Sunday Wrap

Happy Sunday,

Today marks the 15th anniversary of Angela Merkel becoming German chancellor. She celebrates the day with sky-high approval ratings in Germany and a phenomenal standing throughout the world. She'll surely be missed by many when she steps down and leaves politics in about a year (as she insists she will).

That Mrs. Merkel has been great for Europe is – for me – indisputable. Without suggesting that I agree with every aspect of her policies, on the big issues I think the evidence is clear, ranging from her commitment to fighting climate change, to her blocking attempts by her then finance minister Wolfgang Schäuble to push Greece out of the eurozone, to her (critical, if behind the scenes) support for Mario Draghi when the ECB needed to launch QE and the OMT, to her opening the borders during the refugee crisis, to her U-turn on common borrowing when she teamed up with Emmanuel Macron to suggest the EUR 500bn program that then became the European Commission's Next Generation EU. Yes, I have a few quibbles as well, including the missing response to Macron's Sorbonne speech, illustrating either her reluctance as a strategist with a vision, or her instinctive skepticism towards people with great oratory skills (as suggested by Obama in his new book) – or maybe a bit of both? But I'll leave all that for a day closer to her retirement.

Rather, today I'll reflect on our brand new Outlook report, which we published this past Thursday. It includes our revised forecast for 2021 and our first guesstimates as to what 2022 might look like. We call it "the tantalizing prospect of normality", reflecting both the recent news of the imminent arrival of effective vaccines, which we think will boost the European and US economic recovery in the second half of next year, but also our conviction that "normality" in terms of GDP levels, economic policies and therefore markets will remain elusive for much longer.

How "normality" should be defined and what it entails is, of course, debatable, so that's what I'll focus on today:

- **I'll start with a very brief summary of our report, so that we start on the same page for the "normality" discussion, in case you haven't had a chance to read it yet.**
- **I'll then discuss the issue of "returning to normality" and what it means for fiscal and monetary policies.**
- **Finally, I'll discuss the risk of getting it wrong, particularly as it relates to European banks and their ability to intermediate capital on market conditions, and hence function as an effective transmission mechanism for monetary policy – which, in case you have forgotten after all these years, is also part of "normality" in a markets based economy.**

1. Summary of our report:

Our Outlook report includes our best guesses for growth, inflation, policies and markets, as well as our thinking on the many substantial risks facing us right now. Needless to say, I hope you'll take a good look at it and reach out to discuss it with my team. It's here in case it got lost in the mail: The UniCredit Macro & Markets 2021-22 Outlook

But for now, here's a very brief summary: As our starting point, it seems overwhelmingly likely that Asia is already back on track to economic recovery. Following the identification of the first case in Hubei a year ago this past Tuesday, the pandemic hit China and the rest of Asia a few months earlier than the rest of the world. More importantly, Asian governments handled the outbreak, and the containment, more effectively than the rest of the world, thereby limiting the medical and economic downside. All indications are that they will avoid the second wave. In contrast, we feel reasonably confident that the second wave of the pandemic and the resulting necessary lockdowns have caused another contraction in European (and maybe US) GDP in the final quarter of 2020.

We predict that the contraction in GDP will persist in Europe and the US throughout most of the winter, before warmer weather and the likely roll-out of a number of vaccines next summer will result in the lifting of most lockdowns and rising sentiment more broadly. This should fuel a genuine economic recovery in the second half of 2021.

If so, following modern history's most severe collapse in global GDP (of about -4% this year), the global economy will likely grow by 4-5% next year – and, we think, by about the same rate in 2022.

With a growth rate of 8-9% in 2021, we expect China to return to its pre-crisis trend for GDP during the next few months (note, as a warm-up for the next section, that Chinese policymakers were not satisfied just getting back to the pre-crisis level!) US GDP will probably return to its pre-pandemic level during the first half of 2022 and Europe some six months later. We forecast eurozone GDP will grow by about 3% in 2021 and 4½% in 2022, including 3¼% growth next year in Germany and France and 2¾% in Italy. We predict 3½% GDP growth in EU-CEE in 2021.

This macro picture should lead to a moderate increase in the 10Y Bund yield to around -0.30% by the end of next year, while the 10Y BTP-Bund spread should trade around 115bp throughout next year, reflecting the pan-European policy responses, including both the ECB's PEPP and the roll-out of Next Generation EU. In the US, the 10Y yield is likely to rise to 1.30% by the end of 2021.

In such an environment, we expect to see strong growth in company earnings across the OECD in 2021, fueling a continued constructive view on global equities and credit markets. We expect European equities to post double-digit returns next year, led by cyclical stocks. Investment-grade credit spreads will be squeezed by a combination of ECB purchases and low net supply, probably driving them to historical lows. As intended from a policy perspective, this will drive demand towards the lower tiers of the capital structure and high-yield credit (although still leaving businesses dependent on these parts of the financial market, as well as SMEs without access to the securities market, disadvantaged, as I'll discuss in Part 3 below). Risk appetite is also likely to be a key driver in the FX world, pushing the dollar weaker. We expect EUR-USD to reach 1.28 in twelve months' time, which is very close to our estimate of fair value. Brexit is likely to send EUR-GBP to 0.94.

