25 March 2020

Investec
Investec Bank plc (UK)

Economics

Global Economic Overview

COVID-19 to cause global contraction

Global

With the epicentre of COVID-19 shifting to Europe, governments in the Western hemisphere have implemented drastic containment measures. Some of the near-term downside pressures may be mitigated by enormous amounts of fiscal and monetary stimulus, but a greater risk is that the sharp dip in activity becomes a prolonged slump. It is next to impossible to gauge the magnitude and longevity of the downturn at this stage. We expect stabilisation in China in Q2. Elsewhere timings may vary but we broadly expect recoveries to begin in Q3. We now look for a worldwide *contraction* of 0.5% in 2020 (prev. growth of 2.8%) to be followed by growth of 3.9% in 2021 (prev. 3.5%). But we expect to have to revise these numbers frequently.

United States

Usually by the spring of a Presidential election year the primary races are in full swing, but this year events have been overtaken by COVID-19. Many Americans are on lockdown, creating enormous disruptive forces to US economic activity. The US administration, after resolving cross-party disagreements, now looks to be gearing up to unleash a $2trn stimulus package to try and prevent the current disruption turning good business into bad, triggering a ricochet across the economy. The Fed has acted aggressively too with 150bps of rate cuts in totality alongside open ended QE and other initiatives. The scale of the action should help to break the economy's fall. Even so we are pencilling in a GDP drop of 3.9% this year and a rise of 2.5% next. These remain under review amidst an evolving situation.

Eurozone

Whilst China was the original epicentre of the coronavirus outbreak, developments in the Euro area have quickly escalated, with the number of confirmed cases reaching 200k. This combined with the stringent containment measures is set to lead to an unprecedented sudden stop in economic activity, as evidenced by the March PMIs. We suspect that the extent of the downturn in H1 2020 is likely to exceed that of the 08/09 financial crisis. On the assumption that the COVID-19 outbreak does not have a prolonged impact we have materially revised our Euro area GDP growth forecasts, which now see the zone contracting 5.6% in 2020. In 2021 we expect growth of 3.5%. Despite the bleak outlook for 2020, it is worth noting without the significant and timely monetary and fiscal policy measures, the outlook could be much worse.

United Kingdom

While infections have been increasing at a more modest pace than some European nations, a nationwide lockdown has now been implemented to try and slow the spread of the virus. The government and the Bank of England have closely co-ordinated to try and mitigate the economic fallout, but a deep recession is inevitable for H1 at the very least. How long the Social Distancing measures will remain in place and whether they will be tightened further is uncertain. But assuming that they are eased in the summer, activity should rebound in H2. On this basis, we look for GDP to contract 4.4% in 2020 followed by growth of 3.3% in 2021. Amidst this disruption, striking a new UK-EU trade agreement by year-end appears increasingly optimistic. It therefore seems likely that the Transition Period will be extended beyond 31 December.

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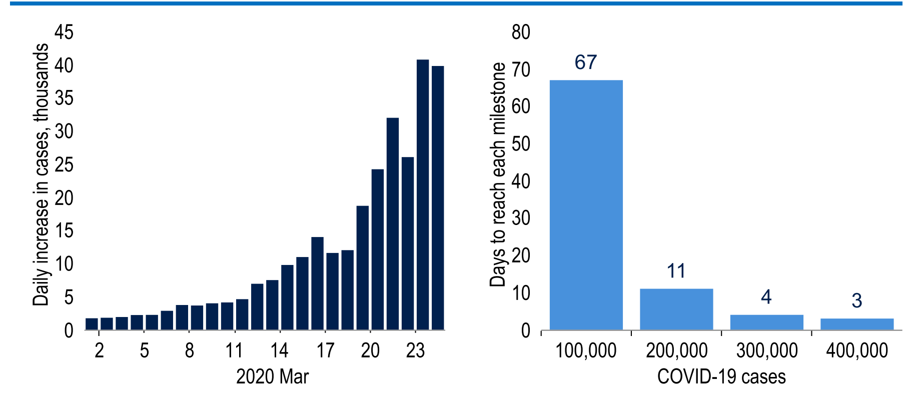
Global

COVID-19 has turned the global economy upside down as the virus has gained a foothold in the Western hemisphere. Indeed, China now accounts for just 18% of the world's total. The epicentre of the outbreak has moved to Europe. 439,940 infections and 19,744 fatalities globally have brought severe containment measures from governments worldwide. It is these policies, including full lockdowns in some areas, which are hampering economic activity. Governments and central banks globally are providing enormous amounts of stimulus to try and reduce the risk of a period of significant disruption turning into a pronounced downturn. Astonishingly world equity…

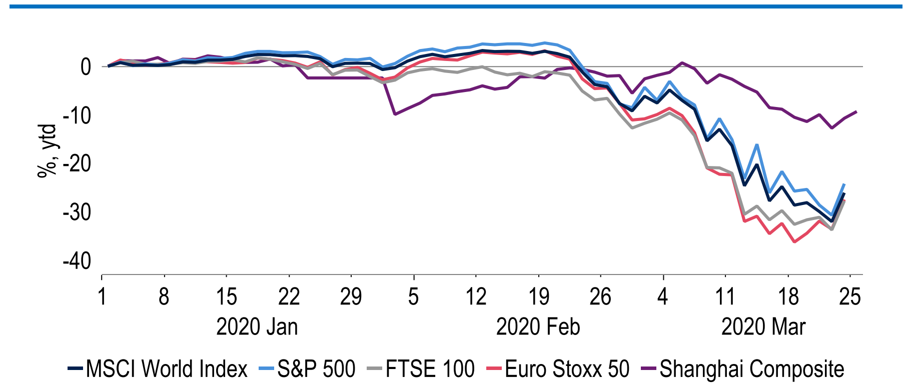
Chart 1: Despite a slowdown of the infection in Asia, COVID-19 is spreading rapidly worldwide



Source: Macrobond, World Health Organisation

…markets were at record highs as recently as six weeks ago. Since then the MSCI world index has plunged 28%. While markets have principally been guided by COVID-19 related newsflow and rose robustly on the progression of the US fiscal stimulus, it seems likely that economic data will become more prominent now as investors seek clues on the depth and duration of the downturn. One view is that a turning point (i.e. slowdown) in the number of cases could be the trigger for the all-clear in risk assets. We are more cautious. This condition seems necessary, but not sufficient. Markets will likely need to see evidence that, what will inevitably be a global recession, is not protracted.

