios, based on the Hong Kong flu pandemic that killed an estimated 1M people globally in 1968. All in all, we peg the odds of an imminent recession at 45%.

A long-term view supports a neutral equity allocation

Our constructive base case scenario leads us to keep a 50% neutral allocation to equities relative to our benchmark. Part of our 50% allocation takes into consideration that global equities tend to recover within three months following reports of the first cases of an epidemic. Equity markets also show mid-to-high single-digits positive returns six months later. Furthermore, the weaker sentiment indicators and lower valuation metrics discussed above create an opportunity for long term investors to remain active in equities this month. Under our base case scenario, commodity prices partially recover some of their recent losses, as well as the Canadian dollar relative to the safe-haven USD. In addition, the time is right to take profit in fixed income as the U.S. and Canadian yield curves approach the lower bound, limiting the extent of future gains. The softer deterioration in corporate credit indices relative to equities, except energy, also leads us to underweight corporate bonds. The reduction in our bond allocation is compensated by an increase in cash. The 10% cash allocation will be used to grab buying opportunities in stocks once the virus abates. Inversely, our cash position will partially hedge the portfolio against major losses if the base case scenario becomes a recession.

The global pandemic favors a neutral view on equity geographical allocation

Equity indices in several regions have moved in tandem lately due to the global nature of the viral shock. The short-term rolling correlation between various stock indices stands very close to 1. Thus, future equity prices performance could be similar across regions. Accordingly, we prefer to turn neutral compared to the benchmark for all geographical indices. As for our sectoral allocation, the technical short-term momentum factors and relative strength indicators we are usually monitoring are not useful in the current context. Granted, there have been developments creating performance divergences among sectors such as Ottawa's call to lower prices in the telecom sector and Joe Biden's Super Tuesday wins supporting U.S. health care stocks. Also, the coronavirus outbreak has been favoring low-beta stocks, high dividend plays, strong balance sheets companies and gold. Inversely, insurers, energy companies, airline stocks and companies exposed to the global supply chain generally underperformed. In the grand scheme of things, the evolution of the coronavirus outbreak matters the most for investment returns in the short run, requiring investors to focus mostly on the bonds/equities allocation. As clarity emerges, we will be able to make firmer decision on geographical and sectoral allocation.

Recommended Portfolio as of March 2020				
Asset Classes & Regions	Recommended Weightings (%)	Benchmark Allocation (%)	Over/Underweights (%)	Recommendation
Bonds	40 (46)	50.0	-10.0	-
Government	32 (34.5)	34.4	-2.4	-
Corporate	8 (11.5)	15.6	-7.6	-
Equities	(50) 50	50.0	0.0	=
Canada	20 (18)	20.0	0.0	=
United States	16 (20)	16.0	0.0	=
Other Developed Markets	11.6 (10.6)	11.6	0.0	=
Emerging Markets	2.4 (1.4)	2.4	0.0	=
Cash	10 (4)	0.0	10.0	+

Note: Numbers in brackets represent previous month allocation.

Source: LBS Economic Research and Strategy.

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