2. The "return to normality" and what it means for fiscal and monetary policies.

I'll address the issue of "normality" in two segments. First, the issue of growth, the level of GDP and the policy mix that follows. Then, in Part 3 below, I'll discuss the risk to the banking sector, and hence the issue of the allocation of capital and the transmission mechanism more broadly.

But first growth, GDP and policies: Judging from the present debate, most European policymakers seem to define a return to "normality" as when GDP reaches pre-pandemic levels, leaving open the possibility of a gradual "normalization" of policies to begin even before that.

This would be a mistake (and it would stand in stark contrast to the Chinese approach where the policy stimulus was designed to restore the trend, rather than just the level.) The end-2019 GDP level surely cannot be more than a milestone on the road back to normality. Only when the GDP level reaches the vicinity of where it would have been had it not been for the pandemic, (i.e. around where the pre-pandemic trend line would have taken us, adjusted for some moderate destruction of potential output), will the additional output gap created by the pandemic and lockdown have been eliminated. And only then should policies be "normalized".

So far, the fiscal rules have been suspended for 2021, which is good, but this past week the European Commission still found it necessary to urge a number of countries, whose 2021 budgets they had signed off on, to be careful about the build-up in public debt. (Countries mentioned, according to the FT, were Belgium, France, Greece, Italy, Portugal and Spain).

To be clear, debt sustainability is critically important, but the obsession with public debt is misguided and potentially harmful for policies and hence the return to "normality". Remember, we learned during our first year in school never to mix stocks with flows, and yet, all we hear is this reference to debt/GDP, with very little mentioning (outside a few academic institutions and think-tanks) of the significant – and positive - effect on debt sustainability (of any given stock of debt) of the structural decline in interest rates in recent decades.

Consider this: 25 years ago, the weighted average of the countries now making up the eurozone paid about 10% of their total government spending on interest payments. Germany and France paid some 7%, Italy and Greece roughly 20% (reflecting the fact that a sizable part of their debt was denominated in foreign currency which kept appreciating). The year before the ECB launched its QE, the eurozone average sovereign interest payments, as a share of total government spending, had fallen by half, to 5%, and the Italian ratio to about 8% (the Greek ratio had fallen to 6-7%, helped by its restructuring). It's now just 3% for the eurozone and some 7% for Italy. If the debt level wasn't a key issue back then, why is it today? (If you tell me the problem will occur when interest rates rise again, I suggest we compare notes again in ten years or so, hoping we are then still alive and living in a flourishing economy and democracy – at which time we can debate how demand and supply for money determine the interest rate and the role of monetary policy.)

Again, debt sustainability is critically important, but the focus on debt/GDP as the key indicator is misguided. Indeed, I would argue that this issue, as well as the highly questionable output-gap calculations, contributed significantly to the decision to pursue (pro-cyclical) fiscal austerity during the last crisis which, in turn, contributed to the lower growth Europe has witnessed these past ten years. Worse, the "selling slogan" of austerity - "short term pain for long term gain" - wasn't even justified because, in spite of the lower funding costs, governments (without exception) implemented their austerity predominantly through deep cuts in public investment, rather than in the politically more complicated public consumption or on the revenue side. As a result, Eurozone average net public investment dropped from an already mediocre 0.5-1.0% of GDP before the financial and sovereign crises to roughly zero, and in many cases into negative territory, thereby depleting the public sector capital stock – and this as additional competition from globalization swept the world. Just saying…

So here is my key concern as we begin to see the end of the pandemic: if fiscal policy "normalizes" too early or at a too fast a pace, say during 2022, let alone 2021, it will slow the recovery while putting additional strain on monetary policy to reach its inflation target. This will leave more people unemployed and at lower income, and - almost certainly - income distribution more skewed, than if fiscal policies are guided by a proper understanding of debt sustainability.

Too early fiscal "normalization" and the renewed stress it'll place on monetary policy will also delay the return to "normality" for the European banking system, with the circular effect that the intermediation of capital will remain skewed and suboptimal, while the transmission mechanism of monetary policies will remain impaired…which leads me to the my next concern about the "return to normality":

3. The risk of getting it wrong as it relates to European banks and their ability to intermediate capital efficiently and function as an effective transmission mechanism for monetary policy.

The past decade's relatively low European GDP growth and very accommodative monetary policy stance with very low interest rates and flat yield curves (both largely courtesy of fiscal policy that has been too tight due the misguided understanding of debt sustainability), the burden of the tsunami of new (mostly uncoordinated) regulation together with banks' remaining bloated cost structures from the pre-GFC era, caused insufficient profit across the banking sector to compete with other sectors for capital. As a result, with few exceptions, European banks have traded below their book value for years, in most cases significantly so, including at the time we were hit by the pandemic. Since then, European banks' 12-month forward earnings per share (EPS) have dropped by two-thirds, making a difficult situation even worse.

