Investec Europe Research Weekly 3 April 2020

Economics | Treasury | Corporate Finance | Private Client Lending

In this, the first edition of our Research Weekly, we take a brief look at economic developments over the past week and we get the latest thoughts from our Treasury and Corporate Finance desks as the world continues to grapple with the outbreak of COVID-19. We have structured the note as follows:

Economic Roundup: Ireland

The pandemic affected economic data came thick and fast towards the end of the week and culminated in some stark analysis from the Central Bank of Ireland. The below is a snapshot of the week's events as they unfolded.

Data indicate an unemployment rate of approximately 17% and rising – Friday 3rd April
Yesterday's Live Register data, combined with new data on temporary COVID-19 related employment support schemes, show that more than half a million people are in receipt of unemployment related benefits.

The Live Register itself showed a 24,400 increase in March to 207,200. However the majority of those whose employment has ceased due to COVID-19 are being facilitated through the COVID-19 Pandemic Unemployment Payment and a remarkable 283,000 people were in receipt of this payment in the last week of March. In addition, 25,100 people were availing of the COVID-19 Wage Subsidy Scheme, introduced by the government just last week. In total, 513,350 were in receipt of unemployment related benefits at the end of March. It is worth noting that the data released yesterday does not translate into an unemployment rate (even the Live Register is not equivalent to unemployment). Indeed, the CSO has postponed the release of its Monthly Unemployment rate so that it can properly evaluate how the new unemployment assistance schemes should be evaluated for statistical purposes. This rate should be available next week and will be adjusted to include those in receipt of the COVID-19 Pandemic Unemployment Payment but not the Wage Subsidy Scheme.

Despite these issues, it is important to try and put the data we have in context. Of course these are unprecedented times, but the scale of these numbers is truly extraordinary. The peak level of unemployment during the last financial crisis was 356,000 in Q3 2011. Therefore, even leaving aside the Wage Subsidy Scheme, there are 38% more people currently receiving unemployment benefits than were classified as unemployed at the 2011 peak. The latest information we have shows that the labour force totalled 2.47m in Q4 last year, with 2.36m in employment. As such, around 20% of the labour force are currently either on the Live Register or receiving the Pandemic Unemployment Payment. Making an adjustment for those on the Live Register but not classed as unemployed (e.g. part-time and seasonal workers) suggests that the unemployment rate is currently in the region of 17%, but likely to go higher still and perhaps considerably so. Most parts of the construction industry remained employed until the government extended the scope of its restrictions last weekend for example.

Services PMI collapses – Friday 3rd April
As expected, and feared, the AIB Ireland Services PMI showed an unprecedented fall in March, plummeting to 32.5 from 59.9 in February. This decline was similar to that seen in the Eurozone as a whole.

Unsurprisingly the 27.4 point drop was the largest one-month fall on record for the Services PMI (the previous largest one-month decline was a measly 6.3 points in comparison) and the 32.5 reading was only marginally higher than the record low of 31.8 recorded in February 2009. The impact of the coronavirus was severely felt throughout the survey. All four sub-sectors registered intense contractions in activity in March, with the Transport, Tourism & Leisure sector posting the fastest fall. New business fell at the fastest rate since April 2009 and demand from international markets dropped at the fastest rate on record. Prior to last month, new business had risen every month for more than seven years. Employment in the service sector declined for the first time since August 2012, even though headcounts continued to grow in the Financial Services and Technology, Media & Telecoms sub-sectors. To round off the dismal results, the 12-month outlook for business activity was the weakest since the survey began almost 20 years ago.

Combined with the Manufacturing PMI, the Composite PMI fell to 37.3 in March after reaching a 17-month high of 56.7 in February. The comparative figure for the Eurozone was even gloomier at 31.4.

Public finances begin to feel the burden – Friday 3rd April
The Exchequer Returns for March gave the first glimpse of what might be in store for the public finances in the coming months.