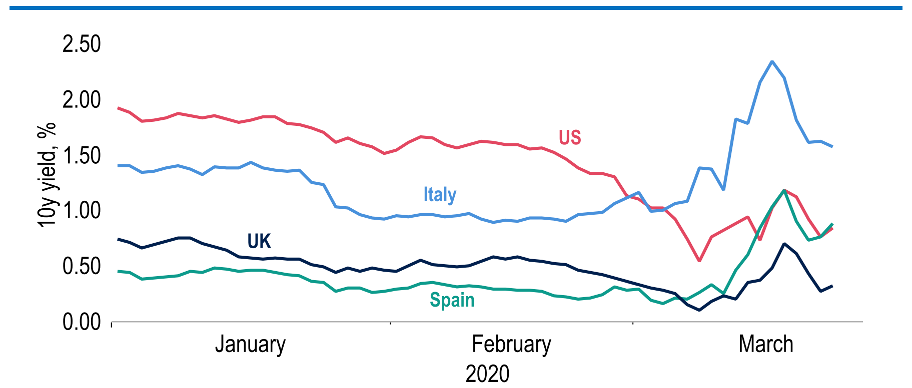
Chart 2: The global equity sell-off has continued after a month of unprecedented volatility



Source: Macrobond

Equity market volatility has been prominent. Equally important has been moves in bond markets. Notably 10y Treasury yields rose by c. 70bps in a fortnight, reaching a high of 1.18%. Those on gilts climbed by c. 60bps. In short, 'safe havens' were no longer considered safe. Signs of wider market dislocation were mounting, including wider bid/offer and inter instrument spreads. An example (frequently quoted in 2008) is LIBOR/OIS (Chart 4), where spreads remain elevated. The recent episode was beginning to look like 2007-2008. This acted as a catalyst for major central banks to re-open/step up QE programmes and introduce new liquidity schemes.

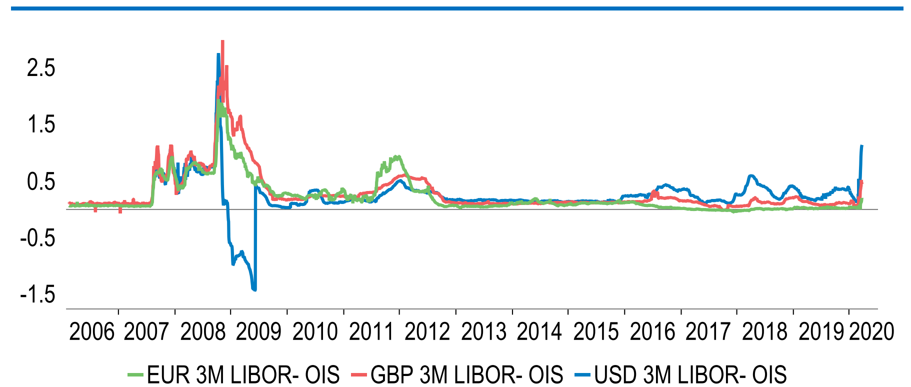
Chart 3: Risk-off assets initially rallied, but 10y sovereign yields have reverted somewhat



Source: Macrobond

Gold has been a puzzle, fading from a 9 year high of $1680 in March to $1610 now. Reports point to sales of gold holdings to meet margin calls in other assets. Meanwhile industrial commodities have reacted predictably to the prospect of a global slump. Pressured also by infighting over supply across producers, Brent crude has more than halved to below $30 per barrel. Copper, currently at $218/lb, is 24% lower. The USD is currently 'enjoying' safe haven status. Other than currencies to which it is pegged (e.g. the HKD), it is difficult to find a currency that has been stronger so far in 2020. US President Trump's obvious dissatisfaction has led to some speculation over US intervention to drive the greenback down.

Chart 4: Money markets have shown signs of stress – LIBOR/OIS spreads (%)



Source: Macrobond

Fiscal policy is playing a huge role alongside monetary policy. Bolstering demand may mitigate some of the near-term downside pressures. But the vital aspect is to prevent a sharp dip in activity becoming a prolonged slump. Here maintaining company cashflow is critical, particularly for small firms, as shedding staff and cutting corporate spending would result in an economic doom loop. Efforts by the US and UK (among others) to pay for furloughed workers should be seen in this respect. Central bank programmes to keep markets functioning are keeping credit flowing further up the chain. In these respects government and central bank policies are joined up.

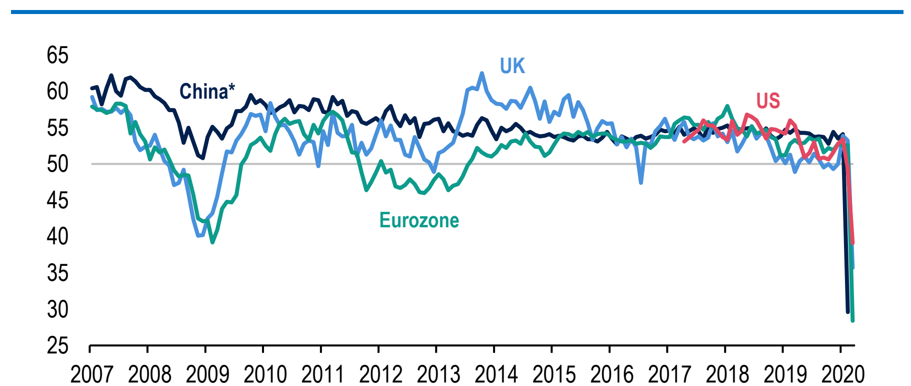
Chart 5: Several major central banks have added stimulus in the past month

Economy	Interest rates	QE
United States	-150bps (0.00-0.25%)	✓
United Kingdom	-65bps (0.10%)	✓
Eurozone	unch (-0.50%)	✓
China	-10bps (3.15%)	
Japan	unch (-0.10%)	✓
Australia	-50bps (0.25%)	✓
New Zealand	-75bps (0.25%)	✓
Canada	-100bps (0.75%)	
Brazil	-50bps (3.75%)	
South Korea	-50bps (0.75%)	
South Africa	-100bps (5.25%)	✓
India	unch (5.15%)	

Source: Various

Putting together a 'bottom up' global GDP forecast is next to impossible. We do know that recent PMIs have plunged to all-time lows. Also Chinese industrial production was 13.5% down on a year ago in the combined Jan/Feb period. Broadly we expect stabilisation in China in Q2, then a rebound. Elsewhere timings may vary but we broadly expect the eye of the downturn in Q2, before recoveries begin in Q3. Our pencilled in world forecasts are now -0.5% for 2020, down from 2.8% last month. If (and we stress if) global policy measures do gain traction, we may see growth of 3.9% in 2021 (previously 3.5%). But we expect to have to revise these numbers frequently.

