Relative speed

38 – 23 March 2020

Lockdowns work but they take time

Focus last week was on the policy response and we will explore this in the next sections, but let's first assess the damage already quantifiable. Lockdowns work, but they will take time to do so, and in the meantime the decline in economic activity is going to be very significant. We are dependent now on the relative speed of the pandemic and the policy response.

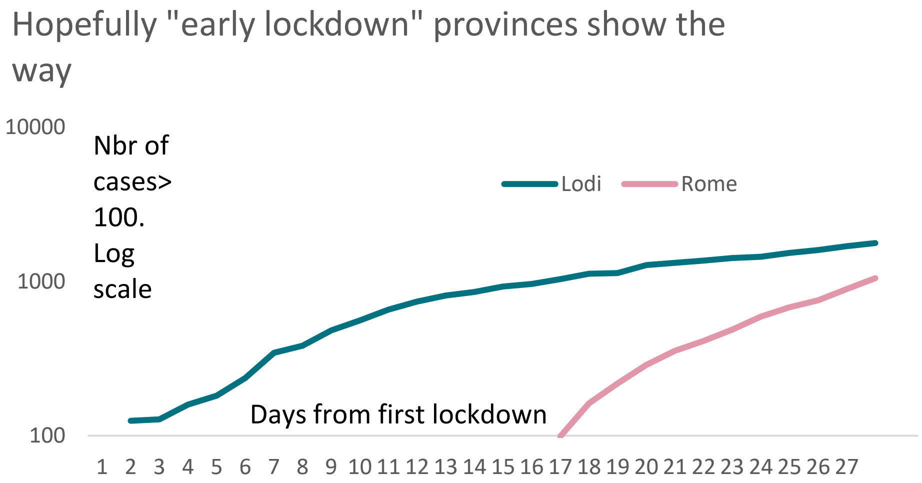
We continue to look at Italy as a "benchmark" for tracking the epidemic in democratic, Western economies. Every day at 6 pm local time the Italian government releases very precise data on the propagation of the virus. The growth rate at the national level has abated. As of March 22nd, smoothed over three days, the average daily growth rate in the number of cases across all Italy stood at 13%, against 20% a week ago (although testing has roughly doubled). Still, there is a stark contrast (see Exhibit 1) between the situation of some of the areas which were first hit, and hence went in "lockdown" early, such as the province of Lodi (where covid-19 cases grew by 4.6% on average over the last three days) and the Southern regions where the restriction measures started on 9 March only (+16% in Rome).

Key points

- The daily growth rate of Covid-19 cases in Italy is abating but stays at a double-digit pace.
- Beyond the inference we can make on a bottom-up, sectoral analyses, the economic impact is now showing in the" traditional" data in the US and the Euro area, strengthening the case for a steep recession worldwide in 1H 2020. We brought our forecasts further down.
- The policy response is "almost there" but we need more details and politicking around the US stimulus is a concern. Swift implementation is of the essence given the level of market stress.
- Looking ahead, we explore whether the crisis will be inflationary. We think it won't.

But for the time being there is no proper "Hubei" like situation in Italy where the epidemic has been completely halted after an initial "explosion". The confinement measures started at the national level on March 9 and in any case, no one was expecting a swift effect. The comparison with Hubei is made more complicated by the changes in counting methods in China at the very end of January, but for now Italy as a whole is still behaving like Hubei with a lag of 37 days, which would be consistent with the daily growth rate in the number of cases falling below 5% in 10 to 12 days, assuming the conditions of the lockdown are comparable.

Exhibit 1 – Give lockdowns time to work



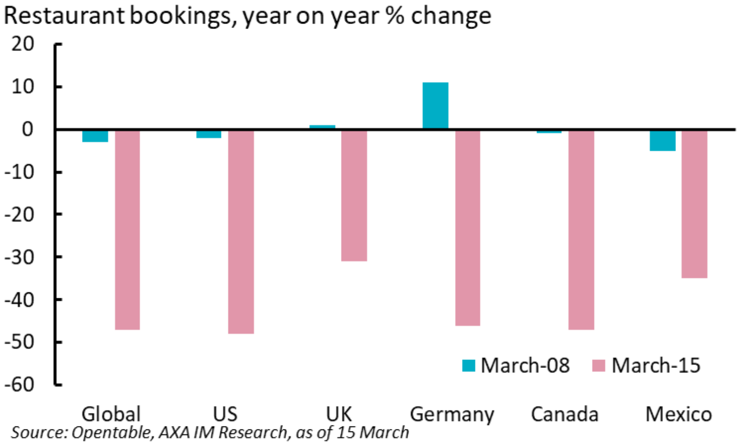
Source: protezione civile, AXA IM Research civile, 21 March

