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Weekly commentary

BlackRock

April 27, 2020

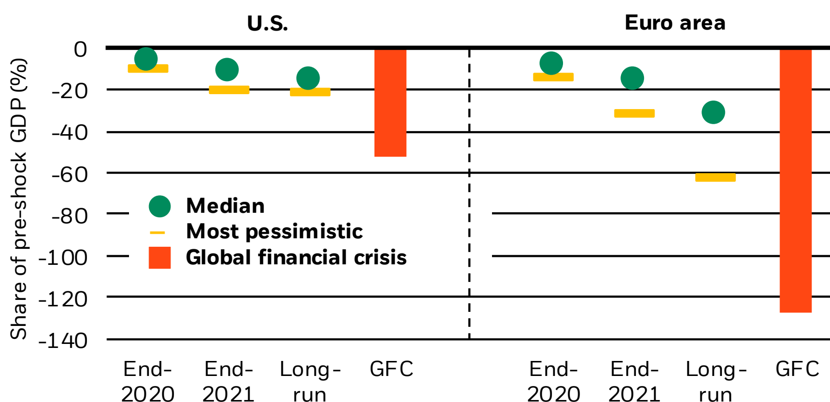
Gauging the virus shock to economy

- The overwhelming policy response to cushion the coronavirus shock is set to prevent a repeat of the 2008 financial crisis, but execution is key.
- Oil prices slumped to historic levels, as a huge demand shortfall has squeezed the limited storage capacity.
- This week's U.S. consumer confidence data will shed light on how much impact the containment measures have hit consumer spending.

Global economic activity is being frozen to stem the coronavirus pandemic. Yet implications for asset prices will depend on the cumulative impact of the growth shortfall over time. We believe that policy actions to cushion the impact of virus shock are nothing short of a revolution. Execution is a risk, but if successful, the cumulative impact of the virus should be well below that seen in the wake of the 2008 global financial crisis (GFC) — despite the historic scale of the initial shock.

Chart of the week

Estimated cumulative GDP shortfalls from virus shock vs. financial crisis



Sources: BlackRock Investment Institute, with data from Reuters News, April 2020. Notes: We show the estimated cumulative shortfall of GDP in the U.S. and euro area as a share of 2019 GDP levels as implied by the median (green dots) and most pessimistic forecasts (yellow bars) in a Reuters poll of 41 forecast for the U.S. and 29 for the euro area, published on 22 April 2020. The red financial crisis bars show the total shortfall accumulated between 2008Q3-2019Q4, expressed as a share of 2007 GDP. There is no guarantee that any forecasts made will come to pass. These hypothetical scenarios are subject to significant limitations given the uncertainties surrounding the virus outbreak.

A banking crisis and overextended household balance sheets led to a "lost decade" of deleveraging after the GFC. This time, the immediate shock is much deeper, but the financial system is not in crisis for the moment. The propagation of the shock is directly linked to the evolution of the virus and the duration of containment measures, in our view. Long-run economic forecasts, including the most pessimistic, imply economic consequences that are much less severe than the post-GFC impact in both the U.S. and euro area, as the chart shows. The cumulative GDP shortfall in the years that followed was ultimately equivalent to 50% of 2007 GDP in the U.S. For the current shock to be on a similar scale, it would have to morph into a financial crisis, in our view. For now, we see the much swifter and greater fiscal and monetary response this time stemming this risk.

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The pandemic has triggered an abrupt, deliberate stop to economic activity. We believe the concept of "recession" doesn't' apply here because this is not resulting from the evolution of a usual business cycle. See details in How large is the coronavirus macro shock? The current shock is more akin to a large-scale natural disaster that severely disrupts near-term activity, but eventually results in an economic recovery. The large and immediate loss of income needs to be addressed with a comprehensive policy response, including a new suite of policy measures designed to help bridge cash flow pressures by backstopping household incomes and small businesses – without which the economy could suffer permanent damage. We have seen these measures – both monetary and fiscal – coming together quickly and on unprecedented scale, especially in key developed economies. Policy coordination is critical, as we wrote in Time for policy to go direct.