To state the obvious (if simplifying matters slightly), if a publicly traded company's equity trades below its book value for an extended period of time, the only rational thing for the company's shareholders to do is to insist on management shutting down business units, freeing up capital and buying back its shares. If it doesn't do so, external investors would want to buy the company outright simply to close it down, thereby walking away with the difference between the purchase price and the book value. And if that doesn't happen, financing would simply dry up and the company would cease to exist.

Of course, as we know, this rationale doesn't apply to European banks. Businesses may have been shut down and assets sold by the banking system, but it make little commercial sense for banks to use the released capital to extend credits to businesses or households because the profitability of such (normal) bank activity is well below the banks' own cost of capital. That, of course, is not sustainable, so the ECB stepped in to fund the banks' lending business, e.g. via the TLTROs.

Then came the pandemic, and banks played their role of intermediating financing to the corporate sector to make sure liquidity problems didn't turn into solvency problems. The general narrative is a celebration of the work done in past years to raise banks' capital ratios (good, to be sure), which – according to the now ruling narrative – made it possible for the banks to become "part of the solution", rather than "part of the problem", as had been the case in previous crises.

I'm not arguing against the existing level of capital, but I find this narrative naïve. Banks' ability to be "part of the solution" have relatively little to do with capital ratios and everything to do with ECB funding and state guarantees. Indeed, the financing to the real sector provided by banks was sourced not commercially (which would have been absurdly expensive, if not impossible), but from the ECB's TLTRO facility, and it was lent mostly with state guarantees – incidentally at low credit spreads, which have further depress the overall margins of banks. Meanwhile, with plummeting forward EPS, banks were persuaded not to pay dividends until further notice, while they lost huge chunks of their market value (surely a chicken-or-egg issue, which I'll leave unaddressed here.)

As a result, two major market distortions have been exacerbated:

First, as long as banks are prevented – legally or politically – from charging their depositors negative rates, the negative repo rate at the ECB implies a tax on banks' profits and thereby on the effectiveness of the transmission mechanism. Yes, you can compensate banks by providing other benefits, such as the tiered funding rate, but that only serves to move financial intermediation further away from market conditions to non-commercial sources, which then comes with various types of conditionality. One cannot escape the conclusion that this – one way or the other – skews markets. The solution is to either raise the depo rate to zero, or to provide banks with the authorities' backing and encouragement to pass on the negative rate to their depositors.

Second, as long as the ECB buys investment-grade corporate debt, but not non-rated debt or high-yield debt, they skew the financing conditions between those lucky enough to have their securities bought by the ECB and the rest, including SMEs, which will need to finance themselves through the banks. And since the banks' own commercial funding costs remain prohibitive, the funding will – again – need to come from the ECB at rates and conditions set by the central bank. The solution is for the ECB to either buy a broader set of private-sector assets, including bank securities (as indices or derivatives to get around the conflict issue), or to scale back their IG purchases. (I favor the former.)

To be sure, distortions happen all the time and are acceptable in extraordinary circumstances, but the cost of distortions accumulates over time. The hope, of course, is that "normality" in terms of GDP and other policies returns before the damage becomes too great, so that the extraordinary measures can be unwound and banks returned to a position from where they regain their place as normal private companies, competing for capital with all other private companies.

However, when a new shock arrives before the first-round distortions can been unwound, as is now the case, one has to think hard as to whether one digs the hole deeper by adding further distortions or whether one designs policies to put banks on the road back to normality where they allocate capital commercially, thereby strengthening the transmission mechanism. Few would argue that banks shouldn't have absorbed part of the shock when the crises hit ten years ago, but it was supposed to be temporary. After ten years, the damage to intermediation and to the transmission mechanism, caused by the asymmetry in banks' balance sheets, is now becoming visible as further stress of low growth and higher NPLs emerge on the horizon. The ECB's bank lending survey in October showed that banks' approval criteria for loans to businesses and households had tightened, reflecting the effects of the pandemic.

The signals from the ECB ahead of its December decision are comforting, but the noise in the background, e.g. on additional (cyclically adjusted) capital buffers and still deeper negative rates leaves me worried for the outcome of the ECB's policy review next year.

Of course, the ECB cannot do it all alone. As I argued above , fiscal policy must play its role, but while it certainly has done so this year, and the outlook for next year remains okay, I detect concerning noises here.

But I'll end on a positive note. My prediction is that the apparent success of mRNA in delivering vaccines for COVID-19 will move the researchers in this field from the fringes of medical research to the center, which will make it much easier for them to attract capital. That, in turn, will speed up the chances of mRNA delivering what most of the researchers always thought it would, namely effective treatment for a multitude of diseases, including cancer. This holds the prospect of generating longer and healthier lives for all – and that will help compress the natural interest rate, making existing debt stocks even more sustainable in the future. But such a prospect, of course, only raises the stakes when it comes to sorting out the environment in which banks can again play their intended role as sufficiently profitable companies.

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

Erik

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