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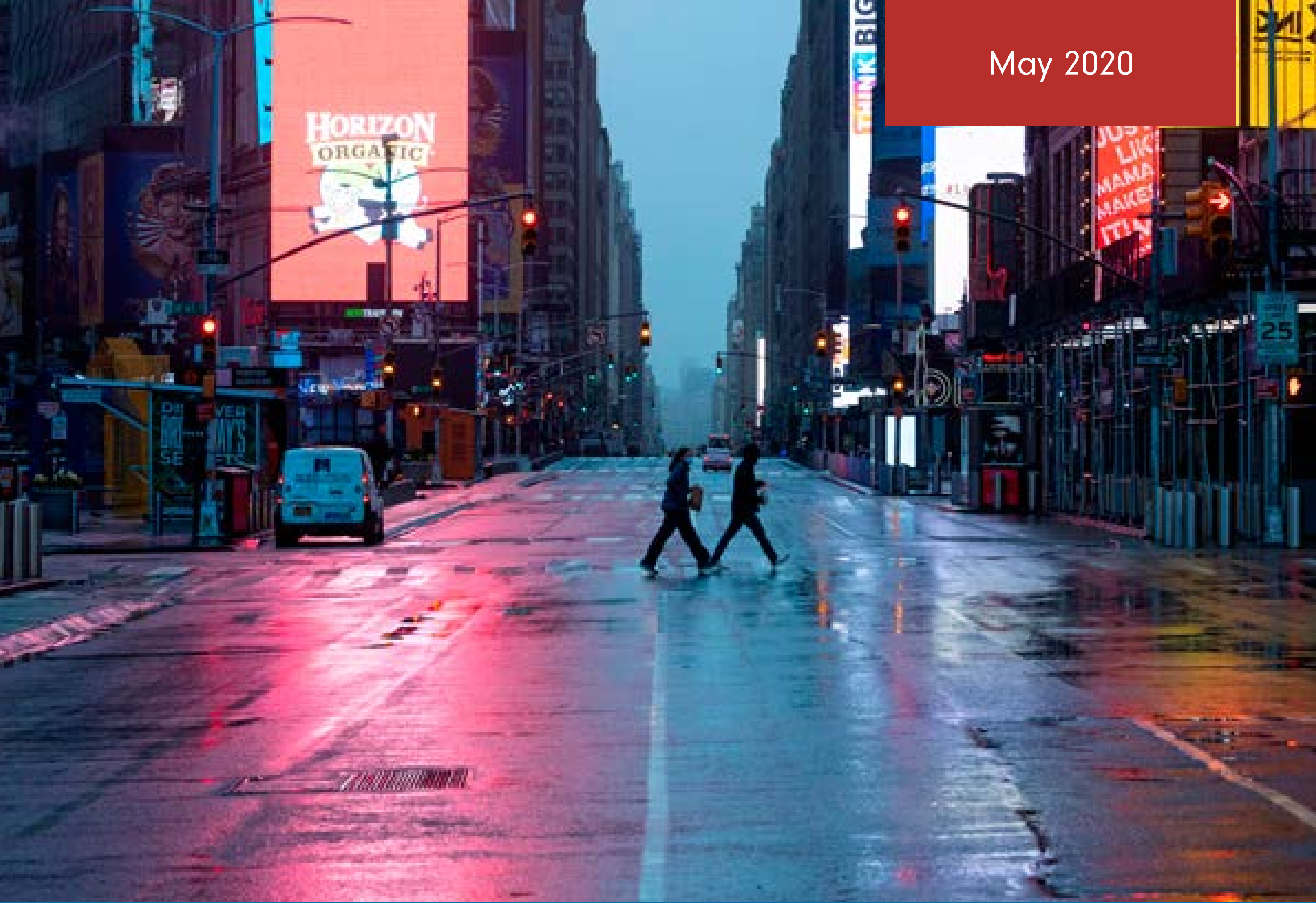

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The New Economic Order

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Introduction

We believe the Covid-19 crisis will trigger a step-change in policy, accelerate existing trends and transform investment frameworks. Government intervention, fiscal activism, corporate governance and sustainability, and continued Asian economic strength will characterise this new order, creating opportunities out of dislocation.

History is littered with examples of large-scale crises ushering in new governmental, economic and social structures. In very recent history, the Global Financial Crisis led to an era of low interest rates and growth, and repeated central bank intervention. Now we think the Covid-19 crisis has the potential to spur its own set of changes.