For now, the epidemic is not slowing down enough to relieve the pressure on the hospital system there. This can be proxied by looking at the status of the infected patients in Italy. On 12 March 52% of those were hospitalised in "normal care" and 9% in intensive care, with only 39% at confined at home. On 21 March, the proportion in ICU had fallen to 6.7% and 52% were home. Some of this may reflect wider testing – thus "catching" more people with only mild symptoms - but can also reflect some limitation of full medical support to the most critical patients.

Economic shock emerging in the data

In a nutshell, for lockdowns to work and reach their intermediate target (keeping the pressure on medical capacity at an acceptable level) they need to be maintained for long and imposed early enough. And, sure enough, more and more countries are implementing them. Actually, what is striking – and relevant from a macroeconomic point of view – is that in quite a few cases the population "took the matter into their own hands" and engaged in fairly drastic social distancing before the authorities imposed anything. Using real time data from Opentable (a restaurant booking website), the contraction last week was already quite severe in the US and the UK (see Exhibit 2).

Exhibit 2 – People did not wait for governments to engage in social distancing



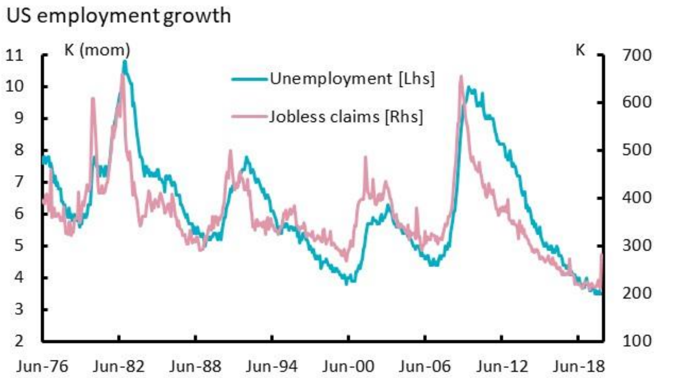
Source: Opentable, AXA IM Research, as of 15 March

Anyway, we no longer need to rely solely on sometimes bizarre real-time data to gauge the impact of the epidemic on the economy. **The first "traditional" indicators are now available for the relevant periods, and they confirm the depth of the contraction.** The relationship between the IFO survey and German GDP has not been perfect over the last 4 years (see Exhibit 3). Still, based on the historical elasticity, the March reading is consistent with a decline in GDP of c.3%yoy, half of the loss seen at the trough of the 2008-2009 Great Recession. We suspect that the survey will tank further when the news of the lockdown are fully taken into account.

In the US, the last weekly jobless claims shot up to their highest level since 2017. The "fit" with the unemployment rate has historically been very tight (see Exhibit 4) even if the lag has been unusually long after the Great Recession. Still, we should already brace ourselves for a rise in the unemployment rate to close to 5% quickly.

