April 30, 2020

# Gloom, but not doom, as recession bites

## Economic and financial consequences of containing COVID-19

The lockdown of many societies in a bid to contain COVID-19 has taken economic activity towards depressionary levels, with Q2 GDP expected to see the worst contraction since the 1930s. An unprecedented policy response and some tentative signs of virus containment suggest a sharp recovery is likely, though output will have been lost permanently. Meanwhile, unlimited monetary support gives investors hope, fuelling asset price reflation.

Source: iStock

**The coronavirus lockdown triggers a deep global recession**

The COVID-19 pandemic has amplified and accelerated the global growth slowdown that we had projected for 2020. Lockdown measures have unleashed a synchronised collapse in economic activity, along with a 70% slump in oil prices and extreme volatility in financial markets. This comes at a time when the global economy is already vulnerable, with high debt levels, persistently weak growth, and elevated political and geopolitical risk.

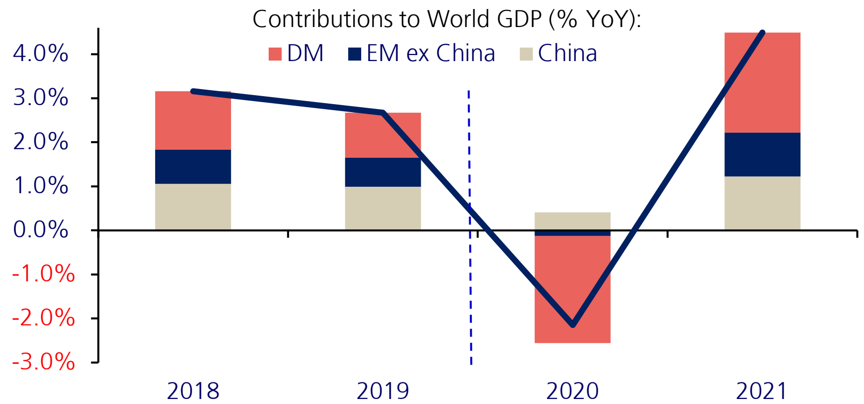
**While deep, the recession should be relatively short-lived**

Profound policy measures have been rolled out globally, which will help to bridge the lack of earnings and income for businesses and households and support a return to almost normality once the virus crisis passes. This is a key reason why we expect a deep, but relatively short-lived, global recession, where the initial collapse in activity is followed by a swift recovery in the second half of 2020, as economies are gradually unlocked and stimulus persists. There are large risks around this V- shaped outlook though, and even if achieved, the scarring of the global economy will be large, with effectively a year's worth of growth permanently lost. Success hinges crucially on positive developments on two fronts: measures to contain the virus are effective, with complete lockdowns not lasting beyond Q2, and policy measures are sufficient to bridge the shortfall in earnings and income and provide a backstop to the global economy and financial markets.

**Lockdowns appear to be an effective tool to fight the virus**

The assumption of a short-lived but severe global recession that we, and many others, expect, hinges on the lockdown being an effective tool to fight the virus, leading to a stabilisation in the global infection rate in the second quarter and a gradual opening up of societies. While it is still in the early days, infection curves have started to flatten out, both in individual regions and globally. Plans to ease lockdown measures are being announced and trialled in some regions. This is encouraging, but there are clearly large risks around the path for the virus infection going forward. A second wave of infections is a possibility, and infection rates are still rising in parts of the world.

### Despite V-shape, there will be a permanent loss to global output




Source: ZIG

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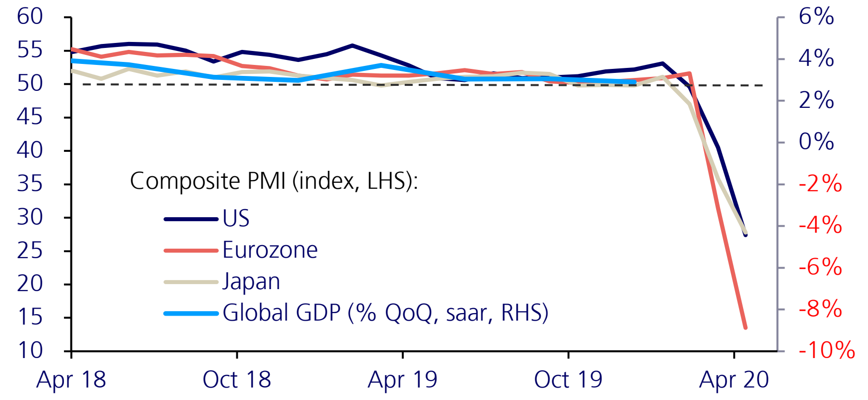
## Q2 likely to see deepest contraction since the Great Depression




