Sunday Wrap

Happy Sunday,

This past week saw the amazing coincidence of the publication of the deepest quarterly economic decline in the Western world in almost 100 years and the conclusion to the strongest monthly equity rally in more than 30 years. The "common wisdom" seems to be that markets are being fueled by the prospect of a gradual easing of the lockdown, and hence a presumption of better growth ahead, as well as by central bank policies.

I'm not so sure this is sufficient justification for the rally. I'll make the following four arguments:

- **It's too early to buy the growth-resumption story. We are probably not through the trough yet, and the implications on activity and earnings of this pandemic will almost certainly be longer than generally assumed.**
- **While major central banks are doing an amazing job, still more will be needed from the fiscal side to get decent growth and earnings back.**
- **In Europe, further challenges are now arriving because the usual race to the bottom among the credit rating agencies has begun. This highlights - again - the rating agencies' outsized, policy-mandated, role in asset allocation.**
- **On Tuesday, we'll learn the outcome of the German Constitutional Court's ruling on the ECB's Public Sector Purchase Program (aka QE). I'm convinced they'll rule in favor of the ECB, but if I were to be wrong, mayhem of a previously unseen scale will descend on Europe and the world.**

1. It's too early to buy the growth-resumption story!

This week's publication of Q1 GDP numbers from the US and Europe confirmed the devastation to growth caused by the lockdown. Eurozone GDP contracted by 3.8% (qoq non-annualized), while US GDP shrank by 4.8% (qoq, but annualized). China, which is faster than anyone else at these things, reported Q1 GDP two weeks ago, at -9.8%.

The importance of the lockdown is evident. Indeed, if you plot the Q1 GDP numbers, including for the individual eurozone countries, (with the US number translated into quarter-on-quarter non-annualized, like the rest, of course i.e. -1.2%) against the Oxford COVID-19 Government Response Tracker, which measures the severity of government lockdowns, you get a virtually perfect correlation. The only serious outlier is Italy, which at -4.7% did a lot better than the -8%-9% suggested by this otherwise impeccable correlation between Q1 GDP and the severity of the lockdowns.

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The question is now what the gradual re-opening of the economies will do to activity in Q2. And after that, what will the trajectory of a H2 recovery look like? My contention is that markets (and consensus) are way too optimistic for the rest of this year – for the US, and for the eurozone.

Being now the epicenter of the pandemic, and well behind Europe in terms of the lockdown, the US surely has some seriously bad numbers ahead. We think Q2 will see a contraction in US GDP of about one fifth (which, yes, will look absolutely mind-blowing when they annualize it!) Can their uneven implementation of lockdowns cushion the blow to GDP? I doubt it because the "economics of fear" will likely dominate. Note, for example, how department store sales in South Korea plummeted even in the period leading up to this past week's great feast of zero new cases! For the bleak US outlook, Jay Powell said as much on Wednesday when he distanced himself from the narrative of a "V-shaped" recovery.

And while Europe is through the peak for infections and heading into some gradual easing of the lockdown, we are not out of the woods yet. Without a doubt, eurozone Q2 GDP will suffer by far the greatest quarterly contraction in living memory; we think on the order of 20%. And while we used to be quite lonely with our deep-contraction forecast (published April 2), the ECB has now published three working-assumption scenarios (while we wait for the new June forecast), which include something very close to ours: Alternative scenarios for the impact of the COVID-19 pandemic on economic activity in the euro area

The three ECB scenarios lead to a full-year 2020 GDP contraction of between 5% and 12%, as referred to by Lagarde on Thursday. Their "mild" scenario of -5% is very close to the present consensus forecast of -6%. Their "severe" scenario of -12% is very close to our forecast of -13%. In the ECB's "severe" scenario, they see Q2 contract by 15%, followed by a gradual recovery which will not see pre-crisis GDP levels restored until 2023. The ECB's very illustrative scenario analysis is here

While our forecast is for a deeper hit in Q2 (-20%) than the ECB's "severe" case, we have a slightly faster recovery than they do in H2. As I discussed last week, I remain very happy with our overall 2020 forecast, but on present information I think the risk to our forecast is towards the trajectory that the ECB has in its "severe case", i.e. a slightly less deep hole in Q2 (as the opening of the economies seems to start a bit earlier than we assumed), but a slower recovery in H2 as it's becoming evident that severe restrictions will need to remain in place until medical treatment or a vaccine is widely available. But for the annual average, -12%-13% still seems good to me – and a whole lot more likely than consensus' forecast of only half of that.

