The Global Economic Backdrop

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Entering 2020, the outlook was for a period of relative calm, but the discovery in January of a novel coronavirus in China introduced a new concern. COVID-19 has since spread globally. While the ultimate breadth and severity of COVID-19 is unknown, it is clear that the economic consequences will be meaningfully negative.

Investors initially assumed the virus would temporarily slow growth but reassessed this view once it spread to Europe. Equities went into a tailspin, falling 20% in only 19 trading days and ending the 11-year bull market. Interest rates declined as markets priced in rate cuts, with the Federal Reserve delivering a 50 basis-point cut on 3 March, and oil prices fell sharply as lower demand from China and a price war initiated by Saudi Arabia and Russia led to fears of excess supply.

Looking forward, COVID-19 is the biggest global uncertainty. In the United States, recent signs of labor market weakening raise questions about the resilience of household finances, and the political calendar is increasingly active. In Europe, the economy was already lethargic and grappling with post-Brexit uncertainties around trade rules. Now, with Italy in lockdown and the coronavirus spreading rapidly, recession appears increasingly likely. In China, COVID-19 cases appear to have plateaued, and people are slowly returning to work. Nevertheless, China's economy has taken a hit, and questions remain regarding its ability to fulfill trade commitments with the US.

Our View

1. COVID-19 is the biggest global uncertainty, raising the risk of recession and dampening near-term growth and profitability.
2. China faces the twin tasks of grappling with COVID-19 while also trying to fulfill US trade commitments.
3. The US consumer remains resilient, but signs of labor market weakness bear watching.
4. The euro zone economy is vulnerable to COVID-19 disruption with Italy in lockdown and the virus spreading rapidly even while export volumes weaken.

Investment Implications

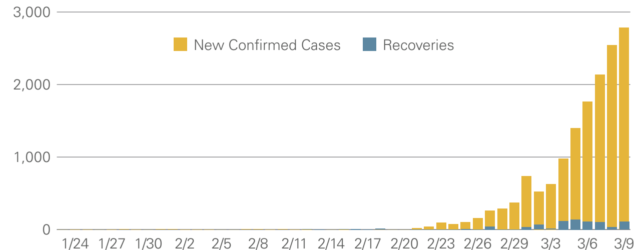
1. As COVID-19 continues to spread, the near-term economic outlook is significantly less positive, and the probability of recession has increased meaningfully.
2. The temptation to reach for yield has increased, and equities offer intermediate-term upside. But risk has increased, too.
3. Security selection is more important than ever. We believe investors should think long term and prioritize fundamental considerations.

Base Case

Immediately after the coronavirus discovery, investors assumed it would be a short-term problem isolated in China. As the virus spread globally, investors recognized the severity of the issue. There are many factors we still do not know with certainty including a) incubation periods, i.e., how long infected people might be asymptomatic, b) infection rates, i.e., how many people typically get infected by each carrier, c) fatality rates, d) mutation potential, and e) the timeline for a vaccine. The US has also faced challenges diagnosing and treating the virus, as the hospitalization rate for COVID-19 approximates 15%, 10 times the rate of seasonal flu.

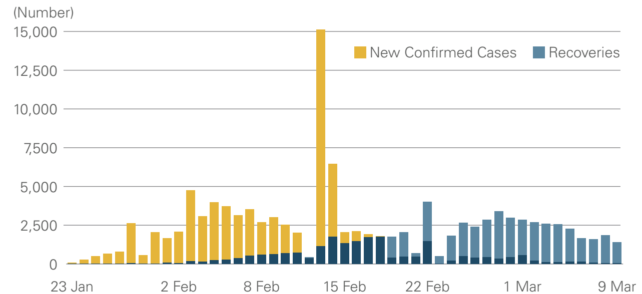
It is too early to gauge the virus' economic effect globally as the supply shock of production disruptions creates demand challenges. Monetary policy can lift demand but is less effective raising supply. Fiscal policy might be more effective, and encouragingly, countries including China, South Korea, Italy, and the UK have announced fiscal packages to address COVID-19 and its economic effects. At this point, our assessment is that China will fall well short of its 6% real GDP growth target in 2020. Recession risk in Europe and the US has increased meaningfully in 2020. The economic hit will depend on the feedback loops vis-à-vis corporate and consumer confidence as well as labor markets as Europe and the US digest the hit from COVID-19.

