CAPITAL GROUP℠

Investment Insights

COVID-19 impact on economies and markets: update from Capital Group

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COVID-19 impact on economies and markets

Key points:

- News of the continued worldwide spread of coronavirus, and the recent plunge in oil prices has sent stocks plummeting towards bear market territory and bond yields have reached new lows.
- While the virus represents a new challenge, there is nothing new about market volatility. Markets have survived viral outbreaks in the past.
- Investors who can look past the current environment and stay the course can benefit over the long run.

Since its initial identification in China in the opening weeks of the year, the coronavirus (COVID-19) has progressed from being a supply chain problem in one, albeit large and important, country to a major shock to the global economy and stock markets. Forecasts for economic growth have been sharply scaled back. Stock markets have reacted extremely negatively, with the MSCI ACWI falling 20%[1] since the start of the year. In this article we give Capital Group's

1. As at 13 March 2020. MSCI All Country World Index (ACWI) with net dividends reinvested, in US dollar terms. Source: MSCI

perspective on current events, the impact on the global economy and markets, and outline what Capital is doing to mitigate the impact on portfolios.

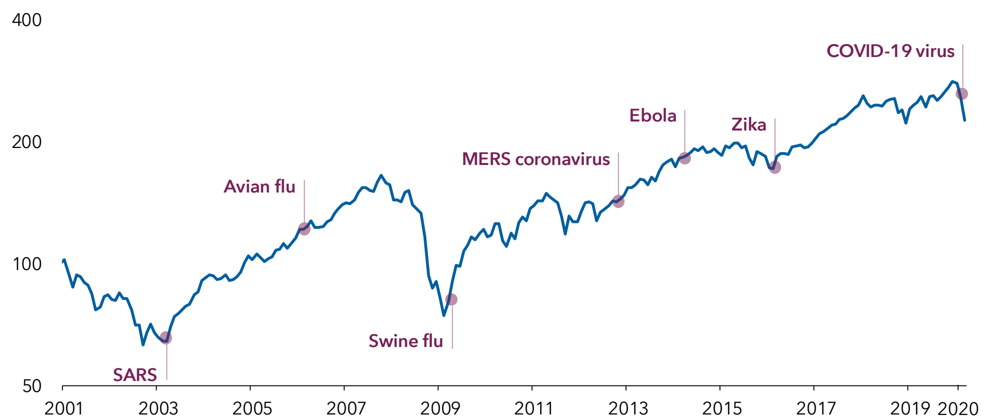
Overview of the coronavirus (COVID-19) outbreak and market reaction

From being almost unknown at the start of the year, coronavirus has prompted increasing social and economic concerns about the prospect of a global pandemic, which the virus has now been declared by the World Health Organisation. People are understandably frightened because this is a new disease, and there is much uncertainty about its severity and transmission process. First and foremost, the virus has a real human cost. We don't know how many people are going to get ill or, worse yet, how many may die. Of course, our first thoughts are with the people who have fallen ill and their families. Additionally, there has been significant disruption to the daily personal and business lives of an increasing number of people around the world.

While this disease is new, there have been many pandemics and other crises in the past, and markets have survived them all. These crises are invariably accompanied by heightened investor uncertainty, which then manifests itself in market volatility. As an organisation, we have been studying the history of pandemics and the pattern that they typically follow. There tend to be hot spots and flare-ups, and they last for a while, but then they go away. Eventually, the spread of the virus will slow down and people will get back to normal, as will markets.

Global equity markets have powered through past viral outbreaks

MSCI ACWI index levels[2]



What does the COVID-19 outbreak mean for the global economy?

The initial impact of the COVID-19 virus was to create problems and delays in the global "just-in-time" supply chain that is now so critical to the provision of manufactured goods from clothing to vehicles. Forecasts for economic growth in China, which has been a major motor of global economic growth over the past decade, were also scaled back. This supply shock has now been exacerbated by a demand shock as consumers alter their behaviour in response to the virus threat. In some countries such as China, Korea and Italy this has been, in part, as a result of government action. In other countries concern over virus transmission has manifested itself in cancelled business events, substantially reduced business and personal travel and curtailed social activities. We are also seeing increasing

2. As at 13 March 2020. Chart shown on a logarithmic scale. Total return index levels in US dollar terms, indexed to 100 on 31 December 2000. Disease labels are estimates of when the outbreak was first reported. Sources: Centers for Disease Control and Prevention, RIMES, MSCI

escalation of travel bans, including the most recent decision by the US government to restrict flights from 26 European countries into the US. The impact of these measures will be felt more broadly than in the obviously affected airline and cruise sectors, and among similar service providers – but at the same time the global economy has a greater weighting to these sectors than in the past.

