

## Sunday Wrap

Happy Sunday – from a very deserted center of London,

My local Caffè Nero is still open, but only for take-aways. So here I sit at my dining table trying to put my notes and thoughts together: First and most importantly, my thoughts are with the many victims, and their family of friends, of this dreadful virus which is still spreading through our global community.

While the number of infected – and the number of deaths – continue to increase throughout Europe and the US (but no longer in Asia), our policymakers have now sprung into action. When the history books about this period are written one day, I'm pretty sure that this past week will be defined as the week when "the policymakers finally got it" – and began to act in a substantial and coordinated way to both curtail the spreading of the virus, and to provide economic relief for those most affected.

**But will this week also mark the turn of market? Of this, I'm less sure. Let me explain:**

- **Unprecedented policy actions are now being rolled out. In general, markets liked it, but it's too early to declare victory.**
- **More likely, we'll have to wait for a flattening of the epidemic curves, and then some more time before restrictions will be eased. And even then, the strength of markets will depend on the likely trajectory of GDP. I'll summarize the alphabet of possible trajectories: The "V", the "U", the "W" or the dreaded "L"?**
- **The outcome will largely depend on the effectiveness of policy measures. So far so good, in general, but we are not done yet (hopefully). There are still some gaping holes in the policy approaches. In particular, I worry about Italy's hesitation to support its SMEs and households sufficiently. And it seems that some of the exciting, far-reaching proposals for a big pan-European response to this crisis are now making headways in key policy circles.**

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## 1. Unprecedented policy actions now being rolled out. Markets like it, but it's too early to declare victory.

Despite the clear evidence from Asia (and now also emerging in parts of Italy), as well as the recommendations from the WHO and the scientific community that social distancing via lockdowns are needed to stop the spreading of the virus, it took until this past week for most European countries and the US to act. (Of course, in federal states, like the US and Germany, the federal level cannot do much more than make recommendations and leave the details to the state level. Merkel has done so forcefully; Trump not so much.)

Facing the enormous economic consequences of these unprecedented decisions to lock down big parts of their economies, the fiscal authorities across Europe and the US are now rolling out some of the most comprehensive measures I can recall ever seeing to cushion the hit to households and SMEs.

In tandem, and to make sure markets don't melt down, the world's major central banks have reacted with promises of enormous expansion of their balance sheets, and – de facto – monetarization of the fiscal effort, as needed. This is a brand new world (if undeclared), and it's a welcome one. Also, led by the Fed, the world's key central banks have stepped up cooperation with massive swap lines between them to alleviate the indiscriminate selling caused by the huge amounts of dollar debt round the world.

As a result, across most asset classes, markets stabilized Thursday-Friday (although US equities ended the week on a bad note), raising the key question whether the enormous and coordinated policy response will be enough to support markets on a more sustainable basis, thereby leaving the trough behind us, or whether – as I, and many others, have suggested so far – we'll still need to wait for the plateauing of the epidemic curves, and some clarity on the degree of damage done to the economies by the lockdown, before the lights turn more firmly green in markets.

If history is a useful guide, there is some hope that we are now through the worst in markets. US Treasury yields seem near what looks like a natural bottom, unless the Fed changes its mind and goes negative. And Bund yields may also be bottoming out in reaction to the news of the German government's enormous fiscal package coming through the Bundestag this coming week, pushing the deficit to maybe 5% of GDP, as well as huge guarantees etc. Also, the door to a broader eurozone fiscal approach to fight the health crisis now seems ajar.

Meanwhile, most equity indices are hitting levels associated with the turning points of some of the biggest crises we have seen in the past. For example, European banks (EuroStoxx Banks) now trade at price/earnings of just 35%, which is as low as during the European sovereign crisis, and lower than during the Great Financial Crisis. And with the ECB ramping up its asset purchases, including of sovereigns (and flexibly so!) and of investment grade non-financial corporates, it hard not to conclude that sovereign – and (ECB eligible) credit - spreads are pretty well anchored from here.

And yet, maybe history is not likely to be an appropriate guide for these unprecedented times! Certainly, in terms of government intervention across sectors, directly impacting millions of businesses' livelihood and thereby households, and central banks fueling markets with unmatched amounts of liquidity, this is "big government" like we have never seen it before in peacetime. To me, this raises many more questions than answers when it comes to the trajectory of GDP, and hence income and value creation in our societies. Certainly, before we even begin to think about what the right asset values are, we surely need to consider how – and when - we get through this, and what the world will look like on the other side. As historian Yuval Noah Harari writes in this weekend's FT, "temporary measures have a nasty habit of outlasting emergencies".