Chart 6: PMIs globally on the tertiary sector have taken a dive



*The Chinese survey is the official non-manufacturing PMI.

Source: IHS Markit, NBS

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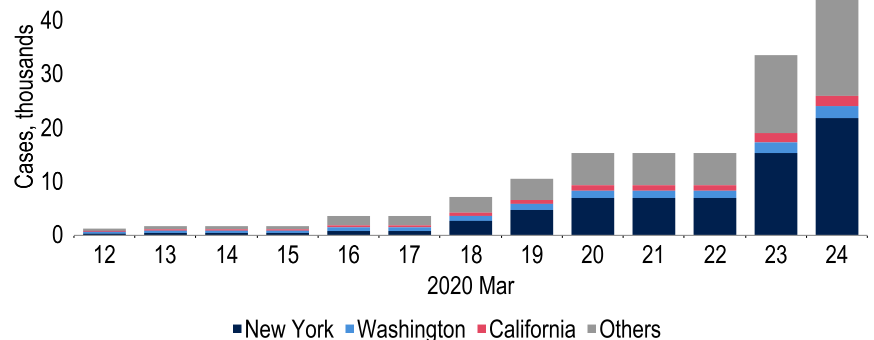
United States

During a usual election year, the Presidential nomination races would be hotting up right now. Instead, primaries are being postponed amidst the COVID-19 pandemic. However talk that Mr Trump might delay the Presidential election itself looks to be just that, with Federal laws setting election day as "the Tuesday next after the first Monday in November" whilst the 20th Amendment provides that the President's term end on 20 January 2021. Most attention is on COVID-19 which has spread like wildfire in densely populated areas. Indeed, New York accounts for nearly half of America's infections (Chart 7). Cases are now increasing at a faster pace than any other nation with the WHO warning the US could become the epicentre of the outbreak. The US now…

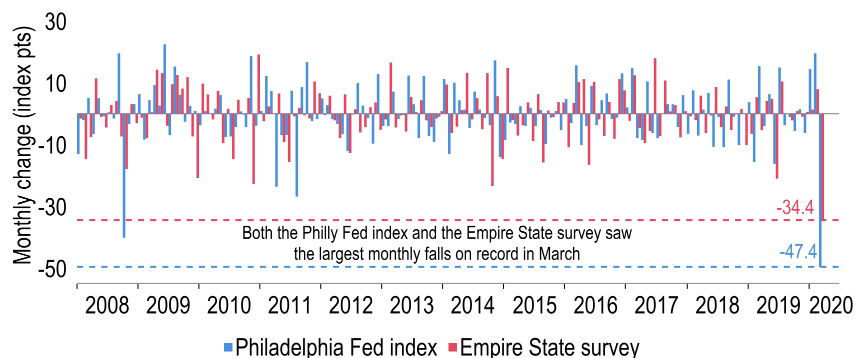
Chart 7: COVID-19 in the United States – New York with the bulk of cases



Source: Macrobond

…has a "lockdown" in place affecting large segments of the American public. Treasury Secretary Steve Mnuchin has indicated this is likely to remain in force for 10 to 12 weeks. We can be sure this will have a hugely detrimental impact on economic output near-term. Trying to predict by how much, to any degree of accuracy is impossible. For now, our best guess is that we will see the US economy contract by a bit more than 20% (saar) over Q2 but with a recovery evident over Q3 and Q4. But we would not wish to present this without clear warnings over the range of possibilities. Chart 8 provides one of the earliest signals of the economic disruption with these two manufacturing…

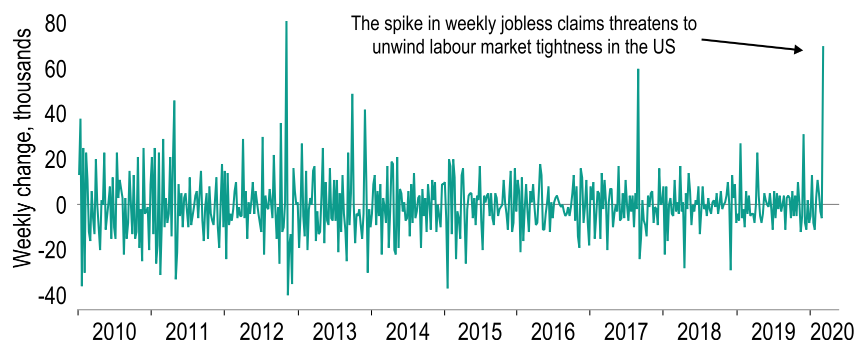
Chart 8: Early survey steers give a taste of falls in broader economic data to come…



Source: Macrobond

…surveys witnessing the biggest drops on record. Our US GDP forecast for this year is now -3.9%, but under constant review as the situation unfolds. We also await news of the final stimulus package from the US administration which at the time of writing looked set to be around $2.0trn (approximately 10% of annual US GDP). The idea of the stimulus package (alongside the Fed policy action, see below) is to stop the period of significant disruption shifting into self-fulfilling downturn, such that when isolation stops the economy can pick up where it left off. The spike in jobless claims seen in the last week, sizeable as it was, will be nothing compared to those likely in current weeks. The Administration Bill, when it comes, will direct more cash…

