APRIL 2020 MACRO BRIEF

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LAST WEEK IN MACRO

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Those with a remaining shred of faith in the world's international or supranational organizations might be interested in the International Monetary Fund's (IMF) estimates of the economic impact from the near-universal 'lockdown' response to COVID-19.

For context, note that the global economy expanded at an inflation-adjusted 2.9 percent during last year. That comprised growth averaging 1.7 percent across the advanced economies and 3.7 percent across the developing and emerging market economies.

For the current year, the tea leaves at the bottom of the IMF cup project a bitter decline totalling 3.0 percent at the global level and incorporating falls of 6.1 percent in the advanced economies and 1.0 percent across the rest.

On a sweeter note, and contingent on the assumption that 'the pandemic fades in the second half of 2020 and containment efforts can be gradually unwound' global growth will stir toward a 5.8 percent gain next year when gains average 4.5 percent for the advanced economy group and 6.6 percent for the developing and emerging economy group.

Here's how the 2019, 2020 and 2021 estimates fall for each of the G7 nations:

USA = +2.3 percent, -5.9 percent, +4.7 percent
CAN = +1.6 percent, -6.2 percent, +4.2 percent
GBR = +1.4 percent, -6.5 percent, +4.0 percent
FRA = +1.3 percent, -7.2 percent, +4.5 percent
GER = +0.6 percent, -7.0 percent, +5.2 percent
ITA = +0.3 percent, -9.1 percent, +4.8 percent
JAP = +0.7 percent, -5.2 percent, +3.0 percent

And the same for the BRICS:

BRA = +1.1 percent, -5.3 percent, +2.9 percent
RUS = +1.3 percent, -5.5 percent, +3.5 percent
IND = +4.2 percent, +1.9 percent, +7.4 percent
CHI = +6.1 percent, +1.2 percent, +9.2 percent
SAF = +0.2 percent, -5.8 percent, +4.0 percent

The China and India figures in the middle, representing the estimates for growth in 2020, are not typos by the way – they really are positive. Bear in mind that these are for the full year, reflecting big but temporary declines in the early part of the year (Q1 in China and Q2 elsewhere).

The 2020 numbers are horrible. They compare with the losses experienced during the 2008-2009 Great Recession when the US economy shrank by around 4.0 percent and the British and German economies contracted by close to 6.0 percent and 7.0 percent, respectively.

I don't know if those forecasts are going to be even remotely accurate - I have no way of gauging that – but I am with the IMF in spirit, I guess, because I too expect a big decline this year and a big gain next.

Mind you, in the interim, you're going to hear and/or read about some much bigger numbers than those…

And Here

That's because the headlines will focus on the data as it arrives and not on its likely evolution over the course of the full calendar year.

Case in point, the Office For Budget Responsibility (OBR) has just hit the headlines having projected a whopping decline in UK gross domestic product in the region of 35 percent during Q2.

Less well-reported is that the OBR's estimations couldn't possibly be described as a 'central forecast' along the lines of those issued by the IMF.

The OBR's analysis forms what they term to be an 'illustrative scenario' and is intended to provide a basis on which policy decisions can be better judged. The reference scenario cited is predicated on a full 90-day lockdown (not a 30-day lockdown, not a 60-day lockdown, a full 90-day lockdown) followed by a gradual easing over the following 90-day period.

In those circumstances, the relevant calendar-year decline amounts to something approaching 12.8 percent because the 35 percent freefall in Q2 is arrested and output 'bounces back quickly' thereafter - in the order, in fact, a of 25 percent increase during Q3 and a further 20 percent in Q4.

Mind you, if you think a full 3-month lockdown is likely, the OBR's 'illustrative scenario' isn't a bad proxy for your 'central scenario'.

Meanwhile I think a 3-month lockdown is unlikely. Others do too, as is evident in the IMF's 'central forecast' for a 6.5 percent decline. Other forecasts I've seen (and which might reasonably be described as 'central forecasts') range between -10.2 percent (SocGen) and -1.9 percent (Hetronomics) with a median of –6.4 percent, almost exactly in line with that from the IMF.

The numbers that really count, of course, are those that will be captured in measures of joblessness. The consensus – insofar as a consensus exists – sees unemployment move from 3.9 percent at the end of last year to 6.5 percent by the end of this year. The OBR's 'illustrative scenario' puts unemployment at a heart-breaking 7.3 percent.

It is sobering to think how high those numbers might have been (and might yet still be) had the Bank of England not acted swiftly to maintain a proper functioning financial system and had those moves not been allied by HM Treasury's efforts compensate employers for the forced closures.

That's what does for optimism these days.

And Here

Or maybe I'm wrong about that. It could be argued that there is no shortage of optimism in the stock market.

The MSCI World index peaked at 2,431 on 19 February before falling 34 percent to 1,602 on 23 March. A decline of 34 percent is big but it's nothing like the 50 percent decline that came about during the 2008-2009 crisis.

No matter, the MSCI World index now stands at 2,017, some 26 percent higher than the 23 March low.

That fact alone is enough to make some investors nervous.