While the recent dramatic fall in oil prices will be beneficial for consumers, it reflects increasing concerns about the outlook for global oil demand and unstable political relationships between the major producers, specifically Saudi Arabia and Russia. The US itself is now a net oil exporter due to growing shale gas production so will also be impacted. Furthermore, energy is a major employer and/or a major contributor to some states' economies.

Overall, it likely that global economic growth will slow sharply in 2020 and a recession in the US itself is increasingly possible. On the positive side, the US economy remains among the most resilient in the world. It has a history of bouncing back from adversity. Globally, the picture is more varied, with Europe in particular likely to experience sluggish growth over a longer period. However, governments such as the UK have signalled that fiscal policy will be used to support the economy during this period of uncertainty. Although fiscal deficits and government borrowing are at elevated levels for this stage of an economic cycle, economists point out that Japan, for example, has been able to sustain a relatively high level of government debt for some years with the intention of supporting its economy.

Although attention has focused on the economic impact of the virus on China – which will undoubtedly see a slowdown in growth in 2020, albeit from a very healthy level – there are also implications for other emerging markets. For example, a number of emerging market economies are significant manufacturing suppliers into the global supply chain centred on China. Any reduction in demand from US and European consumers will have an impact on them too. The oil price fall is not be uniformly negative for emerging market economies; among the larger economies, Mexico and Russia will be significantly affected as they are oil exporters, but India, Turkey and South Africa are importers and will benefit. The typically younger demographics of many emerging markets may tend to support domestic consumer spending over this period too.

What does it mean for markets?

We are experiencing a market decline that we have not seen since the Global Financial Crisis. March 9 was the 11th anniversary of the market bottom during the Global Financial Crisis — and the market noted the anniversary by recording the largest single-day point decline we have ever seen.

At the time of writing, the bellwether MSCI ACWI is down 20%[3] year to date in US dollar terms. Although there have been significant corrections in recent years, most notably in late 2018, this is currently the most pronounced market downturn in more than a decade of generally strong market returns. In general, US equities appeared to be fully valued by most measures heading into this recent period, and markets could remain volatile for some time. Despite relatively favourable valuations, European stock markets have fallen further. Emerging markets, which so often take the brunt of global stock market turmoil, have in fact held up somewhat better in recent weeks, possibly reflecting the greater secular growth potential in many countries. Unsurprisingly, energy stocks

3. As at 13 March 2020. MSCI All Country World Index (ACWI) with net dividends reinvested in US dollar terms. Source: MSCI

have seen the worst price declines, with the sector falling by 45%[4] year to date in US dollar terms, against the background of an oil price that has all but halved since the start of the year.

Turning to the bond market, we have seen a flight to safety that has pushed bond yields to unprecedented lows. For example, the yield on the 10-year US Treasury fell to around 0.5%. However, corporate bond spreads have widened, with highly indebted companies as well as those in the energy- and travel-related sectors most affected.

The US Federal Reserve demonstrated its willingness to take aggressive action, cutting interest rates to nearly zero in an emergency meeting on March 15, which puts its target in a range of 0% to 0.25% - a level not seen since 2015. The Fed also launched a $700 billion stimulus programme. Over time, low interest rates provide support to equities. Similarly, the UK's Bank of England cut rates to 0.25% and the European Central Bank also announced a stimulus package, including bond purchases and cheap loans to banks aimed at mitigating the economic shocks of the virus.

While the pace and magnitude of the recent volatility can be unsettling it is not entirely surprising. Investor sentiment is fragile and will likely remain so until the spread of the virus slows. In times like these, resilient investors who can demonstrate patience can be rewarded over the long term.

How does this compare with crises in the past?

Each stock market crisis has different characteristics, so direct comparisons are of limited usefulness; however, with a history stretching back to the aftermath of the Wall Street Crash of 1929, Capital Group is well-placed to give a considered perspective on such events from the personal experience of our most senior portfolio managers.

Our Chairman and CEO, Tim Armour, wrote last week: "In the 37 years I have spent as a professional investor at Capital, I have experienced a number of unsettled markets, including the savings and loan crisis in the late 1980s, the tech and telecom bubble that ended in March 2000, and the Global Financial Crisis of 2008 and 2009. Each of these crises were very different, with very different underlying conditions. But in each case, the markets bounced back. I believe the markets, and great companies, will survive the current market decline and rebound."

