



The View

THE BEAR & FEAR STALK THE WORLD

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- Covid-19 seems likely to cause a major recession and bear market
- The personal 'worst case' is dire – fear of it is rational & spreading
- Confined to China, the disease was a supply-side menace, but limited
- Spread globally, it is far less easily tackled than in authoritarian China
- DM consumers' discretionary spending is typically one third of GDP
- US consumers' major cutbacks could cut Q2 GDP sharply
- Spillover and 2nd round effects mean Q3 will probably be down further
- China suffered worst in Q1 – recovery starting during Q2
- Big Chinese infrastructure-build to focus recovery on manufacturing
- PBoC's policy largely defensive – loan forbearance for firms in trouble
- US needs positive yield curve out to 2 years for bank loan profitability
- Fed should concentrate QE entirely on ultra-short bills
- In Europe, Chinese policy helps Germany; France, UK, & Spain less so
- Crisis in Italy could turn into financial and/or euro crisis
- US stocks likely to fall to 2500 on the S&P, down 26% from peak

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Summary

Global spread of the Covid-19 virus looks likely to cause a worldwide recession and bear market in stocks. Nobody knows how serious the disease is likely to be. But The Brookings Institution's estimates suggest a reasonable likelihood that 10% of the US population will catch the virus, and of those at least 1% will die. As that implies more than 300,000 US deaths, personal fear is rational – there is more to fear than 'fear itself'. (These estimates are not exaggerated: in the UK, for example, official sources have aired estimates of possible 60% incidence for the disease, not Brookings's 10%. And the Brookings range for the mortality rate was 1-2%, though other analyses suggest rather under 1%.)

DM discretionary consumer spending is typically one third of GDP. Suppose it is cut 5% in Q2 – for Q1, any cuts in March may be offset by consumer hoarding of food and medical/household supplies. Then Q2 GDP will fall 1.7%, or an annual rate of 6½-7% in the US mode of presenting accounts. It could be more, it could be less – nobody knows, and there are no precedents. Such a Q2 decline would certainly spill over into Q3, reinforced by falling business capex and hobbling the nascent housing recovery. European reactions to the threat of Covid-19 are likely to be as strong as in the US – Italy is already in lock-down with thousands of cases and 230 deaths so far.

China, origin of the virus, was worst hit in Q1, in which real GDP almost certainly will have fallen. It seems to have contained the disease by draconian restrictions on movement. Migrant workers are now heading back to the factories, and the supply side should be back on track by the end of Q1 (ie, this month). A major infrastructure programme should cause some recovery during Q2 and H2, but the fear factor and weak exports (owing to recession elsewhere) could inhibit this.

US policy is unlikely to involve major fiscal action until unemployment is clearly rising, at which point tax cuts are likely. The Fed will eventually need to cut rates by another 50bp, but meanwhile needs to focus its QE-type re-investment programme at the very short end, to get short rates, and therefore bank funding costs, below the 2-year yield (now at 48bp) that typifies the rate of bank loans. This could have for stressed US firms the effect of China's mandated 'forbearance'.

In Europe, China's emphasis on manufacturing may help Germany, vis-à-vis France, the UK and Spain, but the recessions on average could match the US. Interaction of Italy's Covid-19 lock-down with its precarious finances and weak banks could roil debt markets.

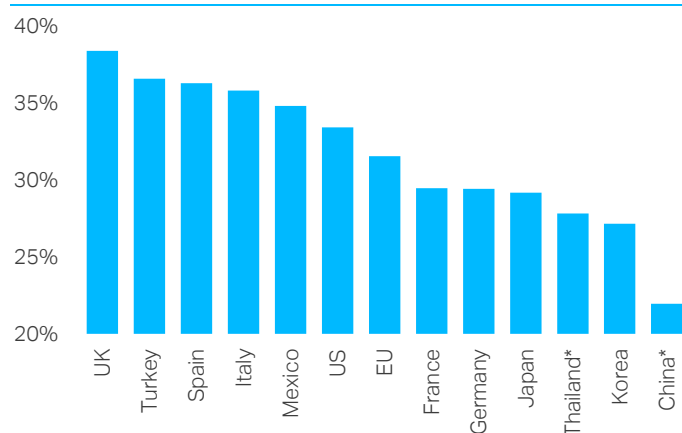
For stocks, we forecast the combination of negligible earnings growth this year with cuts in forward p/e ratios could take the S&P 500 down to the 2500 level, more than 25% down from its February 19th peak. Other markets will be analysed in detail in our *Asset Allocation* this Friday.

