Beyond the mechanical rebound

49 – 7 June 2020

Key points

- We look again at the pandemic dynamics. It seems the appeal of re-opening economies is too strong to resist even where the virus is still progressing quite fast.
- Relaxing lockdown will produce a mechanical rebound which will look quite steep initially. We think big and well-designed policy stimulus will still be needed to turn this rebound into a sustained recovery.

We think at this stage the gyrations in economic activity merely reflect the mechanical supply-side reactions to the changes in the lockdown constraints. These movements – for instance the unexpected decline in US unemployment last Friday - can be quite abrupt and could be interpreted a bit too early as signs economies are absorbing the pandemic shock fast. We have not yet seen much of the impact on demand, which we suspect will last longer, but the market is increasingly tempted to price "V shape" recoveries.

The "moment of truth" may well come by the end of the summer. We remain a bit concerned by the risks some of the advanced economies have taken with their pace of re-opening given how quickly the virus is still progressing in some places. Still, our baseline is that by July most of the administrative impairments to economic activity would be lifted. By then most of the mechanical rebound will be done. Businesses will still face significant headwinds: (i) uncertainty about the pandemic itself, with the possibility of a "second wave" which, as long as no vaccine is available, would depress investment; (ii) potential weakness in world demand as activity in the Southern hemisphere could still be affected by the pandemic's first wave; (iii) a higher level of debt.

We think the size, timeliness and quality of the policy stimulus – going beyond mere emergency measures – will remain crucial to sustain the recovery after the initial mechanical rebound. In Europe, the "Next Generation" scheme is promising but the latest noise from capitals strengthen our view that we may have to wait a lot for the first disbursements. In the meantime, national budgets will have to provide a "bridge". Germany was the first to respond with a finely balanced programme of tried and trusted instruments such as a VAT rate cut and more long term support to industrial reconversion.

Many other countries will hesitate to emulate Germany if they consider their debt sustainability conditions are jeopardized. From this angle, the ECB decision last week was welcome. Some elements are puzzling and we suspect the Governing Council will have to tweak its various quantitative programmes several more times, but the central bank is gradually providing more visibility to the market – and sovereign debt issuers.

Latest dispatches from the pandemic front

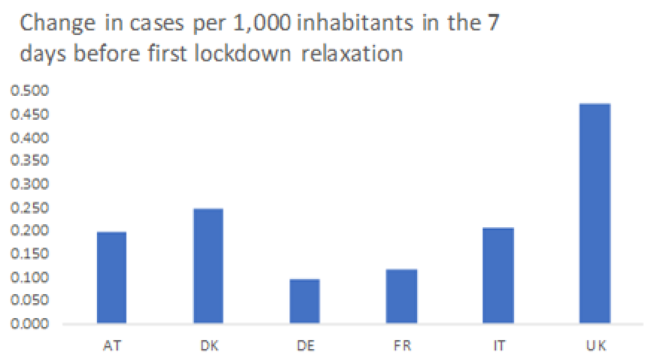
We could think about the probability of a robust recovery in the second half of the year across two axes: the pandemic risk itself, i.e. the probability of a second wave – or of a strengthening of an ongoing first wave – and second the quantum of policy stimulus thrown at the recession and its effectiveness.

We have already discussed at length in Macrocast the contrast in terms of immediate economic cost of the pandemic between the countries which opted for a short and mild lockdown and those which went for more severe forms. But there may be another distinction to draw between those where the local epidemic is clearly under control and those where exiting lockdowns may have come early given what they had achieved on the pandemic front, with potentially a higher probability of a relapse.

In Europe, the UK clearly stands out as one of those "risky exiters". We look at the speed of the epidemic in six countries in the seven days before the date of the first relaxation of the lockdown (first decrease in the lockdown "stringency index" developed by the Blavatnik school of government). Controlled for population size, the virus was still propagating faster in the UK than in any of the other countries in our sample when the British government moved from "all-out confinement" on 13 May (Exhibit 1). Quite late in taking the measure of the epidemic, the UK spent less time at "peak lockdown" (at the highest level of the Blavatnik "stringency index") than some of its continental counterparts (48 days against 56 days in France for instance).