Exhibit 1
COVID-19 Spreading Widely in Europe



As of 13 February 2020
Source: World Health Organization

Exhibit 2
New Cases Are Starting to Decline in China



As of 9 March 2020
Source: Haver Analytics, Johns Hopkins

COVID-19 + US Trade Commitments

Base Case

China's move to quarantine tens of millions of people in response to the Wuhan coronavirus will sharply decrease the country's growth, putting the 6% real GDP target for 2020 out of reach. Many commentators compare COVID-19 to the 2003 SARS outbreak, but we believe the economic implications of COVID-19 are far more material to global growth. China's share of global GDP was 17% in 2019 versus only 4% in 2003.

We initially expected limited monetary stimulus in 2020, but authorities have injected liquidity into the system multiple times. COVID-19 and the related global economic effects also are making it harder for China to buy more US exports, as it agreed to do in the Phase 1 deal. While US-China trade tension has de-escalated on the margin, we worry that failure to deliver on these commitments could re-ignite hostilities. Moreover, the US continues to pursue other avenues to curtail China's advances in information, communication, and technology industries even against the backdrop of a mini-détente.

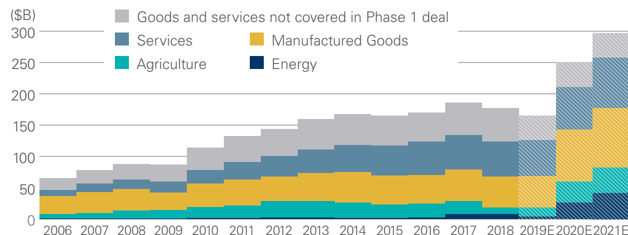
Key Risks

- COVID-19
- Failing to keep Phase 1 trade commitments
- Rekindled hostilities with the US

Exhibit 3

China Made Ambitious Purchase Commitments

US Exports to China, Past and Expected

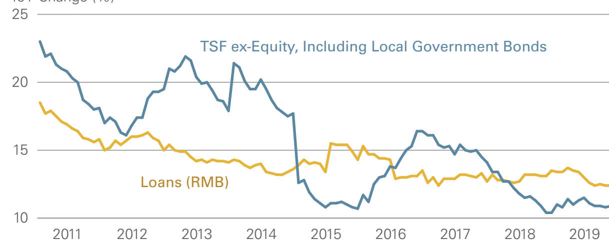


As of 20 January 2020
2019 exports are estimated based on January–November data. 2020 and 2021 exports reflect commitments made as part of the Phase 1 deal. 2020 and 2021 estimates assume that exports of goods and services not covered by the deal stay constant at 2019 levels.
Source: Peterson Institute for International Economics, USTR

Exhibit 4

China Credit Growth Remains Stable at Reduced Levels

Total Social Financing Outstanding



As of December 2019
Source: Haver Analytics, People's Bank of China

United States

Labor Market Weakening?

Base Case

The job opening rate fell from a peak of 4.8% in early 2019 to a two-year low of 4% in December. The decline is worrying, as it could indicate that industrial weakness, tight labor market conditions, and corporate uncertainty are feeding through to decreased demand for workers. Recent worker compensation data compound our concerns.

Turning to the 3 November elections, the field of Democratic presidential candidates narrowed early in March. As important, in November Democrats will defend their 2018 majority in the House of Representatives, where every seat is up for re-election. The GOP currently has a 53-47 majority in the Senate, but must defend 23 seats while the Democrats are defending only 12.

The election outcome is most important to trade policy, as the president has significant latitude to unilaterally change US trade rules. Other likely areas of policy change are healthcare, environmental regulations, and tax policy, but such changes are likely to be incremental rather than radical.

COVID-19 is likely to complicate the labor market situation and could influence the election process. Ongoing testing challenges have exacerbated the spread of the virus, increasing the likely economic disruption.

