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Coronavirus outbreak update

Investment implications

March 5, 2020

Recent market developments

Financial markets have remained very volatile as the number of individuals with the coronavirus disease (COVID-19) has continued to increase. Between February 12 and March 3, the MSCI ACWI Index fell by 10% in USD terms, while the US 10-year Treasury yield dropped by over 60bps to around 1%, its lowest level ever. Gold gained 5%, and the oil price fell by 8%.[1] The last week of February was the worst week for global stock market returns since the Global Financial Crisis.

Financial market weakness and expectations of a material softening in economic activity have prompted central banks to act. The US Federal Reserve cut interest rates by 50bps on March 3, in the first out-of-cycle move since 2008. Other central banks, including the Reserve Bank of Australia, have also cut interest rates. The European Central Bank and Bank of Japan have both provided statements indicating their willingness to stabilize financial markets, even though they have very little to offer in terms of conventional monetary stimuli. In Asia, where the economic impact may be more severe, we have seen combinations of both monetary and fiscal responses.

Outbreak continues to spread beyond China

In recent weeks, the daily rate of new COVID-19 cases within China has slowed significantly, with most of them still confined to the Hubei province. Since February 26, the daily rise in recorded infections outside China has exceeded the number of new cases within China. The isolation and quarantining policies introduced by the Chinese authorities appear to be working, though not without economic cost.

[1] Markets data obtained from Thomson Reuters Datastream.

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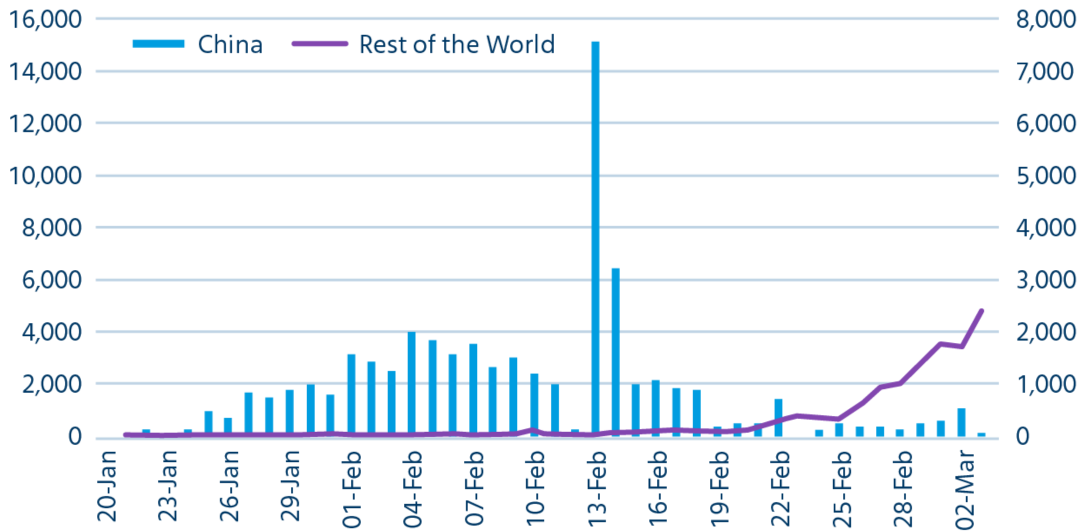
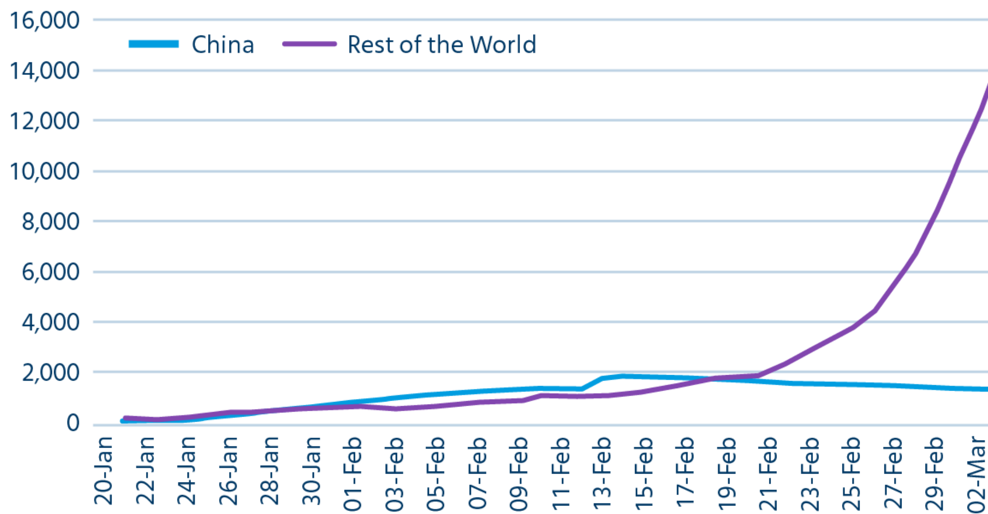
Daily New Cases