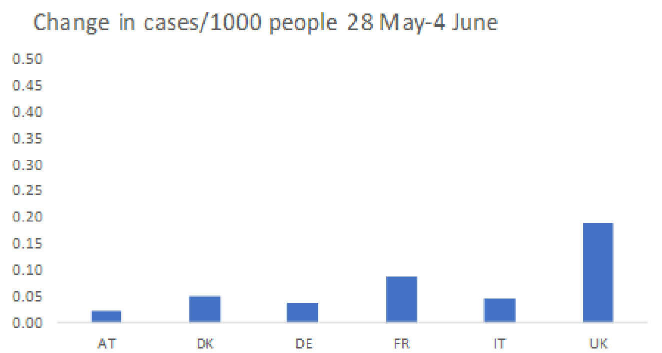
In the UK just like in the rest of Europe the epidemic has continued to slow down post relaxation (see Exhibit 2 for the latest weekly data controlled for population) but the epidemic still propagates much faster in the UK. The current speed in the UK is only now close to where it was in Austria and Denmark a month and a half ago when they started relaxing.

Exhibit 1 - The UK started relaxing lockdown before achieving the same degree of control as the continental countries



Source: Blavatnik School of Government, AXA IM Research, June 2020

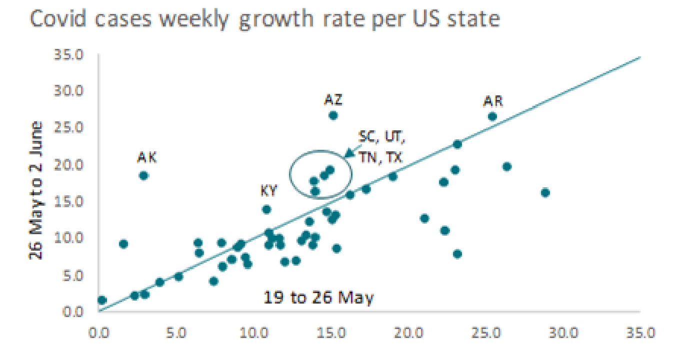
Exhibit 2 - The "early exiters" have not experienced any relapse so far, while the UK still stands out



Source: Blavatnik School of Government, AXA IM Research, June 2020

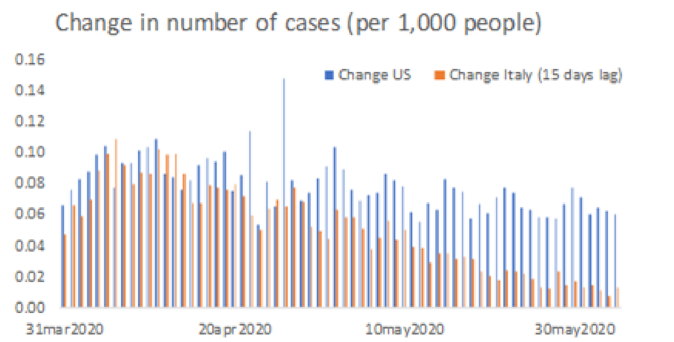
It is difficult to produce the same kind of analysis for the US since the stringency of the lockdown differed a lot across states. **While the national trend is positive, there is a cluster of eight states where the weekly growth rate has accelerated and remains in double digit territory** (Exhibit 3). The sample is too small to ascertain a correlation, but six out of these eight states were among the "early exiters" (the 25 which relaxed lockdown before or on 15 May). **Rather than "dying down" as the pandemic seems to be doing in Europe, in the US it seems to be plateauing** (Exhibit 4): the coastal areas such as New York are following the "Italian pattern" but the central and southern parts of the US continue to face challenges getting covid-19 under control.

