Monthly Letter

July 2020

Economic environment

Marc-Antoine COLLARD
Chief Economist, Director of Economic Research

Lockdown measures to suppress the COVID-19 pandemic have led to a historic synchronized global recession. Economic growth in Q1 2020 was generally worse than expected and high-frequency indicators point to a more severe contraction in Q2, except in China where most of the country had reopened by early April. Looking ahead, investors seem convinced the recovery is getting underway with a bang as they foresee a record-setting surge in GDP in H2 2020 followimg a record-setting plunge in H1. Indeed, sizeable fiscal countermeasures implemented so far – and anticipated for the rest of the year – proved to be a powerful buffer for the economic activity. Monetary policies have also played a major role in the improvement of investors' sentiment as swift and, in some cases, innovative actions by central banks have enhanced liquidity provision and limited the rise in borrowing costs.

Yet, although most countries have begun to roll back containment gradually and economic data have rebounded accordingly, some restrictions might extend well into H2 2020, causing the recovery to lose steam. Business and household confidence have recovered recently, but nonetheless remain low by historical standards. While policymakers have taken unprecedented steps to support their economies, investors have decided, for now, to turn a blind eye on what the limit is, how all this will be paid for and what the consequences are for long-term financial stability. In fact, there is pervasive uncertainty around the economic outlook.

In the eurozone, the ECB has committed to taking strong action to support the economy and has increased its asset purchases, mainly through the Pandemic Emergency Purchase Programme (PPP) by €1,350bn, with net purchases expected to continue at least until June 2021. In the absence of European fiscal capacity, the fiscal response to the crisis has been so far almost exclusively left to national budgets, with governments adopting measures such as income support to households, tax deferrals, public loans guarantees and short-term work schemes. That said, the unemployment rate is expected to rise in the coming months as employment-subsidy schemes expire, bankruptcies pick up and people return to the labour market. In addition, many rounds of talks between the EU and the UK failed to make significant progress. The UK negotiator David Frost stressed that some of the "EU's unrealistic positions" will have to change in order to find an agreement, while EU negotiator Michel Barnier warned that there were still large gaps between both sides on most areas. As a result, a trade deal by end of the year remains uncertain.

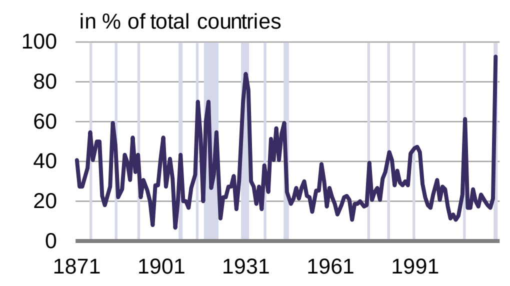
Meanwhile, China's economy is on the road to recovery largely led by the supply side, namely the industrial production. On the demand side, a gradual recovery in household consumption is underway as the economy returns to normal. While the momentum of domestic demand has improved, reduced employment and weak income prospects are weighing on the speed of the recovery.

Performances in local currency

	Price as of 06/30/20	1 month % change	2020 % change
Equity markets			
CAC 40	4 936	5.1%	-17.4%
Eurostoxx 50	3 234	6.0%	-13.6%
S&P 500	3 100	1.8%	-4.0%
Nikkei 225	22 288	1.9%	-5.8%
Currencies			
1 € = ...USD	1.12	1.2%	0.2%
1 € = …JPY	121.24	1.2%	-0.4%

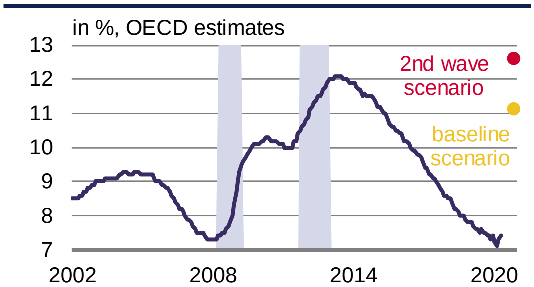
		Price as of 06/30/20	1 month bp	2020 bp
Government bonds				
3 M	Eurozone	-0.52%	-1	11
3 M	United States	0.13%	0	-141
10 Y	Eurozone	-0.45%	-1	-27
10 Y	United States	0.66%	0	-126