Introduction – the fear factor

'Fear' and 'bear' may not rhyme, but they do on paper. Every bear market stems from fear. And fear of Covid-19 is perfectly rational, even if there was a flavour of panic in the week leading up to the Fed's verbal intervention on February 28th. Covid-19 has the terror-value of the unknown. Other diseases can lurk undetected before showing up in symptoms – notably cancer, another potential killer that inspires fear. It may well be that Covid-19 proves either curable or relatively tame (despite the death toll, likely to be a substantial multiple of what happens each winter with conventional flu). But for now we do not know, and what we have to fear is fear itself. Financial markets were not aided by the Fed's dramatic rate cut, between-meetings and extra-large at 50bp – if anything, it raised the old question: 'What does the Fed know that it's not telling us?'

Shock to discretionary spending

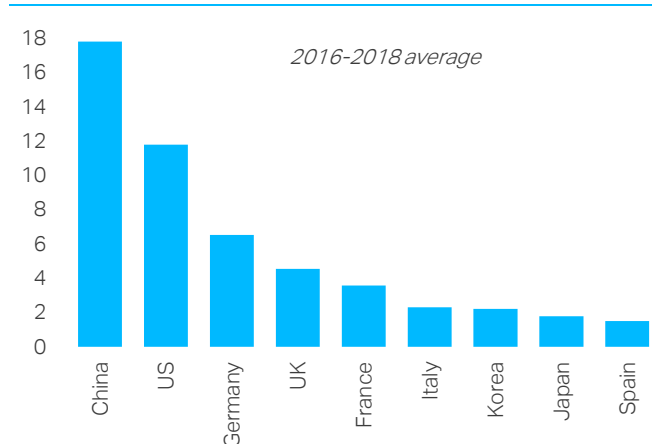
Discretionary household spending as % of GDP



Source: OECD, TS Lombard. *TSL estimates

Chinese tourist dearth leaves major void

Int'l tourism expense, selected countries, % world total



Source: OECD, TS Lombard

'Discretionary' spending by consumers is now roughly a third of GDP. The key change in the last few weeks is that Covid-19 has shifted from being a supply-side threat, largely confined to China, to being a global, demand-side threat. Why? Much discretionary spending has slipped into entitlement (eg, holidays, mobile phones) but it remains something that (at a pinch) one can do without – or at least postpone or do less expensively. Where do you have the best chance of being infected with a virus? In close, crowded conditions such as are normal in mass transit, such as railway carriages, aeroplanes, underground trains. Even the need for cash – a major reason people go to work – can give a little ground, as people use cars, taxis, or work from home, etc. But that nice visit we planned to Venice? Well, even the direst end-of-the-worlder might concede that it will probably still be above water next year.

Linked to all this is that the government in China can (at least in the short term) tell people what to do, whereas the rich democracies cannot (or not so easily). So China imposed a draconian lock-down on Wuhan, and Hubei province of which it is the capital. Covid-19 infection rates in Chinese provinces outside Hubei are less than those in countries to which it has rapidly spread, such as Korea, Japan, Italy and Iran – and the death rate matches the *Diamond Princess* at 0.85%. Now Chinese migrant workers are returning to work as infected cases have topped out. But democratic governments, even where they can adopt emergency powers, are inhibited in using them by the risk of voters' blame. The argument for democracy has always been that it is the 'least bad' system of government, and this is one of those situations to which it is not so well suited. People in the rich democracies, whatever the restrictions of emergency measures, are at least free not to spend, and will exercise that freedom.