Exhibit 3 - Some “stubborn clusters” mostly outside the US coastal areas



Source: CDC, AXA IM Research, June 2020

Exhibit 4 - Epidemic is plateauing, not fading

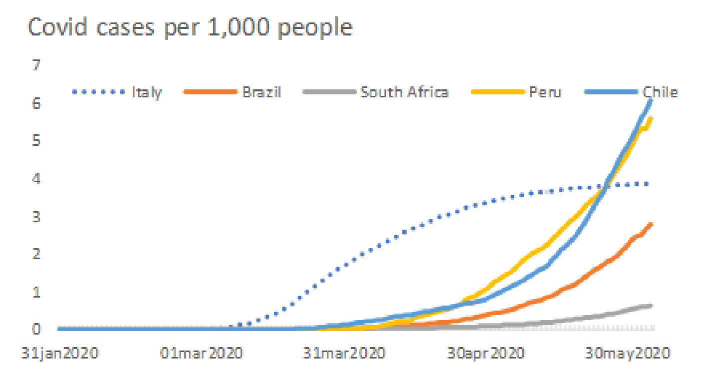


Source: John Hopkins, AXA IM Research, June 2020

Still, even if some risks are being taken here and there, the general trend is favourable across the developed countries. The picture is quite different when looking at some emerging markets. It is well-known that Brazil is now the second highest contributor to the total number of Covid cases worldwide, but the situation is getting out of hand beyond Brazil in large swathes of Latin America. There is no evidence at this stage that Brazil, Chile or Peru are following the “Italian pattern”. Quite the opposite, they are now showing signs of “explosive trajectories” (Exhibit 5).

We also need to monitor the developments in South Africa quite closely. There, authorities had taken some drastic lockdown measures early in the pandemic and until mid-May their strategy had been quite successful. But the last weeks have been disappointing, even though they are still far from the Latin American trajectories. A risk though is that as the Northern hemisphere is getting close to normalisation, the Southern hemisphere goes through an acute phase. This would have an adverse impact on effective global demand, even if Latin America accounts for only 7% of world GDP, and would also affect global confidence, as a reminder that without a vaccine major relapses may not be avoidable.

Exhibit 5 – Watch out for the Southern hemisphere



Source: Blavatnik School of Government, AXA IM Research, June 2020

The irresistible appeal of relaxing lockdowns

National authorities find it difficult not to accelerate the normalisation in activity, given the depth of the macroeconomic cost and the quick reward they can get in the dataflow, which in turn is saluted by financial markets which thus contribute to a “feel-better” sentiment. A “Fear Of Missing Out” on a V-shape recovery could settle in, despite the risks. The city of Rio de Janeiro for instance is re-opening although the city is far from having controlled the epidemic.

At this stage, we believe **the gyrations in economic activity merely reflect the mechanical supply-side reactions to the changes in the lockdown constraints**, compounded in some cases by the specific features of the emergency stimulus. These movements can be quite abrupt and could be interpreted a bit too early as a sign economies are absorbing the pandemic shock faster than expected. We have not yet seen much of the impact on demand, which we suspect will last longer.

The recent US dataflow provides a near-perfect example of such spectacular mechanical rebound. The unemployment rate there unexpectedly fell by 1.4 percentage point between April and May, with the number of jobs rising by 2.5mn on the month. Some technical difficulties made the April and May readings less accurate than usual (some workers on furlough should have been classified as "temporarily unemployed" but were kept as "employed"). But the changes in lockdown conditions explain quite well the numbers. Half of the total rise in employment came from hospitality, as this sector started to re-open. According to the Open Table data, bookings in restaurants were down 83%yoy at the end of May against 99.9%yoy at the end of April, with significant differences across the states (-99% in New York, -57% in Texas).

The rebound was helped by the initial design of the Paycheck Protection Programme on which Washington has already spent more than USD500bn: employers have until the end of June to re-hire employees they have laid off since the beginning of the pandemic to maintain their chance to get the government loans turned into non-repayable subsidies (this has been extended to the end of December, but only on 5 June).

Unsurprisingly, the main contribution to the decline in unemployment came from "persons under temporary layoffs" (down from 18.1mn in April to 15.3mn in May) but the number of "permanent job losers" continues to grow (2.95mn in May from 2.6mn in April and 1.9mn before the pandemic). Moreover, a "waiting room" phenomenon is emerging: the workers who had lost their job before the pandemic, or the new entrants, cannot easily secure another one in the current circumstances. The number of persons who have been unemployed for more than 15 weeks on 12 May has started to rise (from 1.9mn in February to 2.2mn). **The financial market reacted a lot to the payroll data, but the US labour market has recouped only a small fraction of what it has lost.** US employment is still more than 13% below its pre-pandemic level (Exhibit 6). In hospitality, still 42% of the pre-pandemic jobs are missing.