Exhibit 3 – Halway to the Great Recession already

Exhibit 4 – It didn't take much time…

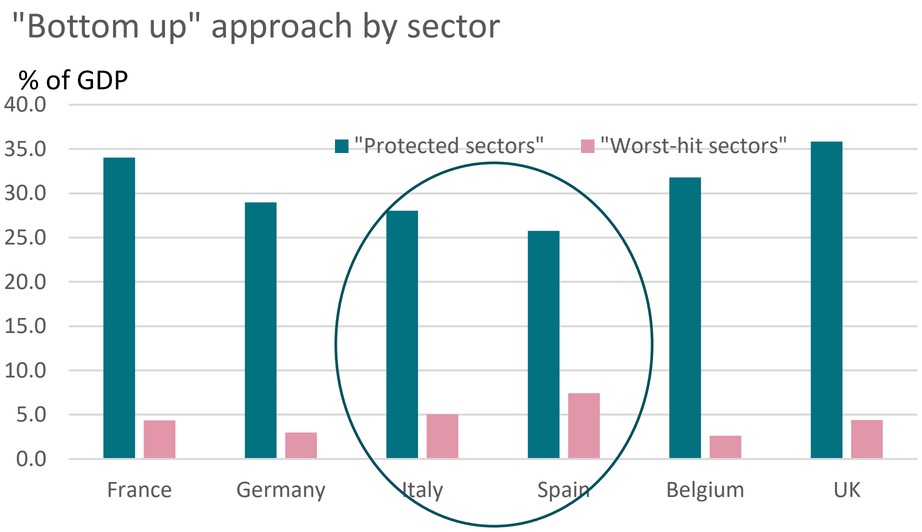


Source: Macrobond, AXA IM Research, March 2020

Last week we lowered further our forecasts for 2020. We now expect US GDP to fall by 0.4% and by 2.1% in the Euro area. The US outperformance does not stem from any specific resilience to the epidemic or its economic impact – we have a shock of about 2% of GDP throughout the developed world – but merely from the fact that the carry-over from 2019 was better there and trend growth higher. The whole first half of the year would see a steep recession, with some rebound in 2H, assuming the epidemic is under control and the most disruptive containment measures can be lifted by the end of Q2.

The message from the first macro indicators is consistent with our forecasting scenario, but at this stage we prefer focusing on a "bottom-up" approach, imposing next to zero output for the duration of the lockdown on the sectors (food services, recreation) which are going to be directly hit. We also must think of sectors which should see little or limited drawdown by nature or because they will be crucial in the current environment and may contribute more than usual to economic activity. We would consider "energy and water supply", "information and communication", "financial and insurance services" and public services in this "protected perimeter". The overall sensitivity of a national economy would depend on the relative weight of those "directly hit" and "protected" sectors (see Exhibit 5). Spain and Italy look particularly vulnerable by these metrics, even if differences across countries should not be overstated.

Exhibit 5 – A sectoral sensitivity approach



Source: Refinitiv, AXA IM Research, March 2020

Policy response: almost there (but details matter)

The risk to our new forecast unfortunately lies to the downside but did not want to take our baseline lower since we also need to consider a policy response which fortunately is starting to take shape, even if implementation remains to be refined in quite a few cases.

After the previous week's miscommunication, the European Central Bank had to dispel any sense that it would be unable to ensure the financial sustainability of the unavoidable steep rise in budget deficits in the Euro area. The market had come to focus on the "limits" (not buying more a third of a government's eligible debt, apportioning the asset purchases according to the capital key). **Last week the ECB delivered beyond expectations.** The limits are still nominally there but they no longer bite. That's the welcome main takeaway from their announcements. Beyond the impressive overall new figure for QE (EUR 750bn until the end of 2020, with the possibility to do more), key is that on the "limits" the "*Council will consider revising them to the extent necessary*". The capital key will remain the *"benchmar*k" of the purchases, but they will be conducted "*in a flexible manner*" across jurisdictions and between public and private assets. So, in reality, those limits are now probably mere "reference values".

The ECB has added non-financial commercial paper (CP) to the list of purchasable assets. It is important given the pressure on this market while from the macro point of view it is key to a number of crucial European corporates which don't need this additional concern at the moment.

In our view the ECB has by now plugged the "reactivity gap" with the Federal Reserve. Actually, we believe that on some issues the US central bank is now "late" and strangely timid in its response. We will need to see how exactly the ECB implements its purchases of non-financial CP but at least it has potentially offered "unconditional protection" to this asset class. The Fed's approach is qualified. The Commercial Paper Funding Facility would purchase at a minimum yield of OIS+200bps, basically replicating the 2008 arrangement, but given the speed of the market deterioration a stronger commitment to "mop up" any liquidity conversion there would be welcome. Maybe more fundamentally, the corporate bond market remains the "gaping hole" in the Fed's new arsenal. There is something quite paradoxical in the fact that the ECB intervenes on this market although loans continue to be the dominant form of corporate funding in Europe, while the Fed does not although market funding dominates in the US.

