

MACRO ECONOMIC UPDATE

April 2020

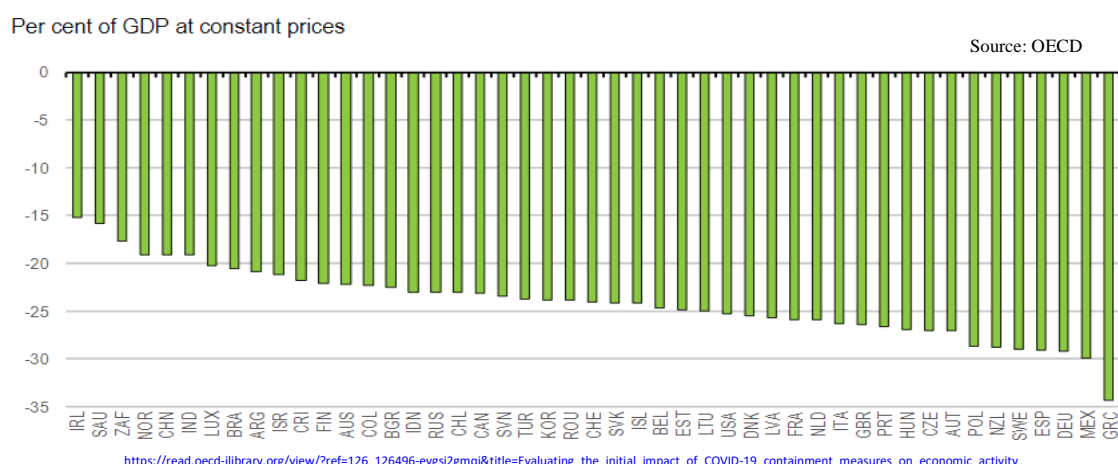
Useful sources to keep track of the latest health toll ?

- ✓ There are several interesting and useful sources to stay informed about the latest developments. Most international top newspapers such as the [Financial Times](#) provide excellent information in this respect. Many of these sources are relying on the figures from [John Hopkins University](#). [Our World in Data](#) is also offering easy access to the underlying data, in turn stemming from the [European Centre for Disease Prevention and Control](#).

What kind of economic crisis ?

- ✓ The coronavirus pandemic, a true exogenous shock, is triggering a global crisis of epic proportions. A global recession is now all but inevitable. Economies around the globe are entering a downward economic spiral and confidence among firms and households is taking a big hit. From an economic point of view, we are dealing with both a negative supply and demand shock. It's a negative supply shock because global supply chains are severely impacted or even completely interrupted. It's also an extremely severe demand shock. Several sectors including tourism, logistics, real estate and leisure for example see demand for their services almost grinding to a complete halt. And because citizens' revenues ultimately derive from production, household income is falling quickly. Meanwhile, companies refrain from investing, international trade is collapsing and unemployment is soaring. In any case, the initial economic impact will be absolutely brutal as also shown in the graph below.

Figure 2. The potential initial impact on activity of partial or complete shutdowns on activity in selected advanced and emerging market economies



- ✓ Unfortunately, the size and persistence of the economic impact are unknowable because the duration of the economic shock depends on how the virus will behave and which public health policy reactions are being put in place (and for how long). Uncertainty looms large. A 'V-shaped' hit seemed likely when COVID-19 was essentially a Chinese problem and China was dealing with it forcefully. However, while a short-and-sharp crisis is still possible, it's looking increasingly less like the most likely outcome. Full recovery may take years, implying that it doesn't make much sense to talk about a 'temporary hit'. That said, economic activity is still

likely to pick up again from the third quarter onwards. Logically, the extent of any subsequent recovery will depend on the effectiveness of the policy actions taken to support workers and companies through the downturn and the extent to which confidence returns.