Exhibit 6 - The "May surprise" in perspective

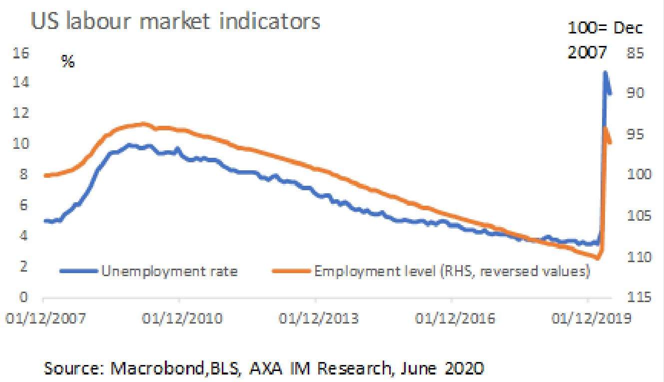
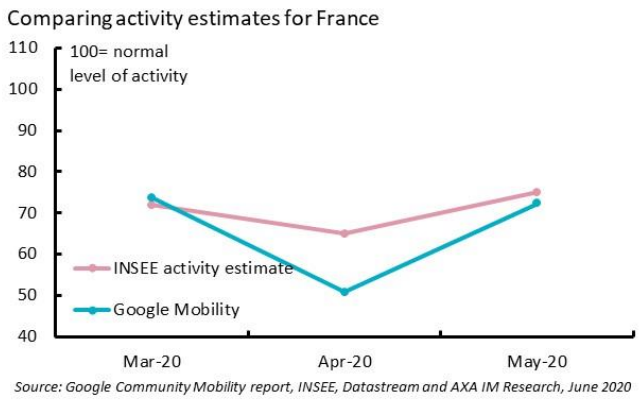


Exhibit 7 - Steep rebound, still to low levels



We expect "good surprises" to materialise in the Euro area as well, as sectors re-open over there. We have already discussed in Macrocast our belief that traditional indicators such as confidence surveys are inaccurate in the current environment. But bottom-up assessments and real time data are already pointing to a significant rebound in activity. In France INSEE considers that activity in May has improved by 10 percentage point relative to April (averaging the estimates from its "*points de conjoncture*", which do not cover the end of May). Data from "Google trends" would point to an even steeper rebound (22 percentage points). The monthly growth rate in output in May and probably even more so in June is likely to be very positive. The output gap though would remain very high though by the end of Q2 (Exhibit 7).

Filling the stimulus gap

The "moment of truth" may well come by the end of the summer. We remain a bit concerned by the risks some of the advanced economies have taken with their pace of re-opening given how quickly the virus is still progressing in some places. We cannot completely discard the possibility that some of them are forced to resume some of the lockdown measures. Still, **our baseline is that by and large by July most of the administrative impairments to economic activity would be lifted**. By then most of the mechanical rebound will be done. Businesses will still face significant headwinds: (i) uncertainty about the pandemic itself, with the possibility of a "second wave" which, as long as no vaccine is available, would depress investment; (ii) potential weakness in world demand as activity in the Southern hemisphere could still be affected by the pandemic's first wave; (iii) a higher level of debt.

We think the size, timeliness and quality of the policy stimulus – going beyond mere emergency measures – will remain crucial to sustain the recovery after the initial mechanical rebound. This will take more than temporarily protecting corporate cash-flows. We discussed last week in some detail the "Next Generation" programme of the European Commission. We like the design, but we are concerned about the time it will take to get effective disbursements. We concluded on the necessity for national governments to "bridge the gap" on their own before "federal support" becomes available.

The latest noises from European capitals make us even more concerned about the timeliness of the programme. The Finnish government has officially expressed its opposition to the Commission's proposal – despite support from some components of the coalition in Helsinki. It seems then that the "frugal 4" are actually five. Moreover, a Financial Times (FT) article this weekend echoed some "technical issues" member states have with the design of the allocation key. We had highlighted last week that the scheme would operate more as a magnified cohesion fund than as a direct recession-busting instrument targeted at the member states dealing with the worst direct consequences of the pandemic. Its "formula" is based on pre-pandemic distance from EU average, and according to the FT it is precisely one of the key criticisms the scheme is facing. Our baseline still is that the programme will ultimately go through, but it may not be as swift as what the market has been expecting over the last two weeks.