> Policymakers will provide further support, both on the monetary and fiscal side, but given the scale of the challenges including falling inflation, high unemployment and a deep recession, this could lead to lasting changes in the economy creating a 'New Economic Order'.

How the crisis unfolds largely depends on the trajectory of the virus, the strategies used to exit from lockdowns, and how policymakers respond. As a result, we see three broad economic scenarios developing. The base case, to which we ascribe a 60 per cent probability, is a U-shaped recovery: this entails social distancing for the rest of the year and lockdown restrictions gradually being lifted throughout the summer. Policymakers will provide further support, both on the monetary and fiscal side, but given the scale of the challenges including falling inflation, high unemployment and a deep recession, this could lead to lasting changes in the economy creating a **'New Economic Order'**.

The New Economic Order will be a world of increased government intervention displacing the free-market policies pursued since the 1980s. Fiscal activism will bear more of the burden and work in conjunction with monetary policy. One area of continuity will be Asia's enduring role in driving global growth.

Investors will have to reconcile themselves to an environment of continued low and negative interest rates, debt overhang, unconventional monetary policy tools such as yield curve control, and fiscal spending on a scale we have never seen before. But these challenges create market dislocations that investors can exploit.

We see emerging **opportunities from dislocation** from new forms of globalisation including building resilience around supply chains (especially where their importance veers into national security), disparities in how regions return to 'normal' after the virus, and differences in demographic profiles. The virus is accelerating the move to online consumption and the best companies are adjusting. Valuation disparities have unlocked rare opportunities to buy quality companies. In fixed income, continued low rates and central bank corporate bond purchase programmes are a boon to risk assets. With ratings in flux, we see attractive opportunities among some fallen angels as well as pitfalls to avoid as the credit cycle plays out.

Finally, if the trend towards **sustainability** was already in motion, then the Covid-19 crisis has sped it up. Corporate governance and sustainability will become widely adopted concepts after proving their worth during the crisis. Our research[1] shows that, as a group, companies awarded higher ratings on environment, social and governance (ESG) factors outperformed the index during the depths of the crisis, while lower rated companies underperformed. There will be a new appreciation of sustainability by markets. There could also be increased collaboration between private and public entities, especially where sustainability issues overlap with national security.

[1]Outrunning a crisis: Sustainability and market outperformance, April 2020.
https://www.fidelityinstitutional.com/en/outrunning-a-crisis-sustainability-and-market-outperformance-2ce135/

Part I - Economic scenarios of the Covid-19 crisis

Base case

Our base case for the outcome of the Covid-19 crisis resembles a **'U-shaped' recovery**, defined by a gradual lifting of lockdown measures as we move into summer, but continued social distancing for the rest of the year and some form of restrictions at different times for at least 12 months. This will plunge most of the world into recession in 2020.

The magnitude of the problem in the US could pose systemic risks that drain households of their savings, increase leverage, and hurt consumer demand.

Inflation will face downward pressure from falling consumption and low energy prices, and it could be some time before it rises. As economies recover, there could be some firming in inflation as pent-up demand is released, commodity prices recover, and supply chains continue to be disrupted. But the direction of inflation, and whether it is kept under control - not too high or low - largely depends on policies and stimulus from the authorities. Data points on real-time online prices, commodity prices, inflation expectations, durable goods orders and the functioning of supply chains will be important indicators of the trajectory of inflation.

We expect a severe worldwide impact of the crisis on **employment**. Unemployment is rising rapidly almost everywhere, most notably in the US, which has flexible labour markets, no wage subsidy mechanisms, and more dependence on small and medium sized enterprises for employment. The magnitude of the problem in the US could pose systemic risks that drain households of their savings, increase leverage, and hurt consumer demand. The political willingness and ability of the US government to introduce a transformative rebuilding and jobs programme will be key to avoiding a long period of economic malaise.

As we move beyond the pandemic into exit strategies from the lockdowns, it will be important to track quantitative and qualitative data points closely to identify which economic scenario is developing - our base case, or something better or worse.

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Upside case

A more positive outcome, but the least likely, is a V-shaped recovery, where the global economy will bounce back in the second half of 2020, supported by stimulus. This optimistic scenario requires the pandemic to be largely over in May, so that economies can **exit lockdowns** in quick succession and resume full activity in H2.

