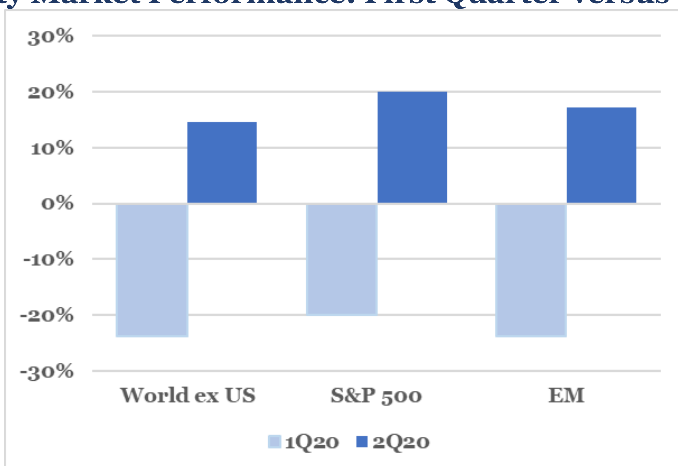
Could the Pandemic Lead to Decoupling of Global Economies?

The year 2020 has already been momentous in many ways. The equity market performance in the first quarter was one of the worst quarters in multiple decades marking the end of the longest equity bull market in the US history. By contrast, the sharp reversal in the second quarter, if sustained, could imply the end of one of the shortest bear markets (Exhibit 1). Furthermore, while negative interest rates are a familiar economic phenomenon, negative oil prices were unheard of until April 20 when West Texas Intermediate dipped to approximately -$37. Another unprecedented event occurred when the car rental company Hertz Global Holdings Inc, which had declared bankruptcy on May 23, asked the bankruptcy judge to let it sell $1billion of new shares! Last, but not least, the civil rights movement has taken a global scale with Black Lives Matter protests not only in the US cities, but also in London, Paris, Berlin, and Tokyo.

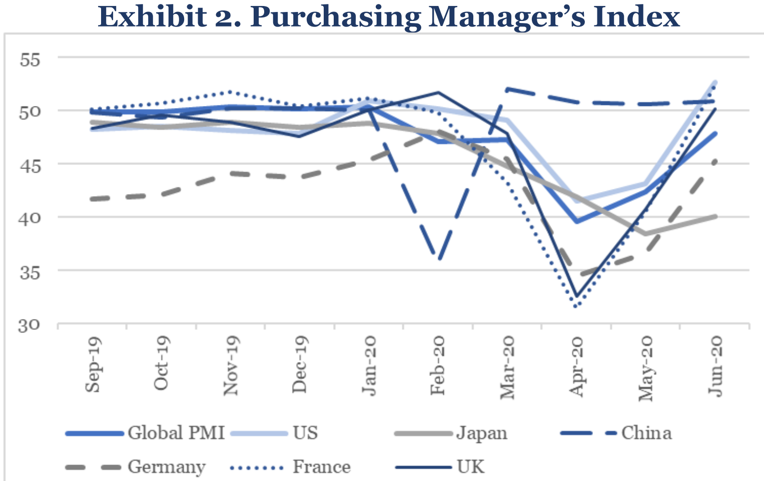
Exhibit 1. Equity Market Performance: First Quarter versus Second Quarter



Source: Bloomberg

Meanwhile, the novel coronavirus, that had led to a lockdown of one-third of the world population in April, has infected nearly 12 million people and has claimed more than half a million of those lives, according to Johns Hopkins Coronavirus Resource Center. The sudden halt in economic activity took a toll on global economies as demonstrated by the global PMI data in Exhibit 2. China went into lockdown in February and hence, the PMI decline was experienced earlier than in other regions where the lockdown started in mid-March and into April.

