Monthly Letter

June 2020

Economic environment

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Outside China, available activity readings point to a sharp and historic decline in global GDP in Q2 2020. Yet, stock markets have recouped almost two-thirds of the total losses in the post-February crash, as the magnitude of this quarter's GDP slide did not diminish investors' belief that global growth would rebound strongly in H2 2020 as containment policies are eased. Correspondingly, two key questions will likely determine if market participants are complacent or far-sighted: the speed of the recovery and the nature of the post Covid-19 new "normality".

During lockdowns, consumers were forced to delay purchases, creating a backlog of buyers – pent up demand – on the market that will suddenly be unleashed as the economy reopens. While the pickup in household spending will lead to a rebound in global growth, some factors might nonetheless limit the recovery in consumption and lead to an incomplete recovery in global GDP. Mobility restriction has been relaxed, but with only a few countries able to implement an extensive testing and contact tracing regime, mobility will not be able to approach pre-lockdown levels without threatening a second wave of the virus. Business confidence improved somewhat in May, although it remains at depressed levels. For instance, in the eurozone, the Markit index rose from an all-time low of 13.6 in April to 30.5 in May, but continued to indicate a rate of contraction in excess of anything seen before the Covid-19 outbreak, the prior low being 36.2 last seen in February 2009 during the peak of the global financial crisis.

Meanwhile, although governments are ensuring that credit is available and cheap and temporary support measures have preserved jobs, weaker business balance sheets will likely slow the healing of labour markets during the initial phase of the recovery and the improvement in hiring is likely to be limited. Furthermore, the global fiscal stimulus has focused on cushioning household incomes, yet most programs are temporary, and some will expire before the end of this year which will mechanically lead to an early tilt toward tight policies, starting in the autumn of 2020.

In addition to the speed of the recovery, the nature of the new normality is also open for debate. The peculiarity of the current health crisis is that it is both a supply and a demand shock. On the former, the impact on businesses could lower potential GDP growth for three main reasons. Firstly, key industries – namely aeronautics and automotive – will be facing a challenging environment. If history is any guide, large industrial sectors disruptions tend to weigh on potential growth partly because it leads to inefficient labour markets caused by mismatches between available jobs and the skills of people looking for work.

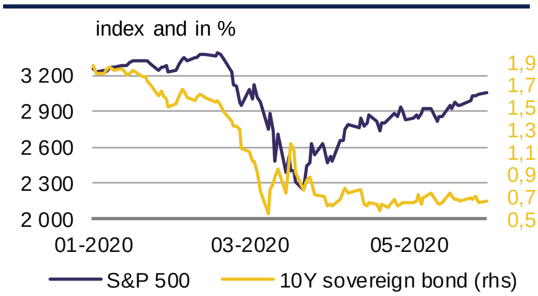
Secondly, private debt post Covid-19 will be such that the global economy could show signs of Japanisation, with zombie firms

Performances in local currency

	Price as of 05/29/20	1 month % change	2020 % change
Equity markets			
CAC 40	4 695	2.7%	-21.5%
Eurostoxx 50	3 050	4.2%	-18.6%
S&P 500	3 044	4.5%	-5.8%
Nikkei 225	21 878	8.3%	-7.5%
Currencies			
1 € = ...USD	1.11	1.3%	-1.0%
1 € = ...JPY	119.77	2.0%	-1.6%

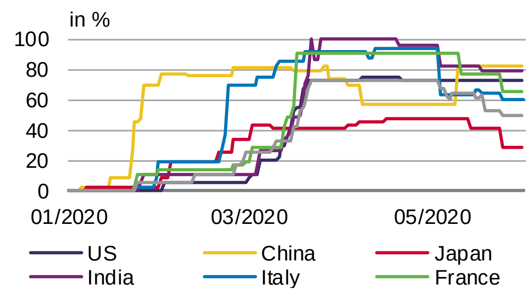
		Price as of 05/29/20	1 month bp	2020 bp
Government bonds				
3 M	Eurozone	-0.52%	0	12
3 M	United States	0.12%	5	-142
10 Y	Eurozone	-0.45%	14	-26
10 Y	United States	0.65%	1	-126

US – S&P 500 and sovereign bond



Source Macrobond, Rothschild & Co Asset Management Europe

World - Covid-19 mobility restriction



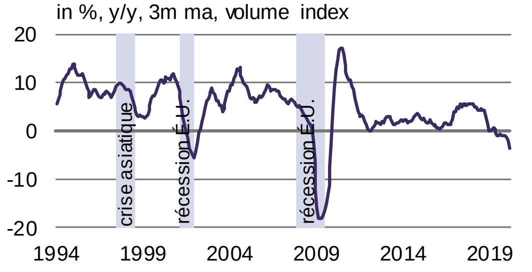
Source Macrobond, Rothschild & Co Asset Management Europe remaining in activity only thanks to ultra-low interest rates and public support, and the lack of creative destruction could lead to lower productivity growth.

Finally, the process of deglobalisation could accelerate. When the crisis began earlier this year, an increasing number of supply chains were seizing up or stalling and many factories had to cut or cease production for lack of vital components from China, where manufacturing has been halted. The virus might lead to greater national emphasis on production, including the field of medical supplies, as the crisis revealed, for instance, Europe's dependence on medicines manufactured in China and India. What's more, the contagion has been so widespread largely because of human hyper-interconnection and borders are staging a comeback, even in the European Union.

At the same time, even before the pandemic, global commerce had been hit by trade wars, namely between the US and China as the world's two largest economies are clashing on a range of issues from trade to Taiwan. Tensions escalated further after the National People's Congress approved national security amendments to Hong Kong's Basic Law in late May, implying a significant risk that the US will withdraw Hong Kong's special status as a separate customs territory for trade and economic purposes. In fact, China will likely be a major issue in the 2020 US presidential election as both Republicans and Democrats are adopting the hard line, although from different angles, which could lead to more global uncertainty.

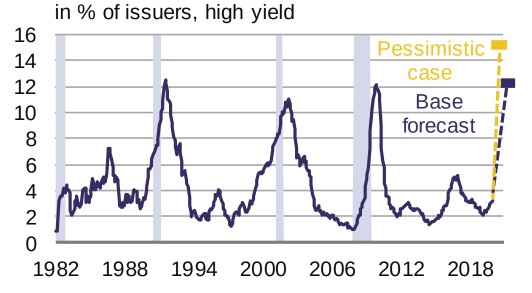
Overall, while sovereign yields signal the economy might remain lacklustre for a prolonged period, equity investors seem convinced policymakers have pre-emptively short-circuited a recessionary feedback loop and that stimulus will be enough to bridge consumers and businesses. Yet, rating agencies have been forecasting a classic recession scenario, accompanied by a typical surge in bankruptcies. For instance, S&P saw both an increase in defaults as well as a historically high number of downgrades and negative outlook in April, as a result of Covid-19 and the acute stress in the oil sector from collapsing prices. Therefore, the US high-yield corporate default rate is expected to increase from 3.5% to 12.5% by March 2021, surpassing the peak reached during the last two recessions. The shape of the recovery is certainly up for debate, and the jury is still out. For now, Wall Street is flourishing will Main Street is suffering, but the more market participants ignore economic and business fundamentals and rely on central banks largesse, the more they risk facing a less rosy immediate future.

World - Trade



Source Macrobond, Rothschild & Co Asset Management Europe

US – Default rate



Source S&P, Rothschild & Co Asset Management Europe