Given the outlook, the ECB didn't wait for further evidence of the collapse in output. On Thursday, they added more, and cheaper, liquidity to the system, in a move that I judge to be more impactful than the market reaction has suggested so far. And, they left no doubt that more will be coming, as needed. In his outstanding blog Friday morning, Philip Lane writes that they will "further adjust our instruments if warranted. This includes increasing the size of the PEPP and adjusting its composition as much as necessary and for as long as needed."

It couldn't be clearer than that – not least when read in combination with their call for more on the fiscal front, as I'll return to below. (Meanwhile, Philip Lane's must-read blog explaining the economics of the ECB decision and their thinking is here: The monetary policy response to the pandemic emergency)

2. Will we get more – and enough – fiscal stimulus?

As you have heard me say before, a good rule of thumb is that when hit by a shock you want to provide as much fiscal stimulus as a percent of GDP as your projected decline in GDP. While it's difficult to translate the European guarantee schemes into traditional fiscal expansion for this purpose, I have argued before (and I still think this is true) that while Germany and France have done just about enough to cushion the downturn, Southern Europe has not. This includes the use of state aid, where the FT reported on Friday that Germany accounts for 52% of Commission-sanctioned state aid following the outbreak of the pandemic, roughly twice its share of the EU economy. (The FT story focuses on complains by Spain and other Southern Europeans that this leads to unfair competition and "rupture of the single market". I agree, and it illustrates the need for a common approach across the EU, but until we get that, I ask the Southern European policymakers: What's holding you back?)

In my book, most of Southern Europe should add another 2%-5% of GDP in immediate fiscal support, primarily for SMEs and less well-off households. Hence, it's good to see the Italian government's package of further fiscal measures now in the pipeline, which is said to be about twice as large as the one approved so far.

In addition, as the lockdown is gradually rolled back in coming months, we almost certainly need an incentive for households to spend and for SMEs to invest. The most attractive measures here would be a large temporary cut in the VAT rate across Europe, e.g. by 5-10pp for 6-12 months as the economies begin to open up again. For the SME sector, I would recommend a comparatively large tax incentive to invest during the next 6-12 months (e.g. 100% tax deductible) and incentives to attract new equity capital.

Yes, I hear the chorus singing the old song of budget deficits and sovereign debt, but the world has moved on from that song – at least for the time being. Like other major central banks, the ECB is there to assure that monetary conditions won't tighten with the budget expansion and higher sovereign debt – and, explicitly now, in any part of their jurisdiction

If in doubt, read what Philip Lane wrote on Friday: "Globally, a potential source of upward pressure on the risk-free yield curve is the prospective scale of public debt issuance: although there is a wide range of empirical estimates, the international historical evidence suggests that an increase in public debt is associated with an increase in real interest rates. Under conditions in which macroeconomic stability and price stability call for an easing of financial conditions, central banks are reacting to this upward pressure by easing the monetary policy stance, including through quantitative-easing measures.

… [and] there is an additional market stabilisation role for the common central bank in a multi-country monetary union. In the absence of the stabilising presence of the central bank, a crisis environment can give rise to self-fulfilling flight-to-safety dynamics and illiquidity in individual sovereign bond markets, on account of the high substitutability across sovereign bond markets in the absence of currency risk. Such non-fundamental volatility in spreads impairs the smooth transmission of monetary policy across countries and it is a basic task for the central bank to counter such destabilising forces."

It really can't be any clearer than that: The ECB will buy whatever it takes to keep yield curves under control, and thereby governments' funding costs, throughout the euro area.

And, as I discussed last Sunday, interest payments made by governments on debt held by the central bank really is payments made to themselves so long as the central banks keep the debt on their balance sheet.

Of course, I too hear the question what then happens when the ECB needs to exit its present very accommodative policy stance and reduce the size of its balance sheet? But the answer is simple: Such a future policy decision by the ECB will be determined on the back of the economic environment in the eurozone. And if you think a future ECB will shrink its balance sheet even though it would put economic and financial stability at risk in any part of its jurisdiction, well, then I'm sure you'll need to think again…

3. The risk posed by the outsized role of rating agencies – again.

As the economic outlook darkened with the arrival of COVID-19 and the lockdown, forecasters around the world have revised down their outlook for growth, and up for budget deficits and public debt, including the credit rating agencies.

