Monthly Newsletter
Savings and Investments

Restart after sudden halt?

June 2020

Market overview

May was the second straight month of rebounding equities after very sharp decline in March. Of course, COVID-19 pandemic impact continued to dominate markets, with an increasing focus on countries' reopening and lockdowns loosening measures and how this would affect the economy. Volatility in markets continued to decline from the levels seen in April suggesting that tension among investors continued to decrease, but investors remain vigilant of how the situation develops. There is positive signs that the spread of coronavirus has stabilized in many countries. However, despite improvements in the statistics, it is still too early to say with confidence how the public health outlook will evolve. The risk of new outbreaks is considered high and remains a cause for concern. Mass testing and new technology (e.g. performing health checks and following the movements of individuals to keep track of where the risk of new outbreaks is biggest) and other methods to combat the ongoing spread of the virus will continue, with the aim of returning as soon as possible to somewhat more normal everyday life. In this newsletter we share our expectations of macroeconomic environment and other market drivers.

Stock market indexes' performance (until 31 May 2020)

Region	Index	Currency	Performance							
			2020 May	2020 YTD	12 Months	2015	2016	2017	2018	2019
USA	S&P 500	USD	4,5%	-5,8%	9,4%	-0,7%	9,5%	19,4%	-6,2%	28,9%
Europe	MSCI EURO	EUR	4,3%	-18,0%	-8,4%	6,1%	1,7%	8,7%	-14,2%	22,0%
Eastern Europe	MSCI EM Eastern Europe	USD	7,9%	-24,3%	-13,3%	-8,1%	33,0%	12,9%	-8,3%	26,9%
Asia	MSCI EM Asia	USD	-0,5%	-11,3%	1,7%	-11,8%	3,8%	40,1%	-17,3%	16,6%
Latin America	MSCI EM Latin America	USD	6,2%	-39,2%	-32,9%	-32,9%	27,9%	20,8%	-9,3%	13,7%

Our expectations

We live in uncertain times. A lot is happening that we have never lived through before. Most important, of course, are the tragic effects of the COVID-19 and the great uncertainty surrounding its future spread. As a result of this we are also in uncharted waters regarding the economic consequences. Because of unprecedented shutdowns of entire societies so far – and their extremely rapid, far-reaching impact on the economy – we have neither economic theories nor similar historical experiences to rely on when predicting the future.

But although this monumental uncertainty makes numerical forecasts outdated as soon as they are published, there are some things we actually know and can use in creating scenarios about the future. The world economy is undergoing the fastest, deepest downturn of our era. Global growth is plummeting and unemployment is soaring. The responses being mounted, mainly by governments and central banks, are completely unparalleled in history.

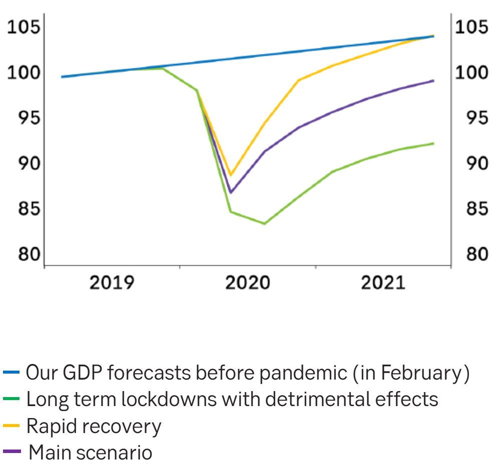
How all this will unfold naturally depends very much on how the virus continues to spread and what the reactions are. We are working with a main economic scenario and two alternative outcomes, one brighter and one gloomier. Below we describe our main scenario, which assumes that European countries and the US will soon gradually reopen and that the world will eventually be better equipped to face any virus setbacks, so that the economic consequences are manageable.

Without a doubt, the sudden halt that has affected the economy will eliminate production resources. Many industries are paralysed. Businesses and large parts of economic sectors will close permanently. Many of the stimulus measures that have been enacted are aimed at limiting these effects and helping businesses survive the crisis. During lockdown periods these measures do not help much, but assuming that countries can reopen at the pace that political leaders are discussing, we see prospects for manufacturers in particular to recover without excessive casualties. The problem is that there must also be demand for the economy to grow. Unemployment is skyrocketing, with fresh statistics pointing to a jobless rate of about 15% in the US, compared to less than 4% just a few months ago. The picture is similar in Europe. Our conclusion is that even if growth rebounds in the second half of 2020 as economies reopen, we will have to live with forces that hold back economic growth for the next couple of years.