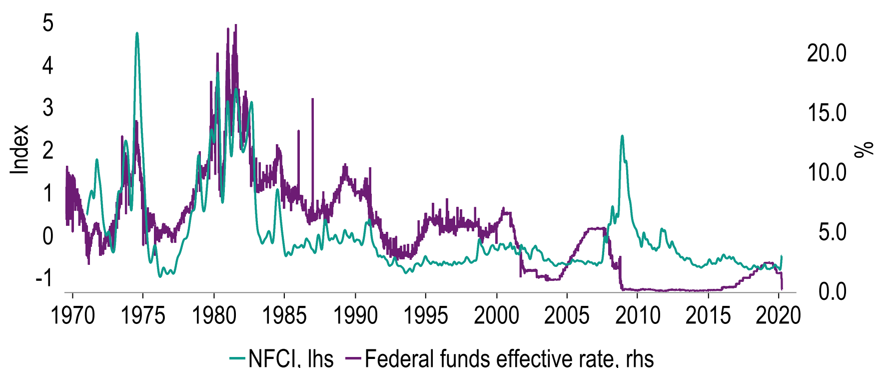
Chart 9: A spike in jobless claims – but much worse lies ahead



Source: Macrobond

...to small businesses to slow the tide of layoffs whilst there is also discussion of direct payments to adults and children. Federal Reserve action has been aimed at ensuring otherwise good businesses can remain afloat and are not shut out by disruptions in funding markets. In this context, Fed action over recent days and weeks has ranged from a total of 150bps of cuts to the Federal funds rate, the launch of open ended QE, large-scale overnight and term repurchase agreement operations, two new credit facilities to large employers and it is also looking at a "Main Street Business Lending Programme". Furthermore it has also re-established a Term Asset-Backed Securities Loan Facility (TALF). Together these should help to ensure that strains…

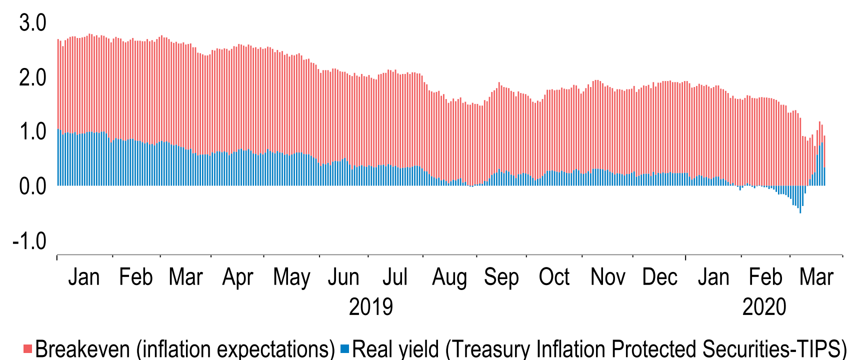
Chart 10: Financial markets strains evident, but conditions are not as tight as previous peaks…



The NFCI is a weighted average of a large number of variables (105 measures of financial activity) each expressed relative to their sample averages and scaled by their sample standard deviations. Positive values of the NFCI have been historically associated with tighter-than-average financial conditions, while negative values have been historically associated with looser-than-average financial conditions. Source: Macrobond

…in financial markets do to reach 2008/09 levels. Chart 10 shows so far they have remained well below these; indeed this time it is hoped that Fed action should help support the solution to the crisis. Market strains have been evident and as such the Fed action looks essential in ensuring the financial sector can support the solution. One such area has been the Treasury market where volatility has been high and despite a risk-off environment, longer-term yields moved sharply higher from record lows earlier in the month. Chart 11 shows, from TIPS prices, that this was not due to inflation expectations (which had fallen), but higher real yields. In common with other countries, investors seemed to be averse to duration. The Fed's more explicit QE (now unlimited) has forced…

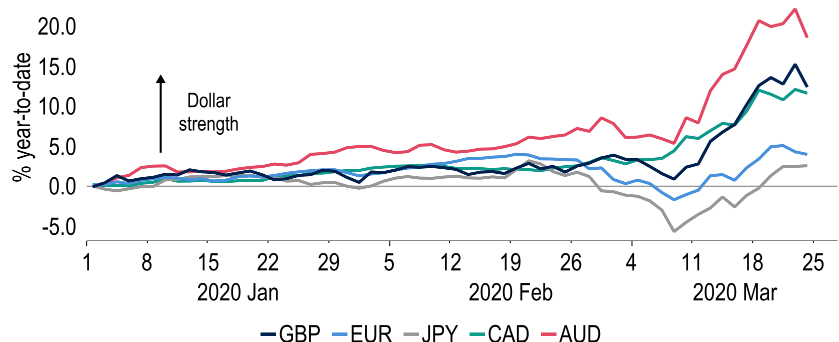
Chart 11: Real 10-year Treasury yields have bounced, but inflation expectations have fallen (%)



Source: Macrobond

…yields lower. But speculation that the Fed could launch a Yield Curve Control policy remains. Currency markets have also seen moves aplenty where the dollar has taken on safe haven status and has been particularly well bid against commodity currencies such as AUD and CAD, but also notably against sterling. We now see the Federal funds rate remain at its current 0-0.25% level through 2021 and with other central banks also holding at new lows. As such a shift in interest rate differentials is unlikely to drive large FX moves over the next 12 months. We eventually see USD strength fading back as coronavirus worries ease. We look for €:$ of $1.10 end-20 and $1.12 end-21.

Chart 12: USD has been extremely well bid since 9 March



The chart shows USD gains against a basket of currencies from 1 January 2020. Source: Macrobond

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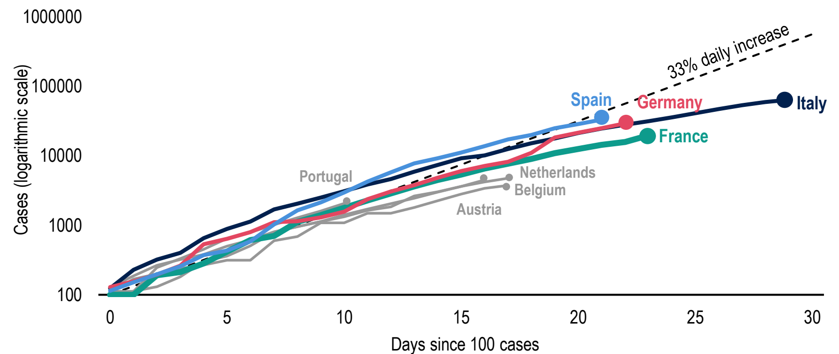
Eurozone

COVID-19 infiltrated Europe, in particular Italy, just as things seemed to be settling down in China. Now, there are over 100,000 infections on the continent, with c. 75% of those in the Eurozone's 'core 4' economies. Northern Italy was the stem of the European outbreak. Since then Madrid and Paris have been established as hotspots. However, Chart 13 shows how the infection pace has slowed somewhat, though this may be due to limited testing capacity. Because of the rapid spread, movement has been acutely restricted. Lockdowns imposed across several member states including France and Italy have affected, and continue to affect, all sectors of the EU19 economy.