Source: Markit, Bloomberg

**Policy support has been significant and will help to contain the crisis**
While lockdowns appear to have been successful in flattening infection curves, they have delivered a brutal economic cost, in terms of job losses and foregone GDP. In times like this, only governments and central banks have the tools and the power to absorb the cost and prevent a depressionary spiral from developing.

The scale of stimulus that is currently being injected into the global economy is unprecedented. The Federal Reserve has launched an asset purchase programme that is unlimited in size, is intervening directly in major domestic credit markets and has extended global dollar liquidity through swap lines. This has resulted in an expansion of its balance sheet by over USD 2tn since the beginning of March. Other central banks have unrolled similar measures, all adhering to 'do whatever it takes' to prevent recession from turning into depression.

Fiscal prudence has been abandoned in the effort to the save economies, as governments have signed off on large discretionary fiscal spending plans, on average amounting to almost 5% of GDP in advanced economies, which is more than what was provided during the great financial crisis. This comes on top of non-discretionary fiscal spending such as unemployment benefits and short-term working compensation schemes and substantial loans, guarantees and tax benefits to the business sector.

This policy support has helped to put a floor under sentiment and risk assets and should prevent a more severe financial crisis from developing.

**Policy measures will not absorb the full economic cost of the lockdown**
There are still significant risks around the policy response though, around both the effectiveness and size of what has been provided. Policy measures do not fully absorb the economic cost of locking down societies, and stimulus may not be effective in reaching those who need it, when they need it. Moreover, the crisis is fought country by country, using whatever resources are available, so support measures are still being limited by fiscal capacities of individual countries, rather than defined by a coordinated global effort. This means that some businesses will inevitably close down, workers will be laid off, and some sectors will face permanent damage as the result of broken business models. As pockets of vulnerability become apparent over the coming days and weeks, it will remain critical that policy makers respond swiftly, adjusting or expanding support as needed. Now is not the time to rest.

**Gloom, but not doom**
Despite being encouraged by the flattening out of infection curves, steps to ease lockdowns and policy measures, the 2020 economic outlook is dreadful. Economic activity collapsed in March and April as businesses were forced to shut operations overnight, leading to a deep contraction in economic output, by over 30% for some sectors and economies. It is likely that the world economy will slump into the deepest recession since the Great Depression this year, exceeding the downturn seen during the great financial crisis. Lockdowns have been much more successful in curtailing mobility, activity and trade than initially expected. There was little slippage and, as a result, the economic collapse is unprecedented.

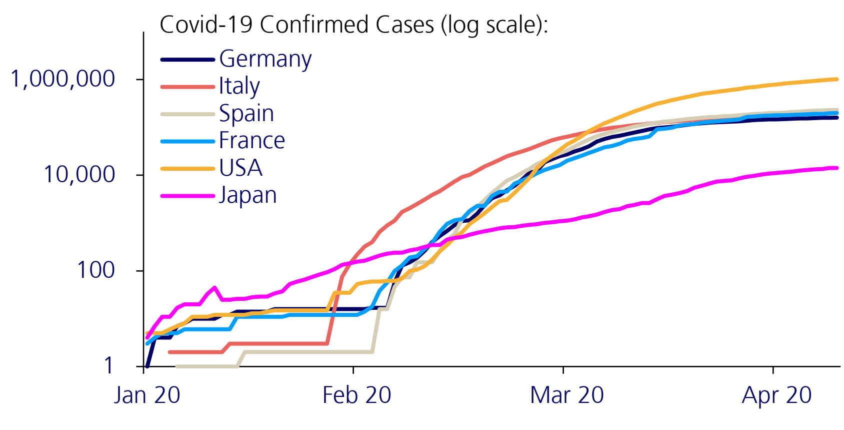
If economies are gradually opened up after May, as we expect, this should result in a return of capacity to near 'normal' in Q3 and Q4, leading to a strong pickup in quarterly growth rates in the second half of the year. This is what generates a V shaped recovery. With this in mind, we currently expect global growth at around -2% in the calendar year 2020, followed by growth at +4.5% in 2021. Clearly uncertainty around any forecasts in this environment is extremely high.