A key risk to our view is policy execution. A recent example shows the difficulty of delivering the aid to those in need: A $350 billion loan program for distressed small businesses in the U.S. quickly reached its limit, with evidence that the smallest businesses had severe difficulty accessing the program. There is also the risk of permanent damage if the freezing of economic activity lasts for an extended period of time – especially if ongoing policy support loses momentum. An extended interruption could morph into a financial crisis if it were to lead to an unprecedented wave of corporate insolvencies, putting pressure on the banking system. Last week's oil price collapse – partly caused by the ongoing drop in demand caused by the economic contraction – illustrates the outsized near-term knock-on effects of halting economic activity.

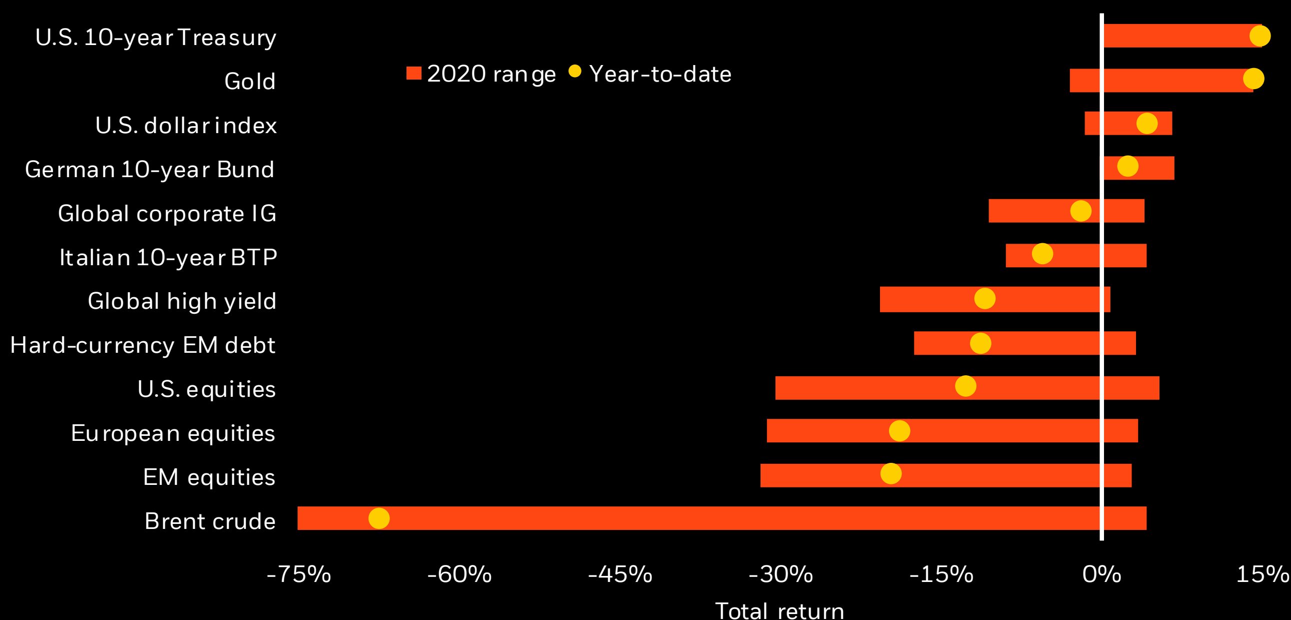
Bottom line: The initial risk asset response in 2020 – with equities down 30-40% across the world – has been on an order of magnitude similar to the financial crisis. We see the lasting impact of the current economic shock as less severe given much greater fiscal and monetary support this time around. Yet effective implementation of such policy support is critical, and we remain cautious over a tactical horizon due to the substantial near-term uncertainty on the evolution of the virus and containment measures. We mostly stick to benchmark holdings on an asset class level, and generally prefer credit over equities given bondholders' preferential claim on corporate cash flows. We prefer U.S. Treasuries to lower-yielding peers as portfolio ballast. Quality equities and a focus on sustainability also can provide portfolio resilience. Read our latest views on global economy and markets in the Global Outlook.

