GLOBAL MARKETS UPDATE

Revisiting our forecasts for equities

• Our view remains that, despite policymakers’ best efforts, a sustained turnaround in equity markets will only come once the virus starts to fade. That hasn’t happened yet. So, we suspect that they will fall a bit further in the coming months, despite plunging already. Thereafter, though, we assume a big recovery in H2 2020.

• At the start of the year, we were relatively cautious about the prospects for equities. But the forecasts that we made then pre-dated the spread of the virus, which has caused their prices to plummet. (See Chart 1.) Indeed, those forecasts now imply gains in the order of 40-60% by the end of this year for the major equity indices.

• We have since argued that equity markets are unlikely to turn the corner until evidence emerges that the virus is being brought under control. This happened in China, at least before the virus spread elsewhere. However, there is not much sign yet of the virus fading elsewhere. So we wouldn’t be surprised if equity markets fell a bit further until the containment measures in other economies show signs of working. In the meantime, monetary and fiscal support are likely to be necessary, but not sufficient, conditions to turn sentiment around.

• Nonetheless, we still think that there could be a big rebound in equity markets later this year. While we, and others, now expect the hit to the global economy in Q2 to be worse than in the Global Financial Crisis (GFC), our central case remains that it could recover fairly quickly if the pandemic is brought under control and the restrictions now in place to halt its spread are eased. In addition, the turmoil has led to indiscriminate selling as investors scramble for safety and liquidate positions to meet margin calls. This should end if the tide turns.

• The risks around this view are skewed to the downside; it relies on the number of new cases stabilising soon and falling thereafter, and on policymakers successfully preventing financial markets from freezing up and keeping the real economy afloat through the pandemic. Even so, we don’t think that it is an outlandish view given how quickly, and far, equity markets have sometimes bounced back in the past after slumping.

• The GFC is one example. After bottoming out in March 2009, the S&P 500 rose by roughly 50% over the next year. In common currency terms, MSCI’s Europe and EM indices climbed by even more: about 53% and 70%, respectively. Some other crises show a similar pattern. (See Charts 2 & 3).

• What’s more, there are a couple of reasons to think that this slump could be over faster than previous ones. First, both the plunge in asset prices and the policy response to the financial market panic has been much faster. Second, the underlying problem is the spread of the virus, rather than a major bubble in asset prices.

• With that in mind, we are tentatively pencilling in a new end-2020 forecast of 2,900 for the S&P 500 (down from our pre-pandemic forecast of 3,300). This would allow for a further 20% fall in the index from here (to just below 2,000), followed by a 50% rebound before year-end. The drop in the S&P 500 over the entire year would then only be roughly 10%.

• The peak-to-trough decline in the index in this scenario would be 43%, which is not a lot less than during the GFC, when it was 57%. Admittedly, it would be only half the percentage peak-to-trough slump (of ~86%) in the S&P Composite after the Great Crash of 1929. But we are not envisaging another Great Depression.

• The rebound in other equity markets could be even sharper in our view, at least on a common-currency basis. A key reason why EM equities and, to a lesser extent, those in most non-US DMs, tend to fare worse in a downturn and better during the recovery when measured in this way is that the US dollar typically strengthens when risk appetite wanes. That has certainly been the case this time around: the dollar has risen by about 8% on a trade-weighted basis this year. Several EM currencies have depreciated by more than 20% against the greenback, and some of the smaller G10 currencies have lost more than 10%. (See Chart 4.)

• The dollar’s rise has been in driven in large part by risk aversion and the need of banks and others to meet funding and payment requirements in dollars – interest rate differentials have generally moved against the dollar as the Fed has slashed interest rates. That suggests that if funding conditions ease – and the expanded swap lines the Fed has offered to other central banks should help – then the greenback will probably give up some of its recent gains. Again, that would be similar to the pattern that played out in 2008-09.
Chart 1: MSCI Indices, Change Since Feb 19th (USD, %)

Chart 2: Selected S&P500 Bear Markets

Chart 3: Selected MSCI EM Bear Markets

Chart 4: Change Against US Dollar Since 1st Jan. (%)
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