Market update

Wealth Management

A very different kind of crisis

The paths of financial markets and economies almost always involve uncertainties—it's par for the course. But the abundance of uncertainties brought about by COVID-19 is making the science (and art) of economic forecasting unusually difficult. As the rates of new infections have improved in Europe and North America, major equity markets have bounced forcefully. The S&P 500 rallied 19 percent from its March low, and is now down "only" 21.5 percent from its all-time high—all the while the economic consequences of COVID-19 have yet to come into view. Economists are still calibrating their recession estimates. RBC Global Asset Management, for example, has cut its U.S. GDP forecast again.

Following are details about the lower estimates along with thoughts from RBC's U.S. equity strategist and the Global Portfolio Advisory Committee. We think there is more market volatility in store—both to the downside *and* upside.

A bigger bite

Even though the statistics surrounding the COVID-19 crisis have improved in two of the worst-hit countries—Italy and Spain—and New York is seeing light at the end of the tunnel, the impact on developed country economies is still being sorted out. RBC Global Asset Management Inc. Chief Economist Eric Lascelles now expects a deeper U.S. recession compared to his previous estimate.

- Lascelles cut his base-case forecast for 2020 U.S. GDP growth to -7.7 percent from his recently lowered -3.2 percent estimate. This would represent the greatest annual decline since 1946, when GDP growth plunged 11.6 percent during the demobilization after World War II, as the demand for weaponry and other industrial goods declined sharply.
- The 2020 forecast assumes that economic growth would briefly plunge 20 percent at its worst point (deeper than his previous estimate of a 15 percent decline), before stabilizing and then beginning a recovery phase. By way of comparison, the Organization for Economic Cooperation and Development, commonly known as the OECD, estimates a decline of 20 percent to 25 percent in GDP growth for developed economies.
- Importantly, given the unique nature of this crisis, Lascelles believes it's prudent to consider other downturn scenarios—some better, some worse—that vary by depth and duration. His scenarios evaluate a shallow, medium, and deep economic contraction, and also consider a contraction that is short, medium, and long in duration. This is shown in the table on the following page, in a matrix of nine scenarios. All of the scenarios are harsher than his previous estimates in terms of the impact to GDP growth, as the depth of the downturns are deeper and the durations are somewhat longer. At this stage, Lascelles' preferred scenario is in the middle of the matrix: A downturn that is medium in depth (down 20 percent at its nadir) and medium in duration (peak-to-trough lasting 12 weeks).
- But it's not just the depth and duration of the economic crisis that investors need to be paying attention to. Lascelles wrote, "It matters enormously how quickly the subsequent economic rebound occurs once quarantining is complete. We have incrementally downgraded our assumptions about this over time, recognizing that real economic damage is almost certainly occurring beneath the surface, particularly given the lateness of the business cycle before this event. As such, although the origins of this shock are

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entirely artificial and we have more than 60 percent of the output decline snapping back in the quarter immediately after quarantines end, we imagine the remaining 40 percent takes another year to reclaim."

The dreaded "D" word

Such a deep downturn naturally conjures up the "D" word, as in "depression"—the Great Depression, specifically. How would an initial 20 percent plunge inside of a 7.7 percent annual decline in U.S. GDP growth compare to that dreadful period?

- Lascelles wrote, "The medium depth scenarios leave the peak-to-trough economic decline [of 20 percent] just shy of that suffered during the Great Depression, which is nevertheless startling. But keep in mind that the biggest problem with the Great Depression was that it lasted unusually long for a recession—four years of declining GDP, not to mention multiple years of recovery—whereas the defining feature of this event is how short and artificial it should be."

Manic markets

Financial markets tend to look forward, not backward. We believe forthcoming poor economic data is largely reflected in the rapid and steep equity selloff of the past month. It's reasonable to assume that equity markets are already pricing in deep (and brief) contractions for the global and developed economies, including the U.S. However, it's not yet clear if markets are underestimating (or overestimating) the magnitude and duration of the economic and corporate earnings retrenchments, and whether they have pegged the recovery trajectories properly.

- RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina wrote, "We are keeping an open mind about whether the S&P 500 saw its coronavirus low on Mar. 23, but we remain skeptical and would not be surprised to see the index retest its 2020 low and make a new one."

- She points out that sentiment among individual investors has not reached extremely bearish levels, according to the American Association of Individual Investors weekly survey, like it often does near a market bottom. When very bearish readings occur, it can be a good contrary indicator for the market. Put another way, the more bearish investors become, the higher the fear, which is an indication that many investors have thrown in the towel—which is then often accompanied by a bottoming process.

COVID-19 crisis: What are the various economic scenarios?

RBC Global Asset Management's U.S. real GDP growth estimates under nine different scenarios that vary by the depth and duration of the COVID-19 economic contraction

Current forecast highlighted: Medium depth and medium duration contraction would result in a 7.7% decline in 2020 GDP growth

2020 GDP growth scenarios

		Duration	
Depth	Short 6-week trough	Medium 12-week trough	Long 39-week trough
Shallow -10% trough	-2.0%	-2.8%	-5.9%
Medium -20% trough	-6.1%	-7.7%	-13.9%
Deep -40% trough	-14.4%	-17.7%	-30.0%

Source - RBC Global Asset Management; forecasts as of 4/6/20. Data show annual average percentage change. Assumes a rapid decline into the trough versus a much lengthier recovery period.

- This COVID-19 crisis has sparked multiday selloffs and big rallies in the S&P 500 and indexes in other major markets. We are reminded that such moves were a hallmark of the 2008–2009 financial crisis, and this process could be playing out again during this bear market.

- Calvasina added, "While we remain constructive on the S&P 500 between now and year-end, we also think it is likely that the S&P 500 will retest its Mar. 23 low. We also wouldn't be surprised to see it hit a new low as equity investors come to grips with the full extent of the damage that the coronavirus poses to the U.S. economy and earnings."

Canada hit by a dual shock

- The S&P/TSX Composite plunged 37 percent from its February high to its March trough. It has rallied 21 percent since, but has nevertheless trailed U.S. benchmarks through this period of upheaval. The Canadian equity benchmark is now trading at a forward price-to-earnings multiple of roughly 13.9x compared to a long-term average of 15.5x. Despite a seemingly discounted valuation, we expect earnings estimates will be subject to downside risk as companies provide updated guidance alongside Q1 results.

- We believe that the dual shocks of depressed oil prices and virus-related disruption have increased the downside risk for the Canadian equity market.

RBC Economics forecasts that the Canadian economy is in recession, and we believe there is considerable uncertainty as to its depth and duration. The S&P/TSX Composite has historically underperformed the S&P 500 during recessions due in large part to its pro-cyclical bias with Financials, Energy, and Materials accounting for nearly 60% of the domestic benchmark. Amid the current contraction, we fear that Canadian households are ill equipped to weather a prolonged downturn given elevated household debt levels and a meagre savings rate.

- Canada's largest lenders are well capitalized and should be able to navigate broad-based credit weakness with dividends intact, in our view, but we expect earnings to contract meaningfully. Dividend yields may look attractive, but we caution that bank investors must be willing and able to stomach the volatility that we expect through this period of uncertainty.

- Amid depressed commodity prices, balance sheet preservation is the top priority for oil producers with capital spending plans cut by roughly 30 percent and a number of dividend cuts announced. In the event that oil prices remain depressed for a protracted period of time, even the largest and best-capitalized companies could be forced to reevaluate their dividend policies.

- The trajectory of oil prices is difficult to chart amid an unprecedented combination of supply and demand shocks. Press reports indicating a renewed willingness among producing nations to coordinate supply cuts have breathed some life into oil prices, but the contours of any potential agreement are hard to assess given the geopolitical considerations at play.