Recession danger starts in Q2

The shape of things is that 2020 Q1 will not be much affected by a 'buyers' strike' as it will only be kicking in for March data – the S&P index recorded an all-time high as recently as February 19th, and both US consumer sentiment/confidence indices were strong in February, as they were in the EA. In the US, real consumer spending in January was ¼% up from the Q4 average (ie, 1% 'annualised'); a further improvement in February and then a sharp drop in March could leave real Q1 consumer spending unchanged from Q4. And this may be too pessimistic for March, as sales may be boosted by hoarding. Inventories were relatively battered down by the end of last year, housing is stimulated by ultra-low mortgage rates, and imports are very constrained by tariffs on China and the inhibition of Chinese output by the virus. So Q1 gross product should show some gain – less than its 2% growth-trend but positive nonetheless.

As with the US, so with Europe. Q1 growth should remain positive. In the EA, consumer and industrial confidence had come off Q4 lows by February and construction remains relatively strong (hardly surprisingly, given negative nominal bond yields – strongly negative in real terms). The UK may even be seeing a small burst of Q1 activity as the EU Brexit question was settled on January 31st; many property transactions in particular have been on 'hold'. Japan, on the other hand, having entered Q1 with a mild gain of industrial output after the Q4 slump caused by the consumption tax increase, saw leading indicators fall back further, perhaps affected by the difficulties across the water in China.

Everything points to a severe slump in Q2 consumer spending. The death rate from Covid-19 is variously estimated to be in the 1-2% range in the 'West' (though this will probably be found to be too high in reality) and eventual penetration of the disease is estimated by the Brookings report (<https://www.brookings.edu/research/the-global-macroeconomic-impacts-of-covid-19-seven-scenarios>) at potentially 10% in the USA, though British 'worst-case' numbers suggest more like 60%. Even at 10% and 1% mortality the US would see more than 300,000 deaths, mostly in the next few months, with comparably frightening numbers elsewhere. Why would people not go to extreme lengths to avoid being a victim? Q2 could see a sharp drop in spending. Transport, recreation and 'other' services in the US amount to more than 15% of consumer spending. It is easy to see how one third of this might be cut, or at least postponed, as is clearly happening with air travel.

How much might real GDP fall? No forecast is 'high conviction', but a 5% cut in US discretionary consumer spending, for example, would be 1.7% of GDP. Yet the trend growth-rate of US GDP is only ½% a quarter (2% annualised). So that scale of switch to consumer restraint would drop real Q2 GDP by 1¼%, an 6½-7% annual rate in the US mode of presentation. This is clearly a drastic scenario, but stock market analysts can easily see impact it would have on the received wisdom that S&P earnings will grow 10-15% in 2020. A market crash would reinforce consumer caution – a 'positive feedback' loop that is extremely negative in its implications.

China past the worst

Why is the outlook for China less grim than elsewhere? Three reasons: (1) its relatively successful lock-down, (2) much of its potential downside has already happened in Q1, and (3) a full-scale fiscal and monetary stimulus programme is being put into action. The fiscal side will feature massive infrastructure spending seen in 2009, as detailed in our China Watch last Thursday. But the overall programme will be less than in 2008-09. On the monetary front, apart

from conventional easing of interest rates and liquidity, such as lowering the RRR (required reserve ratio), the key point is instructions from the PBoC to banks (mostly owned by the government) to 'forbear' from calling in loans to firms in difficulties. This vital aspect of monetary easing will come to the fore in the US (see below).