Tax revenues in the month were close to €1bn lower y/y, and €1.1bn (-22.5%) below target, with effectively all of this underperformance due to a collapse in VAT receipts. The Department of Finance was expecting VAT receipts of €2.19bn in March, but received just under half of this sum. The shortfall was related to non-payment and underpayment as a result of the outbreak. Both Income Tax and Corporation Tax held up relatively well in March and were slightly ahead of expectations, although both tax heads will come under increasing pressure from April. The concentration of Corporation Tax receipts amongst a small cohort of very large multinational payers has been seen as a weakness of the country's tax base but, ironically, we wonder if these payments will prove more resilient than if Corporation Tax was more oriented towards smaller domestic enterprises. Tax receipts in Q1 as a whole still showed a modest 1.1% increase y/y due to strong showings in January and February, but this is clearly about to change.

Total net expenditure to end-March was €13.6bn, a 13.5% (€1.6bn) y/y increase and 7.6% ahead of profile. The Department attributes the increase to COVID-19 related expenditure.

The nature of the current crisis unfortunately creates a multitude of issues for the public finances. Not only will expenditure hugely increase in areas such as health spending and social welfare (see Live Register data above) but tax receipts are about to take a huge hit from the collapse in economic activity (see Services PMI above). Although the outlook is extremely uncertain and dependent on the duration of the current restrictions, the Minister for Finance indicated that the impact of the outbreak could be north of €8bn to both the state's cash inflows and outflows.

Stark Central Bank analysis – Friday 3rd April
The Central Bank of Ireland this morning published its second quarterly bulletin of the year.

In place of its usual economic forecasts it opts for an assessment of the impact of the crisis under certain assumptions. Needless to say, all such projections carry an unusually high degree of uncertainty at present. Nevertheless, its analysis is stark. On the assumption that containment measures and restrictions remain in place for a three-month period, the CBI projects that GDP could decline by 8.3% this year and the unemployment rate could rise to almost 25% in Q2 (610,000 people unemployed), before falling to 10.5% in Q4 which would still be more than double the pre-crisis level. Such a scenario could see the government run a deficit of 6% of GDP (10% of GNI*) this year and debt to GDP rising by 8pp to 66%, although it should be acknowledged that such an increase would be manageable in the context of the improvements to the public finances made in recent years.

The pace of the recovery remains particularly uncertain however and is dependent on the pace with which normal economic life can resume. The unfolding nature of the crisis suggests that the return to normal is likely to be gradual and in stages.

COVID-19 disruption begins to hit – Wednesday 1st April
The AIB Ireland Manufacturing PMI for March showed a marked decrease to 45.1 from 51.2 in February and indicated the sharpest decline in production since 2009. This is the first economic data point that clearly shows the impact of the virus outbreak and associated containment measures.

Output, new orders and exports all declined at their fastest rates in more than 10 years, while supply chains and business confidence were also severely hit. The Output Index fell by a record 8.9 points in March following reaching a 12-month high in February. The 14.1 point fall in the New Orders Index was also a record decline and points to further falls in the headline PMI in the coming months. This decline came despite panic-buying demand surges in areas such as healthcare and food (data in the UK yesterday showed significant sales growth in the Food Retail sector in Q1). March witnessed unprecedented delays in the delivery of inputs to Irish manufacturers and the Suppliers' Delivery Times Index fell by 9.9 points to its lowest level since the survey began 22 years ago. Unsurprisingly, the Employment index didn't fare much better and recorded the sharpest reduction in the workforce since July 2009, albeit only the third largest one-month fall in the history of the series.

While the Irish Manufacturing PMI recorded a severe drop in March, based on evidence from other Eurozone countries, a larger shock is in store for the Services sector when its PMI for March is released on Friday. Also, as with a lot of the economic data at the moment, attention needs to be paid to reference dates. Responses to the Manufacturing PMI were collected between March 12th and 24th and the pace with which events are moving is not encouraging for the next PMI releases.

Economic Roundup: International

Jobless claims skyrocket in the US as Chinese data is tentatively encouraging

The most eye-catching data release this week was probably the initial jobless claims in the US. A startling 6.648m people filed a claim in the US – over 4% of the American workforce. This was a second consecutive record high, more than doubling last week's release of 3.3m, while the consensus estimate for this week's figure was a massive underestimate at 3.5m. The release showed astonishing figures from the US's most populous state, California; 692k claims were filed in the Golden State (186k prior), while a further 286k were filed in New York State (80k prior). The must-watched non-farm payrolls are released this afternoon, but we note that this release will fail to capture much of the COVID-19 impact thus far, since the data relates to payrolls in the week of 12 March.