**V shaped does not mean that all is good**
While the recovery we, and many other, expect is V shaped, the crisis will not leave the global economy unscathed. Even in our relatively benign scenario, the level of global GDP will be down by almost 3% by the end of 2021, compared to where it would have been, had it not suffered the lockdown. In terms of foregone economic output, this is equivalent to one year of global GDP growth – or more than USD 2.5tn. To put this in perspective, this amounts to roughly one year of economic output of France, or of India.

**A longer lockdown would be catastrophic for the global economy**
The outlook for the global economy is likely to be binary. Given effective support mechanisms and a relatively brief lockdown period, the global economy should be able to sustain the sudden stop to activity, with most productive capacity remaining in place. In this case, it will be relatively easy for the lights to be switched on again, with conditions quickly moving towards normal. However, the severity of the economic crisis will not increase linearly with the length of the lockdown. Beyond a certain stage, the damage will be irreparable as businesses shut down permanently, workers lose their skills after a longer spell of unemployment, and consumption habits break down. If that point is reached, and given elevated indebtedness and financial and economic interlinkages, the risk is that a deeper crisis would be triggered, more akin to a global depression. The coming weeks will therefore be critical, particularly with regard to the virus itself and the potential for opening up economies.

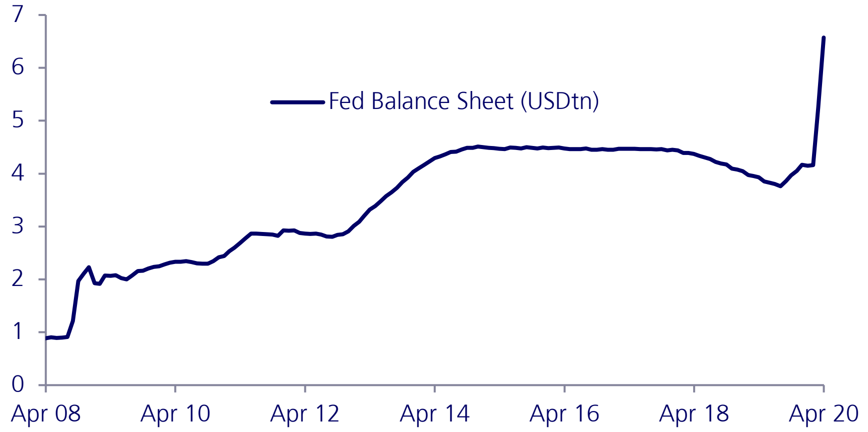
**Oil price collapse and emerging market challenges pose risks to the outlook**
Even if the infection is brought under control relatively quickly, economic costs will be severe, and there are large vulnerabilities that need to be watched.

## Lockdowns appear to have been effective for containing the virus




Source: Bloomberg

## Stimulus injections by the Fed are unprecedented




Source: Bloomberg

Emerging markets potentially face a crisis on three fronts: A health crisis, a deep economic crisis, and a balance of payment shortfall, as currencies have plummeted while dollar denominated debt still needs to be serviced, with limited policy space to act.

Just when we had gotten used to the counterintuitive concept of negative interest rates, oil prices also turned negative, as the world runs out of storage capacity. This is not sustainable, and the collapse is destabilising for the global economy. It will weigh on investment in the capex heavy global oil sector and put pressure on the highly leveraged US shale sector. It also adds to deflationary pressures that amplify negative debt dynamics. In normal times, a lower oil price would have a positive effect on demand, offsetting some of these negative dynamics. However, low prices are not stimulating consumption in a normal manner, given the restrictions imposed on mobility and travel.

**Deeply disinflationary environment, at least in the short to medium term**

The near-term impact on inflation will be deeply deflationary, given the collapse in oil prices and global demand. While disruptions to supply chains and stockpiling could lead to higher prices on some products, such as food and medical material, this will not be the dominant factor in a recessionary environment. Market implied measures of inflation expectations reflect this – they have slumped despite massive stimulus injections. The problem with deflation is that it amplifies the real debt burden. With global debt to the non-financial sector amounting to almost USD 200tn, this is an additional headwind for the global economy.