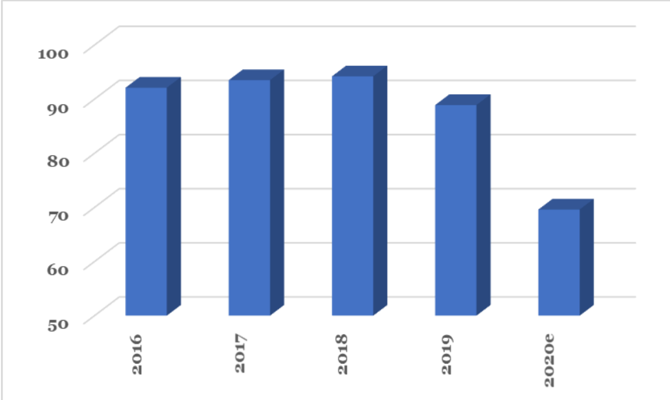
Exhibit 2. Purchasing Manager's Index



Source: Bloomberg

The widespread economic toll can be observed in other macro data as well. By the middle of April, the US had wiped out all 22m jobs that had been created since the Global Financial crisis. The International Labor Organization estimates that, globally, the decline in work hours in the second quarter is likely to be equivalent to the loss of more than 300m full-time jobs. Similarly, IHS Markit lowered global auto sales volume to decline -22.4% from the prior year to 69.6m units in 2020 (Exhibit 3). In comparison, the two-year peak to trough decline during the Global Financial crisis in 2008 and 2009 was -8%.

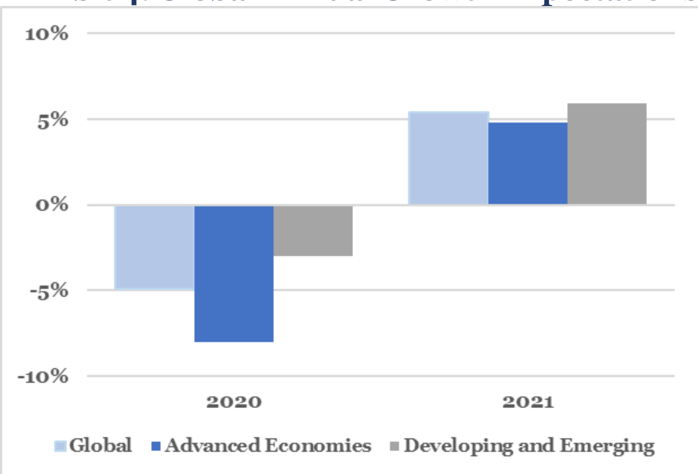
Exhibit3. Global Auto Sales (millions of units)



Source: IHS Markit

The IMF recently downgraded global growth forecast to -4.9% for this year, down from -3% in April (Exhibit 4). However, next year's global growth is expected to be 5.4%. Advanced economies GDP is expected to decline -8% in 2020 followed by a rise of 4.8% in 2021, while GDP growth numbers for emerging markets and developing economies are expected to be -3% in 2020 and +5.9% in 2021. The key difference between the Global Financial Crisis and the current downturn is that Emerging markets are also expected to be negatively impacted this time. Also, these projections come with a higher-than usual degree of uncertainty driven by the unpredictability of the impact and duration of the coronavirus.

Exhibit 4. Global Annual Growth Expectations



Source: IMF

Hence, this has not been a normal cycle triggered by the bursting of a financial bubble, a banking crisis, real estate collapse or excessive monetary tightening. This is a recession caused by social distancing and a lockdown to slow the spread of the coronavirus. As economies have started re-open, economic activity has picked up. Consequently, global PMI bounced back to 47.8 at the end of the quarter (Exhibit 2). While this is still below the 50 range prior to covid-19, it marks a V-shaped recovery so far. Even the equity markets are up erasing most of the losses from the first quarter.