## 2. The alphabet of possible trajectories of GDP: Will it be a V, U, W or an L?

Nobody doubts that both Europe and the US are already in a steep decline in output. Q1 will be down a fair bit (held up by the decent numbers in January-February before the March collapse), while Q2 will surely see huge double-digit declines across the board.

Hopefully, we'll see a trajectory that looks like a "V", with the trough in Q2 and a nice recovery in H2, or, no more than a "U" with a brief "bottom", meaning that the recovery could be delayed until summer or autumn. But there is a considerable risk that we could be heading towards a "W" shaped trajectory of a year or two of ups and downs – or we might even in some places get the dreaded "L" shaped story of permanently lost activity.

### These are the key four considerations for what we may be looking forward to:

**First**, there is the shape of the epidemic curves, specifically when they'll flatten. Developments in most countries continue to broadly follow the Chinese path. If so, Italy should see its curve flatten within a week or two, thereby reducing the number of new cases to a trickle, while France, Spain and Germany seem to be 7-10 days behind Italy, and the UK and US some further two weeks behind. Yet, with vastly different policies of testing, these curves may end up being increasingly meaningless.

**Second**, how long will it take after the flattening of the curves before the various authorities begin to lift restrictions on businesses – and how long will fear remain in the general population - thereby slowing the return to normality? We'll probably have to wait close to two weeks after the flattening of the curve before the lifting of restrictions begins, simply to await the roughly two weeks' incubation period to also pass. And in Europe, there is a considerable probability that we'll need to wait for the laggards, including (on present numbers) the UK. In other words, we may still be 6-8 weeks away from the first tentative lifting of restrictions.

**Third**, I worry about the risk that only stringent containment measures can curtail the spreading of the virus (or that the virus evolves in a way that it keeps evading the human immune system, a bit like the seasonal flu), which means that we may get improvements in curtailing the virus, then some lifting of restrictions, during the summer, followed then by another pickup in new cases later in the year. This may then lead to a GDP trajectory that resembles one or several "Ws" – until either a vaccine is discovered (minimum 12-18 months down the line, they say), or mass-immunity has built up, also many months away. (Amazingly, as the UK government abandoned its (mindboggling) flirtation with "herd immunity" on Friday, the PM seemed to suggest that they would try to engineer a "W" path during the next 12 months or so.)

**Fourth**, we don't know how effective the policy measures taken so far will be. Remember that China not only introduced draconian measures to stop the spreading of the virus, they also delivered a series of targeted fiscal measures to the most impacted businesses and households, as well as a general stimulus. In Europe and the US there is a risk of a "L" shaped trajectory for GDP. This could happen if the lockdowns are not matched by sufficiently aggressive targeted – and general - fiscal policies to keep fundamentally good companies alive. In such a case, what is now a liquidity crisis among SMEs and many others companies as well as households would become a solvency crisis.

Here, I am particularly worried about Italy (with too timid a policy response so far) and the about the US (with insufficient targeted measures – although the flexibility of the US economy would limit the longevity of the flat part of the "L"). I'll come back to Italy below.

### **3. An illustration of how deep a “V” can be – and what to look out for to avoid the “W” or the “L”. My specific concerns are about Italy.**

I am not making any projections here, but just to illustrate the potential severity of the impact of the lockdown, even adjusted for the already announced policy measures, if you were to assume that the most exposed sectors to the lockdown, e.g. hospitality, transportation, retail and wholesale, etc., (which contribute about 20% to GDP) drop by 50%-80% for just a 4-6 weeks period, and the rest of the economy drops by 25%-50% during the same period, and the entire economy then gradually returns to normal by the end of 2020, then you would get annual GDP numbers for this year on the order of -5%--10%.

Needless to say, that's probably as close to the optimistic “V”-shaped outlook that you can get. A “U”-shaped trajectory certainly will get you to the lower end of that range, and more likely into the -10%--15% range for 2020.

In contrast, a prolonged “W”-shaped story, or something resembling the dreaded “L” (through 2020 and into 2021), easily gets you a collapse in GDP of 20%-30% this year. In my assessment, there is no conceivable forecast for 2021 that would bring GDP levels even close to 2019-levels if this year turns out to see more than a 10% drop in GDP. If we end up seeing hits to 2020 GDP of 20%-30% (because businesses are allowed to collapse), it could take a generation to restore GDP levels to what we enjoyed before the crisis – which ought to make you wonder about equity values...