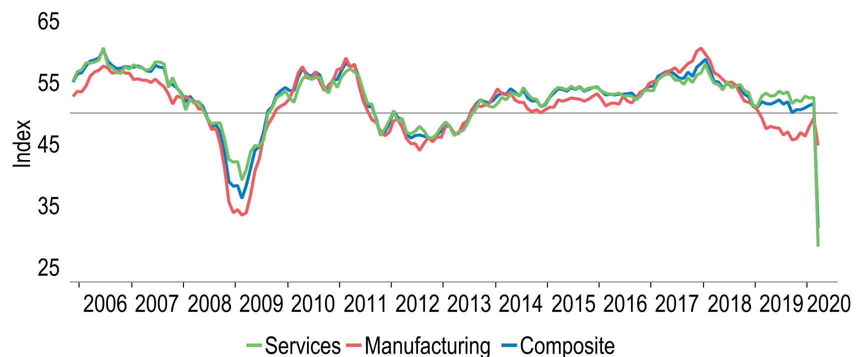
Chart 13: Europe is the new epicentre, but the spread is slowing



Source: World Health Organisation

The sudden drop in economic activity as a result of coronavirus and the associated containment measures is unprecedented. March's Composite PMI, which represents the first insight into the economic shock witnessed a 20pt fall to a record low of 31.4. In comparison the largest monthly fall during the 08/09 financial crisis was 4.7pts. Judging what this means for GDP growth is challenging, but with businesses facing difficulties not seen even during 08/09 a clear contraction is likely near term; we are pencilling in a 9% peak to trough fall in Euro area GDP over H1 2020. That leaves our 2020 forecast at -5.6%. Providing the disruption is relatively short lived we see a 3.5% rebound in 2021.

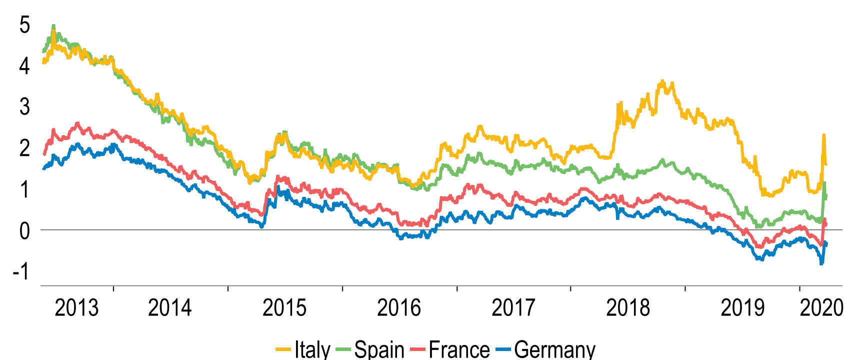
Chart 14: First data insight points to a shock comparable with 2008/09: Euro area PMIs



Source: Macrobond

Market stress has also been clearly evident, with a rise in sovereign bond yields, particularly in those countries suffering the most acute outbreaks, such as Italy where the 10-year benchmark had risen 126bps to 2.34%. Yields remain way below the 7% level which raised questions marks over fiscal sustainability during the euro crisis. However the extent of some of the moves has once again raised some questions over fragmentation in European financial markets. We do not foresee a rerun of such fears, which raised questions over the stability of the Euro area. But nonetheless the ECB will be tuned to such risks once more. Stresses have however not been limited to sovereign markets, with corporate credit markets also showing signs of strain.

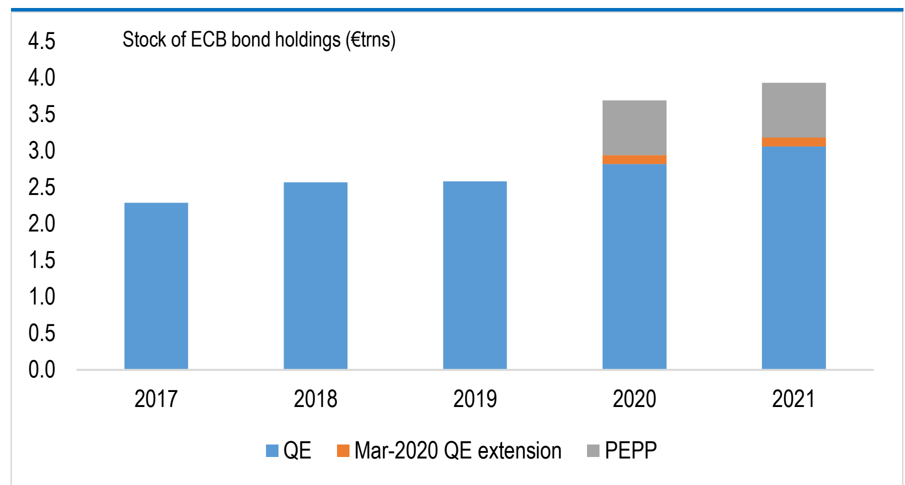
Chart 15: 10-year sovereign yields have been volatile of late (%)



Source: Macrobond

These developments in the real economy and in financial markets have led to a significant ECB policy response, with the announcement of the PEPP*. This constitutes an additional €750bn QE on top of the €120bn announced on 12-Mar. This policy response has been tailored to i) stabilise financial markets, particularly in light of the surge in bond yields on 17 March, ii) providing liquidity and iii) ensuring support for businesses. This last point has been particularly evident through the reworked TLTRO**, which now offers banks the ability to borrow at -0.75% should they meet lending criteria to SMEs and the ECB's decision to buy corporate commercial paper. But despite the extraordinary stimulus, further easing is possible and we would look for a cut in the Deposit rate in Q2.