In the UK, Chancellor Rishi Sunak overhauled the Coronavirus Business Interruption Loan Scheme last night. Previously firms with an annual turnover of less than £45mn were only able to access government-backed loans once they had been rejected for a commercial loan from their bank. This requirement has been scrapped, alongside rules that will prevent lenders from asking company owners to guarantee loans up to £250k with their own personal property. Additionally, he has established a new Coronavirus Large Business Interruption Loan Scheme to enable firms with a turnover between £45mn and £500mn to access government-backed loans of up to £25mn.

The major development from Asia was the release of China's 'official' manufacturing PMI which showed a clear rebound in March as the country started to get back to business with the stats bureau stating that the report reflected that "more than half of the surveyed enterprises have resumed work". It did however caution that it did not mean a return to normal. The official PMI climbed to 52.0 from a record low of 35.7 in February. It is now back above the 50 level which should signal the difference between contraction and expansion.

The week also saw further central bank action, with the Federal Reserve announcing the establishment of a repurchase agreement facility for foreign and international monetary authorities (FIMA) which will allow other central banks to post Treasuries as collateral in return for temporary loans of US dollars.

Investec Treasury

Sterling and dollar sitting at opposite ends of the risk spectrum

Aside from the extraordinarily tragic loss of life and the unprecedented social upheaval, the global monetary policy response and resulting financial markets reaction to the escalation in the COVID-19 crisis is beginning to bear an eerie resemblance to the global financial crisis of '08/'09 . Maybe it is a little too early to begin to compare the two seismic events but for those of us who had a front row seat at that drama over ten years ago, one can't help but see some similarities. There is one glaring difference however; timescales. The concerted Central Bank responses that took over a year to play out during the global financial crisis have now taken less than a month this time round. Lessons learned maybe, but such has been the speed, scope and breadth of the stimulus (monetary and fiscal) that all asset classes have had little choice but to pull back from full blown crisis mode, rub their respective chins and take stock, for the time being at least. As the pandemic began to take hold in major European and North American hotspots and global equity markets started to wobble, it was (as always and thoroughly unsurprisingly) the US Federal Reserve first out of the blocks with (one of two) an emergency rate cut on 3 March.

With such a sharp, surprising drop in US rates, it was therefore no real shock that the USD weakened out dramatically in the following days against most if not all currencies. As the spread of the pandemic appeared to worsen, global central banks began to follow suit shortly thereafter with similar fitting stimulus programmes, so it made sense that the yield differential between the respective currencies would narrow accordingly, bringing more speculative dollar buyers back to the trough. After a shaky start at the outset of the COVID-19 crisis, the almighty dollar has regained its composure and has without doubt taken back its title as the safest of the safe haven currencies. We can't forget that the dollar denominates and funds a huge portion of global trade and the behemoth that is the US fixed income and equity markets. The primal forces of stimulus and market sentiment have seen the benchmark EUR/USD rate swing from $1.08 to near $1.15, back to under $1.07 only to end up sitting right on the six week average rate of $1.10 as I write.

If the dollar has had a volatile few weeks, spare a thought for the pound sterling. In times of extreme financial stress, sterling seems yet again to have taken the mantle of market sentiment proxy within the G10 currency space. Maybe it is the fact that the UK response to the COVID-19 crisis has been extremely sluggish and ill-advised, or maybe global markets now perceive a standalone UK to be in an infinitely more precarious economic position since its exit from the EU. Whatever the main underlying reason is, there's no getting away from the fact that currently the pound is moving almost in tandem with the swings in the US equity markets. As the US S&P 500 index closed out Monday's (23 March) session at multi year lows of just above 2,200, the benchmark EUR/GBP pair sat close to 12 year highs of in/around £0.9500. The welcome news of more global fiscal and monetary stimulus has seen global equity markets stabilise somewhat, lifting a bruised pound in its wake. As I write (31 March) the S&P index is sitting at near three week highs of 2,640. No real shock then that the EUR/GBP rate is near three week lows of £0.8850.