- ✓ Also, keep in mind that top epidemiologists think that the virus can/will do its 'tour du monde' until there's a readily available vaccine, implying that there could be several waves of lockdowns. In that case there's a real risk that the downturn becomes a self-fulfilling and ever-deepening depression. Many companies could face bankruptcy in this scenario, in turn triggering defaults and more trouble for the economic and financial system including a deflationary spiral. This scenario should be prevented at all costs but this is easier said than done.

What kind of financial shock ?

- ✓ The crisis is creating huge havoc in financial markets too. They have been under great stress and volatility has reached historically high levels. S&P 500 stock prices dropped more than 30% between February 19 and March 23. In comparison, the stock market fell 57% peak to trough (October 2007 to March 2009) during the Financial Crisis of 2007-09 when investors were uncertain about the value of structured products related to subprime mortgages and the exposure of financial institutions to subprime risk.
- ✓ The latter type of uncertainty is not present these days but the so-called 'dash for cash' is real. Many investors (including hedge and pension funds) have been hitting the sell button to pile up cash. Money market funds and commercial paper markets have experienced severe stress. Meanwhile, highly leveraged financial firms were getting margin calls that force them to sell assets. Even government bond markets have experienced significant ups and downs. Both investment grade and high yield debt spreads have sharply increased too, signaling severe levels of risk aversion.
- ✓ The shock has delivered a blow not just to stock markets and bonds. It has hit commodities too. One of the main triggers for the big sell-off came on March 6, when oil talks between Saudi Arabia and Russia broke down. Since then the relentless dumping by the main producers has driven prices down. The high-cost upstarts in the United States' shale fields are victim but other oil exporters are suffering too.
- ✓ Financial markets will likely stay volatile until there's more evidence that the Coronavirus is being brought under control more globally. This is something that is likely to play out over months (if not quarters) instead of weeks.

Which measures are being taken by governments and central banks ?

- ✓ The OECD does a very good job in keeping track of the implemented policy support measures. Please find more information [here](#) in detail.
- ✓ All focus should now be on what policymakers can do to cushion the economic fallout. Crucially, effective policy requires central banks and governments to work closely together. Central banks are offering cheap and limitless funding for commercial banks that lend to the hardest-hit companies and households most at risk. They are also taking up their role as lenders of last resort by buying financial assets such as government bonds, non-financial corporate bonds, mortgage bonds and commercial paper. In doing so central banks want to make sure that governments and companies keep access to lending at low borrowing costs. Another goal is to stem panic in financial markets.
- ✓ Arguably, fiscal policy has an even bigger role to play. A broad range of measures including the expansion of access to health care, schemes of temporary unemployment, loan guarantees, deferral of tax payments and social security contributions, direct compensations for income and revenue losses, rescue funds or even direct payments to households are being implemented or considered. Worries about government debt sustainability

should now be of secondary importance but might pop up in the not so distant future, underlying once again the crucial role of central banks as lenders of last resort in this respect.

Will the government support measures prove sufficient?

- ✓ First of all, let's try to avoid using the word 'stimulus' as some observers continue to do. It seems much more appropriate to talk about 'support measures' or 'aid plans'. These are intended to bridge the next couple of months when activity will be extremely hard hit.
- ✓ Also, it should be obvious that measures/numbers in itself should be not be interpreted as an argument to defend any kind of position (optimistic or pessimistic). Importantly, more could and will be done as the economic fallout deepens, both from governments and central banks. Policymakers being 'behind the curve' is only logic at this stage. Notice also, that an important part of the support measures consists of guarantees.
- ✓ That said, the measures announced in several countries (not everywhere) look pretty impressive (but then again, we're dealing with a very severe crisis). US Congress passed an emergency \$8.3billion spending bill and a subsequent bill that is assumed to be worth \$108 billion. The CARES Act will have a total cost of around \$2 trillion or almost 10% of GDP. The German rescue package for example encompasses €400bn in public guarantees, 100bn in equity stakes and 100bn in loans. Total new government borrowing could reach more than 350bn in 2020 (also around 10% of GDP).