National initiatives are thus even more necessary. **Germany – which had already produced a quite comprehensive first reaction plan – has been the "first to strike" last week**. Not all the EUR130bn (3.8% of GDP) will be spent in 2020, but we like the balance between tried and tested short term fixes – for instance a temporary decline in VAT by 3 points for the normal rate and 2 points for the reduced one – and more structural, lasting investment programmes to support the green and digital transition (which would actually nicely complement the "Next Generation" European initiative). The VAT cut alone would bring EUR20bn to the economy (1.2% of GDP over the second half of the year), not an unsubstantial boost for an economy which so far has done comparatively well through the pandemic shock.

The change in tone in Berlin is quite striking. Before the Great Recession Germany was raising its VAT rates (while reducing payroll tax) to boost its competitiveness, mimicking the effect of a currency depreciation within the monetary union. This time it seems the country is not basking in its comparative resilience of the first half of the year and is taking the measure of the risks of a backlash via a still depressed foreign demand in the second half the year which would be particularly detrimental to this export-driven economy. Instead of reacting as it had done over the last 20 years by engaging in even more cost compression, Berlin has opted to support domestic demand, while preparing for a reconversion of some of its key sectors. The absence of a blanket "car scrappage" measure – only electric vehicles will be eligible to the EUR6,000 government bonus – is quite telling from that point of view.

We are now waiting for the response of the other member states. Most of them do not enjoy the low debt level and general credibility of Germany. The quantum of support they will be able to provide beyond the emergency measures is very dependent on their conviction their debt sustainability conditions are not jeopardised. This of course is where the European Central Bank (ECB) comes into play.

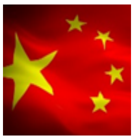
Last week we expressed our expectation the central bank would "top up" its Pandemic Emergency Purchase Programme (PEPP) by EUR350-400bn, which was in our calculation what would provide them with enough room for manoeuvre to deliver on their pledge to be in the market "at least until the end of the year". They provided more than this – EUR600bn – but also extended the term to "at least June 2021". We are a bit puzzled by this. Providing more visibility to the market by extending the PEPP horizon is welcome of course, but at the current pace of purchases the ECB would exhaust this new quantum by February of next year. The Governing Council probably expects some "peace and quiet" to come back to the markets once the worst of the pandemic is behind us which would allow them to show more restraint in their spending pace. But **we suspect the June 2020 Governing Council meeting will not stay as the last one at which a "top up" to the PEPP is decided.**

Habitual readers of Macrocast may remember that our focus is not just on the current purchases but also on the reinvestment strategy of the ECB. We think it is crucial a significant share of the public debt issued as a direct response to the pandemic is held over a long horizon on the central bank's balance sheet through reinvestment so that it is effectively "sterilised" and does not trigger a sharp tightening in financial conditions when it comes back to the market. The ECB has delivered on this as well, with a pledge to re-invest PEPP until at least the end of 2022. But we were happier about the following sentence in the ECB's introductory statement*: "In any case, the future roll-off of the PEPP portfolio will be managed to avoid interference with the appropriate monetary policy stance".* This may sound vague, but it is crucial in our view, as it responds precisely to our concern. The ECB will not "offload" PEPP in a way which would make financial conditions inappropriate.

Still, a key question is the final horizon of PEPP. The ECB's chief economist Philip Lane elaborated on this in his post-meeting blog post: PEPP *"protects smooth policy transmission and supports lower funding conditions for the real economy, with the aim of lifting the medium-term inflation projection closer to the pre-crisis expected trajectory*". To simplify, PEPP is there to avoid a deflationary shock. This is consistent with the profile of the ECB's new forecasts. Indeed, inflation would reach a trough at only 0.0%yoy in Q4 2020, before reaccelerating very moderately to 0.2%yoy in Q1 2021 and 0.8% in Q2. **The idea then seems to be that by mid-2021 and the new term of PEPP, although inflation will still be significantly below the central bank's target, it will be sufficiently far from negative territory to switch off the programme.**

What would happen next? We suppose "normal quantitative easing » would take the lead again. Inflation would be at only 1.4%yoy in Q4 2022 in the ECB's new forecasts, which would hardly qualify as complying with the target. One may regret that the ECB is not more straightforward on its strategy, but we think that implicitly the Governing Council is providing quite a lot of visibility on loose financial conditions for long.

