Monthly Letter

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Economic environment

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In all likelihood, a global recession is no longer in doubt. Indeed, many countries have been forced to implement increasingly stringent measures to slow the spread of COVID-19, from social distancing to strict containment. According to the OECD, each month of containment causes an average loss of -2 percentage points in annual GDP growth. The ultimate impact will depend on the magnitude and duration of isolation, but also on the extent of the destruction of demand and value chains. Investors are therefore flying blind regarding the hit to corporate earnings and profitability, even though most still anticipate a sharp but brief plunge of economic activity.

According to the latest business confidence surveys, the service sector is contracting more sharply compared to manufacturing, since containment particularly affects industries such as catering, hotels and tourism. Consequently, the overall impact will be heavier as services have a preponderant weight in our modern economy. Faced with a self-inflicted shock, governments have provided emergency aid to their economies. Japan, along with South Korea, is one of the countries that has handled the current health crisis best. Nonetheless, it was presumably already in recession prior to COVID-19 and is now facing a depressed global environment, in addition to being forced to postpone the Olympic Games which were to be held in Tokyo next July. The Abe government has thus announced its intention to launch a fiscal stimulus plan representing nearly 10% of its GDP, a third of which would represent direct transfers to households and businesses.

According to most epidemiologists, the chaotic management of the pandemic in the US by the Trump administration could lead to the most serious health crisis among developed countries. Meanwhile, Congress was able to agree on a USD2,000bn package, or about 10% of GDP. The plan includes income transfers for certain taxpayers, as well as an increase in unemployment benefits for a period of four months. The job market has deteriorated sharply as 3.3 million people have filed for unemployment insurance. By comparison, unemployment claims had peaked at just over 650,000 people during the 2008/09 financial crisis, demonstrating that the speed and magnitude of the worsening US labor market is second to none from a historical point of view.

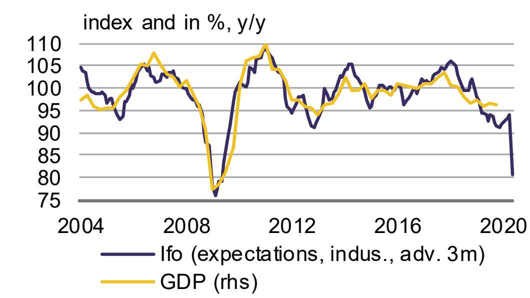
While the US stimulus is undeniably large, the comparison with the different plans in Europe must however be put into perspective. Indeed, only half of the stimulus represents a direct injection into the economy, the other part being linked, for instance, to guarantees or loans for the most affected sectors. In addition, the social safety net in the US is more tenuous compared to social programs in Europe, not to mention a healthcare system where nearly 27 m Americans are without insurance. Therefore, the plan was designed to overcome a system of limited social protection.

Performances in local currency

	Price as of 03/31/20	1 month % change	2020 % change
Equity markets			
CAC 40	4 396	-17.2%	-26.5%
Eurostoxx 50	2 787	-16.3%	-25.6%
S&P 500	2 585	-12.5%	-20.0%
Nikkei 225	18 917	-10.5%	-20.0%
Currencies			
1 € = …USD	1.10	0.0%	-1.6%
1 € = …JPY	118.64	-0.3%	-2.6%

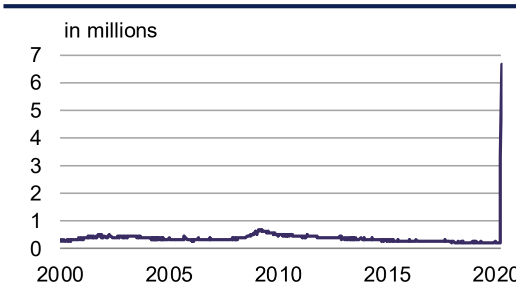
		Price as of 03/31/20	1 month bp	2020 bp
	Government bonds			
3 M	Eurozone	-0.49%	11	14
3 M	United States	0.06%	-121	-148
10 Y	Eurozone	-0.47%	14	-29
10 Y	United States	0.67%	-48	-125