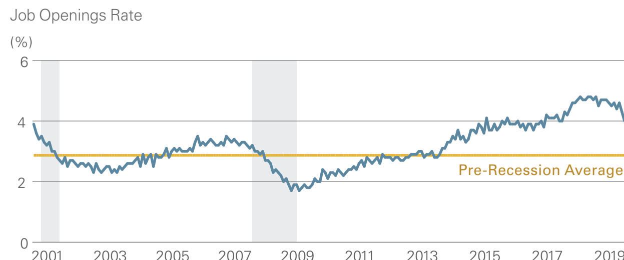
Key Risks

- COVID-19
- Potential weakening in labor markets
- US election

Exhibit 5

US Job Openings Have Fallen to 2016 Levels

Job Openings Rate

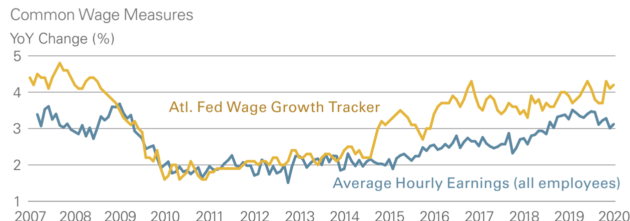


As of December 2019
Source: Bureau of Labor Statistics, Haver Analytics

Exhibit 6

Wage Growth Has Slowed by Some Measures

Common Wage Measures



As of January 2020
Average Hourly Earnings are for all employees. The Atlanta Fed Wage Growth Tracker is the smoothed weighted overall wage growth tracker, which is reweighted to reflect the demographics of wage earners.
Source: Bureau of Labor Statistics, Federal Reserve Bank of Atlanta, Haver Analytics

Euro Zone

Still Sluggish

Base Case

Euro zone growth has been sluggish since 2018, though labor market conditions have remained stable. The European Central Bank (ECB) has largely exhausted its tools to prop up growth, and we look forward to learning more about the ECB's future approach to monetary policy upon completion of a strategic review this year.

The coronavirus has undermined early signs of industrial stabilization. Initially, we were concerned that Europe's elevated reliance on exports would hurt growth due to lower demand from China as it fought the virus. Now, it is clear that the virus is spreading rapidly across Europe. With Italy comprising 11% of euro zone GDP and the Italian economy in lockdown, recession is increasingly likely in the euro zone in 2020.

On the political front, the United Kingdom exited the European Union on 31 January, ending one aspect of Brexit uncertainty, but leaving questions about the future relationship between the UK and its many trading partners.

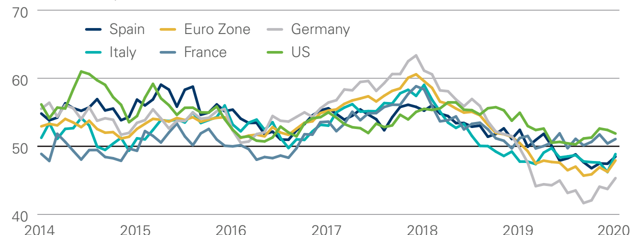
Key Risks

- COVID-19
- Sluggish growth
- Exhausted monetary policy toolkit

Exhibit 7

Pre-Virus, Euro Zone Manufacturing Appeared to Be Stabilizing

IHS Markit Composite Purchasing Managers' Indices (Manufacturing)

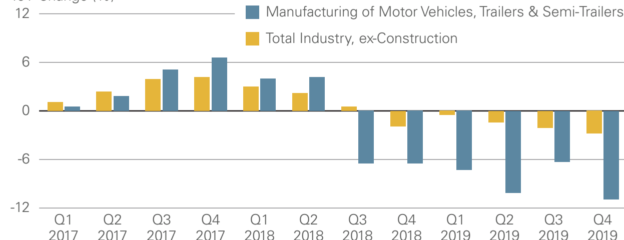


As of January 2020
Source: Haver Analytics, IHS Markit

Exhibit 8

Weak Auto Production Continues to Weigh on Output

Industrial Production



As of December 2019
Source: ECB, Haver Analytics, Statistical Office of the European Communities

Implications for Investors

Base Case

After hitting record highs, COVID-19 triggered a violent sell-off, with the S&P 500 Index falling 20% in only 19 trading days. Bond yields slid to record-low levels while oil prices collapsed under the weight of decreased demand and a price war initiated by Saudi Arabia and Russia. In early March, the Federal Reserve cut rates 50 basis points (bps), and investors quickly priced an additional 100 bps of reductions by July 2020.