At this moment in time it feels like we are standing at a crossroads, news from China is encouraging and the daily change in new cases in Italy reached the slowest increase in a fortnight, while the situation in the US continues to worsen. It would seem that central banks and governments around the world will do 'whatever it takes' both from a monetary and fiscal perspective, but even at that, markets aren't convinced it will be enough to stand in the way of a rampant contagion. Global lockdown is here for now and let's hope that helps to slow / contain the spread of the virus. Any serious deterioration in the situation, particularly in the US, will without doubt bring another sell-off in global equity markets and if and when that happens the dollar will, somewhat counterintuitively, benefit again at the expense of the most sensitive of the G10 currencies, pound sterling.

Oil sets 18 year lows then rallies 30%

The continued spread of the virus is adding more downward pressure to oil prices. New lows were set at the end of March with Brent crude oil trading below 21$/barrel. With India also in lockdown, forward prices are perhaps too optimistic about the recovery in demand and the impact of excess supply in storage.

Yesterday President Trump said the world oil industry has been 'ravaged' this year and plans meetings with industry executives later this week to address this, which could see tariffs imposed on Gulf imports. Global oil prices rallied after Trump said Russia and Saudi Arabia were ready to "significantly" reduce production rates and planned a White House summit to address the issue. Trump tweeted that he expects Russia and Saudi Arabia "will be cutting back approximately 10 million barrels", although it was unclear as to when that would begin and over what time frame. He later tweeted that the cuts "could be as high as 15 Million barrels." However there is much confusion as to whether this is number is per day, week, month?

Investec Corporate Finance

Unprecedented situation brings unprecedented challenges

It is stating the obvious to say that COVID-19 has had, and will continue to have, previously unimaginable impacts on how businesses and economies operate as well as how we live and interact with each other. Compared with previous financial and economic crises the impact has also been extremely swift with little opportunity for businesses in particular to plan a smooth trajectory with customers and suppliers.

Businesses Face Significant Challenges

Unlike the global financial crisis a decade ago, another unusual feature of COVID-19 is that the economic impact is not a universal decline in activity – whilst there is an overall underlying decline in economic activity there are some sectors and business models seeing shut-downs (e.g. non-food consumer retail and restaurants) whilst others have seen exponential growth in business demand (e.g. online retailers and couriers).

All of this is placing significant pressures on business managers and owners in terms of managing customer and supplier relationships many of which were previously based on strong face-to-face interactions; adjusting a company's operations to comply with the fast-changing government policies on distancing; ensuring that a company's employees are able to safely carry out their roles; and, last but by no means least, managing the cash resources of a company to ensure that it has the ability to meet its obligations as they fall due as well as interacting with a company's external providers of finance as required.

In terms of ensuring the long term survival and health of a company, it is crucially important not to ignore the last of these priorities – cash management, financial planning and financial relationship management. The steps to achieve this are relatively simple albeit they can sometimes get forgotten at a time of crises management:

- Ensure a company has full access to all its potential cash resources for the duration of the crisis;
- Prepare budgets and forecasts for the business that look at a range of scenarios regarding the impact of the crisis on the company and the mitigating actions that are available in each scenario; and
- Put in place a plan for proactive and regular engagement with external providers of finance.

Prepare Budgets and Forecasts for a Range of Scenarios
In order to make the best decisions for the long term success of a company it is essential that those decisions are based on detailed and carefully analysed financial budgets and forecasts for the business. It is equally important to understand all of the assumptions that make up the forecasts in relation to costs and revenues. These forecasts and plans (and scenarios) will form the foundation for all decisions and actions around a company's financial health.

Maximise Available Cash Resources
Managing cash resources means managing working capital. This includes, inter alia, extending supplier days and shortening the debtor cycle (in each case without damaging relationships); cancelling or deferring all unnecessary expenditure, ensuring there are no trapped funds on deposit in overseas subsidiaries; and drawing down all available short-term debt facilities (in accordance always with the terms of those facilities). The more cash resources that can be generated the longer a company can endure the crisis period.

