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After the Pandemic: Economic Scenarios in the Post-Crisis World

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Summary

Recent gains in global stock markets suggest investors are more optimistic about the outlook. Surveys of economist forecasts point to a bounce in global economic activity next year following a "sudden stop" in 2020 to enforce social distancing. How the pandemic evolves in the next 18 months is the key short-term factor driving the pace of economic recovery. However, investors are also focusing on the medium-term outlook after the health crisis. As multiple economic scenarios are possible with different implications for asset prices, we believe investors should seek resilient long-term asset mixes with balanced risk exposures to a range of possible economic environments. Alternative investment strategies and asset classes can play a useful role in constructing well-balanced portfolios.

Economic Outlook: 2020-21

Major stock markets have gained about 35% since the low point on March 23 as investors became more optimistic about the economic outlook. Greater investor optimism may reflect an expected bounce in economic activity as many jurisdictions gradually re-open from the lockdown. Surveys of economist forecasts suggest a sharp bounce in economic growth next year following the most severe drop in employment and output since the Great Depression (Figure 1). By the end of next year, corporate earnings in the US and Canada are also expected to exceed 2019 levels.[1] Investors also expect low inflation and interest rates, supporting equity valuations.

Figure 1. | Economic Growth Projections, 2020-22
(real GDP growth rates in annual %-change)
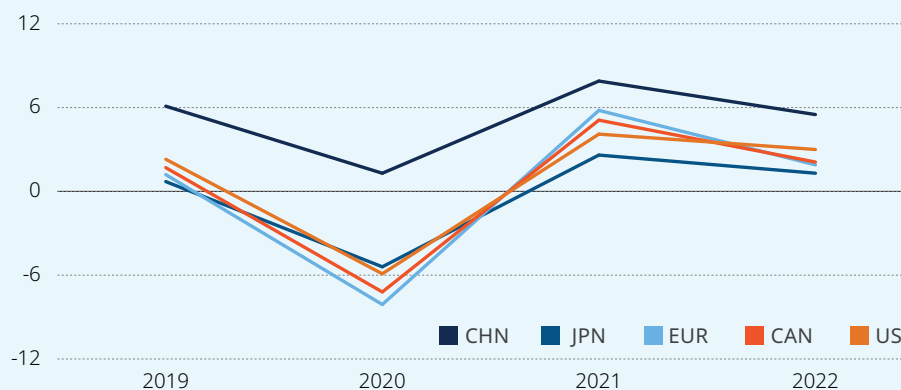
Consensus forecast is a V-shaped recession and recovery in 2020-21, and stabilization in 2022

Source: Consensus Economics and Bloomberg survey of economist forecasts for annual real GDP growth as of May 26 and May 29, respectively.

The success of aggressive economic policies in preventing business failures will be a key factor in how quickly the global economy returns to the pre-pandemic trend. Most post-war recessions were caused by rising interest rates to cool overheating economies. In these demand-led recessions, as in 1979-82, economies typically followed a sharp V-shaped decline and recovery. Alternatively, the build-up of imbalances, such as excessive debt relative to income, can lead to a financial crisis as in 2007-9. These recoveries tend to be L-shaped with a sharp initial recession followed by a slow recovery as the imbalance takes time to resolve. In the "Great Lockdown" of 2020, some economists expect a V-shaped recovery (Figure 1) as there was no prior build-up of imbalances before the lockdown.[2]

The pace of economic recovery will greatly depend on how the public health crisis evolves in the next 18 months. Many questions remain about COVID-19, including how it spreads, seasonal patterns and severity of secondary rounds of infection. Most importantly, we do not know when a medical solution will be widely available. A quick resolution to the health crisis would support a V-shaped recovery. However, the longer that medical uncertainties linger, the more likely that households and businesses will stay on the sidelines, delaying consumption and investment spending. In this case, today's liquidity squeeze threatens to become a solvency problem, leading to greater business failures, more prolonged unemployment and risk of an L-shaped recovery.

Medium-Term Outlook: After the Pandemic

While the short-term outlook hinges on pandemic-related uncertainties, investors are also focusing on the medium-term economic outlook and its implications for financial markets. Asset classes tend to respond in predictable ways to changes in economic conditions relative to market expectations. Positive surprises in economic growth generally lead to gains in equities, corporate credit and emerging markets. Higher inflation is generally positive for inflation-linked bonds, gold and commodities. Figure 2 summarizes how asset classes are expected to behave in different economic conditions or regimes.