Market backdrop

Fiscal and monetary policy action to bridge the economic impact of the coronavirus has taken shape – and now the key is policy execution to ensure households and businesses get the cash being promised. Oil prices crashed last week amid plunging demand and a surging demand for oil storage, dragging down other risk assets such as stocks. The U.S. launched an additional $484 billion relief package, including a $321 billion top-up of its funding for small businesses. That takes the fiscal support passed by Congress to nearly $3 trillion in the past two months.

Assets in review

Selected asset performance, 2020 year-to-date and range



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, April 2020. Notes: The two ends of the bars show the lowest and highest returns versus the end of 2019, and the dots represent year-to-date returns. Emerging market (EM), high yield and global corporate investment grade (IG) returns are denominated in U.S. dollars, and the rest in local currencies. Indexes or prices used are: spot Brent crude, MSCI USA Index, the ICE U.S. Dollar Index (DXY), MSCI Europe Index, Bank of America Merrill Lynch Global Broad Corporate Index, Bank of America Merrill Lynch Global High Yield Index, Datastream 10-year benchmark government bond (U.S., German and Italy), MSCI Emerging Markets Index, spot gold and J.P. Morgan EMBI index.

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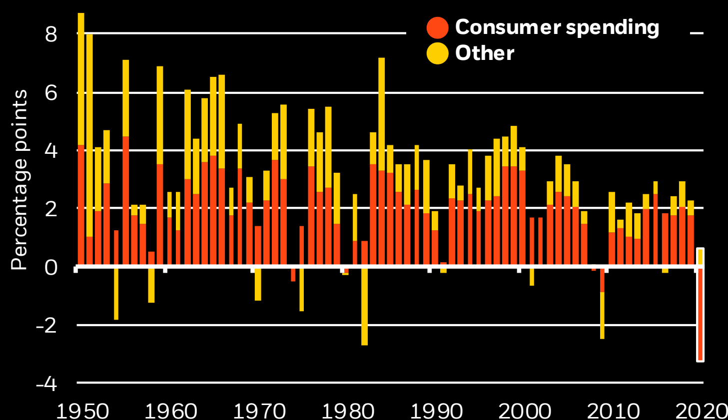
Macro insights

The U.S. consumer has historically played a stabilizing role during downturns. Yet during this shutdown of the global economy, consumers are leading the contraction as a direct result of lockdown measures. This hits the service sector in a way never seen before in the modern economy. Consumer resilience has been the product of steady spending, which rarely falls into negative territory even during recessions. This has been a meaningful cushion for overall growth as consumer spending amounts to nearly two-thirds of total U.S. GDP. In the seven recessions since 1970, consumption never weighed on overall real GDP growth by going deeply negative. This time will be different. The median forecast in the market sees U.S. consumer spending plunging. Other more volatile spending categories such a capex, housing and export demand together pulled GDP growth down by an average 1.9 percentage points during recession periods. The fact that the U.S. consumer is driving this downturn underscores how unusual the coronavirus response – and resulting contraction – is compared to previous recessions.

Consumer blues

Contribution to year-over-year U.S. GDP growth, 1950-2020



Sources: BlackRock Investment Institute and U.S. Bureau of Economic Analysis, with data from Haver Analytics, April 2020. Notes: The chart shows the contribution to year-over-year U.S. GDP growth from personal consumption expenditures and all other areas of spending, such as capital expenditure and exports. The estimate for 2020 is taken from four bank estimates representative of the consensus.