**Bond yields expected to be past their lows**

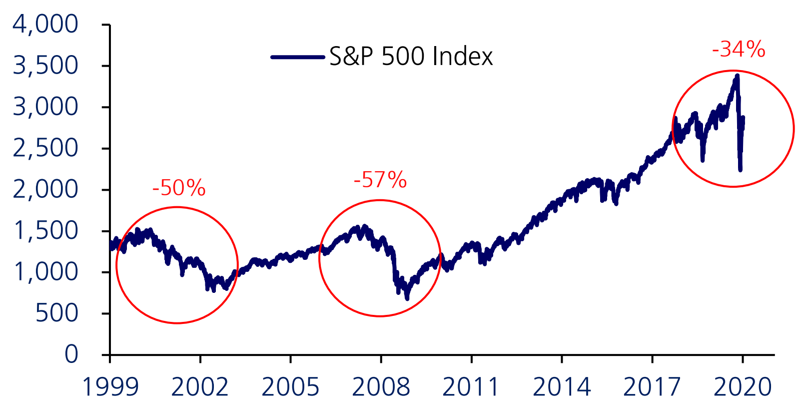
Government bond yields detached from risk asset prices well before the escalation of the coronavirus crisis. In some respect, this reflected the inherent vulnerabilities of the global economy, including high debt, sluggish growth, and persistently weak inflation. Looking forward, however, we suspect that bond yields have bottomed. Central banks are committed to not cutting rates further into negative territory, which should provide a floor for yields across the curve. Indeed, we had expected yields to revisit their historical lows in 2020. This happened earlier than anticipated and our base case forecasts imply that we are now likely to be past those lows.

**Global policy measures are bolstering investor sentiment, reflating asset prices**

Our original forecast for 2020 envisaged equity markets falling in the region of 20% from their highs, given the mild global recession predicted. The dramatic turn of events, however, led to many equity markets experiencing the fastest 30% correction on record, with credit spreads jumping by more than 150bps. Unlike the equity price declines following the bursting of the dot com bubble or experienced during the great financial crisis, when the plunge in stocks breached 50%, the recent sell-off proved short-lived and relatively modest. Despite the gravity and fluid nature of a global pandemic, the MSCI World Index fell only 34% from peak to trough.

This has been the result of the truly profound monetary policy response from global central bank that shows the lessons learned from the global financial crisis. In particular, the open-ended and unlimited nature of asset purchase by the Fed, also being prepared to take on credit risk for the first time, provided confidence for investors. A myriad of support measures is now in place to help businesses remain viable, as earnings are likely to plunge in excess of 25% this year in many regions.

## Rapid policy action limits market decline and fuels the rally




Source: Bloomberg

Asset purchases have been expanded and deepened on both sides of the Atlantic, while abundant liquidity and loan facilities are being provided, largely in line with what we thought would be necessary. Effectively these actions have materially reduced the downside in both equity and credit markets. We suspect that volatility will remain high and that recent lows could be retested depending on the success of containing the virus and reopening economies, but now have more confidence in those levels marking a bottom. The upside has also increased, and we see asset price reflation running ahead of improvements in the real economy for some time, as liquidity is once again the primary driver of risk assets.

Market valuations are certainly not cheap and have actually increased in recent weeks as earnings are likely to fall more than the now relatively modest decline in equity prices. In addition, dividends are being cut and stock repurchases curtailed. Credit fundamentals also are not very attractive, but this is outweighed by the massive purchase programmes that will once again likely lead to spreads being compressed, despite very high and still rising leverage.

### Conclusions

The unprecedented actions in locking down economies in a bid to control the spread of the coronavirus have resulted in a serious economic blow. 2020 Q2 is likely to mark the worst economic performance since the Great Depression of the 1930s, yet the magnitude and nature of the policy response is expected to mitigate long lasting effects. Equity and credit markets are back in ascendency, buoyed by the asset purchase programmes. Despite this, lost global output will be significant and indebtedness will be materially higher at the government, corporate and household levels, increasing the fragility and vulnerability of the economic landscape once the critical battle with COVID-19 is eventually overcome. This raises prospects for a more fundamental shift in the way central banks and governments operate over the next decade, along with a further escalation in political and geopolitical tensions.

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