WHERE WE STAND

CORONAVIRUS AND RECESSION RISK

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The coronavirus (COVID-19) is expected to have widespread negative impacts on the U.S. and global economies throughout at least the next several months. While there is universal agreement as to the directional effects over the remainder of 2020, there remains a lack of consensus as to the severity and duration of the overall impact. Here is what we believe investors need to know as the virus moves from the winter to the spring months and we await hard economic data.

Recession risk in the U.S. has risen sharply in recent days due to the coronavirus (COVID-19). As numbers quantifying the economic impact of COVID-19 are at least weeks, if not months, away, it is clear to us that overall recession risk has increased significantly to above a 50% probability between now and the end of 2020.

We believe recession risk has increased this past week in large part due to a mass shift from caution to cancellations throughout the economy. Coronavirus concerns have been rampant in recent days, as shown in the actions of corporations, educational institutions, and the world of sports. These have included immediate and widespread cancellations of entire travel policies, office locations, seasons, and semesters. These actions will undoubtedly have negative reverberations throughout the economy.

We expect a sharp drop in gross domestic product (GDP) growth into negative territory during the second quarter as mass cancellations begin to take effect. We believe the odds are extremely high we experience meaningful economic contraction (negative GDP growth) from April through June, as we are now on the cusp of the roughest single quarter of economic activity since the financial crisis of more than a decade ago.

The Federal Reserve has responded to this increasing economic risk with dramatic force by reducing short-term rates to zero and reinstituting large-scale asset purchases. On Sunday March 15, the Fed announced it was reducing the Fed Funds rate by a full 1% to a target range of 0% – .25%, effectively returning to a zero-rate environment. In addition, it revealed plans to return to Quantitative Easing by purchasing $700 billion in Treasury and agency-backed mortgage securities in the coming months. While these actions will be helpful at the margin they of course do not directly address the root concerns of the COVID-19 crisis, and markets are looking for dramatic fiscal policy as well in the days ahead.

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The equity and credit markets will likely remain highly volatile and at risk of more selling, however long-term entry points are becoming noticeable. Stock prices have fallen to levels not seen since December 2018, and credit spreads have now blown out to levels not seen since the beginning of 2016. Clearly, COVID-19 has pushed the financial markets into a "not for the faint of heart" zone unseen in more than a decade. In this environment, we believe it is imperative that investors focus not on calling a market bottom but on identifying attractive long-term entry points. As the selloff continues we believe we are at or very close to such entry points.

Interest rates have also seen historic volatility. This is particularly true at the longer end of the yield curve, where the 10-year Treasury yield has fallen to its lowest levels ever. Given these conditions, we feel fixed income investors are potentially well positioned in high-quality, short-term maturities below benchmark durations.

There is light at the end of the tunnel. The problem is nobody seems to know how long the tunnel is right now. Clearly, recession risk has significantly increased over the past week and economic activity in the upcoming second quarter could be the worst in more than a decade. However, should we see a reduction in infection and mortality rates by the summer months, the market could quickly look past a potential "U-shaped" recovery, and this could be quite favorable for equity- and credit-based asset prices.

Summary

Investors should closely watch COVID-19 infection trends, a potentially steep second quarter GDP decline into negative growth territory, levels of short- and long-term interest rates, and potential fiscal stimulus. All of these dynamics should be viewed under the realization that stocks and the credit markets could fall further but are likely now at or closely approaching attractive long-term entry points.

For a more detailed account of COVID-19's economic impacts, please visit our "Monitoring the Markets" page at Transamerica.com/monitoring-the-markets

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Tom oversees investment and mutual fund development and the sub-adviser selection process. He heads Transamerica's investment thought leadership with advisors, clients, and media. Tom has more than 25 years of investment experience and has managed large mutual funds and sub-advised separate account portfolios. Tom holds a Bachelor's degree in political science from Tulane University and an MBA in finance from the Wharton School at the University of Pennsylvania.

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