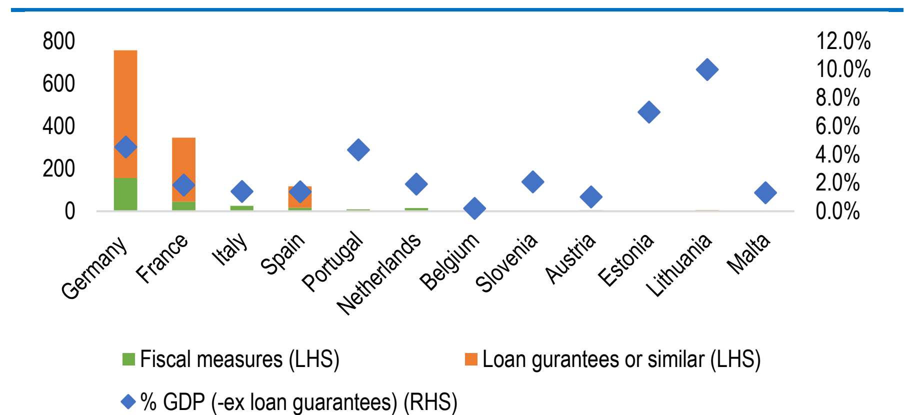
Chart 16: ECB QE holdings to expand by an additional €870bn in 2020



*PEPP- Pandemic Emergency Purchase Programme. **Targeted longer-term refinancing operations (TLTROs)
Source: ECB

The fiscal response has also been significant, with Italy, Germany, France and Spain announcing measures equivalent to 2% GDP on average. On top of these measures are also significant sums of loan guarantees to support businesses facing financial problems, complementing monetary policy action. However the Euro area response has been more disjointed given the lack of a fiscal union. But that looks set to change with moves being made to activate Europe's bailout fund, the ESM, with Eurogroup having agreed to offer pandemic credit lines worth 2% of each country's GDP to countries. A by-product of this is that it could technically open the door to the ECB's OMT*** programme …

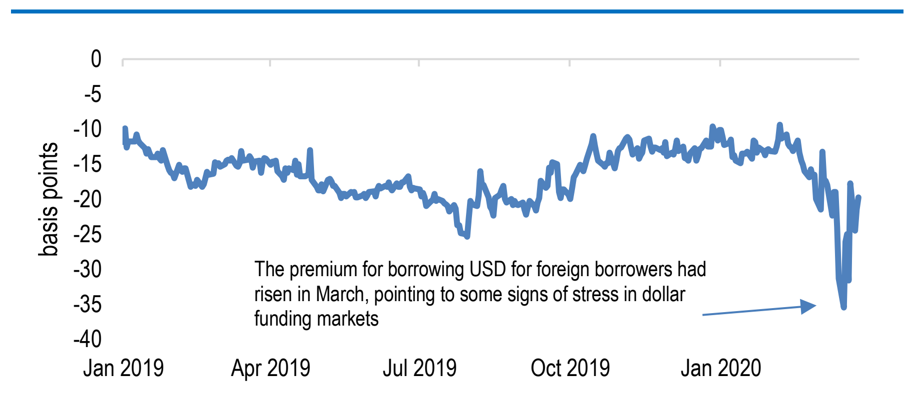
Chart 17: Euro area fiscal policy response (€bn and % of GDP)



*** OMT is the Outright Monetary Transactions scheme.
Source: Various national sources

…i.e. the unlimited purchase of sovereign bonds. The idea of common Euro area bonds is also being raised, a proposal which reportedly has some support from ECB President Lagarde. Against this backdrop the euro has been under pressure, given what had been an unrelenting demand for dollars. Euro cross currency basis swaps highlight the premium that has been placed on trying to access USD funding amidst tightening of liquidity conditions. However the Fed's USD swap lines should alleviate some of this pressure. Near term we suspect that risk sentiment will continue to dominate moves with €:$ likely to trade $1.06 in Q2. But on the expectation of a recovery towards the end of the year we see fundamentals coming back into play, with our end-20 forecast standing at $1.10.

Chart 18: 1-year euro cross currency basis swap: Signs of stress had been seen in March

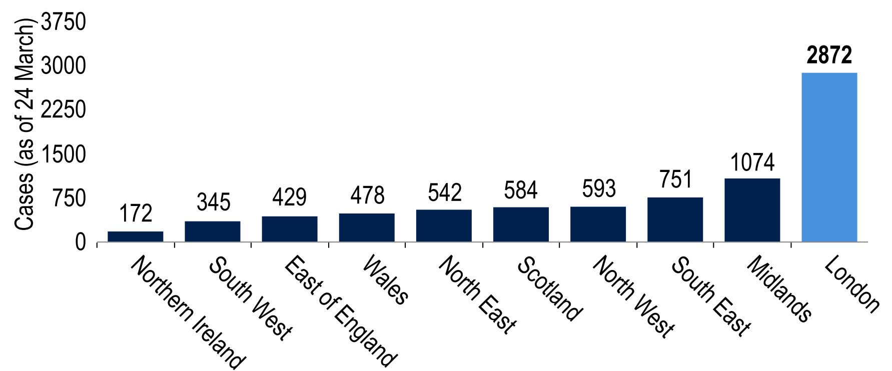


Source: Refinitiv

United Kingdom

Infections in the UK have been increasing at a stark pace, but at a lower rate than some European peers. There are now 8,227 domestic cases of COVID-19, with 433 of those resulting in fatalities. The region most affected is London (Chart 19). PM Boris Johnson has announced more restrictive containment measures to try and slow the spread. All non-essential shops have closed and citizens have been instructed to stay indoors except for food, health or critical work reasons. But 'social distancing' efforts are taking their toll on the economy. The government and Bank of England have been acting to try and mitigate the damage. This initially took the form of co-ordinated action on the morning of the Budget. The MPC cut...