World – Countries in recession



Source World Bank, Rothschild & Co Asset Management Europe

Eurozone – Unemployment rate



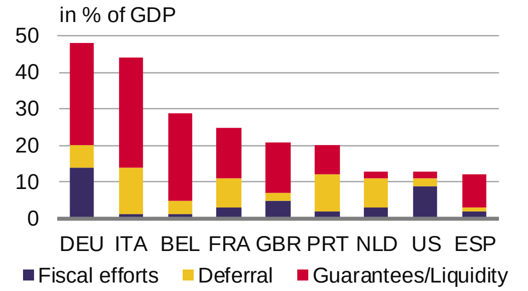
Source Macrobond, Rothschild & Co Asset Management Europe

The outlook for household consumption is also subject to downside risk amid concern over new coronavirus infections in Beijing which raises uncertainty over the possibility of a second wave of cases in China. What's more, the pandemic has had a particularly negative impact on global value chains, resulting in a series of disruptions in backward and forward linkages. In fact, the blurry global economic outlook, the collapse in global trade and signs that tensions in China-US relations are once again mounting all threaten to add downward pressure on China's exports. Overall, although infrastructure investment and moderate monetary easing are supporting China's growth, the process of resuming business has been slow and a quick return to normal remains elusive.

The easing of restrictions was widespread but unfortunately does not reflect the continued success of virus containment policies. In the US, fears of an economic relapse have recently intensified, with the country recording the highest number of new daily infections since the beginning of the pandemic. As a result, some US states have stated that the gradual economic reopening will be halted and restrictions will be renewed as health care capacity is overwhelmed. The risk to the economy is significant as a further deterioration of the health situation could hurt consumer confidence and hence consumption. What's more, with extended unemployment benefits set to expire at the end of July, a failure to provide further fiscal support could constrain income, raising doubts about the sustainability of the nascent economic recovery. The economy has relied on the Fed and Congress to liquefy financial markets, boost asset prices and drive economic growth by avoiding temporary liquidity problems turning into a crippling solvency risk. However, rating agencies have been forecasting a classic recession scenario, accompanied by a typical surge in bankruptcies. The IMF and the BIS recently warned of markets exuberance due to the disconnect between economic and corporate fundamentals on the one hand, and risk appetite on the other hand.

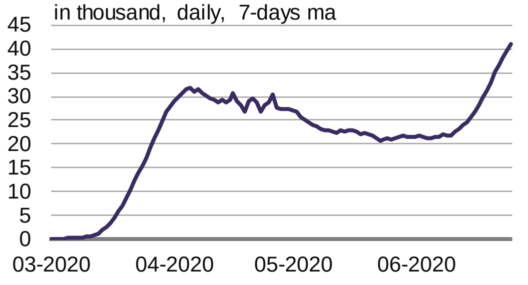
Admittedly, incoming data continue to show an improvement in activity. However, besides the length of the pandemic, several questions remain: How will voluntary social distancing affect spending? How quickly will displaced workers be able to secure employment? How will reconfigurations in the global supply chain affect productivity? In fact, the legacy of the pandemic could be even deeper and more enduring than the great financial crisis of 2008/09. Therefore, a V-shaped recovery is highly uncertain. The risk of a W-shaped recovery has increased due to the sharp acceleration of new COVID-19 cases and the persistence of the shock, which could trigger a tightening of global financial conditions as investors, currently positioned for a quick economic rebound, start pricing in a much slower and bumpier recovery.

World – Fiscal stimulus



Source BdF, Inst. Bruegel, Rothschild & Co Asset Management Europe

United States – COVID-19 new cases



Source Macrobond, Rothschild & Co Asset Management Europe