Outlook for May 2020

Key Market Driver

The Gradual Reopening of Global Economies

Just as the impact of COVID-19 has varied by country, so too will the recovery. All eyes are currently on China and South Korea (among the first hit and the first to reopen) to see if they experience a recurrence and if consumers open their wallets. Early indications are that while production is increasing, consumers appear reticent, and export markets are still largely locked down.

The reopening of the U.S. and Europe will be gradual. Here in the U.S., the process will occur on a state-by-state basis at the discretion of the various governors. The decision to reopen is highly dependent on a consistent decline in infection and hospitalization rates. Greater testing and tracing capacity are essential for easing concerns about the return to everyday life. Across the ocean, hard-hit Italy and Spain are proceeding more slowly than northern European countries like Germany. Lack of a truly coordinated fiscal policy response may mute and perhaps delay the recovery in the continental economy, which was near recession before COVID-19.

Globally, fiscal policy initiatives will play a critical role in providing immediate relief to the newly unemployed and for keeping businesses solvent as the economy reopens. Monetary policy by itself isn't enough.

Our Perspective

Equity Markets

- Aggressive monetary policies and sizable fiscal initiatives have allowed U.S. equity investors to look beyond the economic contraction towards the reopening of the economy and a second-half rebound.
- Without knowing the depth of the second-quarter earnings decline, it's difficult to conduct adequate valuation analysis on prospective earnings. We expect some downward pressure on markets when actual results are released. Lower interest rates should help expand valuations once the economy begins to recover.
- European and Japanese equity markets should track U.S. markets. That said, any advance may be of lower magnitude given the generally weaker economies and more muted fiscal response.
- In emerging markets, Chinese stocks have been outperforming, while the commodity-driven Latin American markets have been relatively weak. Asian markets should continue to do well as the recovery progresses. Investors should watch for any virus recurrence and permanent damage to the supply chain.

Bond Markets

- The upward-sloping U.S. yield curve continues to shift downward due to the economic contraction and the Fed's ongoing purchases. While it's possible Treasury rates could turn negative, the yield curve would likely have to invert for that to happen.
- The municipal bond market got a boost when the Fed extended the maturities it will buy in its Municipal Liquidity Facility. The next fiscal policy initiative will likely include aid to various states and municipalities.
- The collapse in oil prices, defaults, and the future default risk of energy-exposed issuers are putting pressure on the high-yield market.
- As mobility restrictions subside and the dollar stabilizes from its recent strength, emerging market debt should recover. Continued weakness in commodity-driven economies remains a risk in this space.

Outlook for May 2020

Our Perspective (Continued)

Monetary Policies/ Currencies

- The U.S. Federal Reserve has promised to maintain low rates and continue its balance sheet expansion policies to support market liquidity and help achieve maximum employment and price stability.
- Central banks of other developed markets have fewer options. With rates already in negative territory, they're primarily focused on balance sheet expansion.
- The European Central Bank is accepting high-yield debt as collateral for its repurchase operations and using below-investment-grade government bonds in its asset purchase programs under certain conditions. This action deflected a potential supply shortage due to the anticipated downgrade of Italian government debt.
- The Bank of Japan will likely increase its purchases of corporate bonds and equity ETFs over the coming months.

What This Means for Investors

The easing of mobility restrictions is a positive sign that perhaps the worst is behind us. As the road to full economic recovery will likely include some setbacks, investors should expect continued volatility in the financial markets. The level of future economic growth will depend on whether COVID-19 has caused any lasting damage to consumption and production.

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