PIMCO

CYCLICAL OUTLOOK

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From Hurting to Healing

Our baseline economic forecast is a U-shaped global recovery, but substantial unknowns remain.

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- We expect the global economy and financial markets to transition from intense near-term pain to gradual healing over the next six to 12 months. However, there is the risk if not the likelihood of an uneven recovery, with significant setbacks along the way and some permanent damage that is not recouped.
- Investors should brace themselves for a very different investment landscape as the weakest areas in the global credit spectrum will be exposed over the next several months.
- While this should create more attractive entry points in higher-risk segments of the investment universe over time, we remain patient and focus on opportunities that we see as high quality, default-remote assets for now.

Following the longest expansion on record, the global economy is currently plunging into what could easily become one of the deepest but also shortest recessions in modern times. However, business cycle history offers few clues for what is likely to unfold over our cyclical six- to 12-month horizon, which makes the outlook even more uncertain than usual.

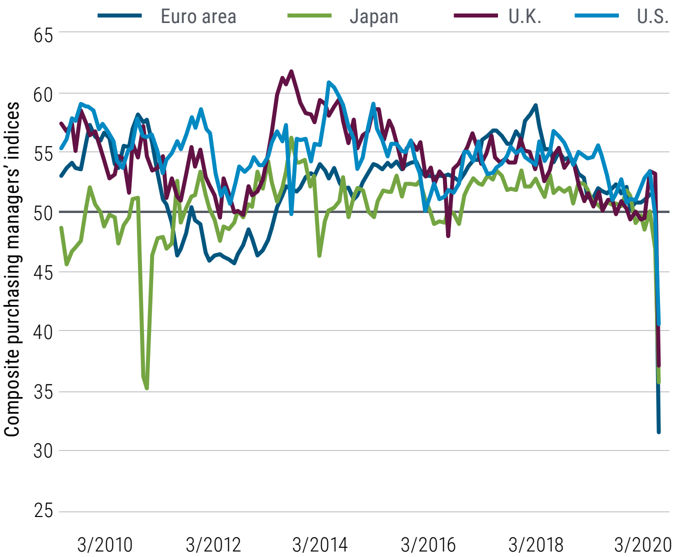
THIS TIME TRULY IS DIFFERENT …

There is no precedent and thus no good playbook for the global recession that is currently unfolding. Recessions are usually caused by the interplay between severe economic and/or financial imbalances building up during the expansion and a typical late-cycle tightening of monetary policy, sometimes aggravated by a sharp increase in the price of oil.

This time is very different because the underlying cause of the downturn is a truly exogenous shock that originated from outside the economic and financial sphere: a highly contagious new coronavirus that has been spreading fast in a globalized world since the start of the year. As the severe health crisis in several strongly affected regions illustrates, the COVID-19 pandemic threatens to overwhelm healthcare systems in many countries around the globe over the next few weeks and months.

Most governments have responded by aggressively curtailing economic and social activity in order to suppress the further spreading of the virus as quickly as possible. This has already led to a sharp drop in aggregate output and demand in many Western economies during the second half of March (for example, composite purchasing managers' indices plummeted – see Figure 1), which is likely to continue in the near term as suppression efforts not only remain in place but are being intensified. Thus, we are seeing the first-ever recession by government decree – a necessary, temporary, partial shutdown of the economy aimed at preventing an even larger humanitarian crisis.

Figure 1: Plunge in PMIs an early sign of growth shock ahead



Source: PIMCO, Haver Analytics as of March 2020.

Importantly, despite the record length of the expansion that likely ended this March, there were no major domestic economic imbalances in most advanced economies: Consumers were less exuberant than in the previous cycle, firms hadn't overinvested in capacity, housing markets – with a few exceptions – didn't overheat, and inflation was generally low and stable. All of this should be conducive to a recovery less impeded by economic legacy issues once the virus is under control.

However, we have been concerned about financial imbalances (as noted in this February blog post) that have been building in the U.S. corporate sector with a significant rise in leverage on the balance sheets of riskier and more cyclical companies. We return to this downside risk below.