An effective vaccine, widely available in the medium term, could form part of the scenario but crucially, policymaking must be swift and effective. Markets should function smoothly, facilitated by easy financial conditions, and existing fiscal support must be implemented and distributed well to cushion the fallout from the pandemic and speed up recovery. To minimise regional risks, the European Union needs to agree a comprehensive package using the full range of instruments at its disposal, and international organisations such as the World Bank and the International Monetary Fund will have to co-ordinate programmes to help manage health crises in emerging markets.

Downside case

We think the downside scenario is relatively more likely than an upside case and we give it a 30 per cent probability. **Investors should be on their guard**. In this scenario, new cases of the virus start declining in May, but once economies reopen there are subsequent waves of infection that prove difficult to control. Emerging markets that lack the resources to contain infections adequately could pose a risk to other countries. These follow-on threats could derail the return of normal activity and lead to more lockdowns.

These events imply a deep economic contraction throughout the world as continued economic restrictions would choke off any recovery. In this scenario, a liquidity crunch could develop and, together with solvency issues, trigger a wave of defaults in corporate and sovereign bonds. Emerging market countries are particularly at risk of rolling crises. The economic damage could be exacerbated if central banks run out of policy tools and

Scenario (at April 2020)	Base	Upside	Downside
Probability	60%	10%	30%
2020 GDP Growth	-1.7%	0.4%	-5.2%
2021 GDP Growth	3.8%	5.2%	-1.4%
Virus projection	▪ New cases/deaths start declining end April/early May. ▪ Continued social distancing through 2020.	▪ New cases/deaths start declining end April. ▪ Vaccine can be rolled out.	▪ New cases/deaths start declining in May. ▪ Once economies re-open, subsequent severe waves of infection cannot be controlled.
Lockdown exit strategy	▪ Lockdowns gradually lifted in summer/autumn. ▪ Restrictions unlikely to be fully lifted for 12 months or until a vaccine available.	▪ Economies exit from lockdowns in quick succession. ▪ Pandemic over by late May. Full resumption of global activity in H2 2020.	▪ Ineffective containment in EM leads to further spread globally, derailing resumption of activity, and necessitates more lockdowns.
Recession & Recovery	▪ Resembles 'U-shaped' recovery. ▪ Global recession starts Q1. Sharpest contraction in Q2. ▪ FY2020 recession for all DM and most EM.	▪ Resembles 'V-shaped' recovery in H2. ▪ Global recession starts Q1. Sharpest contraction in Q2. ▪ FY2020 recession for all DM and some EM.	▪ Resembles 'L-shaped' recovery. ▪ Global recession starts Q1. Sharpest contraction in decades. Slow/no recovery due to continued lockdowns. ▪ FY2020 deep recession for all DM and EM. China flat.

Note: these scenarios are not intended to be exact growth forecasts, but rather illustrations of potential outcomes based on particular assumptions about a number of variables, including the pandemic trajectory, lockdown exit strategies, policies and associated multipliers, corporate and consumer behaviour. Given significant uncertainties related to the Covid-19 pandemic outbreak, these scenarios are subject to change. We will be revising growth numbers and probabilities continuously, as signals evolve and more information becomes available.

Part II - The New Economic Order

As the Covid-19 crisis plays out, and particularly if we see the base case scenario developing, we think new long-term trends will set the world on a unique course. The key features will be state intervention, fiscal activism, and continued Asian economic strength.

Government intervention

Central banks all over the world have embraced an interventionist mantra for years to support the economy, using ever more unorthodox tools at increasing scale. We think these authorities will continue experimenting with creative solutions including some form of yield curve control by the Federal Reserve; but with central banks pushing against the limits of monetary policy, governments will have to step in.

Using the Covid-19 crisis as cover, politicians are embracing interventionism, accelerating a trend that had grown in response to a global economy characterised by low growth, high debt, growing inequality and rising populism. The nascent **reversal of liberalisation, deregulation and freemarket politics** - which were first ushered in by Margaret Thatcher and Ronald Reagan in the 1980s - has now moved into overdrive.

Austerity and privatisation trends will continue to be undone, and **more regulation and higher taxes** will become permanent features of the landscape. Social welfare schemes, particularly relating to healthcare, are likely to be expanded. Some measures, such as nationalised benefits, could remove liabilities for corporates, but others, such as greater scrutiny of share buybacks and executive compensation, could constrain shareholder returns.