- The Bank of Canada has done its part by cutting its benchmark interest rate to near zero; however, we believe fiscal stimulus is critical to any attempt to offset the economy's rapid and severe contraction. The Canadian government has caught up with other developed nations with direct support estimated at CA$105 billion, according to RBC Economics. Of this total, CA$71 billion comes in the form of wage subsidies designed to keep workers connected to employers, which will be key to a post-virus recovery.

Sourcing value through credit markets

Equities aren't the only market moving quickly. Within fixed income, the credit market also deserves attention.

- The yields on the main U.S. investment-grade and high-yield bond indexes have fallen roughly one percent and two percent, respectively, since peaking on Mar. 23. A confluence of factors, including commitments from global central banks and governments to fully fight the loss of economic output, has helped settle nerves within credit markets. The yield on the high-yield index remains historically high at approximately 10 percent, but the yield on the investment-grade index has fallen back towards its five-year average.

- A number of companies have taken advantage of this window of opportunity to issue debt. There has been more than $100 billion of investment-grade supply in the U.S. over the past week, with year-to-date issuance more than 50 percent higher than last year. Even the high-yield and leveraged-loan markets have seen a couple of issuers test the water after two and four weeks' hiatus, respectively. With coupons in the high single-digit to double-digit range, the water appears lukewarm for lower-quality issuers.

- A rapid repricing of credit compensation—the quickest jump in corporate bond yields in history—is one reason investors (ourselves included) have started to look more favourably on corporate bonds. Looking at bond yields with the level of corporate leverage in mind, i.e., how much compensation investors receive for the amount of debt that corporations have on their balance sheets, investment-grade and high-yield bonds show a much improved risk-return profile, in our view.

- A number of recent announcements by global central banks targeted at providing relief to financial markets have contributed to the improving credit outlook. The European Central Bank expanded the size and scope of its bond purchase programs, a notable shift away from the complex and restrictive rules previously in place, while the Federal Reserve will start purchasing corporate bonds and bond-based exchange-traded funds (ETFs), a first for the U.S. central bank. So far, these measures appear to be having the desired effect; a number of bond ETFs that had been trading at sizeable discounts to their net asset values are now trading at modest premiums.

- We believe the repricing of risk in the corporate bond market has tilted the medium-to-long-term risk-reward profile back in favour of investors, making it an attractive place to put cash to work. From current valuations, corporate credit has historically

outperformed government bonds and often managed to keep pace with equities in the initial leg of a recovery.

- We continue to view the Canadian preferred share market as down, but not for the count. Yields in excess of six percent are available on a diverse mix of structures, and companies must continue to serve this dividend stream unless common equity dividends are reduced to zero dollars.

Step by step exit strategy

We continue to view the COVID-19 crisis as transitory, believing it will pass, and that major economies will eventually heal. The exit strategy from mass quarantines represents one of the key sources of uncertainty for the economic healing process, including in North America. We think there are a number of steps for economies to get back to "normal."

- **Step one: Social distancing on a mass scale.** This is well underway and seems to be reaping positive results, which is one reason equity markets have bounced lately.
- **Step two: Partially reopening major economies while maintaining some level of social distancing.** This is more complex.

  This could require much more COVID-19 testing and contact tracing, strengthened medical capabilities, and more reliable therapeutic treatments. Lascelles said, "Progress is being made on all fronts, but none of these have been fully achieved. In turn, it is pure speculation how long economies must remain shuttered."

  Lascelles added, "One can imagine developed-world economies implementing a tiered return to work along a combination of four lines: (a) by region, based on local conditions; (b) by age and health status; (c) by whether people have already been infected and subsequently recovered; and (d) by incrementally expanding what constitutes an 'essential' function."
- **Step three: The full re-opening of economies without physical distancing.** Lascelles believes this requires strong COVID-19 therapeutics or an outright vaccine, alongside continued aggressive infection testing and contact tracing.
- **Step four: Be prepared for the next pandemic.** In Lascelles' view, this would require putting in place systems and safeguards that will "prevent daily life from skidding to a halt during the next pandemic."

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