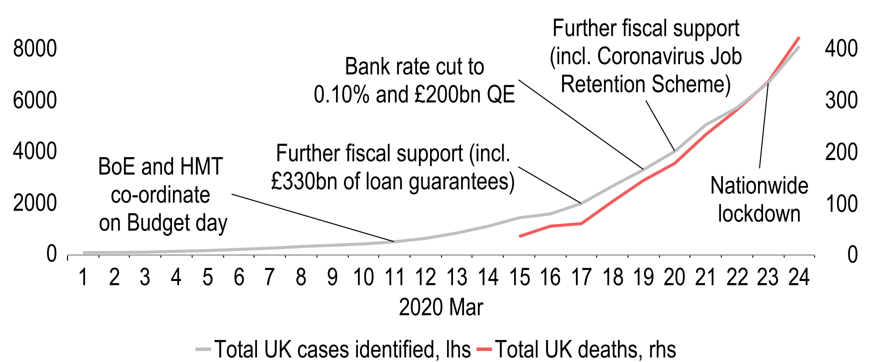
Chart 19: A regional breakdown of COVID-19 infections shows London is struggling most#



#Figures for the North East include Yorkshire and the Humber. Source: Macrobond, Public Health England

...Bank rate by 50bp to 0.25% and the FPC lowered the countercyclical capital buffer rate to 0%. This was then followed up by the Chancellor unveiling £12bn in dedicated COVID-19 spending. But with the situation escalating dramatically, the amount of fiscal support provided has been scaled up accordingly. The most significant to date is a commitment to pay 80% of furloughed employees' salaries (up to £2.5k per month) in an effort to reduce layoffs. Companies will also be able to delay VAT payments for most of Q2 until the end of 2020/21 in a move that the Treasury estimates will provide a direct injection of £30bn (or 1.5% of GDP). Meanwhile, the BoE has gone on to...

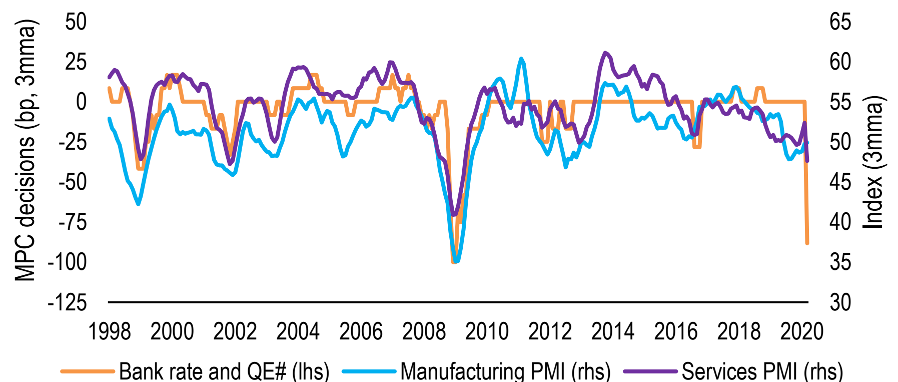
Chart 20: As the number of cases has escalated, the UK authorities have



Source: Macrobond, Public Health England, HM Treasury, Bank of England, Investec

...slam its foot to the floor. Bank rate has been cut further to its estimated effective lower bound of 0.10%. QE has also been restarted, with a further £200bn of (mainly) gilts and corporate bonds set to be bought. Cumulatively, these actions represent around 265bp of conventional rate reductions (Chart 21). Additionally, the BoE has announced a number of initiatives to try and ensure corporates can access cheap credit. This includes the establishment of a new Term Funding Scheme to provide business loans closer to Bank rate, with additional incentives for extending credit to SMEs. Overall, the BoE estimates that the various measures announced will provide £100bn in funding for businesses. But despite the...

Chart 21: The MPC has been on the front foot in responding to the incoming economic shock



#Every extra £25bn of asset purchases (gilts and corporate bonds) is treated as equivalent to a 25bp cut in Bank rate (see Joyce, Tong and Woods, 2011).

Source: IHS Markit, Bank of England, Investec calculations

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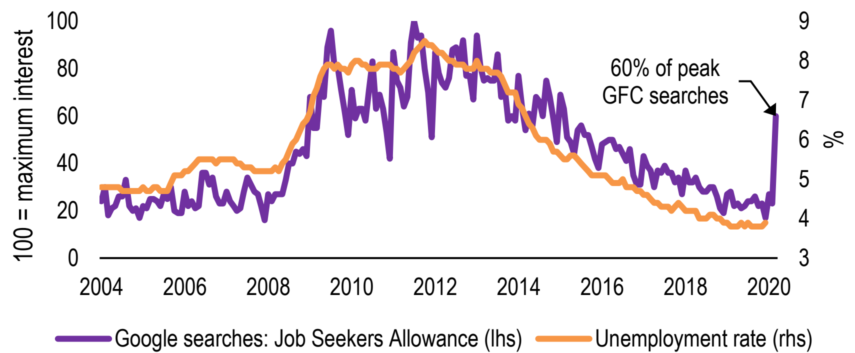
...colossal scale of this stimulus, the UK economy is nevertheless set to fall into a deep recession. For one, the preliminary composite PMI slid nearly 16pts to 37.1 in March, the lowest since the series began in 1998. Also, Google searches for "Job Seekers Allowance" have spiked to a five-year high in a sign of widespread layoffs (Chart 22). However, the peak of the downturn looks set to be Q2, with restrictions likely to remain in place across most (if not all) of Q2 and possibly tightened even further. But assuming that restrictions are eased in the summer, activity should rebound in H2. On this basis, we look for GDP to contract 4.4% in 2020 followed by 3.3% growth in 2021.

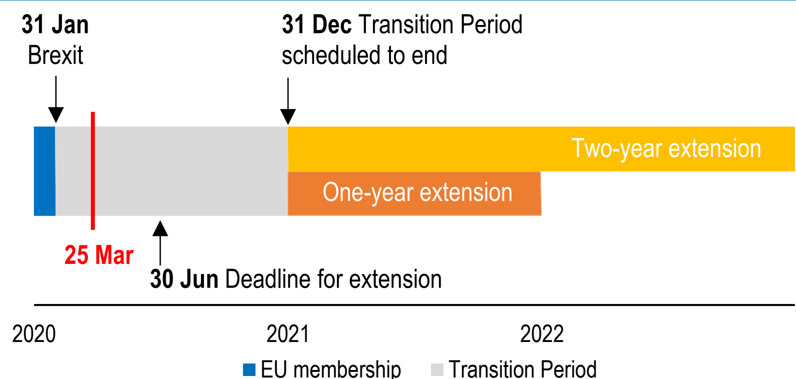
Chart 22: Google searches for Job Seekers Allowance have spiked over the past month



GFC is Global Financial Crisis. Source: Google, Office for National Statistics

With much of the civil service dedicated to tackling the coronavirus, the PM's plan to strike a trade agreement with the EU by year-end appears increasingly optimistic. The pandemic has already led to this month's talks being cancelled, whilst the EU's chief Brexit negotiator, Michel Barnier, subsequently tested positive for COVID-19. His British counterpart, David Frost, is also now in self-isolation after exhibiting symptoms. It therefore appears likely that the Transition Period will be extended beyond 31 Dec in order to put Brexit on the back burner. According to the Withdrawal Agreement, this can be done once for up to two years through mutual UK-EU agreement by 30 Jun.

