Morgan Stanley

INVESTMENT MANAGEMENT

Global Multi-Asset Viewpoint

Global Recovery Delayed, But Not Derailed

SOLUTIONS & MULTI-ASSET | GLOBAL MULTI-ASSET TEAM | MACRO INSIGHT | JANUARY 2020

In this month's letter, we address the impact of the recent outbreak of the novel coronavirus on global markets and economies, and what this means for our global investment outlook and portfolios. We believe that the likely economic impact will be a significant hit to China's growth in the first quarter of 2020, followed by a rebound in the second quarter *(Display 1)*. The net impact to global GDP growth for the full year is likely to be a modest -30 basis points, based on our analysis, and assuming the virus is contained, as it appears to be.[1] This will likely extend the current "goldilocks" environment, further delaying overheating as well as the recovery in global growth that we were expecting in the first half of this year by a couple of quarters. Such an environment will likely be good for bonds, and could also be good for equities if most major equity markets look through the near-term first quarter economic impact, taking into account both the drop and the rebound in activity.

In the second half of February, reports of a rapidly-spreading coronavirus in Wuhan, Hubei Province, China caused fears of a global pandemic. Growth-sensitive assets sold off: from January 17-31, global equities fell -3.6%, U.S. 10-year Treasury yields fell by over -30 basis points to 1.51%, and Brent oil and China H-shares were each down over -10%.[2] Most markets have since rebounded, as it appears the virus may be contained. But the economic impact of the containment on China's economy is likely to be substantial.

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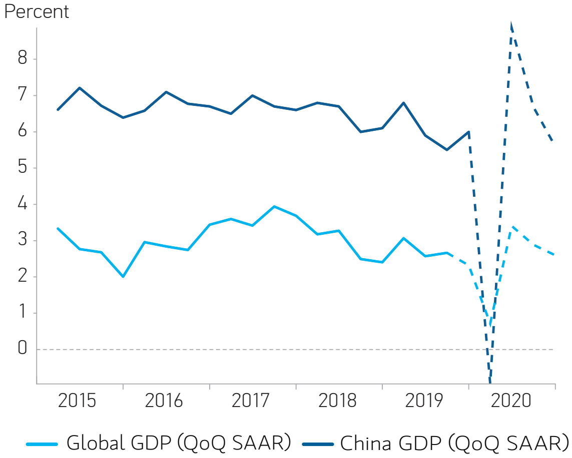
Display 1: **Coronavirus Impact: 1Q 2020 Drop in GDP Growth, Followed by Q2 Rebound**



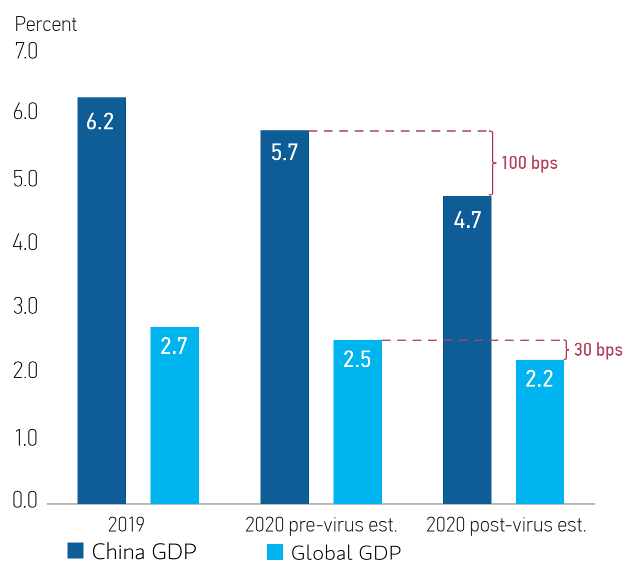
Source: MSIM Global Multi-Asset team analysis, Haver analytics. Data as of February 13, 2020.
Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

The SARS virus infected 8,421 people over the course of six months in 2002-03. Clearly, having infected over 75,000 people in just over a month, the coronavirus has sickened more people, more quickly. While China's containment measures appear to have been effective, this means China will likely bear the brunt of the economic impact. But China's economy represents a much larger share of global GDP today (18% vs. 5% in 2003), and tourism and leisure represent a larger share of the global economy.[3]

We estimate that China growth could decelerate from 6% in the fourth quarter of 2019 to -1% in the first quarter of 2020, quarter-over-quarter, seasonally-adjusted annual rate (QoQ SAAR). This is based on our assessment of the impact of measures to contain the virus (e.g. travel restrictions, extension of the Lunar New Year). We estimate that the impact to global growth will be a deceleration from the 2.6% pre-outbreak run-rate to 0.7% in the first quarter (QoQ SAAR), with the global PMI falling from the current 51.9 to 45.0 at the trough.[4]

We then expect a big make-up bounce in the second quarter in China (+9%) and global (+3.4%) growth (QoQ SAAR), once China lifts travel restrictions and economic activity returns to normal. By the second half of 2020, we believe China and the global economy could return to roughly their fourth quarter 2019 pace of growth. The permanent loss as a result of demand destruction in the first quarter would be -100 basis points lower growth for China for the full year and -30 basis points lower for global growth, based on these estimates. We are now expecting 2.2% global growth for the full year 2020 on a year-over-year basis, compared with 2.5% previously *(Display 2)*.[5]