Figure 2. | Expected Asset Class Sensitivities in Different Economic Environments
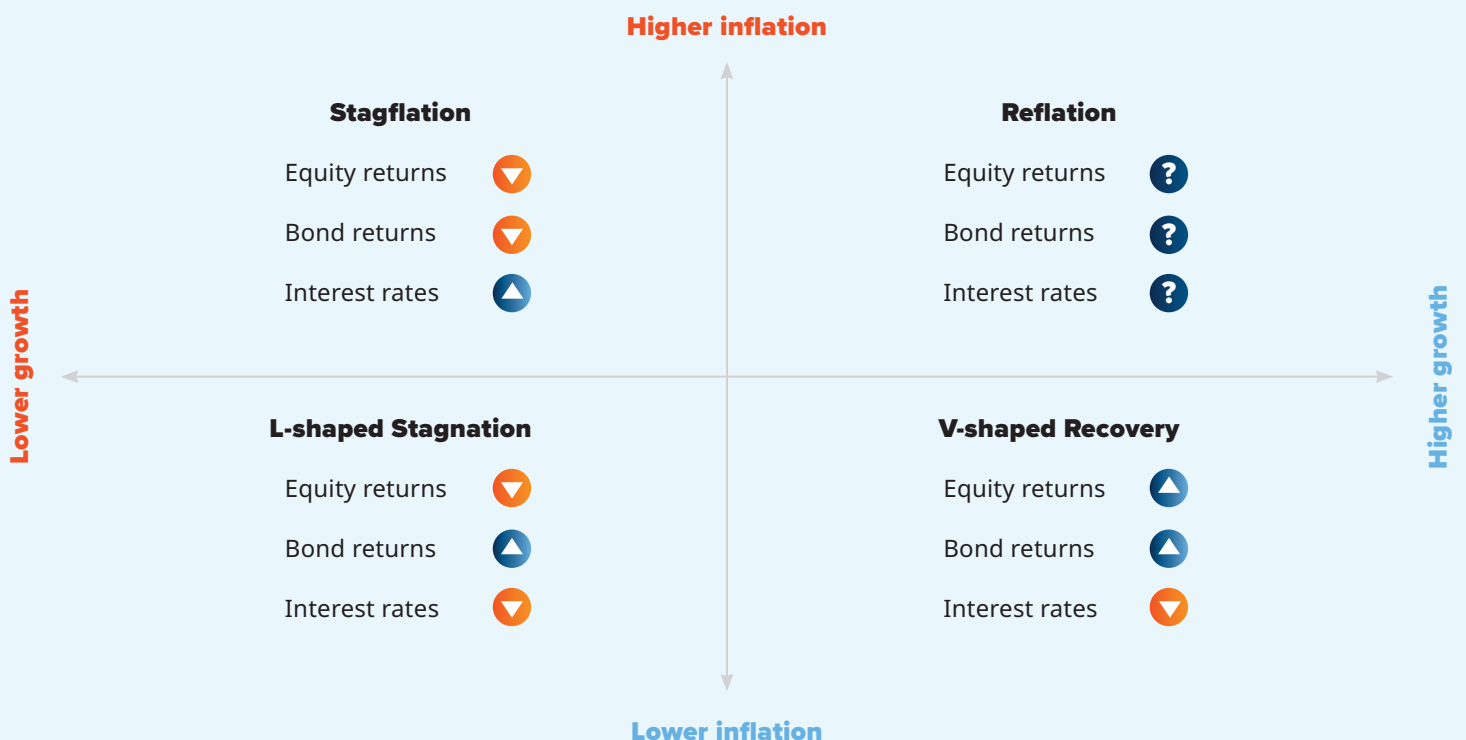
Source: See Bridgewater "The All Weather Story". https://www.bridgewater.com/resources/all-weather-story.pdf

As highlighted in Figure 2, four broad types of medium-term scenarios are possible. Economic growth and inflation differ in these scenarios with implications for investment returns. The range of possible outcomes underscores the need to build resilient asset mixes across different economic conditions.

1 V-shaped Recovery.
Consistent with consensus expectations, economic activity rebounds to the pre-pandemic trend with modest inflation, keeping interest rates low relative to history and supporting both stock and bond market returns.

2 L-shaped Stagnation.
A longer resolution to the pandemic and greater financial distress could lead to a prolonged slump in economic activity with very low inflation and interest rates, leading to gains in government bonds while detracting from risk assets like stocks and credit.

3 Stagflation.
A prolonged slump in economic activity could coincide with higher inflation given the enormous increase in monetary liquidity and disruptions in global supply chains as multinationals seek to re-shore production to strengthen security of supply. These forces would detract from stock and bond returns while benefitting inflation-sensitive assets, such as inflation-linked bonds and gold.