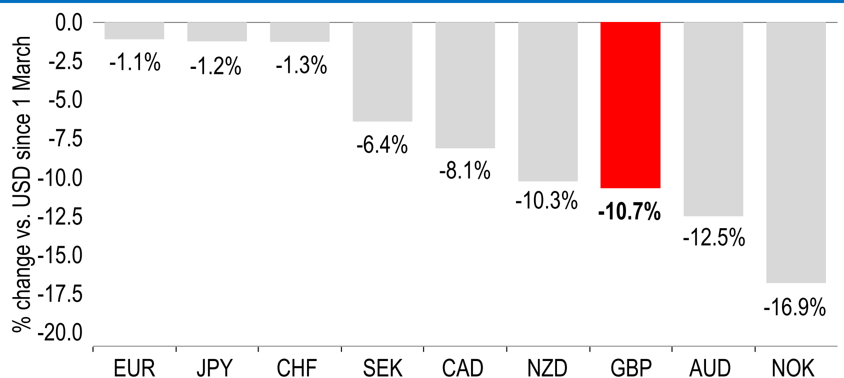
Chart 23: Will Boris Johnson put Brexit on the back burner?



Source: Investec

This should provide a welcome boost to sterling, which has been one of the worst performing G10 currencies amidst the recent strengthening in the greenback, with only commodity-dependent AUD and NOK faring worse (Chart 24). Last week, the pound reached a low of $1.1412, a level not seen since 1985. Exactly why it has underperformed relative its peers is not yet clear, but we would be surprised if Brexit was not a factor. However, for the same reason we believe sterling stands well-placed to benefit from a resumption in 'risk on' sentiment. Therefore, based on our expectation of a broad-based global upswing in H2, we look for the pound to rise to $1.20 and 92p (vs. €) by year-end.

Chart 24: Sterling has underperformed against other G10 currencies



Source: Macrobond

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Global Forecasts

GDP Growth (%)

	Global	US	Japan	China	UK	EU19	Germany	France	Italy
2015	3.5	2.9	1.3	7.2	2.4	2.0	1.5	1.0	0.7
2016	3.4	1.6	0.5	6.8	1.9	1.9	2.1	1.0	1.4
2017	3.8	2.4	2.2	6.9	1.9	2.7	2.8	2.4	1.8
2018	3.6	2.9	0.3	6.6	1.3	1.9	1.5	1.7	0.7
2019	2.9	2.3	1.0	6.1	1.4	1.2	0.6	1.2	0.2
2020	-0.5	-3.9	-3.2	0.1	-4.4	-5.6	-4.9	-5.4	-8.4
2021	3.9	2.5	3.0	9.4	3.3	3.5	4.0	3.4	2.7

Source: IMF, Macrobond, Investec forecasts

Key official interest rates (%, end quarter):

	US Fed funds	Eurozone refi rate	Eurozone Deposit rate	UK Bank rate	Australia cash rate
Current	0.00-0.25	0.00	-0.50	0.10	0.25
2020					
Q1	0.00-0.25	0.00	-0.50	0.10	0.25
Q2	0.00-0.25	0.00	-0.60	0.10	0.25
Q3	0.00-0.25	0.00	-0.60	0.10	0.25
Q4	0.00-0.25	0.00	-0.60	0.10	0.25
2021					
Q1	0.00-0.25	0.00	-0.60	0.10	0.25
Q2	0.00-0.25	0.00	-0.60	0.10	0.25
Q3	0.00-0.25	0.00	-0.60	0.10	0.25
Q4	0.00-0.25	0.00	-0.60	0.10	0.25

Source: Macrobond, Investec

10-year government bond yields (%, end quarter):

	US	Germany	UK
Current	0.79	-0.29	0.43
2020			
Q2	0.75	-0.30	0.50
Q4	1.00	-0.30	0.75
2021			
Q2	1.00	-0.30	0.75
Q4	1.25	-0.10	1.00

Source: Refinitiv, Investec

FX rates (end quarter/ annual averages)

		Current	2020				2021				2019	2020	2021
		25-Mar	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	average	average	average
Euro	€:$	1.804	1.08	1.06	1.08	1.10	1.10	1.10	1.12	1.12	1.12	1.08	1.11
Sterling	€:£	0.922	0.92	0.91	0.91	0.92	0.89	0.86	0.85	0.83	0.88	0.91	0.87
	(£:€)	1.085	1.09	1.10	1.10	1.09	1.12	1.16	1.18	1.20	1.14	1.10	1.15
	£:$	1.172	1.17	1.16	1.19	1.20	1.24	1.28	1.32	1.35	1.28	1.20	1.28
Yen	$	111.6	112	108	110	110	108	107	105	104	109	110	107
	€	120.6	121	114	119	121	119	118	118	116	122	119	118
	£	130.8	131	126	131	132	133	137	138	140	139	131	136
Aussie Dollar	$	0.596	0.60	0.59	0.60	0.62	0.64	0.65	0.68	0.70	0.70	0.61	0.66
	€:AUD	1.813	1.81	1.81	1.80	1.77	1.72	1.69	1.65	1.60	1.61	1.78	1.69
	¥	66.48	66.5	63.2	66.0	68.2	69.1	69.6	71.4	72.8	75.8	67.0	70.2
	£:AUD	1.966	1.97	1.99	1.98	1.93	1.93	1.97	1.94	1.93	1.84	1.96	1.94
Swiss Franc	€	1.059	1.06	1.05	1.06	1.08	1.09	1.10	1.11	1.12	1.11	1.06	1.10
	$	0.981	0.98	0.99	0.98	0.98	0.99	1.00	0.99	1.00	0.99	0.98	0.99
	£	1.149	1.15	1.15	1.16	1.17	1.22	1.28	1.31	1.35	1.27	1.17	1.27

Source: Refinitiv, Investec