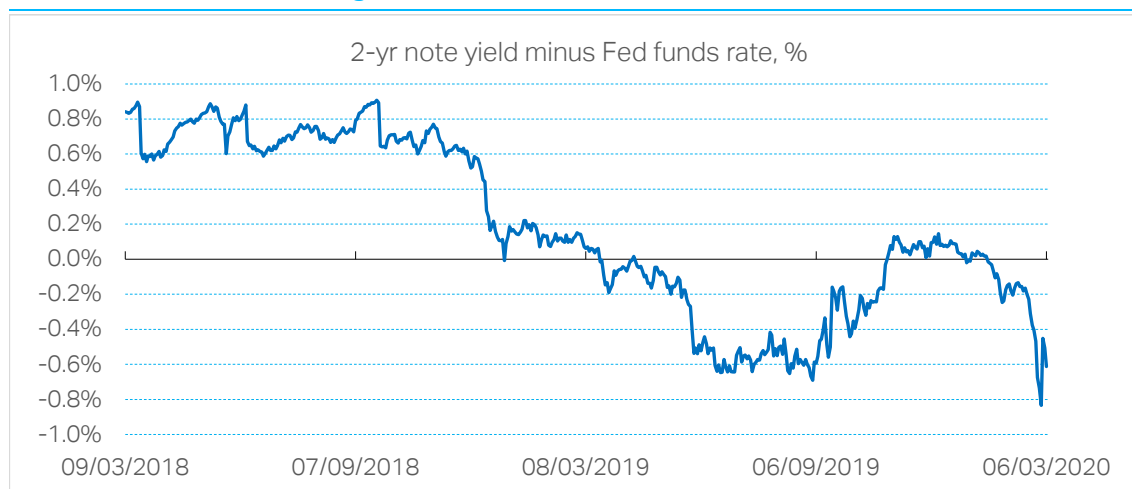
The latest real GDP data for China showed some recovery of domestic demand in Q4 – our recalculation of the Chinese data suggests the heaviest inventory liquidation was in 2019 Q1. In that quarter, despite plunging exports as US tariffs exerted their full force, import volume plunged even more, so that net exports actually grew. By the end of the year the worst of the trade-war-tariff impact was past. But Q1 will have been badly hit by Covid-19. Migrant workers stayed home well after the end of their New Year celebrations. The lock-down will have hammered service spending in particular – though no doubt exports too, as the return to work was very gradual, and is unlikely to be complete until the end of this month. The powerful seasonal adjustment applied to Q1 data because of the New Year effect will far from fully compensate for the extreme weakness likely in the eventual Q1 figures.

The initial demand effects of the virus were strongest on consumer spending, and therefore the service sectors more than industry. Reinforcing this tendency, the focus on infrastructure in the fiscal stimulus programme is likely to promote manufacturing recovery more strongly than in services. But the global weakness we are forecasting here will feed back into China, slowing the recovery of ground lost to the Covid-19 supply-side hold-up. And the fear factor could restrain Chinese consumer demand through into H2, much as elsewhere – additional help is likely for laid-off workers and/or companies in trouble.

What role for monetary policy? Largely defensive. The many firms whose finances have been stretched by the effects of Covid-19 badly need bankers' forbearance. And the government has given the wink to the fringe banks that measures to rein them in will be postponed ... What matter the port in stormy weather?!

Can the Fed induce banks' 'forbearance'?

Chart 1 US banks' funding curve => loans at a loss



Source: Datastream, TS Lombard

When it comes to US policy, the fiscal route is barred unless and until recession is evident, which we expect – but not until well into Q2. For now, my colleague Steve Blitz, our chief US economist,

has pointed the way for the Fed. Basically, the rate banks lend at is best indicated by the 2-year note yield. So when that yield falls below the Fed funds rate, banks are potentially lending at a loss. They may tighten loan conditions to drive up credit spreads, but that is precisely the reverse of what stretched US firms will need to survive if their debts fall due and demand has collapsed – as the Fed's startling between-meetings rate cut last week suggests it expects.

The solution will at some stage involve another 50bp rate cut (see our daily chart above) as the 2-year note is now trading at 48bp of yield, while 50bp off the funds rate would 'only' bring it down to 59bp, still above the 2-year yield. But such a signal of massive monetary stimulus might well cause Treasury yields to perk up after their massive collapse – though monetary policy alone cannot deal with this type of crisis. In the meantime, the Fed needs to redirect its massive 'stealth-QE' to buying short-term bills: its best chance of reversing funding curve inversion.

