COVID-19 impact on economies and markets

Since its initial identification in China in the opening weeks of the year, the coronavirus (COVID-19) has progressed from being a supply chain problem in one, albeit large and important, country to a major shock to the global economy and stock markets. Forecasts for economic growth have been sharply scaled back. Stock markets have reacted extremely negatively, with the MSCI ACWI falling 20%[1] since the start of the year. In this article we give Capital Group's perspective on current events, the impact on the global economy and markets, and outline what Capital is doing to mitigate the impact on their portfolios.

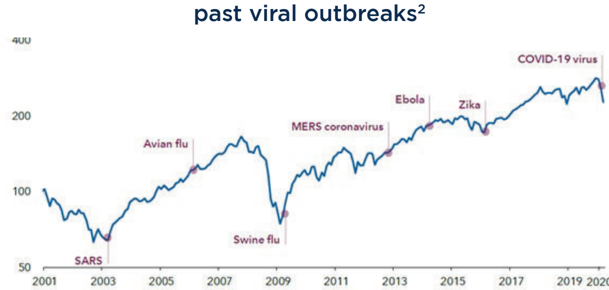
While this disease is new, there have been many pandemics and other crises in the past, and markets have survived them all. These crises are invariably accompanied by heightened investor uncertainty, which then manifests itself in market volatility. As an organisation, we have been studying the history of pandemics and the pattern that they typically follow. There tend to be hot spots and flare-ups, and they last for a while, but then they go away.

Eventually, the spread of the virus will slow down and people will get back to normal, as will markets.

What does the COVID-19 outbreak mean for the global economy?

Overall, it's likely that global economic growth will slow sharply in 2020 and a recession in the US itself is increasingly possible. On the positive side, the US economy remains among the most resilient in the world. It has a history of bouncing back from adversity. Globally, the picture is more varied, with Europe in particular likely to experience sluggish growth over a longer period. However, governments such as the UK have signalled that fiscal policy will be used to support the economy during this period of uncertainty.

Global equity markets have powered through past viral outbreaks[2]



Sources: Centres for Disease Control and Prevention, RIMES, MSCI.

Although fiscal deficits and government borrowing are at elevated levels for this stage of an economic cycle, economists point out that Japan, for example, has been able to sustain a relatively high level of government debt for some years with the intention of supporting its economy.

A number of emerging market economies are significant manufacturing suppliers into the global supply chain centred on China. Any reduction in demand from US and European consumers will have an impact on them too.

The oil price fall is not uniformly negative for emerging market economies; among the larger economies, Mexico and Russia will be significantly affected as they are oil exporters, but India, Turkey and South Africa are importers and will benefit.

What does it mean for markets?

We are experiencing a market decline that we have not seen since the Global Financial Crisis. March 9 was the 11th anniversary of the market bottom during the Global

Financial Crisis — and the market noted the anniversary by recording the largest single-day point decline we have ever seen.

At the time of writing, the bellwether MSCI ACWI is down 20%[3] year to date in US dollar terms. Although there have been significant corrections in recent years, most notably in late 2018, this is currently the most pronounced market downturn in more than a decade of generally strong market returns. In general, US equities appeared to be fully valued by most measures heading into this recent period, and markets could remain volatile for some time. Despite relatively favourable valuations, European stock markets have fallen further. Emerging markets, which so often take the brunt of global stock market turmoil, have in fact held up somewhat better in recent weeks, possibly reflecting the greater secular growth potential in many countries. Unsurprisingly, energy stocks have seen the worst price declines, with the sector falling by 45%[4] year to date in US dollar terms, against the background of an oil price that has all but halved since the start of the year.

Turning to the bond market, we have seen a flight to safety that has pushed bond yields to unprecedented lows. For example, the yield on the 10-year US Treasury fell to around 0.5%. However, corporate bond spreads have widened, with highly indebted companies as well as those in the energy- and travel related sectors most affected.

The US Federal Reserve demonstrated its willingness to take aggressive action, cutting interest rates to nearly zero in an emergency meeting on March 15, which puts its target in a range of 0% to 0.25% - a level not seen since 2015. The Fed also launched a $700 billion stimulus programme. Over time, low interest rates provide support to equities. Similarly, the UK's Bank of England cut rates to 0.25% and the European Central Bank also announced a stimulus package, including bond purchases and cheap loans to banks aimed at mitigating the economic shocks of the virus.

While the pace and magnitude of the recent volatility can be unsettling it is not entirely surprising. Investor sentiment is fragile and will likely remain so until the spread of the virus slows. In times like these, if you remain resilient and demonstrate patience, you can be rewarded over the long term.

Market downturns happen frequently but don't last forever

Size of decline	-5% or more	-10% or more	-15% or more	-20% or more
Average frequency*	About 3 times per year	About once per year	About once every 4 years	About once every 6 years
Average length #	43 days	112 days	262 days	401 days
Last occurrence	August 2019	December 2018	December 2018	December 2018

*Assumes 50% recovery of lost value. #Measures market high to market low

Sources: Capital Group, Standard and Poor's

Should we expect a quick recovery?

Although we expect this setback to be temporary, at this point, it may not be realistic to expect a quick recovery. Circumstances may very well get worse before they get better as we adjust to the prospects of slowing economies over the near term. Investor sentiment is likely to remain volatile day to day depending on the global progression of the virus and the measures taken to combat it, which create economic friction. But eventually, as in every previous crisis, markets will rebound. Judging that moment is particularly difficult as it often comes at a time when market sentiment is extremely negative. However, when it does, if you are a long-term investor who can tune out the daily distractions of short-term market movements and focus on the long term, you will ultimately be rewarded.

Capital's portfolio managers seek to focus on the companies we invest in rather than simply thinking about stock prices. By maintaining a dialogue with corporate managements throughout the economic cycle we are able to keep external events in perspective and ground our judgements better on the underlying prospects for the company.

What should investors be doing?

In periods of declining markets, emotions run high, and that's natural and understandable. But it is exactly in times like these that a long-term orientation is important. We believe that, eventually, markets will rebound and life will return to normal, as has been the case in every previous crisis. Now more than ever, as an investor, you should be in close communication with your advisers reaffirming your long-term objectives.

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[1] As at 13 March 2020. MSCI All Country World Index (ACWI) with net dividends reinvested, in US dollar terms. Source: MSCI.

[2] As at 13 March 2020. MSCI ACWI index levels Chart shown on a logarithmic scale. Total return index levels in US dollar terms, indexed to 100 on 31 December 2000. Disease labels are estimates of when the outbreak was first reported. Sources: Centres for Disease Control and Prevention, RIMES, MSCI.

[3] As at 13 March 2020. MSCI All Country World Index (ACWI) with net dividends reinvested in US dollar terms. Source: MSCI.

[4] As at 13 March 2020. MSCI All Country World Index (ACWI) with net dividends reinvested. Source: MSCI