Market and economic insights

Recovery by 2022? It's fiscally possible

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Multi-Asset Solutions, EMEA

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BMO's global multi-asset team typically gathers every September to discuss and update our three- to five-year outlook. With Covid-19 preventing our usual in-person meeting, and with the rapidly changing macro outlook presenting important thematic ideas, we are holding a series of virtual mini-forums on key topics. In our second session, the debate focused on why the global economy may pull out of Covid-driven recession more quickly than consensus believes.

The global economy could return much more quickly to pre-virus levels of GDP than was seen in the aftermath of the financial crisis of 2008. Back then, it took seven years in Europe and three and a half in the U.S to regain lost output. This time around, it could just be two.

There are six critical determinants of how much growth will actually be lost in the current contraction.

1 How much do business models change?

It's fashionable in every recession to say that there will have to be a fundamental change in business models. While out of consensus, maybe business models will not be so different in the future. Of course, there's going to be a need to diversify supply chains as opposed to bringing them onshore, particularly with regard to medical equipment. But bearing in mind this is a global virus, it would not have helped that much to diversify that supply chain outside China. Indeed,

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having a Chinese supply chain currently is an advantage given that China has been the first major economy to reopen. If anything, companies will need to be smarter with inventory management rather than obsessing with 'on-shoring'.

2 How much do bankruptcies rise?

When businesses start to go bankrupt, it is naturally much harder for an economy to recover. In response to the massive pressure on companies' finances, what has been impressive is the scale of loan guarantee schemes.

In contrast to the Global Financial Crisis (GFC) and, given that Covid-19 is an exogenous shock, governments and central banks appear to be unconcerned over moral hazard. They are deploying seemingly unlimited financial firepower to help keep companies solvent and to stem the rise in unemployment.

A further reason that bankruptcies could remain limited is that corporate lending conditions remain relatively easy, and in the case of the eurozone they are expected to ease further. This will be particularly important for the region because 70 per cent of corporate lending is undertaken by banks.

Finally, insolvencies should be relatively muted compared to earlier fears because many countries are changing legislation to protect corporate failures. Indeed, in the UK we are almost starting to see accommodative 'chapter 11' style creditor arrangements come into play.

3 Can fiscal easing offset falling consumer confidence?

The boost to people's financial well-being of fiscal easing is greatly underestimated. Broadly speaking, there is a lack of appreciation of how generous welfare benefits are and how encompassing the social security safety net is. In the U.S. individuals can receive nearly $1000 a week on benefits and can still apply even if they are part-time workers or a member of the 'gig' economy.

In most major regions, the take-up of unemployment benefits has been three-times greater than expected. In the UK, for example, the furlough scheme started out costing £10 billion. Now the taxpayer's bill is likely to exceed £80 billion. It's another example of governments throwing moral hazard to the wind. If the policy isn't enough to protect employment and consumer spending, then we may simply get more of it.

The financial largesse of governments has, incredibly, seen a spike in disposable incomes of consumers and a similar jump in savings ratios. Importantly, history has shown the ratio to be sensitive to sharp rises in household debt prior to a recession. While this was ballooning in the run-up to the GFC, it was shrinking as we approached the current crisis.

4 Will pre-existing problems set off further crises?

There were arguably three pre-existing problems hanging over the global economy as we entered 2020. The first was private sector leverage in China. We know that China accounts for nearly two-thirds of the increase in private sector leverage globally since 2010. By any ordinary standard, the country has seen an extraordinary credit bubble, which has fuelled a frenzy of investment and super-heated the property market. However, history would suggest that credit bubbles, when combined with a property bubble, do not unwind until there is a drop in property prices. At the moment, property prices for Chinese developers are showing little sign of meaningful declines.

The second pre-existing issue is Italy, a country which is suffering its fourth recession in 12 years. Remarkably, even before the virus took hold, GDP per capita was two per cent below 2000 levels. And with house prices falling consistently, it is little wonder that the social backdrop has become toxic. Italy has been a major destabilising factor for the EU for some time and there has been a looming threat of the country leaving the EU in the event of a severe European recession or the ECB hiking interest rates. But now with ECB rhetoric indicating that it is going to stand by the country, we can afford to be more sanguine and accept that, at least for the moment, an Italian crisis is off the table.

The third problem is the scale of corporate debt in the U.S., which as a share of GDP was already at peak levels at the turn of the year. We should nevertheless not be too concerned. Interest charged to EBITDA (earnings before interest, taxes, depreciation and amortisation) is at average levels and any credit with a

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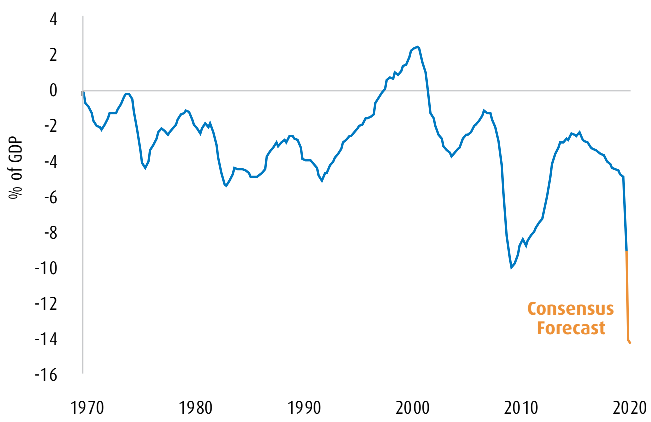
BBB or higher rating has seen a fall in the cost of debt over the year to date. But while we can expect some modest corporate deleveraging in the U.S. we should remain mindful that investment could once again pick up if the rate of GDP growth and capital utilisation accelerates.