Further integration between government and industry could take the form of long-term loans and equity stakes, to address short-term liquidity and solvency concerns. We may see partial nationalisation of the airline industry, and, in a deeper, longer downturn, intervention in the infrastructure and healthcare sectors as well. Governments will reassess their national industrial policies and seek to remedy vulnerabilities, particularly around national security.

Fiscal activism

In the aftermath of the Global Financial Crisis bailouts, governments argued that austerity measures were required to restore discipline to public purses. That philosophy has been discredited to the extent that the last decade has seen anaemic growth while the cost of debt has remained at rock-bottom levels. Both of these factors are now compelling arguments for greater fiscal activism.

Developed market economies will need **transformative programmes** to escape low growth once the Covid-19 crisis has passed. The US will be a key test. Since March, the US labour market has experienced an unprecedented rise in unemployment, which could easily peak at 20-30 per cent of the workforce - levels last seen during the Great Depression. The resulting impact on consumption from severe job losses threatens not only US GDP, of which 70 per cent is consumer-driven, but by extension the rest of the world. The US worker, a factor of production, is one and the same as the US consumer, the source of final demand. Returning to a virtuous cycle of high employment and growing consumption will likely require expansive fiscal support.

The fiscal injections that the US and other governments are currently deploying are insufficient to produce long-term growth; indeed, they are better described as interventions to bridge populations through lockdowns, rather than stimulus per se. To steer through this crisis and recover fully afterwards will likely require a sustained and large-scale programme of government investment targeted, crucially, at the average person on Main Street.

Continued Asian strength

The virus originated in Asia and the region is returning to normal sooner than elsewhere, barring any significant second and third waves of infection. Mainland China, Hong Kong, Taiwan and South Korea demonstrated organised, disciplined, well-resourced and targeted reactions to the outbreak and, as a result, appear to have it more under control than others and are beginning to re-open their economies. This puts **Asia at an advantage** as the rest of the world still organises its responses.

However, there are deeper structural reasons why we think Asia is primed for economic leadership. Asia has higher economic growth, stable political regimes and wide-scale adoption of technology that will help it take a lead. Certain countries also have lower debt and supportive demographics. Asia has arguably been driving global growth for the past 10-15 years, so this is a continuation of

Part III - Opportunities from dislocation

A global economic recovery will unfold in several phases: fixing the financial plumbing, stabilising the spread of cases country-by-country, fixing the plumbing of the real economy and finally, economic expansion. Central banks have partially addressed the financial plumbing and there is progress in stabilising case numbers, although we cannot dismiss the potential for recurring waves of infection. Given that lockdowns remain largely in place in most countries, the real economy still requires fixing. Until final demand and employment stop falling, the stress on the real economy will persist. Market dislocations are continuously evolving, presenting both challenges and opportunities for investors.

A wide dispersion in outcomes for regions, sectors and individual companies means selectivity will be key to capturing the long-term value creation. Identifying survivors and winners while avoiding value destruction in harder-hit segments will require detailed knowledge of companies and sectors. This means being nimble and adjusting investment approach and asset allocations as we move through different phases of the crisis and recovery.

Below we discuss tactical views on asset allocation and identify longer-term opportunities from secular changes.

Tactical asset allocation

Despite some encouraging signs, we think it is premature to switch to a full risk-on posture. The policy-driven rally over the past month is running ahead of weak economic data in some regions, although there are attractive risk-return opportunities in credit, especially within US investment grade and high yield.

During the depths of the market sell-off, credit spreads widened meaningfully, and indiscriminate selling led to attractive valuations, particularly in corporates with strong balance sheets and cashflows. We turned constructive on investment grade bonds in March on valuations and a major Fed policy intervention on 23 March. The Fed's more recent decision to purchase corporate bonds, including fallen angels, has prompted a more positive stance on high yield. Until we see a turnaround in the economic backdrop, our preference for adding risk is likely to remain in debt rather than equity.

We are cautious on US equities, particularly small-caps, which are less equipped to deal with the crisis. On a relative basis, we prefer Asian equities given the larger composition of energy importers, which can take advantage of low oil prices; progress around managing the fallout from the virus; and long-term themes around Chinese consumption. However, we are cautious on Emerging Markets across both equity and debt. These markets generally have less capacity to embark on stimulus, keep rates low and avoid capital flight.

Equity valuations and opportunities

The near-term uncertainty and indiscriminate selling have resulted in major price anomalies, particularly for high quality businesses where earnings and dividends could start to normalise as lockdown restrictions are lifted. The nature of this crisis is very different to almost any other - companies that proved resilient in the Global Financial Crisis have seen parts or all of their business shuttered overnight. Understanding their capacity to manage this situation through access to funding and the ability to manage their cost base is vital and requires a deep understanding of the company and the industry in which it operates.