Early Engagement with Finance Providers
At a time of crisis and uncertainty it is natural to have a preference not to engage with external providers of finance until there is greater clarity or 'better news'. This is rarely the right approach. It is our overwhelming experience that the best approach is to engage early and proactively with external providers of finance. It is equally important for business managers and owners to demonstrate that they have a firm and realistic understanding of the issues facing the business and what is required for the success of their company. This approach will always yield both greater levels of support (including potentially additional funding) and also more time to address the challenges.

Conclusion
It is impossible to predict how long COVID-19 will impact our economy and businesses but it could potentially be longer than originally envisaged. In this regard, business managers and owners will be challenged to use all of their experience and expertise to maintain the success of their companies. In the coming weeks we will write in more depth about each of the above topics and our experience working with clients to deliver appropriate and sustainable financial solutions and partners for many of Ireland's most successful public and private companies.

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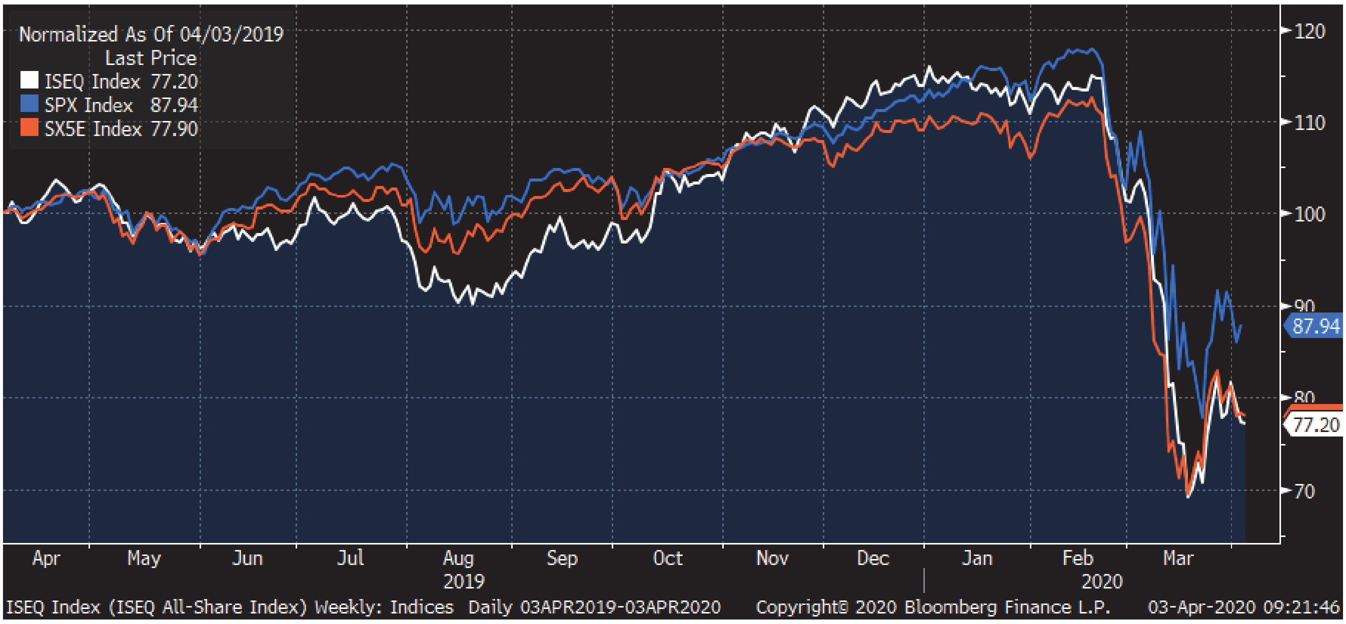
Currency Pairs: EUR/GBP (white, LHS); EUR/USD (blue, RHS)

Source: Bloomberg

Stock Market Indices (indexed to 100): ISEQ (white); S&P 500 (blue); Eurostoxx 50 (orange)



Source: Bloomberg

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