Morgan Stanley

INVESTMENT MANAGEMENT

Tales from the Emerging World

Why Markets Are Partying Through the Pandemic

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AUTHOR

RUCHIR SHARMA

Head of Emerging Markets and Chief Global Strategist

One of the questions we get most frequently now is about why stock markets are rallying amid the worst economic crisis since the Great Depression.

The answer, we think, is threefold: the shocking scale and speed of the global economic contraction has been matched by the shocking scale and speed of the largest stimulus rescue operations in history. Markets are counting on governments to save the day, and are now confident that with central banks holding rates near zero and buying up bonds at a record clip, even the most heavily indebted Zombie companies will survive this passing disaster.

The "passing" factor is key. Markets seem to see this crisis as akin to a hurricane or flood, a natural disaster that can't linger for long, and will certainly be gone before the year is out. They now seize on every piece of positive pandemic news—and there has been plenty of late, with curves flattening in many major countries—as new reason to buy the dips.

The panic that seized markets back in March already feels like a memory. As the coronavirus started to break out of China, economists began to rip up what had been rosy forecasts for 2020, and replace them with predictions of double digit GDP declines in the first half of the year. The scale of the revisions was unprecedented, and the market's waterfall decline in March was the steepest in recent history.

Typically, our research shows, when the U.S. stock market falls in anticipation of a recession, it starts declining about seven months before the recession begins and drops by a total of 30 percent over 15 months. This time, the market fell 30 percent in 18 days, a collapse equaled in speed and scale only by the crash of 1929—an event that may yet prove instructive.[1]

[1] MSIM, Bloomberg, Factset, Haver, as of April 2020.

Back in '29, the market started falling, stabilized for a few weeks, then resumed its decline amid more bad news. It finally hit bottom in 1932, down by nearly 90 per cent from the peak.[1] The obvious risk now is that if there is a second wave of the virus and is not a passing natural disaster, what looks like a new bull market may be just a bear market rally, with another leg down still to come.

Over the last month, the economic outlook has only gotten worse, with data consistently surprising to the downside. The late March consensus was that the pandemic would lead to a one percent contraction in global GDP in 2020, matching the contractions that accompanied the global financial crisis of 2008, and the Spanish Flu between 1918 and 1920. The late April consensus is that the 2020 recession will shave nearly five points off global GDP, approaching the 6 percent contraction between 1929 and 1932.[2]

Yet fear of another Depression appears to be fading, buried under multiple rounds of government spending, central bank bailouts, and a hopeful reading of pandemic forecasts. The S&P 500 is up 27 percent from the March 23 bottom. The market rebound was as rapid and as unusual as the crash.

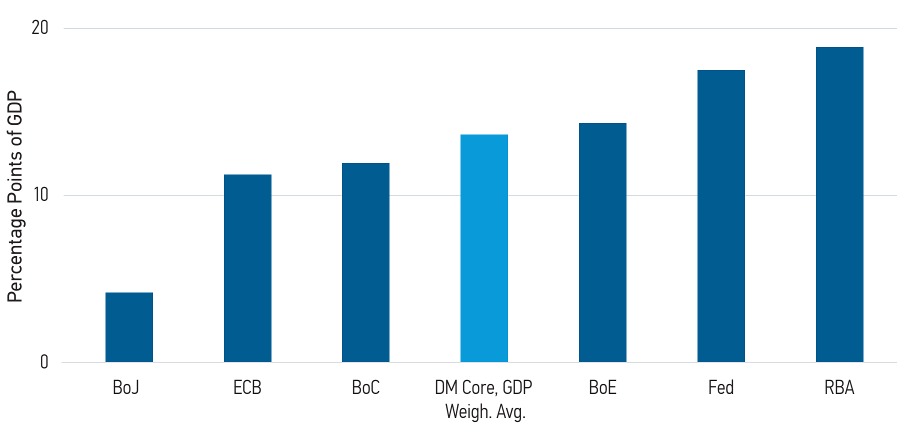
This rally is growing in a flowerbed of government money, hastily shoveled out over the last two months. In developed economies, central bank balance sheets have expanded by a sum equal to nearly 14 percent of GDP on average, and close to 18 percent in the United States. Government's discretionary fiscal stimulus amounts to around 4 percent of GDP on average, and more than 7 percent in the United States—with more on the way.[3]

Already, according to a Deutsche Bank estimate, total fiscal and monetary stimulus amounts to more than $10 trillion in the G7 countries alone, a sum five times greater than the stimulus they rolled out to combat the global financial crisis of 2008. The prevailing assumption in markets is that the authorities will shovel out enough money to fill the gaping but temporary hole created by economic lockdowns.

DISPLAY 1

With More Easy Money Still to Come

Expected Change in Central Bank Balance Sheets in 2020



Source: Goldman Sachs, Haver Analytics as of April 2020.

Confidence that this hole is temporary has been lifted by recent pandemic news, which is indeed trending up. Daily global growth in the number of cases is slowing, forecasts for when a vaccine will arrive are shortening, and estimates of how many people will die in major countries, including the United States, are falling sharply. The news is shifting the political discussion to when to exit lockdowns, and many major economies, from China and Korea to Australia, Austria and Switzerland, are opening up and not seeing any significant second wave of outbreaks.

The markets continue to choose winners as if the pandemic had never happened. Within emerging markets, those with good healthcare systems, low debt and low exposure to commodities and tourism, are outperforming their peers. Those include China, South Korea and Taiwan, the same countries that were outperforming before the crisis hit. If the pandemic ebbs in coming months, as widely expected, this situation is likely to reverse, with other EMs outperforming.

We are still reluctant to adopt any particular pandemic scenario as our baseline assumption. Experts continue to disagree on how many people have been infected so far, which muddies any guess as to how long it will take the virus to hit the wall of "herd immunity." If the rate of growth in new cases does not abate as fast as the consensus expects, projections of an economic rebound beginning as soon as the second half of 2020 may not pan out either.

The longer the coronavirus lasts, the less effective current stimulus measures will be. Back of the envelope calculations suggest that just the current shutdowns in U.S. service industries, including airlines, restaurants, hotels and sports, are costing about $1 trillion each month.[4] At that rate the United States would burn through its current stimulus

[2] Bloomberg, J.P. Morgan, as of April 2020.

[3] Goldman Sachs, as of April 2020.

[4] Wall Street Journal, as of March 2020.

packages — totaling more than $5 trillion — in midsummer.

Whenever the pandemic passes, the market is likely to turn its full attention from the impact of the virus to the impact of the steps taken to contain the economic damage. The vast scale of the new powers governments have acquired, and of the debts they are ringing up, could act as a weight on economic growth long after the pandemic is over. But that may still not matter to financial markets, which seem increasingly confident that policymakers can and will do whatever it takes to prop up asset prices.

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