4 Reflation.
Policymakers may pursue more aggressive programs to support the recovery and avoid a return to Japan-style secular stagnation. As elaborated below, the expected return of stocks, bonds and other assets would depend on the choice of policy mix.

Given the most severe economic contraction since the Great Depression, policymakers are actively pursuing reflationary economic policies. The mix of policies they implement after the pandemic will have implications for expected returns. Aggressive fiscal policy in 2020 has been critical to remove the tail risk of a broader financial crisis. The US has already approved about $3 trillion (over 13% of GDP), raising the total budget deficit from about 5.8% of GDP last year to an estimated 18% of GDP this year. In Canada, the pandemic could increase the budget deficit by over $250 billion (over 10% of GDP). Other major economies have also announced large fiscal programs, providing support for the global recovery. Governments may continue deficit-financed spending programs after the pandemic to provide stimulus for the recovery and absorb a glut of global savings, helping to avoid a return to Japan-style secular stagnation. While boosting productivity in the long term, large deficit-financed spending may initially lead to higher inflation than expected, a steeper yield curve and higher rates, weighing on both bond and stock market returns.

Alternatively, the reflation scenario could be driven by central banks cutting policy rates into negative territory. While the Bank of Canada and US Federal Reserve currently have little appetite for negative interest rates, a sustained period of high unemployment could persuade central banks to cut policy rates further, continuing the multi-decade decline in rates that began in the early 1980s. This scenario would be associated with stronger expected returns for both bonds and stocks. Figure 3 illustrates that the long-term historical decline in 10-year real rates has been associated with rising US stock market valuations as measured by dividend yields.

Investment Implications

Given the wide range of potential economic conditions in both the short and medium term, we believe in building resilient asset mixes by balancing risk concentration to any single scenario. Most investors rely on equity to achieve their total return target. However, equities are volatile and typically dominate total risk. Consequently, most portfolios tend to have a concentrated sensitivity to specific economic environments, outperforming in a V-shaped recovery and underperforming in stagflation and stagnation scenarios. In this context, investors may wish to consider alternative investment strategies and asset classes to achieve their return target. Alternative investment strategies tend to have lower correlation to traditional stock and bond returns over an investment cycle. In this manner, they can play a useful role in building resilient portfolios across different potential economic environments. In next month's economic commentary, we will focus on these issues in more detail.

Figure 3. | US 10-year Real Bond Yields and Stock Market Valuations
(10-year Treasury rates after inflation and S&P500 dividend yield)
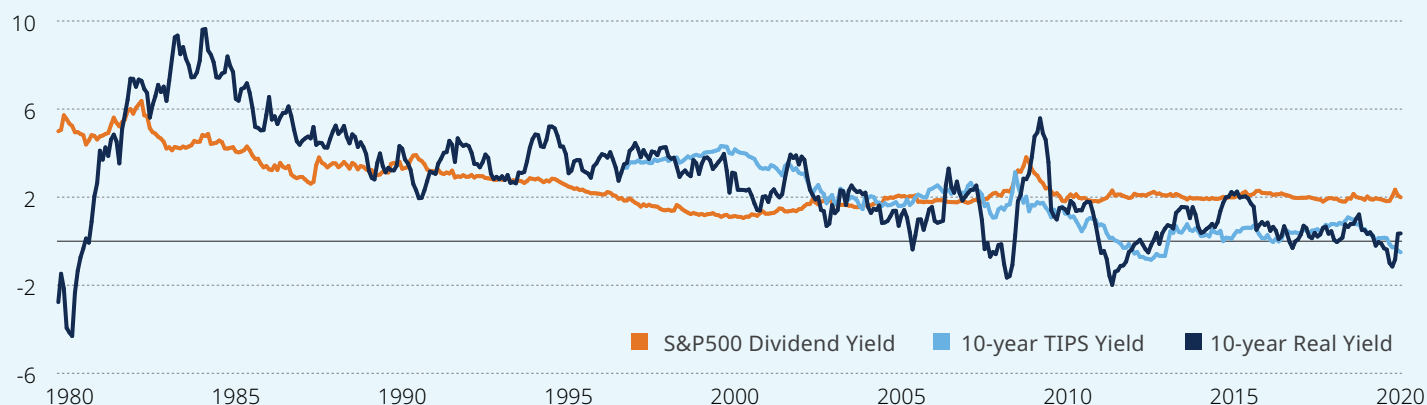
Source: Economic and financial market data obtained via Bloomberg as of May 29, 2020.

[1] Based on Bloomberg data as of May 29, 2020.
[2] See Paul Krugman: https://www.bloomberg.com/opinion/articles/2020-05-27/paul-krugman-is-pretty-upbeat-about-coronavirus-economic-recovery