Germany – Confidence and growth



Source Macrobond, Rothschild & Co Asset Management Europe

US – Unemployment claims



Source Macrobond, Rothschild & Co Asset Management Europe

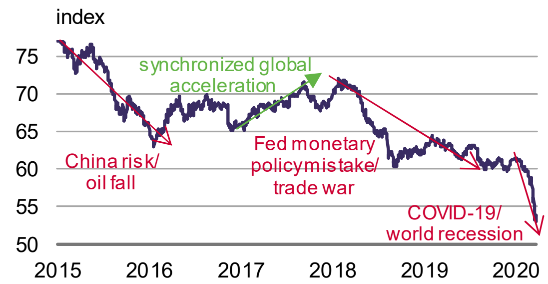
Undoubtedly, the question of sovereign debt sustainability will arise, not only for the US but also for all countries whose fiscal deficits will quickly worsen due to the fall in revenues and the jump in expenses. However, for now, central banks have decided to do everything possible to allow governments to intervene without constraint and to ensure the proper functioning of the financial system.

Indeed, the spread of the virus as well as its consequences on economic activity have caused high volatility in financial markets. Equity indexes fell and credit spreads widened, particularly in the high-yield segment, hitting corporate sources of financing. For instance, the Fed's unlimited liquidity injections via the extensive emergency credit facilities, unlimited QE and repo operations, as well as extended dollar swap lines have lessened stresses across a wide swath of the credit market. This includes investment grade corporate bonds, commercial paper and mortgage-backed bonds. Finding ways to restore liquidity and unfreeze these vital portions of the financial market is critical to staving off a full-blown credit crunch that would deepen the economic downturn and endanger the economic recovery.

Meanwhile, the price of oil has collapsed, penalized both by a fall in demand and an increase in supply orchestrated by Saudi Arabia. This will support consumers' purchasing power, but the price correction's speed will also add to financial stress as many producers will go bankrupt. In emerging countries, currencies depreciated sharply against the USD amid massive capital outflows, which will weigh on the private sector's ability to service USD denominated debt.

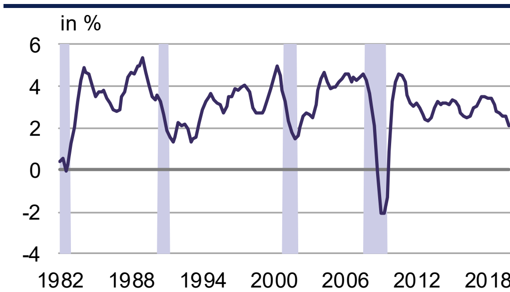
In short, recession is inevitable and is part of the treatment of the health crisis. However, it will have very serious consequences on global supply and demand. The economic policy response has certainly been very rapid, but it has proven to be proportional to the challenge of a deep recession hitting an already weak global economy, running at a mere 2% y/y, coupled with uncomfortably low inflation. Correspondingly, the end of the crisis promises to be highly complex. Budgetary and monetary support measures aimed at encouraging part-time unemployment rather than layoffs, deferring corporate costs (taxes, rents) and avoiding credit rationing are all elements that will help prevent a shock a priori temporary to cause permanent damage. However, until the population is reassured about the evolution of the pandemic, it is rather illusory to hope it will produce, spend or travel as if nothing had happened. In that regard, reports from China have suggested that a county in Henan has been asked to stay at home following news that there were infection cases due to a doctor returning from Wuhan having the virus and already spreading it to his colleagues. It's unclear if this is a one-off, but if this is a re-surge of cases particularly as mobility picks up, then clearly there is the risk of lockdowns again.

EM countries – Exchange rate vs. USD



Source Bloomberg, JPM, Rothschild & Co Asset Management Europe

World – Economic growth



Source Macrobond, Rothschild & Co Asset Management Europe