What about the common European response ?

- ✓ Despite the fact that health policy is a national responsibility, the common European response and solidarity has been disappointing so far. This is worrying as Italy has seen its economy stagnating for two decades now. At some point, the question might pop up (again): *'what has Europe/the euro ever done for us'?*
- ✓ There is some support of course. The ECB has announced its pretty impressive Pandemic Emergency Purchase programme (PEPP) on 18 March. And the European Commission applied the full flexibility of the EU fiscal rules, has revised its State Aid rules and set up a €37 billion Coronavirus Response Investment Initiative to provide liquidity to small businesses and the health care sector. [More here](#).
- ✓ However, a much more forceful pan-European response is needed. Announcing some form of mutualisation would send a strong signal of unity to the world in these difficult times. Unfortunately and worryingly, this solidarity is lacking at this point in time (some are even referring to 'moral hazard', can you believe this?).
- ✓ True, several options are currently being discussed in policy and academic circles including ESM credit lines and 'corona-bonds'. For most economists, it has been long obvious that the monetary union of the Eurozone should be cemented in a much stronger budgetary and political union. In order to better understand this discussion, it could be useful to listen to this interesting [CEPS webinar](#).

What's the biggest risk: inflation or deflation ?

- ✓ We're dealing with both a very severe supply and demand shock as explained in the beginning. Supply constraints will push prices for some products (manufacturing inputs or food) up while weak demand will push prices for other products (oil and other commodities) down. All in all though, the net effect should be disinflationary as demand weakness will likely last for longer than the effects of supply disruption. Indeed, output gaps are rapidly diving into negative territory. This is also the message we get from price surveys.
- ✓ Note, however, that huge swings in commodity prices will have big consequences for headline inflation in the short term. Headline inflation will first dive into negative territory before probably shooting up sharply again as the economic recovery picks up steam. Of course, these are base effects and should be interpreted accordingly.

- ✓ The crisis may have inflationary implications in the long term given the huge fiscal and monetary stimulus that is being provided and the risk that governments will later try to inflate away their debt. That said, Japan's experience suggests that this is far from easy. And the fall in long-run measures of market inflation expectations suggests that there are risks to the downside too.

How fast is the Chinese economy recovering ?

- ✓ The Chinese economy has taken a worse hit than initially expected. Chinese data for January and February reveal that industrial output in China was down by 13.5% compared to last year while retail sales fell by 20%. Spending on machinery and infrastructure declined by 25%.
- ✓ While the total number of infections has stabilized, the economy has not. Activity is recovering but only very gradually and output is still way below levels seen at the start of the year. The March PMI survey published this week surprised on the upside but we would strongly caution against too much optimism. It simply reflects that conditions are improving vis-à-vis February. Weakness will drag on because China is now facing severe headwinds from falling demand overseas. To keep track of China's recovery, we are keeping a close eye on [The Financial Times China Economic Activity Index](#)
- ✓ What rescued emerging markets (and the world) in 2008 was among other things the gigantic stimulus delivered by Beijing. China launched a credit expansion of wartime proportions at the time, confirming the role that it had increasingly played since the early 2000s as an engine of global growth. Having successfully achieved a grip on the virus, China will be exiting the economic crisis sooner than either Europe or the United States. However, economic and financial support measures, including special lending by policy banks, amounted to no more than \$430 billion or 3% of GDP. More will likely be done, but this time China will not save the day in terms of policy response.

What about the role of the USD ?

- ✓ The global role of the dollar and the global nature of the dollar funding markets make it impossible for the Federal Reserve to focus exclusively on domestic funding conditions. Indeed, the BIS estimates that banks outside the United States have over \$13 trillion in dollar denominated assets.
- ✓ The issue isn't new of course. The need to assure access to hard currency has long led emerging economies to hold significant amounts of dollars as part of their central banks' reserves, and it was also a big issue during the 2008-2009 global financial crisis.
- ✓ The strength of the dollar exchange rate and the magnitude of the cross-currency basis are undoubtedly key barometers to watch for. The Fed is now expanding and fine tuning dollar swap line arrangements to other central banks in order to provide dollar liquidity. This is reducing some of the stress but the USD remains strong.
- ✓ For an in-depth explanation of the crucial USD role in funding markets, please find [here](#) a very useful and interesting source of information. And of course, it's also important for emerging markets.

