

# Mid-Year Update 2020

## Phoenix from the flames

A global pandemic and self-imposed lockdowns lead to the sharpest contraction in global growth since the Great Depression. Yet a truly profound policy response has prevented a health and economic crisis becoming a financial crisis. However, the recovery will still leave a large hole in global output and a greater dependency on support mechanisms. With economies now re-opening and some financial markets hitting new highs, hopes are rising like a phoenix from the flames.



Source: iStock by Getty Images

Words fail to do justice to the remarkable first half of 2020. While we had been predicting a mild recession for the year, with stocks falling around 20%, the double whammy of a global pandemic coupled with an oil price shock was unimaginable. What was clear, though, was that the global economy was ill-equipped to absorb such heavy blows. Global growth had

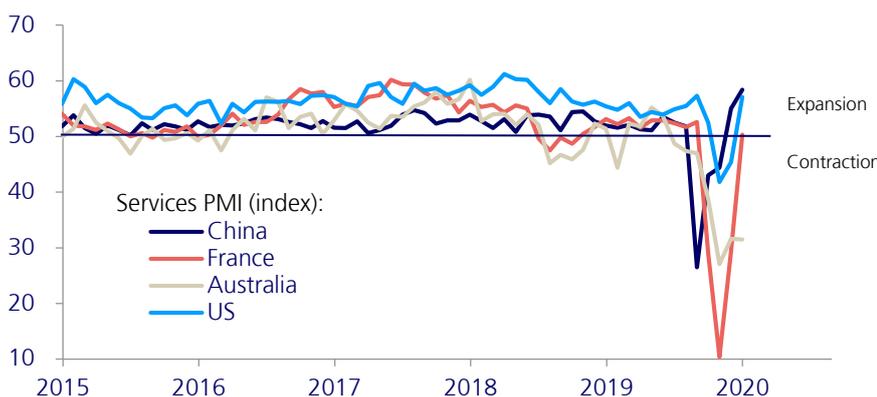
been slowing markedly since the peak in 2017, government and corporate debt were at record levels and bank rates were already in negative territory in some key regions. However, as economies were deliberately closed down to try to minimise the rapid spread of the coronavirus, bold policy actions were forthcoming.

### Profound and integrated policy responses have averted a depression

Lessons from the financial crisis had been learned, with policy initiatives crafted to surprise positively, being open ended and of a scale that was overwhelming. The aim was to preserve productive capacity and confidence, which would allow workers to have jobs to return to, while investors had functioning capital markets in which to deploy funds. Governments were compelled to open the fiscal spigots, with Germany even prepared to suspend its 'Schwarze Null' debt break as more coordinated fiscal and monetary policy were necessitated. Perhaps most encouragingly, there is a shift in mindset now underway in the EU with the concept of debt mutualisation finally gaining traction.

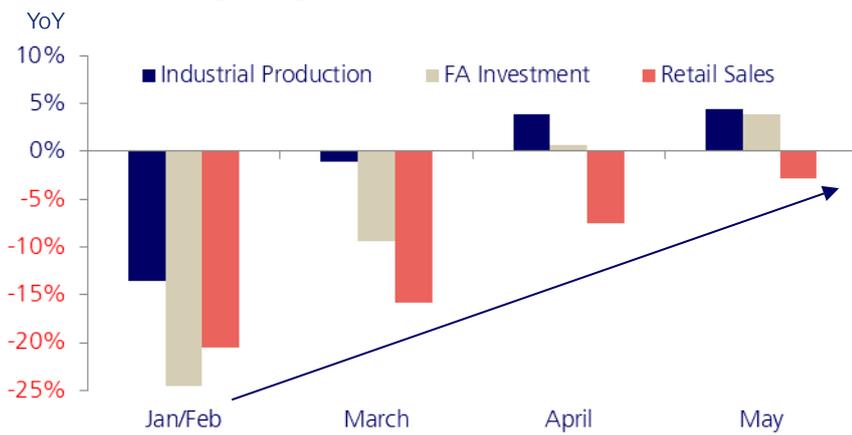
With many central banks unwilling to cut rates below the zero bound, it has been asset purchases that have been deployed with force. The USD 6tn that has been committed globally dwarfs that applied during the financial crisis