**So what's needed to increase the chance of a “V” trajectory and, most importantly, to reduce the risk of something resembling the dreaded “L” shaped outlook?**

**In my assessment, we need three components:**

**First**, the opening shots for direct support of the most impacted areas have been good in many countries, but not sufficient in all areas. Coverage of part of workers' salaries and other measures are necessary, but not sufficient. Therefore, many countries have rolled out guarantees for the SMEs to stay alive, particularly with comprehensive programs in Germany and France. In contrast, Italy (which, ironically, is more dependent on the survival of their small companies than most other countries) has been strangely timid when it comes to helping their SMEs and households.

As far as I understand, the way-too-timid response in Rome is rooted in a misguided obsession with the Italian sovereign debt level. There are two key problems with such an obsession: (i) As I have argued before, debt sustainability is a function of debt service obligations relative to your income stream (i.e. fiscal revenues), and not the stock of debt over the potential source of income (GDP). Let me remind you that Italian interest obligations as a share of fiscal revenues are in the same ballpark as e.g. Spain and the UK. And if anyone doubted the “low for longer” interest rate story before, the world's central banks have now effectively put that to rest. So how about GDP, the base for fiscal revenues? (ii) When considering policy measures, you need to consider the impact on GDP, and hence the fiscal stance, relative to the counterfactual – not relative to present state of affairs.

Without urgent and sufficient targeted support for the SMEs during this unprecedented crisis, a very large number of Italian SMEs will surely collapse into bankruptcy, thereby accelerating the collapse in GDP. If so, Italian GDP is unlikely to pick up along with other countries later this year, or next, making the “L”-shaped trajectory a real risk in Italy. In such a scenario, it is not difficult at all to see the risk of a 20%-30% decline in Italian GDP this year. If anything of this magnitude were to materialize, parts of the Italian banking system would be in trouble – and before you know it, sovereign debt to GDP will end up much higher than in a scenario of support for SMEs and households comparable to what's being rolled out in other major European countries.

And when acting to rescue SMEs (and the households depending on them), a guarantee scheme is a particularly efficient way of doing it because the required institutions and networks are already in place so valuable time is not wasted. In Germany, for example, KfW provides the guarantee (starting tomorrow, Monday) and the SMEs can use their normal banking partners to get the needed credits. Why Rome is hesitating beats me.

The **second** component of the policy response needed to maximize the chance of a “V” scenario, while minimizing the risk of (negative) long-term effects, is “general purpose” fiscal stimulus. This is needed because it’s unrealistic to think policymakers can hit all the deserving parts of the economy, and when crisis hits, you better do too much than too little. Also, general fiscal stimulus will help support the recovery when it comes. In Asia, both Hong Kong and Singapore have sent cash directly to all households, and in the US a bill is now making its way through Congress which would authorize the Treasury to send cash (\$600-\$1,200) to everyone with an annual income below \$100,000. I hope Europe would do something similar.

It’s indeed a great time to be bold - and to show the necessary solidarity within the eurozone during this health crisis. Seven German economists, including professors Jens Suedekum and Moritz Schularick, have proposed a common eurozone bond issuance for a trillion euros to fund the efforts, and a (different) group of 13 economists from across the eurozone (including Agnes Benassy-Quere, Marcel Fratzschner, Clemens Furst and Beatrice Weder di Mauro) has proposed a dedicated Covid Credit Line for all member states at the ESM. Both are excellent ideas; I hope our political leaders will act on them – if not now, when?

**Finally**, central banks need to remain alert, and to add further liquidity to markets, if needed, including via further swap lines between each other. Further expansion of QE-like instruments may become particularly important if the fiscal authorities were to go all out (as they ought to) and expand their budgets more dramatically, e.g. via direct payments to the most vulnerable households. I find it difficult to see the downside to such a radical fiscal measure, combined with proportional increases in QE, at this time – while the potential upside would be substantial.

And on that note, I’ll brew some more coffee, put on a coat and find a spot in the sun on my balcony for a brief rest – before turning to the many emails in my inbox from this morning.

I hope you are all in good health – and will remain so. And thank you to all the health workers out there!

Best

Erik

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