Investment themes

1 Activity standstill

- The coronavirus shock is unprecedented and sharper than what we saw in 2008 - but its cumulative hit to growth is likely to be lower as long as authorities deliver an overwhelming fiscal and monetary policy response to bridge businesses and households through the shock. The main risk to our view: The decisive policy response is not delivered in a successful and timely fashion, causing lasting damage to the economy.
- The rate of growth in virus cases looks to be slowing in many regions as stringent shutdown measures take effect. A key question: Can such measures be lifted without a major second wave of cases?
- The nature of the rebound will depend on the path of the outbreak, effective delivery of policy response and potential changes to consumer and corporate behaviors.
- The U.S. will likely prove more resilient than many other developed economies because of a smaller share of manufacturing in its GDP, a relatively high share of healthcare spending and an aggressive policy response.
- **Market implication**: We are mostly sticking to benchmark holdings on an asset class level; prefer credit over equities; and favor rebalancing into the risk asset decline.

2 Bold policy action

- We believe the required policy response includes drastic public health measures to stem the outbreak. A decisive, pre-emptive and coordinated policy response needed to stabilize financial markets is taking shape, particularly in the U.S. The key: policies to forestall any cash flow crunches among small businesses and households that could lead to financial stresses and tip the economy into a crisis.
- The Federal Reserve built on its "whatever it takes" approach to helping the economy through the coronavirus shock and ensuring markets function properly. We could see its balance sheet more than double to $11 trillion by year end. U.S. lawmakers have passed $3 trillion worth of fiscal stimulus to cushion the blow.
- European Union leaders agreed on the need for an emergency fund of at least 1 trillion euros. They stopped short of agreeing on how it will be financed, and tasked the European Commission to sort out details.
- Some actions are raising questions about whether they may undermine the independence of central banks. The UK Treasury activated a funding facility for spending that will be directly financed by the Bank of England, rather than the gilt market, but called the move temporary.
- It's crucial to have proper guard rails around policy coordination, as we wrote in Dealing with the next downturn.
- Central bank policy has moved from mostly alleviating the dysfunction of market pricing and tightening of financial conditions to ensuring credit flows to businesses and local governments.
- **Market implication**: Coupon income is crucial in an even more yield-starved world, including corporate credit and dividend income in selected equity sectors.

3 Resilience rules

- The valuations of developed government bonds look stretched in light of our economic outlook, but we still see them providing diversification – albeit less so with some yields near levels we consider to be their lower bounds. The recent bounce in Treasury yields off record lows illustrates the risk of snapbacks.
- A focus on sustainability can help make portfolios more resilient. We believe the adoption of sustainable investing is a tectonic shift that will carry a return advantage for years to come.
- **Market implication**: We prefer U.S. Treasuries to lower-yielding peers as portfolio ballast and see a strong case for integrating sustainability into investment processes.

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Week ahead

Apr. 28	U.S. consumer confidence	**Apr. 30**	China official purchasing managers' index (PMI); euro area flash GDP, European Central Bank rate decision
Apr. 29	U.S. preliminary Q1 GDP, Federal Reserve rate decision	**May 1**	Manufacturing PMI for Japan and the U.S.

This week's U.S. consumer confidence data will be in focus. Consumers have tended to play a stabilizing role during past economic downturns. Many of the social distancing measures to contain the pandemic specifically target consumers' activities, such as dining out and shopping. Consensus estimates point to the consumer confidence index plunging to a four-year low.

Directional views

Six to 12-month tactical views on major global assets from a U.S. dollar perspective, April 2020