### Economic rebound is evident as restrictions are eased



Source: Bloomberg

## China activity is getting back to normal



Source: Bloomberg

and has had the desired effect of putting a floor under credit and stock markets. While the 35% plunge in global equity prices was the quickest on record, so too has been the recovery. The Nasdaq Index in the US is up more than 16% this year, hitting new records as sceptical investors are seduced by the sheer volume of liquidity that is flooding into markets, resulting in a stark divergence between asset prices and economic conditions. Indeed, the first half of the year will likely prove to be the worst period of economic activity in living memory. Australia is now in its first recession in 29 years, while most other developed economies have reported depressionary conditions over the past few months. However, investors are looking forward and we concur that there is light at the end of the tunnel, though it will be the development of the virus itself that will likely determine the destiny of both economies and markets for the remainder of the year.

### China gives cause for optimism, but also highlights the challenges that remain

China provides some cause for hope. Recent data show that many parts of the economy are back to, or even above, pre-crisis levels. Auto sales are up on a year-on-year basis, as are fixed asset investment and industrial production, while even domestic air travel is increasing rapidly. That noted, it is also clear that the services sector will take longer to heal, with social distancing a lasting obstacle. Unusually, no growth target was forthcoming at the National Peoples' Congress in May, but it is likely that further targeted stimulus will be deployed to ensure employment conditions improve and sentiment is bolstered. This gives us

conviction in our above-consensus view of growth for the year. The rebound in China is also reverberating in the region where, with perhaps the exception of India, the impact of the virus has been well managed and economic activity is rebounding. However, trade remains poor and we suspect that as the US presidential election in November nears, tough policies towards China from both the Democratic and Republican parties will be potentially disruptive.

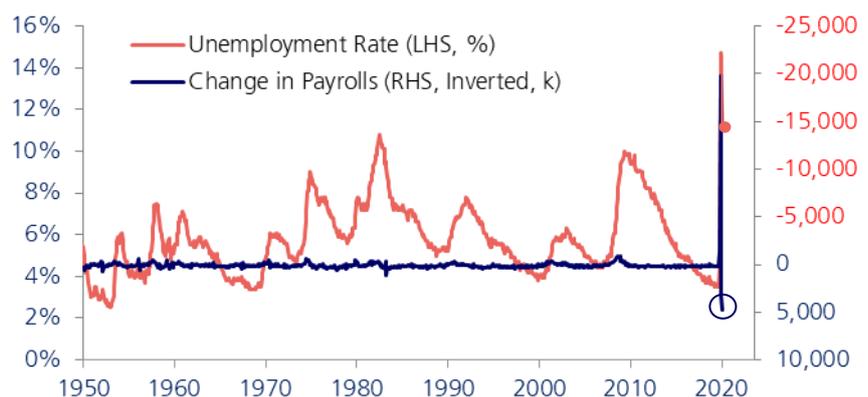
### US unemployment shows the human cost of the economic lockdown

The US was ill-prepared for the effects of COVID-19, despite the dynamism and flexibility of the economy ([see our US Topical Thoughts](#)). The scale of job losses has been staggering, with around 25% of the working population either losing their job or having their working hours cut back. Within two months unemployment moved from a 50-year low to a historic

high. Once again, however, US monetary policy has moved swiftly, with the Fed offering open-ended and unlimited asset purchases, taking on credit risk for the first time, and finding ways to support businesses to allow them to re-open and re-hire. The scale and pace of its actions also arrested the decline in financial markets, but it means that its balance sheet, which has breached USD 7tn, up from around 4tn last year, will balloon much further. The fiscal side has been equally impressive, representing around 13% of US GDP and rising, and will take the deficit close to 20% of GDP by the end of the year — again a truly unprecedented number.