Timeliness in implementation is of the essence though, including in Europe. Policy announcements must be followed by swift action. The current crisis is of a different nature than the Great Recession but some of the ramifications in the financial system materialise much faster.

Yet, in both the US and the Euro cases, on the sovereign funding side the central banks are providing a very significant backstop. The bond market sell-off on Friday triggered some questions on the capacity to absorb the looming fiscal deficits. We are not worried. In the Euro area the two instalments of additional QE directly triggered by the necessity to deal with the pandemic amount to EUR 870bn by year end. Assuming only 65% of that goes into sovereigns (a low proportion now that the "limits" do not force a shift towards private assets irrespective of market developments there), this would still be enough to purchase a borrowing requirement of 7.3% of GDP. We think most of the sell-off late last week "merely" reflects the need from some investors to sell their safest assets in their search for liquidity. Their price had actually remained resilient so far. Selling them implied little or no capital loss.

True, the figures announced by some governments are staggering, but a bit of national accounting theory is needed there. The German Finance Minister shifted decisively on its approach to mitigating the economic cost of the pandemic by announcing the huge figure of EUR 650b for his programme, which makes the ECB purchasing commitment look small. But most of it is very unlikely to trigger actual borrowing. The majority (EUR500bn) are state guarantees to private businesses. These will count towards the deficit – and trigger debt issuance - only if they have to be drawn. The additional "traditional deficit" is limited to EUR 150bn. It is still a very large number: 4.5% of GDP, now exceeding the French package (2% of GDP for the "traditional" deficit spending) but well within the absorption capacity of a bond market underpinned by ECB buying.

There again, implementation is key. The announcements are impressive, but details should be available as fast as possible, for instance on the precise forms state guarantees will take, and when they become effectively available, to support financial conditions for the corporate sector.

In the US, the package discussed in the Senate is worth about USD1.8trn (5% of GDP) but Secretary Mnuchin was talking about USD4tn in "liquidity that can be used to support the economy". Still, as we are writing those lines on Sunday night no agreement has been found between Republicans and Democrats on the bill. This is particularly concerning given the weakness of automatic stabilisers in the US.

Discussing the European coordinated response

A group of prominent European economists have just argued in favour of using the European Stability Mechanism (ESM) in Vox on March 21st ("A proposal for a Covid Credit Line") to **fund some of the fiscal push in the member States with joint issuance**. We supported a similar approach one week ago, but at the time the rationale for us was to incentivise the ECB to dispose of its "limits" (an ESM programme in principle opens the door to Outright Monetary Purchases). Now that the ECB has stated its readiness to exceed its limits anyway, there might be less of a point here. However, there is still probably some political value in expressing European solidarity in a jointly-backed package, at a time when retraction on national lines is clearly a temptation. But fundamentally, this would still be a second-best. Indeed, loans from the ESM count towards the member State's public debt. Joint issuance allows to reduce the funding cost, but the impact on national debt sustainability is not absolute.

Are we taking risk with inflation?

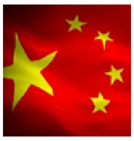
Focus remains squarely on the emergency policy response, but some fundamental questions still need to be addressed. One is the impact on consumer prices of the current crisis and its policy management.

In our view the current supply-side shock takes the form of an extreme decline in capacity utilisation, while not much of the existing capacity is destroyed. This suggests **inflation should remain subdued when demand starts**

normalising. In the meantime – during the lockdown – there may be sharp price increases for some items which are highly in demand, while some businesses in crucial sectors may have to hike wages to reward their staff risk-taking. Yet, there should be some stabilisation mechanisms. For instance, food hoarding – which may push up prices – will at some point collide with maximum stocking capacity at home. Then, home de-stocking should provide respite for shop re-stocking. Besides, some sectors currently facing high demand can raise their supply easily without facing a steep rise in their production costs (if the networks operate well). In clear, streaming services should be able to respond to a rise in demand without hiking their fees.

What about the impact of the fiscal/monetary stimulus? The fiscal measures everywhere aim essentially at (i) replacing lost income (e.g. via more comprehensive/readily available unemployment benefits) or (ii) ensuring there is no lasting decline in production capacity (guarantee on business debt). That cannot be inflationary. The monetary stimulus works by making the fiscal support financially sustainable. The private sector is highly unlikely to engage in "runaway borrowing" because of QE.