Source: Kompa, Mercer

Daily Infection Multiplier



Source: Kompa, Mercer. The daily infection multiplier is defined as the ratio of total cases to date compared with the number when the outbreak was first reported (January 20 2020), adjusted for number of days since the outbreak.

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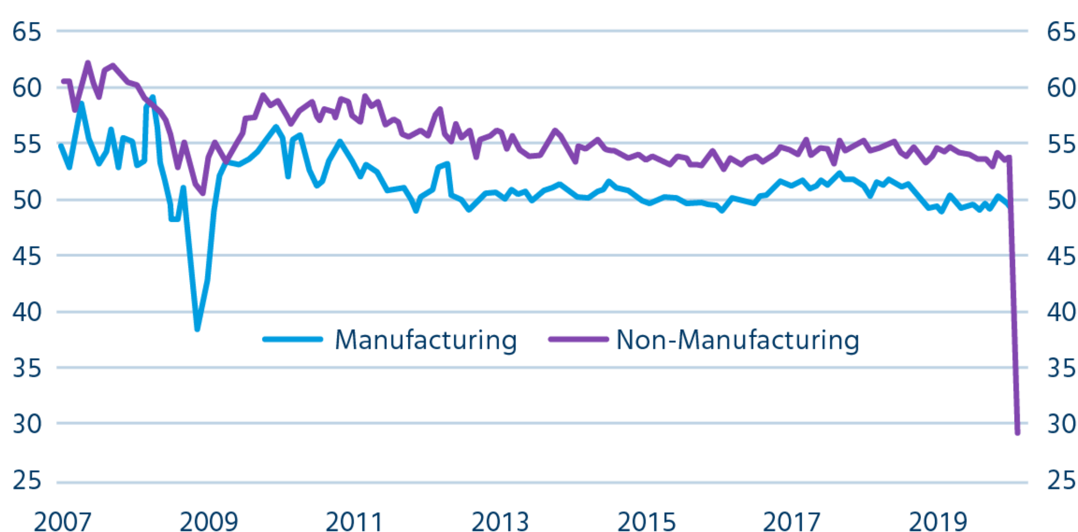
Rapid outbreaks, such as those witnessed in Italy, South Korea and Iran, would be a cause for serious concern if they were to occur in other countries, particularly in the United States, given the size of its economy. Although slowing the spread of the virus, geographical lockdowns, travel bans and forced quarantining would likely lead to significant economic disruption, similar to those witnessed in China. In February, the official business confidence indicators (PMIs) were at their lowest levels ever, after the lockdowns in the Hubei province and delays in recommencing economic activity in other regions of China, following the Lunar New Year holidays.

Official China PMIs



Source: Bloomberg, Mercer analysis

Economic outlook

Economic growth in the first quarter in China is likely to be negative for the first time in decades. With the number of new infections falling, Chinese people have started to go back to work, although it is unclear to what extent. The Chinese authorities will be closely watching whether the return to work results in an uptick in infections, requiring a further shutdown.