But these restraints should not be overstated either. After the recent plunge in global GDP, we expect a major rebound in growth, albeit from low levels. As mentioned above, large-scale stimulus measures will help. We estimate that government and central bank support totals more than 17 trillion US dollars so far – a very incomprehensible figure, perhaps more easily understood as equivalent to about 20% of global GDP. To date, these stimulus packages have primarily been aimed at crisis management: saving businesses, injecting liquidity into the financial system and helping hold down interest rates and thus funding costs. Once the economy hopefully leaves the acute crisis phase, the focus of attention will shift towards starting to rebuild the economy, both in terms of production and demand. Here, we expect continued big stimulus measures, especially from governments.

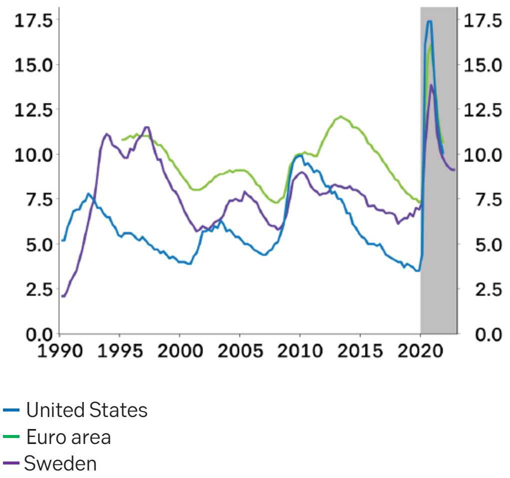
We expect that growth will restart in the second half of the year and that we will see a fairly rapid recovery with solid growth percentages next year, but given the current halt, it is still likely to take several years before the economy is back to its previous trend. We expect global GDP to be around 5 percent lower by the end of next year than predicted before pandemic (in February).

Economic recovery scenarios



In our main scenario, we expect the economy to accelerate again at a healthy pace, but because of the deep decline it will take several years before the economy has regained lost ground. We believe that the global economy, measured as GDP at the end of 2021, will still be some 5 percentage points lower than it would have been if it had followed the trend we predicted before the crisis.

Record-fast upturn in unemployment is worrisome



Unemployment is rapidly increasing to levels not seen since the 1930s depression. This will have a major impact, especially on demand. But most of the increase consists of temporary actions, such as furloughs. If the economy restarts again as expected, unemployment should then fall quickly, but there is a major risk that it will get worse before it gets better.

Given all the policy responses so far – with governments borrowing to cover stimulus measures and central banks "printing" money to cover bond purchases – two important questions arise: How should all this be financed? And won't it lead to rapidly rising inflation?

As for financing, we believe it will not be a problem, at least in the near future. The answer to the question about where the money will come from – big stimulus measures, that is, increases in government debt – are financed when central banks buy bonds issued by governments and others. This is like letting central banks print new money. In theory, they can do this in an unlimited amount. Higher government debt becomes a problem in two cases; if interest rates rise, or if lenders demand repayment of the debts. But interest rates are of course largely controlled by central banks, and they are behind the loans (bonds), so none of these risks will necessarily be a problem in the near future.

As for inflation, short-term forces will keep it down. Weaker demand and higher unemployment will slow pay and price hikes, while falling energy prices will push inflation down towards zero in the near future. In a few years inflation is likely to climb again, but we believe the structural forces that previously kept inflation down will still be in play, especially globalization and digitization/automation. The latter trend is likely to intensify, since at this writing many of us are learning that more of everyday life can be managed without travel, business meetings and other activities.

Finally, if inflation should nonetheless show signs of accelerating, central banks can quickly withdraw liquidity from the market and thus hold back that trend. So neither debt nor inflation appears to be a problem in the short or medium term, but there will be consequences that must be dealt with – especially the allocation of roles between central banks and political leaders, as the potential influence of the former increases.

To summarise, Although it will probably take several years before the economy reverts to its old growth trends, we still expect the rebound to begin during the next few quarters. This also gives us reason to be cautiously optimistic about the long-term stock market outlook, although the rally of recent weeks appears a bit too fast and frenzied. This has made equities expensive by historical standards, probably increasing the risk of setbacks if there are new disappointments.

But continued low interest rates and bond yields, as well as the prospect of several years of recovery-driven economic growth, suggest that higher share valuations may be acceptable in the future. At present, we regard stock market downturns as potential buying opportunities.

We do not feel it is necessary to point out once again that we can expect more drama, both in the news headlines and in financial markets. Many things will also be different once we emerge from the dark tunnel that is the coronavirus pandemic. We are more humble than usual about future challenges. But unprecedentedly aggressive stimulus measures and extremely low interest rates and bond yields – together with the stock market's ability to look past today's crisis towards future growth – nevertheless make us confident that there will be opportunities to generate long-term returns in riskier investments.

Source: SEB Investment Outlook, May, 2020