Looking ahead, should policy support be "unplugged" quickly once the lockdowns are over? We don't think so. The hike in public debt will be permanent and sustainability will still need to be protected. This calls for prolonged accommodative monetary policy. Besides, demand may well be "shell-shocked" for a long while after the lockdowns are over. This may take some pump priming. Fiscal policy will have to be able to continue helping.

Country/Region	What we focused on last week	What we will focus on this week
	• Fed cut FFR to 0-0.25%, started $700bn QE, and relaunched facilities to support commercial paper and money market funds. • NY and Calif urged people to stay at home • Jobless claims rose 70k to 281k (highest ex-hurricane since 2016) in latest week • Biden won Az, Fl and Ill primaries	• Liquidity conditions in US markets. • Further policy action with likelihood of ~$1.5tn government stimulus and additional Fed QE. • Jobless claims, fears of a sharp rise in claims as economic disruption mounts. • Feb consumer spending and PCE inflation
	• In a surprise move the ECB announced an additional EUR 750bn of QE, with flexibility across jurisdictions and between public and private assets; capital key are now mere reference values. • German Flash IFO shows record plunge in expectations, business climate at a 2009-low	• Flash March PMIs are likely to follow the ZEW and IFO and show sharp plunge in sentiment • The weekly call on joint fiscal response of EU's leaders might give interesting headlines, especially after last week rumours on potential attempt to work on Eurobonds
	• In unscheduled meeting BoE cut Bank Rate by 15bps to 0.10%, restarted £200bn QE and launched Commercial Paper funding scheme. • Chancellor announced further £20bn fiscal stimulus, £330bn loan guarantees. • Employment growth solid at +184k 3-month to Jan pre virus. Unemployment rose to 3.9%	• BoE scheduled meeting. No expectation of further easing. Minutes to this and unscheduled meeting published. • Preliminary PMIs for UK economy to give first official estimates of scale of impact in Q1/Q2.
	• As expected, the BoJ announced an increase in ETF purchases (Y12tn per year from 6) and some lending facilities. No rate cut. • Tankan DI fall to an 8 year low. • February trade data showed a major drop in imports (-14%yoy) and exports stuck in negative territory for the 15th month.	• March Manufacturing PMI Flash • CPI Tokyo is a good proxy for national index, already low in February (+0.5%yoy from 0.7%). • February chain store sales is likely to drop as a consequences of low inbounds tourist.
	• Jan-Feb data shows unprecedented weakness, foreshadowing a sharp contraction in Q1 GDP • New local virus infections fell to zero for the first time, but imported cases on the rise	• Expect economic resumption to continue as virus containment makes further progress • Policy easing will continue, although substantive measure will likely be announced at the NPC in April
	• EM assets saw massive outflows. EM equities are now down 20% year-to-date, hard currency debt spreads widened significantly (above 500bp). • EM central banks are using all tools to limit the damage towards the real economy: rate cuts, liquidity injections and FX interventions. • Polish CPI rose to 4.7% in Feb, fall in oil price should grant an upcoming slowdown in trend.	• Taiwan, Indonesia, Philippines, Turkey and Russia central banks to meet. Policy easing ahead. • Chile Q4 GDP is expected to have contracted as the social unrest likely weighed on both demand and supply.

Upcoming events	US:	Tue: mfg, servs, comp PMIs, new home sales; Wed: durable goods orders, FHFA house price index; Thu: final Q4 GDP, trade balance, initial jobless claims; Fri: PCE indices, Michigan consumer surveys
	Euro Area:	Mon: Ez consumer confidence; Tue: Ez, Fr, Ge mfg, servs, comp PMIs; Wed: Ge Ifo surveys, France jobseekers total; Thu: ECB economic bulletin; Fri: Fr, It consumer confidence, It business confidence
	UK:	Tue: mfg, servs, comp PMIs, CBI industrial trends; Wed: CPI; Thu: retail sales, BoE MPC meeting; Fri: nationwide house price index
	China:	
	Japan:	Tue: mfg, servs PMIs, leading index, BoJ core CPI; Thu: Tokyo CPI

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