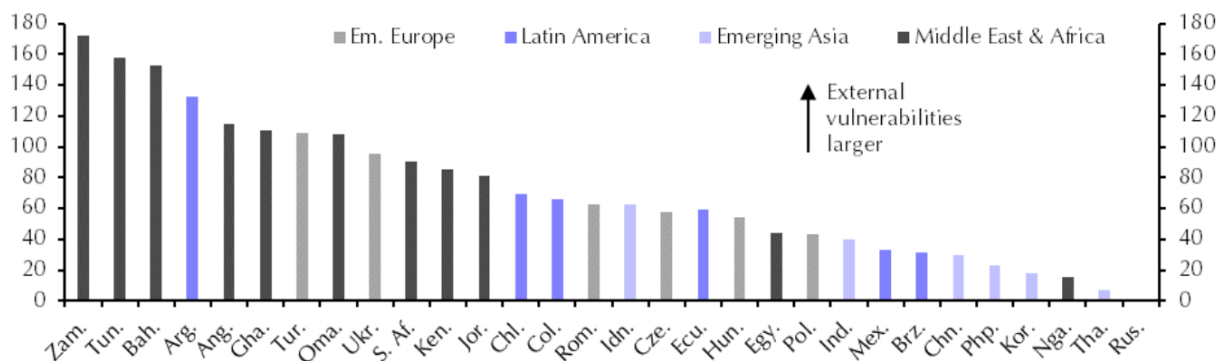
Which EM are facing the biggest risks ?

- ✓ Emerging markets are experiencing another severe crisis in a short period of time. There was the (mini-)crisis in China in 2015, when the stock market crashed, the currency slid, and \$1 trillion fled the country. A year earlier, oil prices and other commodity prices tanked, sending a shock wave through commodity producers. For many EM, the general slowdown began in 2013 with the so-called taper tantrum, when rumors of a tightening in US Federal Reserve policy had money sloshing back to the United States in search of higher interest rates. Ever since, many

EM currencies have been facing downward pressure.

- ✓ Historically, EM have been particularly vulnerable for sudden-stops and balance of payment crises. This is a risk that requires close monitoring. Steep falls in commodity prices and pullbacks in capital flows because of risk-aversion could trigger balance sheet problems. A very interesting way to assess EM vulnerability is to monitor the gross external financing requirements, i.e the foreign capital flows needed over the next year to roll over maturing external debt and to finance the current account deficit. Another useful metric is to look at how much policy room (both from a monetary and budgetary point of view) EM have left to deal with the crisis and its aftermath. Please contact us, in case you have questions on specific countries.

Gross External Financing Requirement
(in % of FX-reserves)



How does the Coronavirus affect our LT macroeconomic scenario ?

- ✓ In essence, this is a question that is almost impossible to answer right now. Of course, there are big concerns on big themes including globalization, China-US relations, the future of the euro, populism, inequality, sustainability, etc.
- ✓ However, while it's fairly easy to make big statements on these themes, that may not be the wisest thing to do at this point given that we are living in highly uncertain times right now.
- ✓ That said, the coronavirus again illustrates the complexity of long and complex global supply chains. What's more, these had already come under pressure over the last decade because of technological, (geo)political and environmental reasons, as highlighted before.
- ✓ All in all, our underlying economic scenario of modest growth, low inflation and loose monetary policy remains in place for now (this is the secular stagnation/liquidity trap scenario elaborated on in previous communications) but this can of course change fairly rapidly in the face of new developments.

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