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Companies with the most sustainable financial structures tend to perform better in highly uncertain environments and take market share from struggling competitors. This provides some protection from downside risks as well as offering an upside in the recovery phase. Companies exposed to global and Chinese growth trends should be able to recover more quickly.

Fixed income valuations and opportunities

Both liquidity and valuations in the credit markets have responded positively to massive policy interventions, although Developed Market government bond yields remain near historical lows. Credit spreads globally have recovered significantly, and liquidity and market access for bond issuers have improved. Valuations post the rally reflect a desire to 'look through' the challenging macroeconomic backdrop, warranting some caution and selectiveness.

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However, we believe parts of the high yield market compensate for the increased default risk and offer attractive risk-adjusted returns over the long term, even if volatility remains elevated as we move through the crisis. Credit rating downgrades will continue in the coming months, with rating agencies lagging corporate stress as they update their assessments. Some of the fallen angel credits - investment grade companies downgraded to high yield - are providing opportunities, particularly those that can deleverage and eventually return to investment grade and/or benefit from central bank purchases targeted at BB-rated securities.

Secular dislocations

Regional disparities

Differing speeds and conditions of normalisation will create winners and losers at the country level and over different time horizons. Allocating capital in a way that is sensitive to recovery rates and learning from recovery trajectories can offer opportunities. Longer-term, demographics remain a relatively predictable and central input into investment outcomes. Countries with youthful populations and growing middle classes will have consumption tailwinds, first in technology, and later in leisure and travel. Countries with ageing populations will require investment in healthcare and technology solutions. We believe that **Asia**, with its faster normalisation and young populations, offers some of the best long-term growth opportunities, particularly in **insurance** and **healthcare**. We are more concerned about non-Asian emerging market countries given their more limited resources in responding to the crisis.

Globalisation to 'indigenisation'

The conditions of globalisation were already changing before Covid-19 - most clearly reflected in the US-China trade war. That shift has been accelerated by the Covid-19 shock testing supply chains in **healthcare and pharmaceuticals, food supply chains** and **technology infrastructure**. These sectors will be increasingly treated as areas of national security, with sourcing brought inside country borders or regional blocs. They will also be subjected to increased regulation and oversight, giving them characteristics closer to the utility or defence industries. While more regulation could lead to lower profits over time, it is also likely to create more stable earnings and cash flows, potentially benefiting valuations. These sectors should prove to be winners, but due to less physical travel between and within countries, **travel and leisure, lodging, transport and cross-border education** could be impaired.

Technological revolutions in consumer behaviour

The lockdowns have forced consumption away from physical retail and towards **e-commerce** and **home delivery**. The shift is especially visible in **online food retail** where adoption was previously slow but is now experiencing a step-change in pace that we expect will persist after the lockdowns. Consumers are also paying more attention to their well-being, benefiting **sporting goods** and companies that **improve quality of life**. Leisure travel will eventually resume, particularly among younger people, but with more concern around the safety and quality of destinations and accommodation.

People are adapting to working from home and we will probably see consumers investing in their home offices and digital equipment as a result. **Telecommunications, technology and connectivity** should be long-term winners, as well as **contactless payments, education and medical consultations**. More broadly, many activities which have been forced online such as face-to-face work meetings, gym workouts and grocery shopping will continue post-lockdown as people enjoy time and cost savings. Companies that own the **platforms** used for these services and the **connectivity/ infrastructure providers** that deliver them will benefit. Connectivity providers could also be elevated to greater national importance, receiving increased investment. Europe is behind the US and China in adapting networks for the next telecommunication standard (5G), but post-pandemic it could receive more attention, given the likely increase in online activity.

Covid-19 has reframed the debates around **online privacy** and the **dominance of 'Big Tech'**. The crisis has brought to prominence how critical the technology giants are in modern society, most clearly seen in the approval of Amazon's investment into Deliveroo because food delivery is deemed an essential service. Another example is China's ubiquitous video surveillance that is perceived negatively in Europe and North America but enabled China to contact-trace effectively and enforce lockdowns. That perception could evolve through the crisis, creating opportunities for a number of technology companies.