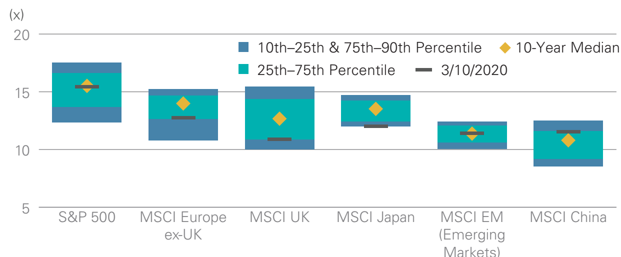
With a significantly less positive near-term economic outlook, investors are trying to quantify the duration and severity of earnings risk facing companies while contemplating asset allocation decisions in a world with even lower interest rates.

This uncertain backdrop highlights the importance of security selection. For debt investors, the pressure to reach for yield has increased. After the sell-off, equities offer meaningful intermediate-term upside. However, both credit and equity investors face more risk as the probability of recession has increased meaningfully in the near term. Balancing risk and reward is critical to success in volatile markets. To protect capital and benefit from an eventual recovery, we believe investors should focus on the long term and prioritize fundamental considerations such as the level and trajectory of financial returns, balance sheet strength, and valuation.

Exhibit 9

Equity Valuation Dispersion Reflects Differing Market Conditions

Forward P/E (Next 12 Months), Past 10 Years

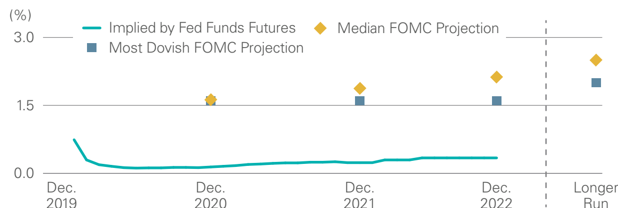


As of 10 March 2019
Median and percentiles calculated based on month-end values.
The figures above represent expected returns. Expected returns do not represent a promise or guarantee of future results and are subject to change.
Source: FactSet

Exhibit 10

The Fed "Dot Plot" and Markets Offer Very Different Forecasts

Projected Fed Funds Rate



As of 11 March 2020
FOMCa Projections as of 19 December 2019
Source: Bloomberg, Federal Reserve

Ronald Temple, CFA
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Ronald Temple is a Managing Director and Co-Head of Multi-Asset and Head of US Equity, responsible for oversight of the firm's multi-asset and US equity strategies as well as several global equity strategies. He is also a Portfolio Manager/Analyst on various US and global equity teams. He joined Lazard in 2001 with ten years of global experience, including fixed-income derivative trading, risk management, corporate finance, and corporate strategy in roles at Deutsche Bank AG, Bank of America NT & SA, and Fleet Financial Group in London, New York, Singapore, San Francisco, and Boston. Ron has an MPP from Harvard University and graduated magna cum laude with a BA in Economics & Public Policy from Duke University. He is a member of the Council on Foreign Relations, the Economic Club of New York, Duke University's Graduate School Board of Visitors, and the New York Society of Security Analysts (NYSSA). He also served as a trustee of the Link Community School in Newark, New Jersey, from 2006–2014, as a member of the Trinity Board of Visitors at Duke University from 2006–2012, and a member of the Financial Accounting Standards Advisory Council from 2013–2015.

Important Information

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The S&P 500 Index is a market capitalization-weighted index of 500 companies in leading industries of the US economy.

The MSCI Europe ex-UK Index is a free-float-adjusted market capitalization index that is designed to measure equity market performance in Europe excluding the United Kingdom. The Index comprises 14 developed markets countries in Europe.

The MSCI United Kingdom Index is designed to measure the performance of the large and mid cap segments of the UK market.

The MSCI Japan Index is a free-float-adjusted market capitalization index that is designed to measure equity market performance in Japan.

The MSCI Emerging Markets Index is a free-float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. The MSCI Emerging Markets Index consists of 26 emerging markets country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

The MSCI China Index is constructed based on the integrated China equity universe included in the MSCI Emerging Markets Index. The index aims to represent the performance of large and mid cap segments with H-shares, B-shares, red chips, P chips, and foreign listings (e.g., ADRs) of Chinese stocks. China A-shares will be partially included in this index.

These indices are unmanaged and have no fees. One cannot invest directly in an index.

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