Monthly Letter

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Economic environment

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The Covid-19 pandemic is inflicting high and rising human costs worldwide. Ensuring health care systems can cope by slowing the spread of the virus has required social distancing and widespread closures, which are having a severe impact on economic activity. In fact, the output loss this year will most likely overshadow the losses that triggered the 2008 Global Financial Crisis. What's more, extreme uncertainty persists regarding 2021, due to the difficulty in predicting factors such as the pathway of the pandemic, the intensity and efficacy of containment efforts, and the extent of supply disruptions and behavioural changes.

The wide variations in economic growth in Q1 2020 among advanced economies — US GDP dropped -4.9% q/q ann., the eurozone -14.4% — can be attributed to the timing of the outbreak. While Covid-19 and the associated lockdowns have put a large dent in Q1 GDP, those same forces will almost certainly generate a much larger decline in Q2, and this dramatic synchronised collapse in global growth poses unique challenges to policymakers.

Correspondingly, tax and spending policies are projected to surpass what was delivered in 2009. For instance, the US Congress has passed trillions of dollars in legislative relief in response to the pandemic, expanding and extending unemployment benefits, sending most Americans a $1,200 check and incentivising businesses to keep workers employed. Meanwhile, central banks have become increasingly innovative and interventionist across different markets. While interest rate cuts have been relatively modest, their balance sheets will rise sharply this year. This is because government securities purchases are expected to enhance the transmission mechanism of the "low-for-long" interest rates policies, while a wide range of credit instruments should improve market liquidity and boost lending. Governments are supporting central bank activities through off-budget loan guarantees. These unprecedented actions have intertwined monetary and fiscal policy.

Overall, these broad-based stimuli and liquidity facilities aimed at reducing systemic stress in the financial system have lifted confidence and bolstered expectations for the eventual economic recovery. That said, liquidity measures cannot completely fix the solvency risk, and one should not lose sight of the fact that these unprecedented policy responses are commensurate with the unprecedented collapse of economic activity.

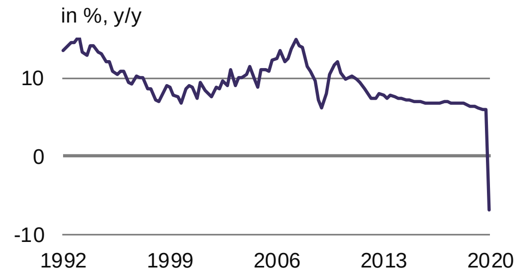
In many countries, public debt will exceed 100% of GDP and, while debt service costs are being contained by low rates, debt dynamics have become unstable. Furthermore, a quick return to normal is highly uncertain. In China, GDP fell an unprecedented -6.8% y/y in Q1 2020 and March activity data suggest the recovery will be long term, with domestic demand still hampered by quarantine curbs, as shown by improving yet still depressed daily indicators.

Performances in local currency

	Price as of 04/30/20	1 month % change	2020 % change
Equity markets			
CAC 40	4 572	4.0%	-23.5%
Eurostoxx 50	2 928	5.1%	-21.8%
S&P 500	2 912	12.7%	-9.9%
Nikkei 225	20 194	6.7%	-14.6%
Currencies			
1 € = ...USD	1.10	-0.7%	-2.3%
1 € = ...JPY	117.42	-1.0%	-3.6%

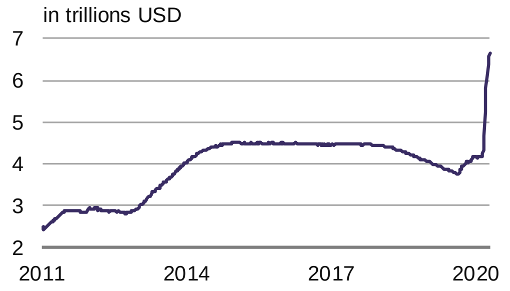
		Price as of 04/30/20	1 month bp	2020 bp
Government bonds				
3 M	Eurozone	-0.52%	-3	12
3 M	United States	0.08%	2	-146
10 Y	Eurozone	-0.59%	-12	-40
10 Y	United States	0.64%	-3	-128