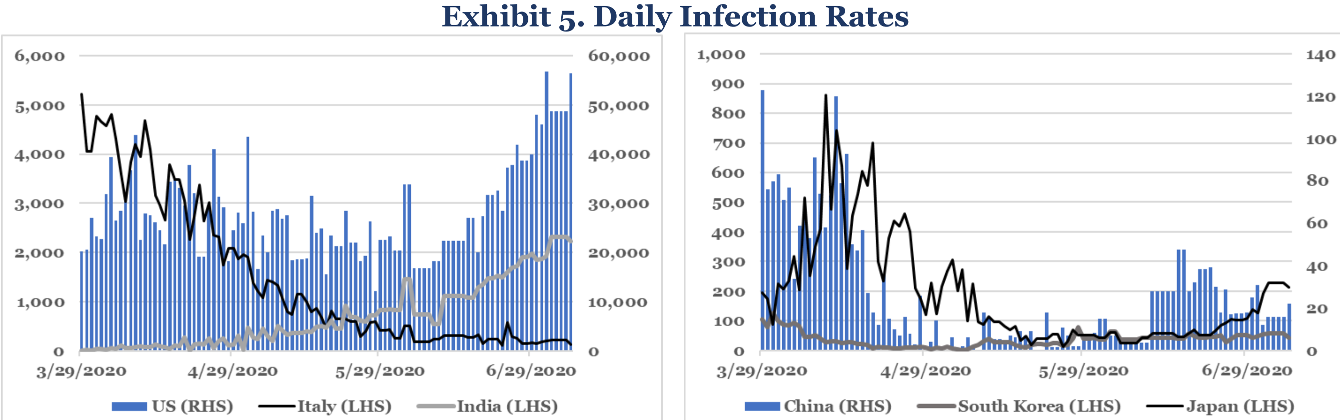
In addition, the USD dollar and the VIX index are both down, indicating a risk-on investment tilt. Is the equity market rally justified and is the recession behind us?

It is possible that the equity markets may have risen too much too fast, but there are reasons to believe that equities will perhaps not break the recent lows. We believe there are three reasons. First, although the economic shock from the pandemic was unprecedented, so too were the policy responses providing fiscal and monetary stimulus. The Fed balance sheet has expanded almost 70% since the end of February while the ECB has increased about 35%. Similarly, fiscal stimulus has ranged as high as 40% of GDP in Japan. Meanwhile the IMF has already agreed on programs to help 72 countries.

Secondly, jobs are coming back as economies have started to re-open. US unemployment rate has improved to 11.1% from a much higher level in the April, as employment rose by 4.8m in June. Similarly, EU unemployment rate has increased to 6.7%, but it is still below expectations. Current unemployment rate in the UK is 3.9%. However, it is quite possible that some of the lost jobs are never regained due to structural changes.

Third, as retail stores closed, and travel and tourism ground to a halt, households were left with fewer opportunities to spend thus boosting savings rates. In the US, the personal savings rate - defined as gross saving divided by gross disposable income - surged from 7.9% at the start of 2020 to more than 32% in April, before receding to 23.2% in May, according to the Bureau of Economic Analysis. The eurozone household savings rate rose to 16.9% in the first three months of the year, up from 12.7% in the previous quarter and the highest since records began in 1999, according to Eurostat data. In the UK, savings ratio rose to 8.6% in the same period, from 5.4% in the same quarter a year earlier. As savings ratio has increased, bank deposits have also surged. The sharp rise in household bank deposits in the eurozone suggests increased savings continued for much of the second quarter. In the three months to May, euro-zone households increased bank deposits by €71bn a month on average - more than double the same period last year. Although consumers have saved firepower, will they be back as economies reopen?