US tax cut when unemployment up

Recessions galvanise political response. The House of Representatives is where all Federal tax and spending legislation must emanate from. Without a downturn the Democrat House majority would not want to help President Trump's re-election chances by allowing him a pre-election spending spree. So far, legislation has been passed to increase funding for the Center for Disease Control to fight the virus. And we might yet see some more specific allocations, including loan programs through the Small Business Administration to offset falling revenues. But in the context of an emerging, election-year recession in Q2, likely to spill over into Q3, any rise in unemployment will get a tax-cut passed. The parties will argue on the scope and design, just as the Republicans did when Obama was president. A middle-income tax cut is our forecast, most likely putting employees' social security contributions in abeyance.

German revival, Italian/euro crisis

The past year has been brutal for the German economic model, based on undervalued labour costs and export-led growth. China's long-term switch away from excessive metal-bashing towards hi-tech and services, together with widespread EM financial problems, has punctured growth in an economy with excellent manufacturing but weak service sectors – and feeble domestic consumption. In the past year, France, Spain and the UK, all countries with strong domestic demand, have grown faster than Germany (and German-centred, north-central Europe generally) – in the UK's case despite worries about Brexit. An added German problem has been the ascent of electric cars and decline in its car industry.

This could now reverse, at least for Germany if not for virus-plagued Italy, which is similarly dependent on manufacturing – in Italy's case concentrated in low-value, commodity products often supplying the German-centred export 'machine'. If China is reverting to type (as we forecast) in its infrastructure-led stimulus, then it is manufacturing that will lead such recovery as is seen in Europe – probably not until the end of the year as the consumer strike is likely to be even more devastating than in the US during Q2 and Q3.

Fiscal stimulus will be vigorous in the UK. But on the continent the only EA-wide policy-maker is the ECB, which is largely powerless with interest rates already heavily negative. Fiscal stimulus is the only policy approach that could secure recovery in a disease-ridden economy (*vide* China). So the dominant EA approach is deeply perverse: the 'fiscal compact' unwisely adopted in the

midst of the euro-crisis in 2011, reproducing Germany's own 'debt brake' of 2009. Constitutional prohibition of budget deficits is waived if the Bundestag declares an emergency. It would not be unreasonable for the Bundestag to declare either the Covid-19 crisis, or the longer-term issue of climate change, as an emergency. But it is not going to happen soon.

So the salient European issue will be the coming financial crisis in Italy. The banking system is unlikely to be able to remain solvent or liquid in the current conditions of nationwide lock-down. The tourist industry is effectively dead for 2020. Fiscal stimulus could be counter-productive if, as is possible, investors demand a much wider credit spread to accept fresh Italian paper. Italy will need massive support from EA partners to avoid going the way of Greece. So far, at the level of declaration, support is assured. Hopefully, when it comes to real money, that support will be clear enough to enable the country to issue its debt at reasonable rates, and without onerous conditions that could worsen the slump and/or lead to 'internal devaluation' (aka, massive wage cuts) of the type imposed on peripheral EA countries in 2012-15.