China – Economic growth



Source Macrobond, Rothschild & Co Asset Management Europe

Fed – Balance sheet



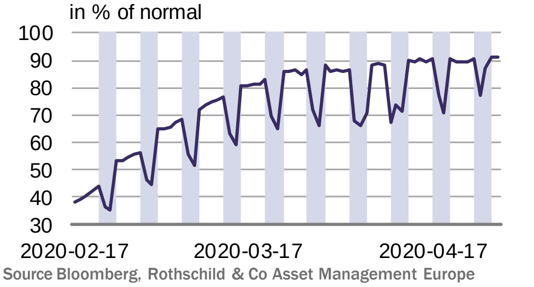
Source Macrobond, Rothschild & Co Asset Management Europe

The pandemic, first reported in China, has been spreading quickly in Europe and then in the US. The WHO has warned the fourth wave will likely strike emerging countries (EM). On the one hand, advanced economies with well-equipped health care systems and the privilege of issuing hard currencies are better placed to cope with this crisis. However, the challenges facing several EMs without similar assets are infinitely greater. These countries experienced the largest capital outflow ever, and almost all currencies slipped against the USD, with commodity-producing economies (such as Brazil, Mexico and South Africa) tumbling by -25% year-to-date, in some cases reaching an all-time low. Overall, the sudden stop in economic activity and portfolio outflows, together with the oil price shock, represent a severe stress test for many EMs, especially as many of them entered the Covid-19 crisis with weaker initial conditions than in 2008. The upshot is that the sharp rebound of the past few weeks in equity markets seems consistent with a seamless return to growth in H2 2020, as investors speculate the pandemic is similar to a natural disaster where the economy collapses, but then more than makes up for the lost output, all the more due to the swift and substantial economic policy actions. However, measures by the central banks and government can't completely modify human behaviour and force people to leave their homes, eat at restaurant and shop at malls. In that regard, Covid-19 could end up being a classical balance sheet-driven recession where stress aggravates pre-existing vulnerabilities, namely the high private and public debt levels. For instance, the ECB stressed the eurozone economy could shrink as much as -12% in 2020 and fail to return to its pre-pandemic size until the end of….2022.

Although mostly absent for now, international coordination seems crucial as uncoordinated confinements raise the possibility that the virus will re-emerge sequentially across the globe. Incidentally, even a country that engineers an effective lockdown will not be immune from insufficient or ineffective policies put in place in other parts of the world. Yet, tensions between the US and China escalated as Secretary of State Mike Pompeo claimed that there was "enormous evidence" that the coronavirus originated in a Chinese laboratory, something Beijing has denied. In this election year, the Trump Administration is discussing options to punish China for the pandemic, with possibly reimposing or expanding tariffs.

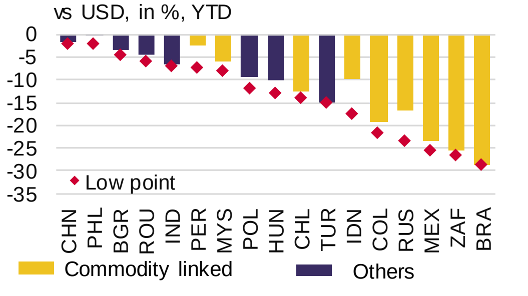
On the bright side, the wildcard is vaccine development comparable in speed to what is occurring with therapeutics, although it is more likely to be medium-term. Nonetheless, many investors seem to be increasingly drawn to the possibility of the fastest-ever development, approval and deployment of mass vaccination, as private sector focus is unparalleled and government financing seems unlimited.

China – Activity economic indicator



Source Bloomberg, Rothschild & Co Asset Management Europe

EM – Currency performance



Source IMF, Rothschild & Co Asset Management Europe