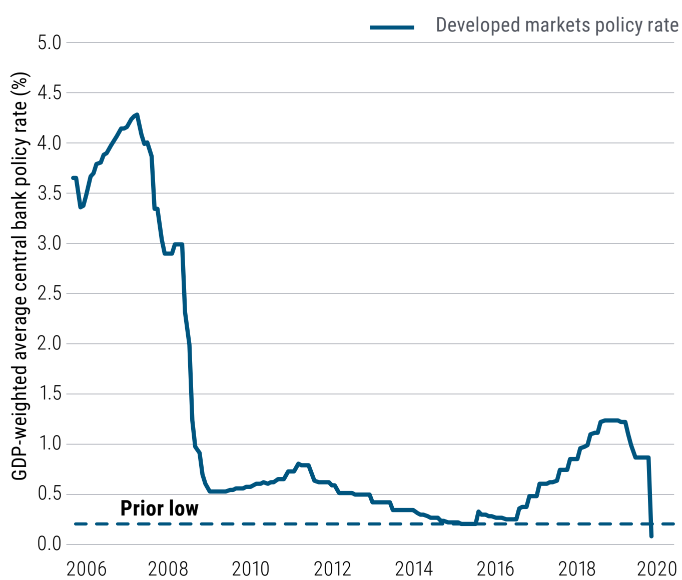
… AS IS THE ECONOMIC POLICY RESPONSE

What is also different this time is the unprecedented speed and size of the monetary and fiscal response to the crisis. Policymakers have been pulling out virtually all the stops in an attempt to keep the recession from turning into a lasting depression with mass bankruptcies and mass long-term unemployment.

Central banks have stepped up as lenders of last resort not only for banks but increasingly also for other financial intermediaries and even for nonfinancial corporations through a range of lending and asset purchase programs (for details on the U.S. Federal Reserve's response, see PIMCO's blog post, "The Fed: Avoiding a Depression"). Moreover, through near-zero or negative interest rates (see Figure 2) and large-scale purchases of government bonds, central banks also provide a much-needed backstop for fiscal policy.

As ever, the euro area faces additional coordination challenges. After initial communication missteps, the European Central Bank (ECB) appears to have put in place a robust framework for dealing with the strains on the euro area during a deep recession, while acknowledging the necessity of a significant fiscal response.

Figure 2: Developed market central banks in aggregate cut interest rates below previous low levels



Source: PIMCO, Haver Analytics as of 31 March 2020.
Developed Markets = Australia, Euro area, Canada, Japan, Sweden, Switzerland, U.K., U.S. Dotted line = prior low (in 2015).

Many governments have also reacted swiftly by addressing both liquidity and solvency concerns. Liquidity support includes large-scale guarantees for bank loans to businesses, delaying tax payment deadlines for individuals and corporations, and providing backstops for central bank lending programs (not all programs are being implemented across all governments). Many governments are also providing income support for households and firms through a range of transfers to individuals and subsidies for companies. (For details on the latest U.S. fiscal relief bill, see the blog post, "Economic Fallout: Here Comes Congress!")

In many countries, the fiscal response underway already exceeds that during the Great Recession of 2008–2009, and additional measures are likely to be announced over the next several months.

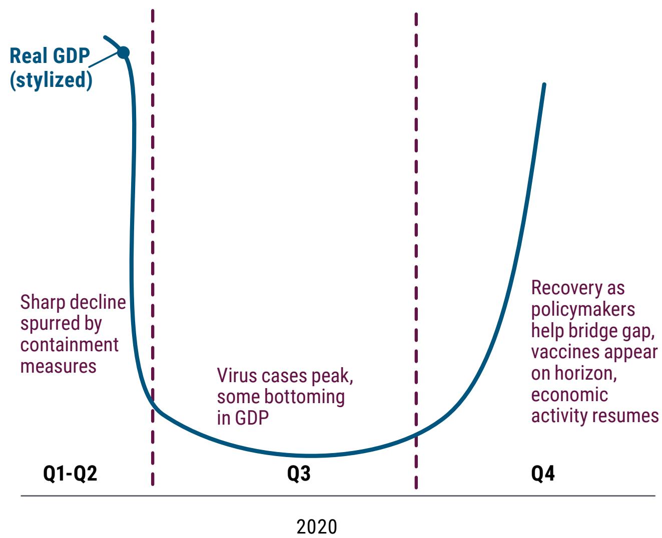
While a deep recession is inevitable given the mandated temporary shutdown of major parts of the global economy and given that many of the recently announced transfers and loans will only arrive after some delay, the large fiscal response will very likely help prevent a global depression and support economic recovery once the restrictions on economic activity are lifted.