Exhibit 5. Daily Infection Rates

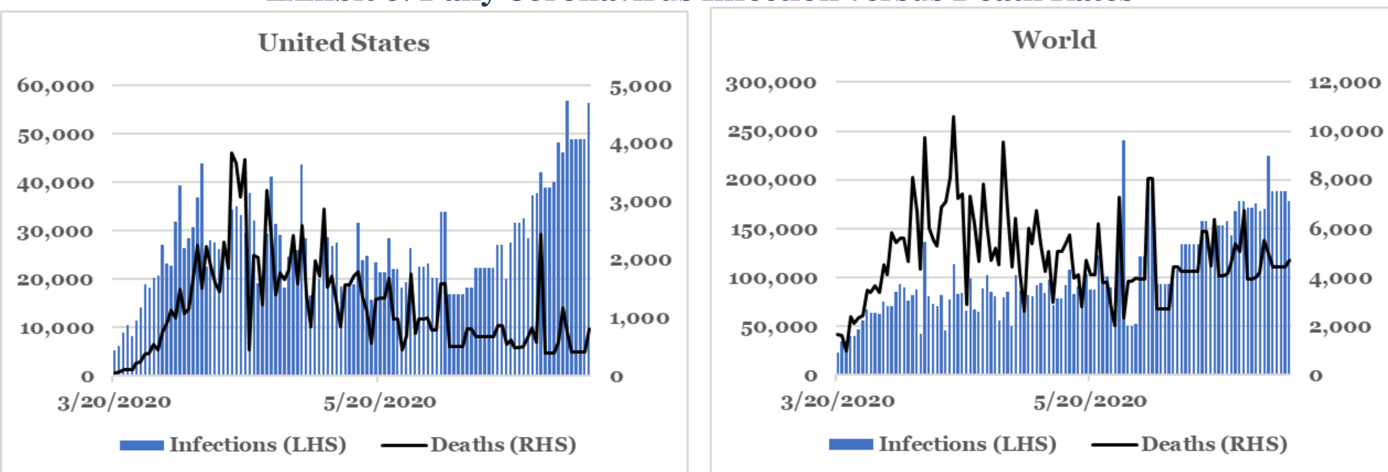


Source: Johns Hopkins University

We believe that whether these green shoots last will depend on whether the economies can resume normal activity and stay open. After all it is the not the virus, but the fear of the virus, that has led to an economic downturn. After one round of lockdown, a need for another lockdown could be economically devastating. Hence, we believe the effectiveness in controlling the spread of the coronavirus – be it through testing and contact tracing or by other means - will determine the path to recovery, until a vaccine or therapy is widely available. Countries that are successful in controlling the spread of the virus and can function at close to normal levels will see higher economic growth. Countries where the virus continues to be a problem will likely be disadvantaged and decouple.

Unfortunately, the coronavirus infection has resurged in many cities and countries around the world (Exhibit 5) as they have reopened. The United States, in particular, has experienced a resurgence in covid-19 with record new cases on a daily basis, and to the point that many states have had to roll back reopening.

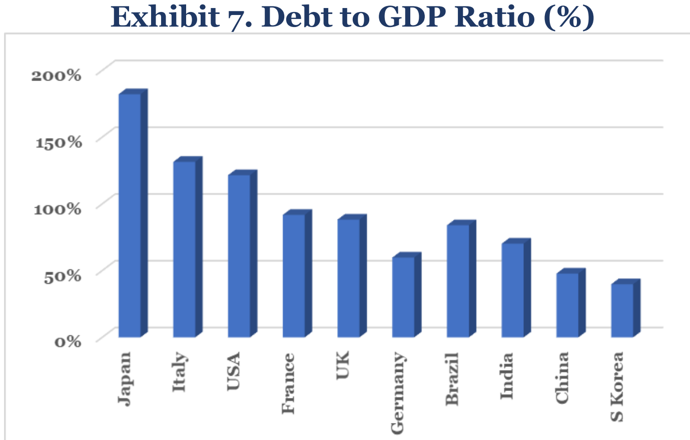
Exhibit 6. Daily Coronavirus Infection versus Death Rates



Source: Johns Hopkins University

By contrast, Europe has quietly made progress even with lockdown easing. Similarly, Japan, Taiwan, South Korea, Thailand, and China, have demonstrated the ability to keep a lid on the virus spreading - perhaps due to their experience with SARS in 2003. However, other Emerging countries such as India, Mexico and Brazil are falling behind. One positive development with the resurgence is that death rates have declined as the virus has spread to younger population (Exhibit 6). However, the death rate is a lagging indicator and thus it is too early to conclude that the coronavirus has become less fatal.

Exhibit 7. Debt to GDP Ratio (%)



Source: Bloomberg, Reuters, CEIC

Countries can continue to use expansionary monetary and fiscal policies to offset the negative economic impact from the virus, as they have done so far this year. However, as presented in Exhibit 7, many countries already have high debt levels, and these are expected to rise further as debt increases while GDP declines by the end of 2020. Meanwhile central bank balance sheets have also expanded at unprecedented levels. Hence, the virus progress will determine how much policymakers rely on fiscal and monetary policies to maintain current growth trajectory. Over-reliance on policy stimulus today poses an even bigger risk to consider when the central banks start reigning in monetary policy and the debt buildup must be paid down. However, that is a question for the future. Currently, we wonder if the lack of success the United States has had in containing the coronavirus, which restricts economic activity, combined with lofty valuations, have finally tipped the equity markets' scales in favor of non-US equities - a trend that has been a long time in coming but, accelerated by the pandemic.