These past few weeks, the credit rating agencies delivered down-revisions of their outlook for a large number of European sovereigns (although not for the US or China), and in two cases, full downgrades of sovereigns were announced – both by Fitch. On March 27, the UK was downgraded from AA to AA- with negative outlook, and this past Tuesday Italy was downgraded from BBB to BBB- with a stable outlook, but now hovering on the edge of junk-status.

If you are a regular reader, you know that I believe that the role of credit rating agencies in determining eligibility criteria for securities at central banks as well as in financial sector regulation, and therefore in asset allocation, is destabilising for the economy and therefore deeply troublesome.

To be clear, everyone has the right to publish forecasts about anything, but when the official sector takes the forecasts of an extremely small subset of forecasters and uses them for operational aspects of policies we are in deep trouble. Not only are the rating agencies pro-cyclical, given their history of panic (the latest during the sovereign crisis), they literally have the ability to turn a manageable downturn into a full-fledged crisis.

I'm not aware of any other qualification for rating agencies to be used in policy operations than the fact that they have the guts to translate their assessment of countries into a simple numerical scale. They are surely not more accurate than other forecasters on average and their track record in predicting actual defaults is dismal to say the least, as shown by plenty of studies, including one done by my colleague Daniel Vernazza and myself a few years ago.

But even though, as part of their "post-sovereign crisis" regulation, they now need to stick with pre-set dates for changes in their ratings, there are loopholes, as we learned this past week when Fitch downgraded Italy. On its own schedule, Fitch was set to announce its next decision for Italy on July 10, but – apparently – it couldn't wait. So, when it announced on Tuesday its decision to downgrade Italy, it explained itself as follows: "Under EU credit rating agency (CRA) regulation, the publication of sovereign reviews is subject to restrictions and must take place according to a published schedule, except where it is necessary for CRAs to deviate from this in order to comply with their legal obligations. Fitch interprets this provision as allowing them to publish a rating review in situations where there is a material change in the creditworthiness of the issuer that we believe makes it inappropriate for us to wait until the next scheduled review date to update the rating or Outlook/Watch status..."

I remind you that, according to the rating agencies themselves, their outlook focuses on the next three years, so this claimed urgency is – of course – absurd. Rather, I suspect the issue is this: As we have witnessed in the past, the three major rating agencies are watching each other carefully and trying their best to avoid being last in what they may fear could turn into a series of downgrades. This is precisely what caused the mayhem in 2010-12 (e.g. Portugal was downgraded more than 10 times within 18 months in a clear race to the bottom!), which – on BIS statistics - contributed to more than a trillion euros to be withdrawn from the eurozone periphery by banks in the core of the eurozone.

This is, of course, madness. Granted, the probability of sovereign default has gone up with the onset of this crisis – but, surely, only marginally so. There is plenty of evidence that economic variables have very little explanatory power in default probability models because a default is (virtually always) a political decision. As I discussed last Sunday, whether 5% or 10% of fiscal revenues is allocated to interest payments (or even more than 30%, as Italy did at times before joining the eurozone) has nothing to do with economic or financial capabilities, but all about political will.

Not surprisingly, therefore, the single most important variable in any default probability model is, by far, whether a country has defaulted in the past. (And in case you wondered, since World War II, only the following European countries have ever defaulted: Germany, Poland, Romania, Russia, Yugoslavia and Ukraine – and, sort of, Greece, although their debt deal was done without an actual default.)

When designing the PEPP, the ECB took the madness of their own rating agency dependence into account and including Greece in the program. And there is no doubt that any potentially future sub-investment grade sovereigns would remain eligible for the PEPP as well – but maybe not for the standard QE?

To be clear, no other central bank in the world cares about the rating of its own sovereign when conducting policies, and ultimately the ECB will need to find a way of dismissing – completely and on a permanent basis - sovereign ratings for their operations as well.

But even as the ECB is watering down its own direct dependency on sovereign ratings, the ratings by predominantly just the three big agencies still matter for the effectiveness of policy making because they drive real money private investors. As such, there is an important institutional impediment to the proper functioning of the single-currency union.