As with the monetary policy response, the logic of the euro area dictates greater uncertainty over the fiscal response and its implications in the short and medium term (for details, see the blog post, "In Europe the Crisis Policy Response Is Substantial, But More Is Likely Needed"). Fiscal and monetary coordination is of course easier to achieve with one Treasury and one central bank.

OUR CYCLICAL BASE CASE: FROM HURTING TO HEALING

Given the swift and large monetary and fiscal policy response and in the absence of major imbalances in the real economy that would require a prolonged period of cleansing and adjustment, we expect the global economy to transition from intense near-term pain during the virus-suppression phase to gradual healing over the next six to 12 months, once the spread of the novel coronavirus is under control and the restrictions are being lifted.

Figure 3: We forecast a U-shaped recovery in real global GDP but there is much uncertainty around this baseline



Source: PIMCO. **For illustrative purposes.**

However, our base case remains a U-shaped rather than a V-shaped recovery (see Figure 3) because the restrictions on economic activity will likely be lifted only gradually and at different speeds for different sectors and regions. Also, repairing the supply chain and overcoming logistical and transport bottlenecks will take some time. As a consequence, following the nosedive in economic activity that is currently underway (the downward I in the U), we expect the bottoming process to last a few months after the virus is under control (the L in the U), before output and demand ramp up back closer to more normal levels eventually, helped by fiscal and monetary support (the upward I in the U).

We plan to provide more details on our growth forecasts for the major economies in a follow-up publication in the coming weeks.

THE RISKS: LONGER STAGNATION, OR RECOVERY AND RELAPSE

We see two main downside risk scenarios to our base case of a U-shaped economic trajectory over the next six to 12 months: a prolonged L-shaped trajectory, or a recovery interrupted by relapse – call it a W. The two main swing factors that could push us into these more adverse scenarios are 1) the shape of the pandemic curve, and 2) the shape of the default curve in the highly leveraged, cyclical sectors of the economy that may not have direct access to central bank and/or government balance sheets.

A prolonged stagnation would likely result if governments' current suppression strategy turns out to be insufficient to significantly slow the spread of the virus, so that suppression measures have to be kept in place for longer than the six to eight weeks currently anticipated. With activity depressed for longer in this scenario, many of the more highly leveraged firms in the cyclical parts of the economy would likely default, feeding back negatively into jobs and demand.

Conversely, even if the virus suppression is successful in the near term and a lifting of containment measures leads to a revival of economic activity, we may experience a second wave of contagion later this year that leads to renewed economic stoppages. A relapse following the recovery would likely be exacerbated by defaults of cyclical companies that survived the first wave.

A V-shaped trajectory is in theory possible, although not something that we are currently placing a great deal of weight upon. Such a trajectory would be the result of the combination of successful macroeconomic policy interventions and also, crucially, medical breakthroughs and increases in the capacity of health systems and public administration more generally to surprise on the upside in terms of dealing with the current crisis.

A GLIMPSE INTO THE POST-COVID WORLD

Markets are discounting machines, so it's never too early to think about the potential longer-term consequences of this crisis. Even if the more adverse cyclical risk scenarios (the L and the W) can be avoided and our U-shaped "hurting to healing" base case comes to pass, this crisis is likely to leave some long-term scars that investors should start considering now.

First, globalization may be dialed back even faster now as firms try to reduce the complexity of their global supply chains, which proved vulnerable not only to trade wars but also to sudden stops caused by natural or health disasters. In addition, governments may use health concerns to implement further curbs on trade, travel, and migration. Thus, companies, sectors, and countries that are very dependent on trade and travel are likely to take more than just a temporary hit to their business models.