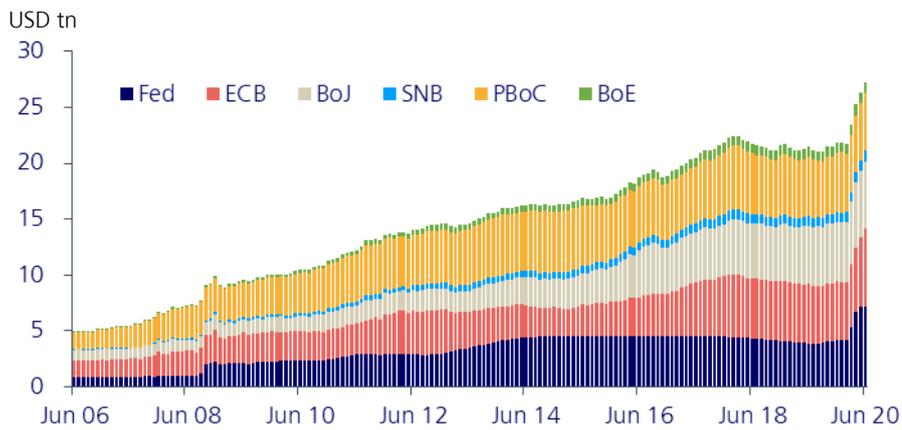
Consequently, we believe that the scale of the support in the US will allow the economy to rebound fairly vigorously and we see unemployment falling sharply in the second half of the year. That noted, it will remain significantly higher than pre-COVID. This will be a challenge for the President in the run-up to the November election and the chaotic approach to containing the virus is creating greater uncertainty than need be. However, when it comes to uncertainty, LatAm is the standout. The myriad of policies being applied both from an economic and health perspective leaves forecasting prospects nigh on impossible. While infection rates remain alarming, fiscal and monetary policy have at least been ramped up substantially, with the Selic rate in Brazil now standing at an almost unimaginably low 2.25%, and Chile committed to unconventional measures in the order of 25% of its economy. Profound indeed, but we still envision a depressionary like contraction in most of the region this year, with risks still skewed very much to the downside.

## US job losses unprecedented, but latest data give hope



Source: Bloomberg

## Central bank balance sheets jump as asset purchases are extended



Source: Bloomberg

### The EU moves in the right direction as the crisis forces a sea change in thinking

While Eurozone economies have been severely impacted by the lockdown, with growth contracting at the sharpest pace on record in the first half of the year, purchasing manager indicators for both the manufacturing and services sectors have bounced sharply. Forward-looking sentiment indicators are also showing a marked improvement. Despite signs of recovery, the ECB has increased its PEPP asset purchase programme to EUR 1.35tn, around 11% of GDP, and extended the support through mid 2021, while continuing to reinvest coupons until the end of 2022. More importantly, we believe that there has been a profound shift in fiscal thinking. This has the potential to reposition the EU by finally embracing the concept of debt mutualisation. The EUR 750bn Recovery and Resilience Fund (RRF) being proposed by the European Commission would grant the EU the power to raise funds in the capital markets and allocate them in the form of grants (EUR 500bn) and loans (EUR 250bn) to member countries in need. While we expect considerable obstacles and resistance, it is likely that traction will be made. This should boost confidence in a region that would then have at least the makings of a long overdue fiscal union as well as monetary union. Consequently, while debt levels and deficits are expected to climb significantly this year, with Italian debt to GDP hitting at least 160%, progress on the RRF, if agreed upon, could keep funding costs low. This would make the debt more manageable, particularly for the periphery countries, though actual implementation of the RRF will not be

until the first quarter of next year at the earliest. Once again it has taken extreme pain and hardship to push the EU in the right direction.

### Brexit is not forgotten and creates additional uncertainty

The UK has been badly hit by the COVID-19 outbreak from both a human and economic perspective and now faces the uncertainty of Brexit negotiations to establish its future relationship with the EU. No request for an extension to the transition period has been made, meaning that the potential of a hard Brexit will likely intensify as the year-end deadline approaches. While we believe that compromise will again be achieved to prevent such a disruptive outcome, the risk remains very real and uncertainty will hinder growth until an agreement is reached.

