COVID-19: Plotting a path to eventual recovery

7 April 2020

Quarantine measures to tackle the COVID-19 coronavirus outbreak pushed down global economic activity in mid-March. We expect further steep declines through April and a sharp plunge in second-quarter activity data.

Beyond that, however, thoughts will turn to when and how the current crisis will end. With this in mind, we describe three scenarios for the expected economic and asset market recovery (the central case, the downside case and the upside case). A guiding principle is that asset markets will react first and foremost to the peak in infection rates, with economic data the next to turn and employment data the last to follow.

Three major questions guide our analysis:

1) How long will the restrictions stay in place, preventing any meaningful recovery from taking hold?
2) To what extent will second-order effects kick in, such as failing businesses producing additional layoffs and spending cutbacks?
3) How will individual behaviour change once social distancing measures have lifted?

Central case

The central case scenario assumes successful social distancing measures force a flattening of the virus infection rate. The patterns seen in China and South Korea imply a peak of new COVID-19 cases by the middle of the second quarter and a lifting of quarantine measures by mid-year. China and South Korea, which were among the first to feel the effects of the virus, shut down their economies early and saw infection rates fall. As both countries return to work, infection rates have remained low. It is too early to declare victory, but so far so good.

Translating the China/South Korea roadmap to western economies suggests the downturn will last until the middle of the year and will almost certainly exceed a "typical" recession by a wide margin. In this scenario, the unemployment rate rises between four and six percentage points and the recovery begins in the second half of 2020. Although the services sector is contracting at an unprecedented rate, the characteristics of the sector suggest that the stark plunge in activity could eventually turn into a relatively fast recovery in employment if the underlying health shock does not persist for too long. However, in the short term we do not expect the activity currently being lost to be fully made up.

Unprecedented levels of fiscal and monetary stimulus should limit the downside and help to reduce second round effects, allowing sentiment to improve in the second half of the year. Governments, in particular, are putting in place the right type and magnitude of stimulus. For example, in many European nations very generous subsidies have been made available to companies to prevent them from cutting jobs. And a number of grants are available for small businesses. In our view, it is critical that these government payments are gifts, not loans, since the loss of revenue is a solvency problem as well as a liquidity problem.

Central banks have also responded with admirable speed and vigour, focusing measures on keeping bond yields low to allow governments to raise finance at attractive levels. Credit easing measures have also been implemented to help support corporates and to keep banks supplied with cheap liquidity, reducing the chances of a new banking crisis. In this scenario, firmer demand and a thawing in supply tensions should help support a modest uptick in oil prices.

Downside case

The downside case scenario assumes the virus spread is worse than expected and persists well into the third quarter. The economic and market recovery will have to wait for a vaccine to be developed, which currently is expected to take 12 to 18 months. In this scenario, governments have difficulty imposing quarantine measures, which would mean that the China and South Korea models do not work, while the lifting of quarantines in Asia spark a second wave of the virus outbreak.

The result is a prolonged economic recession that spills over into 2021, despite the strong policy stimulus measures that are in place. A weakening labour market, depressed final demand and falling earnings become entrenched, leading to a sharp rise in defaults and unemployment. Lingering uncertainty over the virus keeps growth weak and the prolonged nature of the lockdown damages the perception that earnings will bounce back by the end of the year.

Excess leverage in private and public markets leads to greater credit distress than anticipated. Banks also come under pressure due to loan impairments and asset write downs. Impaired banks increase the likelihood of a balance sheet-type recession, which means that it takes longer for a recovery to take hold. We would not expect a 2008/09-style banking crisis, as the banks are now much better capitalised and less levered, while several policy tools have been developed to help the banks in times of stress. Credit stresses are therefore likely to be centred on the more vulnerable corporate sector.