Jim Fullerton, who was Chairman of Capital in 1974 in the depths of one of the worst bear markets ever seen, wrote these words that are relevant today:

"One significant reason why there is such an extreme degree of bearishness, pessimism, bewildering confusion and sheer terror in the minds of brokers and investors alike right now is that most people today have nothing in their own experience that they can relate to, which is similar to this market decline. My message to you, therefore, is courage! We have been here before. Bear markets have lasted this long before. Well-managed mutual funds have gone down this much before. And shareholders in those funds and the industry survived and prospered."

And Jim Rothenberg, former Chairman of Capital Group, said this in the midst of the Global Financial Crisis in 2008:

"I have seen many turbulent markets and know how hard it is to avoid getting caught up in the here and now. This is especially true when the media bombards

4. As at 13 March 2020. MSCI All Country World Index (ACWI) with net dividends reinvested. Source: MSCI

us hourly with news, speculation and rumour. I also know, though, that as long-term investors we must focus on the real world underneath the noise and mesmerising flow of data."

Market downturns happen frequently but don't last forever
Standard & Poor's 500 Composite Index (1950–2019)

Size of decline	-5% or more	-10% or more	-15% or more	-20% or more
Average frequency*	About three times per year	About once per year	About once every four years	About once every six years
Average length†	43 days	112 days	262 days	401 days
Last occurrence	August 2019	December 2018	December 2018	December 2018

* Assumes 50% recovery of lost value.
† Measures market high to market low.

Sources: Capital Group, Standard & Poor's.

Should investors expect a quick recovery?

Although we expect this setback to be temporary, at this point, it may not be realistic to expect a quick recovery. Circumstances may very well get worse before they get better as investors adjust to the prospects of slowing economies over the near term. Investor sentiment is likely to remain volatile day to day depending on the global progression of the virus and the measures taken to combat it, which create economic friction.

But eventually, as in every previous crisis, markets will rebound. Judging that moment is particularly difficult as it often comes at a time when market sentiment is extremely negative. However, when it does, long-term investors who can tune out the daily distractions of short-term market movements and focus on the long term will ultimately be rewarded.

Capital's portfolio managers seek to focus on the companies we invest in rather than simply thinking about stock prices. By maintaining a dialogue with corporate managements throughout the economic cycle we are able to keep external events in perspective and ground our judgements better on the underlying prospects for the company.

At Capital, we are taking every precaution to prepare for the impact of COVID-19. Of course, while the effects are now global, Asia has been dealing COVID-19 for some weeks. For the significant number of associates in our offices in Beijing, Hong Kong, Singapore and Tokyo and for clients in the region this is nothing new. They were dealing with an emergency a month ago but today they are already beginning to return to a more normal life and business environment. In Asia the number of new cases of coronavirus appears to have stabilised and in China, people are already starting to go back to work. While it is too early to forecast the timing of a complete resumption of normal life in Asia, the outlook is more reassuring. Providing the outbreak in the rest of the world follows a similar pattern there are grounds for cautious optimism.

What is Capital doing to guard against market volatility, ensure continuity and take care of client assets?

Our company was founded in the US in 1931 in the depths of the Great Depression, with the aim of managing investment mandates designed to do well in volatile market periods. We seek to protect our investors' capital on the downside, and we invest for the long term.

A primary concern is to ensure the health and safety of our associates, and we are of course mindful of that for investors and advisors as well. With Capital's primary mission of enhancing peoples' lives through successful investing as our goal, our more than 350 investment professionals in offices around the world continue to do what they have always done: analysing companies and making real-time judgements about their potential long-term value. We continually reassess businesses in the light of new information – for example, how this crisis may lead to long-term changes in ways of doing business and how patterns of trade will develop in response.

In-depth, fundamental research and a long-term view of markets is at the core of what we do. We've made significant investments in technology that allow our associates to remain in close contact with clients, companies, colleagues, and markets while working remotely. This has allowed us to maintain strong continuity of our investment process, trading, investment operations, and all other business practices even as we make further adjustments in the light of COVID-19.

Meetings with companies are continuing uninterrupted using virtual means such as teleconferencing and videoconferencing. We've found that companies – many of which are implementing their own COVID-19 response plans – have been quite receptive to this.

Downside protection has always been an important aspect of Capital's investment approach and in this market environment as in previous ones we will strive to provide investors with a potentially smoother and less volatile experience than that experienced by investors exposed to broader market measures.

What should investors be doing?

In periods of declining markets, emotions run high, and that's natural and understandable. But it is exactly in times like these that a long-term orientation is important. We believe that, eventually, markets will rebound and life will return to normal, as has been the case in every previous crisis. Now more than ever, investors should be in close communication with their advisers reaffirming their long-term objectives.

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