After the sharp fall in 2020 Q1, the Chinese economy is likely to rebound strongly in 2020 Q2 & Q3, assuming activity returns to something approaching normality. Chinese authorities have been loosening monetary and fiscal policy, focusing on measures to support businesses that have been directly impacted. Some

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examples include delaying tax payments, deferring bond payments and lowering borrowing costs. To date, hundreds of these return-to-work measures have been announced across Chinese provinces, making an aggregate evaluation difficult.

Economic growth in other Asian economies is also likely to be very weak or negative in the first quarter. This is because Chinese tourism has collapsed and some countries have initiated quarantine measures. Supply chain disruptions will also slow economic activity in some countries. Again, a sharp recovery is likely at some point, with the timing of that recovery determined by when the virus is brought under control.

In Europe, the UK, the Americas and Africa, some slowdown is likely, whatever happens next. Economic activity is already being curtailed. An increase in COVID-19 cases in most countries is likely. The full economic hit depends on whether a country has to initiate severe quarantine measures. The range of possible outcomes is wide. A moderate fall in activity is possible if the virus is contained. If it isn't, a severe shock is likely.

Central banks and governments have started to ease monetary policy. They are also likely to loosen fiscal policy and initiate measures to support those directly impacted. In the near term, these monetary and fiscal measures are unlikely to have much impact on economic growth. They may, however, help diminish the risk to economic growth from weak financial markets and the banking sector.

In our base case, we expect a sharp economic slowdown in the first half of the year in most economies, followed by a steep recovery. As economic activity returns to normal and lockdowns, quarantines and travel bans are lifted, stronger global growth in the second half of the year should largely offset the weak, or even negative, growth in the first half. That said, some of the activity lost in the services economy in the first half of the year is unlikely to be recovered. So we expect the overall growth rate for 2020 to be lower than our original forecasts.

Meanwhile, the spread of COVID-19 to more countries adds a significant degree of uncertainty to our base scenario. The inflection point in global activity which underpins our base case may well be delayed.

Mercer's dynamic asset allocation view

There is now greater downside and tail risks to the economic outlook than we previously anticipated, and we see a potential delay in return to growth.

Uncertainty over the financial and market impact of COVID-19 remains high, but we expect more clarity on the potential outcomes over the coming weeks. Although there is risk of further downside in equity markets in the short term, we do not recommend clients make significant changes to their asset allocations in

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response. Significant downside risk to economic growth has been priced in already, and there has been a forceful policy response.

We continue to focus on the intermediate term (one to three years) in our dynamic asset allocation process and, given current volatility, successfully timing short-term moves is extremely challenging. Our main asset classes dashboard for the first quarter of 2020 is shown in the Appendix.

Instead, we urge clients to maintain discipline in their asset allocation approach. With the significant recent losses in equity markets, many investors have become underweight equities and overweight fixed income relative to their strategic benchmark. They should consider rebalancing their portfolio. Additionally, we recommend that investors develop a plan to respond to future market volatility (if they have not done so already). This plan should be strategically consistent with their investment objectives, loss tolerance, governance framework and implementation constraints.

Mercer will continue to monitor economic developments and the market environment. Should our views change, we will provide further communication.

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Appendix

GLOBAL DAA DASHBOARD
MAIN ASSET CLASSES 2020 Q1

* In lieu of cash, investors might consider liquid alpha-oriented strategies with low sensitivity to equity, credit and duration.

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This document summarizes Mercer's views on the medium-term outlook for relative returns from the key asset classes; by medium term we mean one to three years. The views expressed in this report are relevant for reflecting medium-term market views in determining appropriate asset allocation and manager benchmarks. We do not expect clients to make frequent tactical changes to their asset allocation based upon these views. The views expressed are provided for discussion purposes and do not provide any assurance or guarantee of future market returns.

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