Asset	Underweight	Neutral	Overweight
Equities		■	
	We previously downgraded global equities to neutral. Global economic activity has been almost halted in order to stem the spread of the coronavirus. Overwhelming and aggressive policy action – both fiscal and monetary – help support the asset class. We prefer an up-in-quality stance, and like economies with ample policy room. We favor rebalancing back toward benchmark weights as markets fall.		
Credit			■
	We have upgraded credit to modestly overweight. Extraordinary measures by central banks – including purchases of corporate debt – provide a favorable backdrop. Developed market central bank actions should pave the way for lower volatility in interest rates, providing a stable environment for credit spreads to narrow. The risk of temporary liquidity crunches remains. Yet valuations have cheapened and coupon income is crucial in a world starved for yield.		
Government bonds		■	
	We stay neutral overall on global government bonds. They act as ballast against risk-off episodes. Additional easing by major central banks has become more likely, in our view. We favor U.S. Treasuries over government bonds in other regions, but see risks of a diminishing buffer against equity market selloffs and a snap-back in yields from historically low levels.		
Cash		■	
	We maintain our neutral position on cash for risk mitigation. We also see cash as a robust buffer against risks around regime shifts, especially those triggered by a negative supply shock that could drive both stocks and bonds lower together.		

Note: This material represents an assessment of the market environment at a specific time and is not intended to be a forecast or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

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Granular views

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, April 2020

	Asset	Underweight	Overweight	
Equities	United States		■	We are overweight U.S. equities for their relative quality bias and the sizable policy response to the outbreak: large fiscal stimulus coupled with the Federal Reserve's commitment to keep rates low and markets functioning.
	Euro area	■		We stay underweight on European equities. We see greater upside elsewhere in an eventual recovery. Europe is more dependent on foreign trade.
	Japan	■		We are underweight Japanese equities. The country has limited monetary and fiscal policy space to offset the outbreak's impact.
	Emerging markets			We are neutral on EM equities. Valuations have cheapened, but the global economic slowdown and cheaper oil challenge many EM economies. The outbreak also is a big test for weak public health systems.
	Asia ex-Japan		■	We are overweight Asia ex-Japan equities on prospects of an eventual growth uptick. We see China as in the early stages of restarting its economy and having more policy space to revive activity.
	Momentum			We are neutral on momentum. The factor has outperformed in the growth slowdown, partly due to its exposure to "secular growers" in the tech industry as well as dividend paying bond proxies.
	Value	■		We remain underweight value. Value has historically performed best in periods of accelerating growth, and we now see the coronavirus outbreak posing downside risks to the economy.
	Minimum volatility		■	We like min-vol for its defensive properties in a growth slowdown. The factor has historically performed well late in the cycle.
	Quality		■	We hold quality as an overweight. We like that it has been resilient in late-cycle periods, despite relatively high valuations.
Fixed Income	U.S. Treasuries		■	We like U.S. Treasuries. Low rates reduce their ability to cushion against risk asset selloffs, but we see greater room for long-term yields to fall further in the U.S. than in other developed markets.
	Treasury Inflation-Protected Securities			We are neutral on TIPS. After a huge decline in rates that makes the entry point less attractive. We still see potential for higher inflation over time and like TIPS in strategic allocations.
	German bunds	■		We remain underweight bunds. They provide little cushion against major risk events, but would not add to our underweight after recent underperformance versus U.S. Treasuries.
	Euro area peripherals		■	We like euro area peripheral government bonds. Renewed asset purchases by the European Central Bank are a major support, and valuations have cheapened.
	Global investment grade		■	We like global investment grade credit. Renewed asset purchases by central banks as well as the prospect of a stable rates backdrop support the sector at a time when valuations have cheapened.
	Global high yield		■	We stay overweight high yield as a source of income, despite recent underperformance. We avoid energy as a lower-for-longer oil price challenges the ability of issuers to refinance near-term maturities.
	Emerging market – hard currency			We stay neutral on hard-currency EM debt due to the heavy exposure to energy exporters and limited policy space among some markets. Default risks may be underpriced.
	Emerging market – local currency		←●	We have downgraded local-currency EM debt to neutral because we see a risk of further currency declines in key markets amid monetary and fiscal easing. This could wipe out the asset class's attractive coupon income.
	Asia fixed income		■	We stay overweight based on a slowdown in the spread of the virus, Chinese monetary easing, low energy exposure and reasonable relative value. We see demand from Chinese and regional investors.

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