Put differently, when Philip Lane (correctly) writes, "A crisis environment can give rise to self-fulfilling flight-to-safety dynamics and illiquidity in individual sovereign bond markets, on account of the high substitutability across sovereign bond markets in the absence of currency risk", he is not just talking about speculative capital flows, but the underlying institutionally-driven capital flows, dictated by the role in asset allocation – via regulations – of less than a handful of private, for-profit, research outfits (none of which based in the EU, let alone the eurozone), whose only real qualification is their willingness to put complex evaluations into an easy-to-understand (if deeply flawed) numerical scale.

But until this deeply troublesome distortion is addressed, and with Italy now teetering on the edge of sub-investment grade, and given that the rating agencies' own crisis-induced race to the bottom seems to have begun, we are all bound to look forward with excitement to what Moody's and DBRS have to say about Italy on Friday, May 8 – and, of course, what Moody's says about Greece (also on Friday), and what Fitch may have to say about Portugal on May 22, and S&P about Ireland on May 29. Or maybe these dates don't matter anymore, as claimed by Fitch?

My point is this: The credit rating agencies serve as a hugely destabilizing force in times of crisis – and their music has just started again this past week. Tighten your seatbelts as the ECB tries to fight the effects of this crazy situation. Volatility will be the inevitable outcome (but it didn't have to be this way …)

4. German Constitutional Court: The decision on the ECB's PSPP.

On Tuesday, May 5, the German Constitutional Court (GCC) will announce its final ruling on the ECB's Public Sector Asset Purchase Program (PSPP), aka QE, namely whether it is in violation of the German constitution. As my colleague, our Chief German Economist, Andreas Rees, has argued repeatedly, the GCC is almost certain to follow the European Court of Justice's decision and legitimate the PSPP.

As you may recall, the GCC has been thinking about this issue since 2015, when it was brought to the court by several complainants, including Peter Gauweiler (a former CSU member of the Bundestag) and Bernd Lucke, (the former party head of the AfD). In July 2017, the GCC temporarily suspended the case to send a number of questions to the European Court of Justice (ECJ), since it had concerns that the PSPP might violate various parts of EU Law, in particular those related to the prohibition of monetizing public deficits and the mandate of the ECB. However, in December 2018, the ECJ ruled that the PSPP is in line with all EU laws.

As Andreas argues, there are two key reasons why the GCC will rule in favour of the ECB. First, in 2016 they allowed the Bundesbank to participate in the more extensive OMT program, which allows unlimited government bond purchases of single eurozone countries (but based on policy conditionality). In comparison, the PSPP is finite (but without policy conditionality). With such precedence, it would be really odd for them to now rule the PSPP illegal.

Second, while the outcome is decided by judges, they are not detached from the political reality outside the court in Karlsruhe. As former deputy chancellor Joschka Fischer quipped when the case was accepted by the GCC, "the GCC does not have the mandate to derail the European project".

Specifically, if the GCC were to rule that the PSPP is non-compliant with German law, it would solely prohibit the Bundesbank from participating in the program and, strictly speaking, not block the PSPP itself. But it would put the Bundesbank in an untenable position because it's legally obliged to follow ECB decisions. With the Bundesbank thus stuck between a rock and a hard place, the PSPP program could only limp on (without the Bundesbank) for a short while. This would surely bring the existence of the eurozone at risk, thereby sending this most fundamental of European issues back to the lawmakers to clarify - urgently. I have no doubt about the outcome of that political process, not least at a time when the euro enjoys record-high support throughout the eurozone, including in Germany.

But these things would take time, and in the interim we would see unprecedented political, financial and economic turmoil – in the middle of the pandemic. Without a doubt, the GCC in Karlsruhe knows this, and it's not an outcome they would want to trigger. But it'll be good to get this issue behind us.

Finally, and wrapping it all up, I was – regrettably - wrong a month ago when I cautioned against risky assets. But my underlying worries for the outlook back then haven't gone away these past weeks. For that to happen, I'd like to see more aggressive and targeted fiscal expansion, particularly in Southern Europe – or the prospect of a widely available vaccine and/or therapeutic treatment within a 3-6 month period.

And on that note, I wish you a continued good Sunday afternoon.

Best

Erik

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