5 Will there be a second lockdown?

A second lockdown would have deeply damaging economic consequences. However, the evidence of very low mortality rates across most of the population from Covid-19 should mean that, in the future, wholesale lockdowns can be avoided. It could also be the case that the true mortality rate is considerably below current estimates. But the more important point is that, as suggested by the Office for National Statistics, just one per cent of virus-related fatalities are under 40 years of age and only eight per cent are under 60. The overwhelming majority of fatalities had prior underlying health conditions.

US Budget Balance



Source: Bloomberg, BMO Global Asset Management, Jun-20.

Of course, every death is tragic, but it appears that the risk is sufficiently small for getting most under 60s back to work. Moreover, ongoing improvements in testing and treatment should keep the reinfection rate down.

The job of the politicians in protecting their citizens is to weigh risk against reward. Helpful to this end is the experience of those places that opened up the earliest (for example Korea, China and some U.S. states), where infections have been kept encouragingly low. In the likely scenario of a secondary pickup in infections, it would appear reasonable to follow the Swedish model and avoid a national lockdown in favour of local lockdowns benefiting from improved treatment and testing.

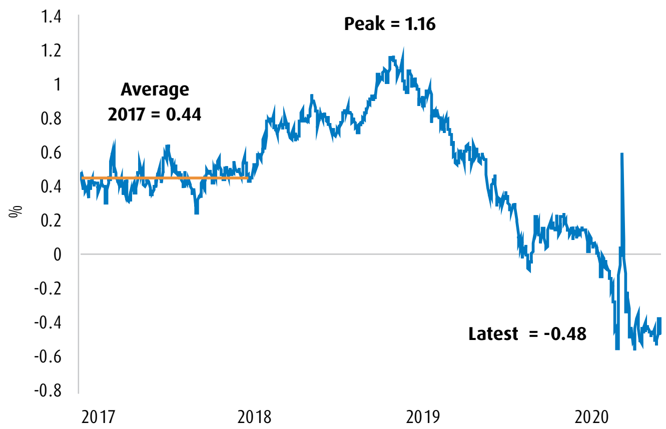
6 The stance of policy into the recovery.

The principal reason the world economy could emerge from the current downturn much more quickly than after the GFC is the politicians' embrace of fiscal spending. One of the reasons for the eurozone's laboured recovery from the last crisis was an early tightening of fiscal policy. The story was similar elsewhere. Indeed, it is calculated that, in the two years from 2011, fiscal tightening cost the global economy two per cent of GDP.

The big difference this time around is that we are likely to get easy fiscal policy well into the recovery. And as budget deficits have surged to record levels, politicians no longer live in fear of bond vigilantes forcing fiscal orthodoxy. We should also consider that, unlike a decade ago, the policy makers have the intellectual cover of modern monetary theory, which conveniently says 'print and spend until inflation rises', which still seems some way off. Government debt to GDP in both the US and UK looks likely to rise to the highest levels seen since WWII. Governments cannot tax the wealthy and corporates too much because without capital controls, they can move. There is likely to be a period of extended negative real rates requiring much of this crisis to be paid for by inflating away the debt.

On the subject of inflation, there will most likely be a deflationary shock in the short term, which is something to be expected in the wake of a recession as the wage share of GDP falls. However, this time the fall could be relatively moderate because of legislation on minimum wages. Other factors are inflationary, such as looser bank lending conditions, the prospect of oil price rises and the impact of de-globalisation.

Yield on 10 year US inflation protected security



Source: Bloomberg, BMO Global Asset Management, Jun-20.

This time, central banks will be willing to accommodate higher inflation because, unlike April 2011 when the ECB and the Bank of Japan raised interest rates, all the major banks are prepared to tolerate an inflation overshot to compensate for an undershoot. The danger, however, is that inflation picks up to a level that is unacceptable to central banks before employment has recovered to satisfactory levels.

In conclusion, it would seem fair to argue that the global economy will fall short of the hoped-for v-shaped recovery, but not by as far as consensus is telling us. There is no established correlation between the depth of recession and the time it takes to recover fully from it. This is because the most important determinant is policy. On this occasion, the unprecedented fiscal response of governments, allied to easy monetary conditions, could well see the global economy returning to its pre-virus growth rate by as early as mid-2022.

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