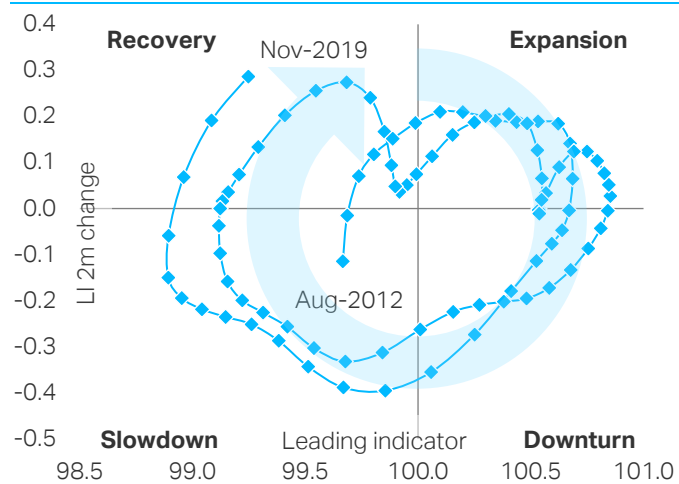
A double whammy for stocks

Equity prices have dropped sharply in the past 2½ weeks to reflect the risks. Since 1990, the S&P 500 price return during the average Recovery has been 22%, as opposed to an 11% fall during the average Slowdown (see left-hand chart below). This last figure, of course, includes episodes when growth fell below potential but remained positive. Looking at economic contractions alone the typical equity drop is significantly greater. Both of the last two recessions (the dot-com bubble-burst and the global financial crisis) saw equities falling more than 50% peak-to-trough. And the best example of a recession caused by non-US events was the first oil crisis, 1973-75 – in the two years to December, 1974, the S&P fell 45% peak-to-trough.

Equity valuations have indeed adjusted, but have they gone far enough? Clearly not. Even after the recent decline, S&P 500's p/e remains close to its cyclical average of about 17.5x forward earnings and 19.5x trailing. During the typical Slowdown, p/e ratios tend to fall below average – often significantly so (right-hand chart overleaf). More de-rating seems in order.

What about earnings expectations? These have also come down in recent weeks. Company after company issued profit warnings and lowered forward guidance. But estimates for 2020 EPS growth remains between 10% and 14% for the S&P 500. This is optimistic. We see EPS growth for 2020 closer to 0% than 10%. This too may be a conservative estimate. Looking at EPS growth during the different stages of the economic cycle, Slowdowns tend to result in an average earnings contraction of 1%. Again, this does not include only recessions, in which case EPS falls tend to be sharper.

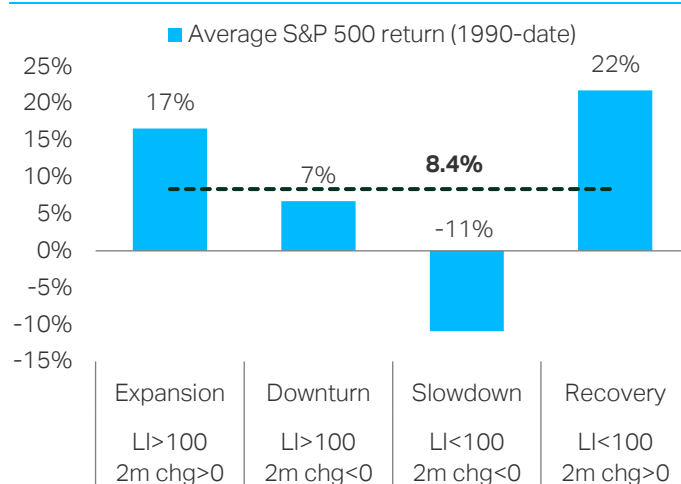
US Recovery under threat



Source: OECD, Bloomberg, TS Lombard

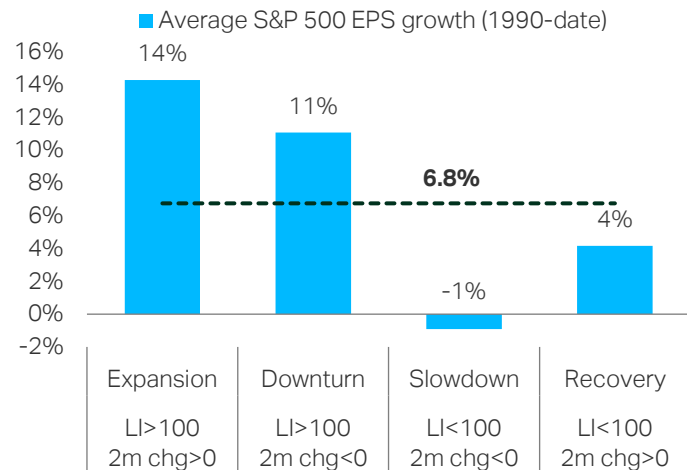
It goes without saying that certain sectors will suffer a lot more than others. From what we have seen so far, Consumer Discretionary and Industrials are the sectors more likely to be directly impacted by a demand shock. Some of this will be temporary – those not buying a new car now may buy one after the virus emergency is over – leading to a V-shaped recovery in the affected sectors. Others – think Hotels, Restaurants & Leisure – will enjoy a shallower recovery, but recover they will.