### A financial crisis is averted as asset purchases become the weapon of choice for the central banks

Monetary policy makers have succeeded gallantly in putting a floor under risk assets, resulting in the peak to trough fall in equities of around 35%, significantly smaller than the 50% plus declines during the financial crisis and bursting of the dotcom bubble. Liquidity is indeed having a remarkable effect. Earnings are likely to be down in excess of 30% in most regions this year, while dividends are being slashed, stock repurchase programmes shelved, and ratings downgrades are becoming rife.

### Bond yields are being managed, with yields staying low

Bond markets have benefitted from the commitment of central banks to maintain low interest rates and increasing evidence of implicit, if not explicit yield curve control. Inflation expectations are unlikely to move meaningfully higher in the short to medium term regardless of the scale of stimulus, as deflationary forces are the dominant feature. Oil prices remain depressed, down around 35% since the start of the year, despite recovering sharply from the record lows of March. With both government and corporate debt continuing to hit new highs, we reiterate the view that interest rates will have to stay depressed in order to manage this burden. Bond yields may push a bit higher as recovery becomes more sustainable, but the move is likely to be modest and controlled by central bank interventions.

### A new cycle for credit will see some purging of the weak to the benefit of the strong

We have written extensively about credit prospects in our [Topical Thought](#) and, to us, a new cycle is dawning. Credit is the prime beneficiary of the

## Record credit issuance is well absorbed by the market



Source: Bloomberg

## Equities recover sharply though valuations are extreme



Source: Bloomberg

asset purchase programmes, with policy makers trying to keep businesses functioning, even to the extent of providing support to fallen angels – companies that have been downgraded from investment grade (IG) to high yield (HY). The scale of buying will provide significant support to both the US and European credit markets. In the HY space, we do expect defaults to rise, but peak at around 10% in the US, leading to a cleansing in parts of the market. That noted, fundamentals generally remain poor across the credit markets and leverage will almost inevitably rise in the short term, given the hit earnings will take this year.

Cash is expected to be cherished, with pressure from the rating agencies reducing the appeal of M&A activity or stock repurchase, which could improve leverage levels longer term. IG companies have been quick to use the market rebound to raise financing, with issuance far surpassing prior records over the past few months. Indeed, this suggests that issuance has been front loaded this year and is likely to recede in the second half. This, in combination with the staggering policy support and continued search for yield by investors, bodes well and spread compression is expected to be meaningful on both sides of the Atlantic into the end of the year.

### Liquidity outweighs fundamentals for stocks, as investors get back on the bandwagon

The V-shaped recovery in equity markets has been dramatic and a consequence of the policy moves implemented, as fundamentals are woeful. Earnings could fall around 35% and 50% in the US and Europe

respectively this year, while dividends continue to be slashed and stock repurchases halted.

Valuations are extended by historic standards on practically all measures in many regions. While investors have been reticent to buy-in to the rally given the fundamentals, the scale of liquidity provisioning and the cost of remaining on the side-lines from a performance perspective has encouraged funds to be gradually committed, squeezing the market higher. Policy initiatives continue to grow, with the Fed indicating a willingness to tolerate resurgent asset prices as a side effect of addressing its policy goals of full employment and stable prices. Consequently, we suspect stocks have further to run. As interest rates will be maintained at exceptionally low levels for the foreseeable future and explicit purchasing of credit is now being undertaken by key central banks, equities are likely to benefit by default.

Stock indices may well test the highs of earlier this year, although we suspect that it will require success around virus vaccines for the market to push meaningfully beyond that. In the shorter term, while liquidity will be a powerful driver, a significant second wave of infections following the current re-opening of economies is an ever-present risk. Bouts of profit taking need to be expected following the fairly linear recovery to date for equity markets.

## Conclusion

Exceptional policy action at both the monetary and fiscal levels is expected to avoid a prolonged growth contraction and support asset price appreciation. The effects of the recession will be long lasting, however, with a substantial loss in global output and even higher levels of debt.

Liquidity is likely to remain a potent driver of both credit and stocks, but a transition to better fundamentals is a necessity for a sustainable bull market in risk assets.

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