Healthcare

The healthcare industry is set to change in several ways. Firstly, **pharmaceutical and biotech** companies are at the forefront of the fight against the pandemic and could find political and pricing pressures ease given their role. Another area that is set to benefit is **diagnostics**. Diagnostics are a cost-effective and crucial way to identify the spread of the virus and we expect greater investment in this area in the future.

Telemedicine, the practice of caring for patients remotely, has seen a significant increase in demand and this should continue in the longer term as part of ongoing investment in **healthcare IT and digitalisation**. Finally, the crisis has shown that some hospital systems are underfunded, and it's reasonable to expect increased investment in the future to ensure they are better prepared for pandemics. The costs of this will be low compared to the economic destruction that can occur from lockdowns.

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Part IV - Sustainable capitalism

In the summer of 2019, the influential Business Roundtable of top US executives rejected the decades-old notion of shareholder primacy and instead advocated embracing wider stakeholder interests. So far, this has proven to be largely a statement of intent, but we think that will change. Global corporations cannot hope to continue business as usual amid growing public scrutiny of their operations (and profits) while the wider economy looks increasingly moribund.

We expect not only investors, but society in general, will require firms to consider the welfare of their employees, communities and suppliers - ahead of short-term profits - as part of ensuring the long-term sustainability and resilience of their businesses.

Sustainable business models prove resilient

The outperformance of more sustainable companies in recent weeks is renewing appreciation for these businesses. In recent research,[2] we found that companies at the highest Fidelity ESG rating collectively outperformed the index by 3.8 per cent during the depth of the market crisis, while those with the lowest rating underperformed by 7.8 per cent. This pattern was repeated at the sector level.

On average, among the 2,689 companies rated, each ESG rating level was worth an additional 2.8 percentage points of stock performance versus the index. The findings in fixed income are similar to those in equity. The securities at the highest ESG rating level fell 9.2 per cent from the start of the year up to 23 March, while the lowest rated group fell 20 per cent on average. This relationship remains even when adjusting for a potential bias towards high quality credit in the ESG ratings.

The study suggests that what initially looked like an indiscriminate and panicked selloff did in fact discriminate between companies based on their attention to sustainability matters. It supports the view that a management team that focuses on sustainability is more likely to be a high-quality one and has a better chance of building a business that is resilient in a downturn. The idea of sustainability as a luxury, employed in bull markets but discarded in bear markets, continues to lose credibility.

Public and private sustainability collaboration

The crisis has also brought into sharp focus the juncture between public health, migration and climate change. Climate change-induced migration will have far reaching

[2]Outrunning a crisis: Sustainability and market outperformance, April 2020. https://www.fidelityinstitutional.com/en/outrunning-a-crisis-sustainability-and-market-outperformance-2ce135/

Emanuele Cremaschi / Getty Images

effects for disease control, and public and private entities will need to co-operate to understand and manage these dynamics.

A development that could pave the way for further public-private collaboration around sustainability is the EU's Green New Deal. The EU has committed to rolling out its €1 trillion plan over the next decade, and to becoming carbon-neutral by 2050. The EU intends to fund the programme by drawing on the European Investment Bank (EIB) and a combination of public and private sector co-investments.

While there is broad consensus among member states on the overall deal, agreeing how to apportion funds will require compromise. Regions that will be hardest hit - economically and socially - by the need to tackle climate change are expected to receive a higher proportion of funding. For instance, coal-reliant countries in Eastern Europe will require more funds to transition to a green economy and re-train workers. Where investment will end up will be nuanced, but certain sectors are more likely to emerge as winners.

Renewable energy, technologies to de-carbonise energy-intensive industries such as steel, chemicals and cement, and companies in the electric vehicle supply chain are likely to receive investment. Sustainable food production could also benefit as the EU seeks to ensure food security and incentivise new farming and fishing techniques while reducing reliance on pesticides, fertilizers and antibiotics in animal and plant production.

Conclusion

Periods of crisis cause history to speed up. Trends are fast forwarded or suddenly displaced by new ones. We could be entering such a phase in which the foundations of policymaking have permanently shifted, and governments and central banks are forced to think of new ways to tackle a social and economic threat not seen for decades.

For investors, our previous macro assumptions must undergo a major update. As we work through these challenges, we believe that greater government intervention, fiscal activism, corporate governance and sustainability, and continued Asian economic strength will become permanent features of the investment landscape in the New Economic Order. Finding flexible ways to navigate these changes will be crucial to generating robust, risk-adjusted returns in the future.

Important Information

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