Second, private and public sector debt levels will likely be significantly higher after this crisis. This could erode central bank independence further as monetary policy becomes increasingly involved in allocating resources to the nonfinancial corporate sector (essentially a fiscal act) and needs to ensure that the costs of servicing government debt remain low. If governments continue to engage in more expansionary policies even after the crisis, fiscal dominance of monetary policy may eventually lead to significantly higher inflation rates than markets currently price in. But with central banks capping the rise in nominal yields that would normally result from higher inflation, real rates would tend to fall as inflation rises.

Third, many households will likely come out of this crisis with higher levels of personal debt and will have experienced severe income and/or job losses. This in turn could increase the demand for precautionary saving in relatively low-risk instruments such as cash and bonds. Also, we expect many households will strive to build home equity faster by reducing mortgage debt. Thus, with the private sector saving glut likely to rise further, investors should brace themselves for a New Neutral 2.0 of even more depressed real interest rates over the secular horizon.

Investment implications

We are "dealing with disruption" (as we discussed in our 2019 Secular Outlook) on an unprecedented scale. In this highly uncertain environment – as PIMCO has done during previous periods of extreme dislocation – we will focus on a defensive approach at a time of heightened volatility. We will look to position to take advantage of normalization of market conditions over time but, for now, we believe a caution-first approach is warranted in an effort to protect against permanent capital impairment.

STILL PREFER U.S. OVER GLOBAL DURATION

We believe a focus on U.S. duration over other global markets has been the right approach over recent weeks and, in spite of the significant relative outperformance of U.S. duration, we see room for U.S. rates to move further in the event that economic and market stabilization takes longer than our baseline outlook. There is of course the possibility of global yields moving somewhat higher as crisis management measures take hold and investors look across the economic valley ahead to the eventual recovery. While maintaining a preference for U.S. duration, we do not anticipate taking large positions and generally expect to stay fairly close to neutral in overall duration positioning across our portfolios.

ATTRACTIVE DISLOCATED HIGH QUALITY ASSETS

U.S. agency mortgage-backed securities (MBS) and U.S. Treasury Inflation-Protected Securities (TIPS) are high quality assets that have been negatively affected during extreme market conditions. Agency MBS have recovered significantly, in part owing to the Fed's actions, and TIPS should also recover as liquidity conditions normalize with continuing Fed purchases and as longer-term inflation expectations pick up.

U.S. non-agency MBS, U.K. residential MBS, and many other asset-backed securities (ABS) have been negatively affected during the period of market dislocation. We see these as resilient assets, with diversified pools of borrowers, and generally low leverage and loan-to-value ratios. We will look for attractive opportunities to acquire defensive assets when they present themselves.

While we have for some time taken a cautious approach on corporate credit, in part owing to concerns about valuation and market functioning, we now see some good opportunities to add longer-dated exposures in high quality issuers where we believe we will be well-compensated for the risk. We plan to take a patient approach but will look to redeploy capital into attractive credit opportunities in the highest-quality segments of the investment grade corporate bond, ABS, and commercial MBS markets, including new issues. In private credit approaches, similarly, we anticipate good opportunities to deploy capital and to seek attractive liquidity premiums. Meanwhile, we remain cautious on the weaker segments of the investment grade, high yield, and loan markets.

ECB ACTION CRITICAL FOR EURO AREA SPREADS

We will generally take a cautious approach on exposure to European sovereign risk and watch closely the ECB's actions and, over time, the potential for more coordinated fiscal policy actions to build a more resilient euro area. In the short term, peripheral euro area spreads should be well-supported by the ECB, and central bank purchases could potentially push spreads significantly tighter if the ECB is prepared to take on this role at a time of increased pressure on fiscal balance sheets. We will watch closely for evidence. The ECB's actions will speak louder than its words.

CAUTIOUS APPROACH IN EMERGING MARKETS

Emerging markets are heading into this recession with few major macro imbalances, which should leave sovereign balance sheets more robust to a severe, but fairly contained, growth shock. It will be harder for emerging market central banks and fiscal authorities to do the large-scale backstops that are being deployed in developed countries. This, together with a persistent negative shock to oil prices, mandates a cautious approach in emerging markets, in our view. But dislocations should lead to good opportunities for active managers and we expect to find select opportunities that offer attractive risk/reward balance in positioning for global market healing.

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