Returns are usually negative during Slowdowns



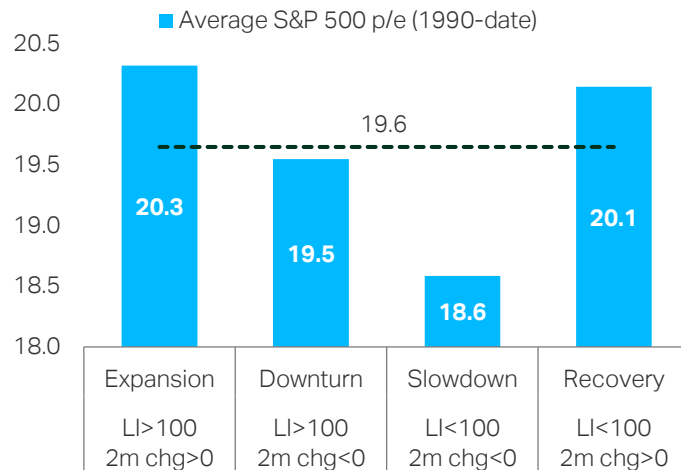
Source: OECD, Bloomberg, TS Lombard

Earnings tend to fall when the economy slows...



Source: OECD, Bloomberg, TS Lombard

...and valuations decline to below-average



Source: OECD, Bloomberg, TS Lombard

What is perhaps more worrying is possible second-round effects. The Hong Kong experience during the 2003 SARS coronavirus outbreak is informative. The economic sectors most affected by the epidemic were, unsurprisingly, Hospitality, Transport and Retail & Wholesale. But virtually all of the 19% earnings contraction in the quarters following Q2 2003 was in Financials – which represented 50% of the index in market cap terms. Here EPS dropped 52% Q3 on Q3, and stayed flat for a year. Given the systemic importance of Financials, policymakers will need to make sure that the direct impact caused by any supply- and demand-side shocks doesn't result in potentially larger indirect damage.

Coming back to US equities, it is easy to see how risk remains skewed to the downside even after the 12% drop so far. Even assuming unchanged valuations at about 17.5x forward earnings

(again, in line with the long-term cyclical average), 0% earnings growth from the 150-160 12-month trailing EPS would imply an S&P 500 level of 2,600-2,800 – another 6-13% fall from the 2972 closing level on Friday. Measured from the February 19th peak, this would be down 17-23%. (The bear market threshold, 20% peak-to-trough, is 2690.)

Assuming a lower p/e ratio, as it would be consistent with an economic Slowdown, the downside would be greater – and firmly in bear-market territory. Valuations tend to be 1 p/e points below average during a Slowdown – though they dip more than that at the trough. But even assuming, conservatively, that the more appropriate p/e to use is 16-16.5x forward earnings, we're easily looking at the S&P below 2500 – itself a 26% drop from the February highs.

And what if one assumed a p/e one standard deviation below average – not at all unreasonable in case of a recession? With the standard deviation for forward p/e at about 3, we'd be looking at 14.5x forward EPS, ie S&P 2,200-2,300 – a nearly 30% further drop from current levels. Again, all of these assumes unchanged earnings compared to 2019. Upside and downside risk can be applied to this assumption, but it's easy to see that the resulting distribution of possible outcomes seems skewed to the downside.

In many ways the outlook for European markets is worse, except for them being less buoyant before this crisis hit. Our Asset Allocation publication on Friday the 13th will give the detail.

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