Display 2: **Permanent Loss in GDP Growth from Coronavirus Modest**



Source: MSIM Global Multi-Asset team estimates.
Data as of February 13, 2020.
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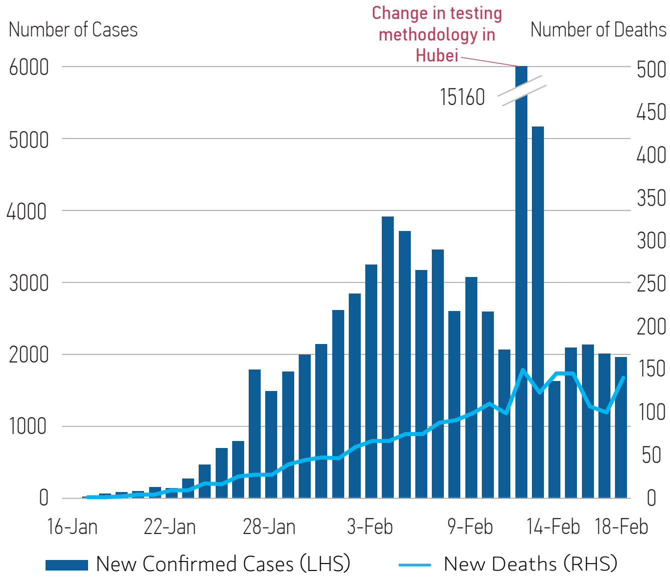
We expect that the market will look through the first quarter impact on growth, taking into account both the drop and the rebound in activity in essence, looking at the first half in its entirety. If so, the U.S. 10-year Treasury yield could fall as low as 1.25% in the first half of the year—discounting the drop in global growth for the combined first half of the year to 2.1%, rather than the actual first quarter trough of 0.8% that we believe is likely. By the second half of the year, if growth recovers to its pre-coronavirus baseline, the 10-year Treasury yield could rise back to pre-virus levels of roughly 1.85%. In equity markets, we expect modest mid-single digit additional downside in China and emerging market equities from current levels, while most of the damage to U.S. equities has likely already played out. We forecast moderate additional upside for gold through the end of the year; our year end-2020 target for gold is $1900 per ounce.[6]

We are watching the number of new cases for evidence of containment, given that in historically similar episodes, such as SARS, markets have looked to a peak in the number of new daily cases as an indication that the virus is under control. In 2003, the bottom in Hong Kong equity market performance relative to global equities coincided roughly with the April 2003 peak in the number of new SARS cases.[7] The daily incremental number of new coronavirus cases appears to be peaking now, both within and outside of China, with the peak in the number of daily incremental new cases potentially reached in the first half of February. The percentage change in daily new cases has been falling, such that the number of daily incremental new cases has declined (with the exception of what we expect to be a temporary pop in new cases in Hubei as a result of a new testing methodology) *(Display 3)*. In addition, the virus appears to have been mostly limited within Hubei province, China (Hubei accounts for 4% of Chinese GDP), where about 80% of all confirmed cases are located. Greater China outside of Hubei accounts for another 20% of total cases, while global cases outside of China represent just 1% of the total number of cases.[8]

Our economic and market forecasts assume that the virus is contained relatively quickly, by the end of February. However, one of the risks to our view is that the epidemic turns out to be much worse than currently understood. Under-reporting or delayed reporting in Hubei province, given resource constraints there, or a more aggressive spreading of the virus within and beyond China as individuals return to work could cause a longer period of travel restrictions or a slower re-starting of China-based production from Chinese and international companies. Another possibility is that the slowdown is exacerbated by excess leverage in China's economy. Any of these could cause the economic impact to be bigger, with the subsequent recovery being slower, and could cause us to revise down our economic and market projections.

Display 3: **Virus Contained - Daily Incremental Change in New Cases Coming Down**



Source: MSIM Global Multi-Asset team analysis, China's National Health Commission, World Health Organization, John Hopkins University. Data as of February 18, 2020.

On the other hand, an upside risk to our view is that more aggressive monetary policy easing in China and potentially by the Fed could generate a bigger growth rebound. Indeed, recent statements from the People's Bank of China appear to indicate a prioritization of economic support over debt reduction amid the crisis.

Recognizing near-term risks to growth and earnings, we have taken equity and bond exposure to neutral from overweight equities and underweight bonds. We reduced positions in value stocks relative to low volatility and momentum stocks in the U.S. and Europe, where valuation and sentiment are extreme, but we are awaiting evidence of the key fundamental driver of this trade which is evidence that global growth is imminently rebounding, before adding back to these positions.

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FOOTNOTES

[1] MSIM Global Multi-Asset Team analysis and estimates

[2] MSIM Global Multi-Asset Team analysis; Bloomberg

[3] MSIM Global Multi-Asset Team analysis; Haver Analytics

[4] MSIM Global Multi-Asset Team analysis and estimates

[5] MSIM Global Multi-Asset Team analysis and estimates

[6] MSIM Global Multi-Asset Team analysis and estimates

[7] MSIM Global Multi-Asset Team analysis; Bloomberg

[8] MSIM Global Multi-Asset Team analysis; Haver Analytics; China's National Health Commission; World Health Organization; John Hopkins University

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