It won't be a walk in the park though. We have discussed several times in Macrocast the difficulty the ECB will face with its "limits" as it constantly tops up QE. This discussion is not yet explicit although the German Constitutional Court ruling makes it increasingly difficult to avoid. As we expected, Christine Lagarde did not directly respond to the GCC, even if she was keen to demonstrate the ECB is acting in a "proportionate" manner (she used the word twice) and expressed her hope a "good solution" would be found by the German stakeholders. Still, the issue may not want to go away on its own. There will be new episodes.

Country/Region	What we focused on last week	What we will focus on this week
	• US demonstrations in the wake of George Floyd killing • US payrolls rise by 2.5mn in May, jobless rate falls to 13.3%, which we expect past peak. • US senate extends PPP support program • ISM indices rise in May to 43.1 (m) and 45.4 (s)	• FOMC decision. No policy change expected, nor forward guidance shift. Fed to publish updated mid-term forecasts (SEP). • US jobless claims for first continuing rate fall. • CPI inflation for May, markets expect stabilisation at 0.3%, we see downside risks.
	• The ECB boosted the PEPP envelope by €600bn, extended it until June 21 and announced PEPP reinvestments until end 2022, as inflation forecasts dropped sharply • Italian unemployment rate declined further to 6.3% as labour force participation tumbled • Germany agreed on a €130bn fiscal package	• April Industrial production data to show significant contraction in Germany, France, and Italy. • Eurogroup might give some insights on the negotiations of the Next Generation EU package, after Finland's rejection of the current European Commission proposal.
	• UK official new cases flat line as restrictions begin to ease in wider economy • UK-EU trade negotiations make "no real progress" ahead of June extension deadline • May PMIs rise more than first estimates • House prices fall at fastest pace since 2009 in May, following sharp drop in April lending	• April output figures including monthly GDP estimate, services and industry. • RICS housing survey for May to monitor outlook for housing activity. • BRC retail sales monitor to gauge any rebound in retail in May.
	• May final Services PMI remains extremely weak at 26.5 but it probably reached the bottom in April (21.5). Manufacturing PMI has been confirmed to 38.5 from 41.9 in April • April household spending declined by 11.1%, a little bit better than expected (-15.4%)	• 2nd estimate of Q1 GDP should be revised to the upside (-0.5% from -0.9%qoq) • April IP and Machinery orders • May Economy Watchers poll should rebound from the lifted of the lockdown • May Bank lending figure will be useful to gauge BoJ's monetary policy transmission
	• Manufacturing PMI falls slightly in May, while the services-sector recovery accelerates • PBoC introduces new facilities to support SME lending	• CPI inflation to fall further, while the PPI remains in deflation
	• Korea released an extra budget of KRW35.3tn (1.8% GDP) to support the economy and Korean export growth contraction continued. • Weak economic momentum persists in EM. PMI figures remain the in-contraction territory.	• Central Bank meetings: Peru. • Czech Republic industrial production (April). Mexico headline inflation (May) Brazil headline inflation (May)

Upcoming events		
	US:	Tue: NFIB small business optimism, JOLTS; Wed: CPI, FOMC announcement, FOMC Economic Projections; Thu: PPI, jobless claims; Fri: Michigan consumer sentiment, import/ export prices
	Euro Area:	Mon: Ge industrial production (IP); Tue: Lagarde appears at Econ & Monetary Affairs Comm., Fr, Ge trade balance; Wed: Fr IP; Thu: Fr payrolls, It IP; Fri: Ez IP, Eurogroup meeting, final Fr, SP CPI, HICP
	UK:	Tue: BRC retail sales; Thu: RICS housing survey; Fri: Apr GDP estimate, IP, mfg output, construction output, trade balance
	China:	Wed: CPI, PPI
	Japan:	Mon: final Q1 GDP, trade balance, Economy Watchers Survey; Wed: private core machinery orders; Thu: BSI large mfg conditions; Fri: final IP, capacity utilisation

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