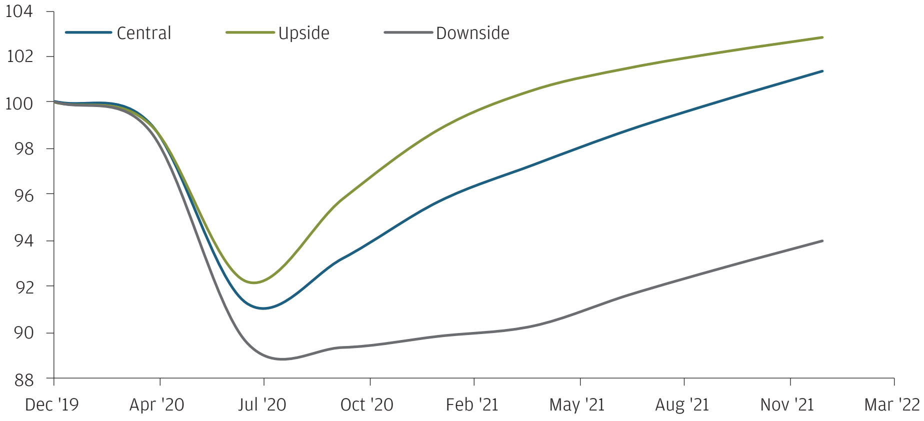
In emerging markets, a collapse in the oil price and international funding pressures could generate widespread creditworthiness problems, which feed back into the developed market banking system, and dampen demand for commodities and manufactured goods for an extended period. Investors could also begin to fear adverse political ramifications, including implications for the US election, eurozone solidarity and broader trade tensions.

Upside case

The Upside case scenario assumes better treatment measures, improving seasonal temperatures and stringent lockdown measures lead to a quick fall in the spread of the virus. Treatment therapies begin to produce successful results and healthcare systems are able to cope with severe cases. Wide-scale testing and a stronger belief in the concept of "herd immunity" allows workers to return to work quickly (in the coming weeks) and the second quarter marks the low in economic activity. In this scenario, Asian economies (China, Korea and Taiwan) return to work quickly, opening up supply chains and providing a cushion globally as developed market activity falls.

Strong stimulus measures support the recovery and avoid lasting economic damage. Growth and investor sentiment rebound strongly and yet central banks prove willing and able to hold down bond yields, increasing the relative attractiveness of risk assets. In contrast to the central case scenario, the upside case scenario leads to a much quicker rebound in confidence and hence a quick recovery back to pre-virus levels.

Stylized quarterly profile for US activity data in each scenario (Q4 2019 = 100)



Our central, upside and downside scenarios translate to different levels of GDP but a similar trajectory. In any event U.S. GDP dips into recession and in our base case we see a gradual but accelerating recovery starting in 3Q20, in our upside case this occurs more rapidly, while in our downside case the virus lingers through the summer and delays a rebound until early 2021.

Source: J.P. Morgan Asset Management

Asset allocation implications and potential fund solutions

The sharp rise in market volatility and the distortions created by central bank intervention are increasing the opportunities for skilled active managers to add value across equity, fixed income and multi-asset portfolios—whatever the eventual recovery scenario.

The table below summarises the economic impact of each scenario along with the key asset allocation considerations for investors.

SPEED OF RECOVERY	DOWNSIDE CASE – 2020 IN RECESSION	CENTRAL CASE – GRADUAL BUT ACCELERATING RECOVERY	UPSIDE CASE – QUICK RECOVERY
Virus backdrop	The South Korea/China model doesn't work – quarantine measures are hard to impose and aren't lifted until a vaccine is available. The drawn out spread means the virus is prevalent throughout the year.	Quarantines are required until May/June but prove successful in flattening the curve; the lifting of quarantine measures follows the South Korea/China model.	Better treatments and testing allow a quick lifting of quarantine measures.
Economic backdrop	The suspension of quarantine measures sparks a second wave of the virus. The subsequent prolonged economic weakness spills over into 2021, leading to credit stress and high unemployment.	Weakness persists in the second quarter. Growth picks up by the end of the year and stimulus tailwinds last into 2021.	The second quarter is the trough for global growth, with a sharp recovery in the second half of the year with limited second round effects.
Asset allocation considerations	Overweight to cash Meaningful underweight to equity, favouring defensives vs. cyclical markets Meaningful underweight to credit, favouring higher quality securities Overweight to duration across all developed market bond markets, negative on inflation	Overweight to cash Modest underweight to equity, favouring defensives and the US; Look to bring equity exposures up on confirmation of virus cases slowing Modest underweight to credit, favouring higher quality securities Overweight to duration	Neutral to cash Overweight to equities, favouring cyclical equity markets vs. defensive, and equity markets outside the US. Overweight credit exposure, favouring non-US markets Neutral duration, favouring the US, and positive on inflation

Source: J.P. Morgan Asset Management; as of 31 March 2020. Scenarios defined by Multi-Asset Solutions and Market Insights teams. For further reading please see the Market Insights bulletin "*Monitoring the global impact of COVID-19*" and "*Q2 Global Asset Allocation Views*" from Multi-Asset Solutions.

NEXT STEPS

To discuss this topic further, please contact your J.P. Morgan representative

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