Scott Minerd, Chief Investment Officer at New York-based Guggenheim Investments, is convinced that stocks are 'propped up by liquidity'.

With the S&P 500 index up at 2,850 today, he is warning of a likely retreat to much lower levels. He is quoted by Bloomberg as saying, 'it could be 1,500, 1,600, 1,200'.

Quite what 'propped up by liquidity' means, and why any of the numbers he picks might offer more realistic valuation levels is left out of the report. We do, though, get an insight into the reasons for his pessimism. He is said to be forecasting 'rolling shutdowns for the next two years, preventing a full-scale return to work'.

As it happens, I think Scott Minerd and I would agree on quite a few things. COVID-19 isn't going away any time soon and it seems quite reasonable to assume that it will have an impact on our societies for two years or more.

We're going to see a great many lost lives and a great many lost livelihoods.

First The Hammer

And therein lies the puzzle that the stock markets are trying to unpick.

On one side of the equation are the number of COVID-19 deaths and injuries and on the other side are the deaths and injuries associated with sustained and/or rolling economic lockdowns.

Severe societal restrictions, and plummeting economic activity, are not without consequence. The question is not one of 'health versus wealth', it is of health versus health.

The more we know about COVID-19, the more we increase our hospital capacity, the more we learn to contain the spread, the less damage it will do. At the same time, the longer the lockdowns persist, the more damage they will do.

There is a trade off here.

In my judgment, severe restrictions on economic activity will not last for as long as two years, COVID-19 or no COVID-19.

My understanding of the virus and the necessary policy response was helped along in leaps and bounds when I came across Tomas Pueyo's articles published on medium.com.

That's where I picked up 'the hammer and the dance' metaphor and from that moment, my research has been better focussed and I quickly developed a more useful framework for analysis.

Incidentally, be careful when you google 'the hammer and the dance'. You'll almost certainly hit upon the right article, but the temptation to click on an MC Hammer dance tutorial might manifest in a little lost time and an amazon order for a pair of 'hammer pants'. You've been warned.

I realise now that, Prior to reading Tomas Pueyo's musings, I had underestimated the immediate threat that COVID-19 posed. The reality was far worse than I imagined and doing nothing was not an option for policymakers.

The lockdown phase we are in represents 'the hammer' – a drastic tool with two objectives: 1) to buy time to increase capacity across the healthcare system and 2) control the outbreak.

The outbreak is controlled when the spread rate is represented by an 'R0' ('R-nought' or just R for short) of less than 1 – meaning that, on average, those infected pass the virus on to fewer than 1 other person. We don't know what the true R number is or was, but in some parts of Europe it is estimated that it was as high as 3 or 4 in the early phase of the pandemic.

More recently, Sir Patrick Vallance, the Government's Chief Scientific Officer, has speculated that R has now fallen to less than 1 across the UK, perhaps it is even as low as 0.6. Nevertheless, our government will likely maintain the current lockdown for the full 3-week extension. Who knows, we might see R dip close to zero and, in any case, we need time to build more testing capacity.

And so, it appears that the hammer works. (Though we don't know if R would have come down all the same even with less stringent measures).

Remember though, that the hammer will not eliminate the threat from CoVID-19. There will still be daily incidents of new cases and, sadly, more deaths.

That is why 'the dance' is so important. And it is a dance that will go on long into the night, until a vaccine is found.

Then The Dance

The main objective of the dance is to maintain R at or below 1. With am effective testing regime, life can begin to look a little more 'normal'. Still not actually 'normal' though, mind. The more effective the testing regime, the better the contact tracing effort, the further into normal life we can extend.

Social distancing in its milder form, including wearing masks, bans on large gatherings and travel restrictions, and ramped up hygiene will still be necessary. But more businesses will be allowed to open, with all that entails. And the sooner we get there, the fewer livelihoods will be lost.

Of course, there will be times when, and places where, R creeps above 1, necessitating a stricter policy response but with a proper testing regime those measures can be temporary and, importantly, they can be applied at a local rather than national level.

Just as there is evidence to support the hammer phase as an effective policy tool. There is increasing evidence to support the dance phase too. It is working in China, South Korea and Taiwan. In the next few weeks, before our dance begins here in the UK, we will have further evidence from Europe, particularly in Germany and some parts of Italy.

We'll also have further data from Sweden where the hammer phase was, almost uniquely, skipped entirely. The policy response in Sweden looks a lot like a dance we can do too.

NOTES.

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(1) MSCI United Kingdom Value, Bats 100, Bats 250, Bats UK Small Companies, S&P 500, Euro Stoxx 50, Nikkei 225, MSCI Brazil, MSCI Russia, MSCI India, MSCI China, Financial Analytics (2) MSCI United Kingdom, MSCI World ex Value, MSCI Emerging Markets, MSCI United Kingdom Value, Bats 100, Bats 250, Bats UK Small Companies, Barclays Gilt 1 – 5 Years, Barclays Sterling Gilts, Barclays Sterling Gilts 15+, Barclays UK Government Inflation Linked Bond, Financial Analytics (3) MSCI World, Barclays Global Convertibles, Barclays Global Treasury, MSCI World ex UK Large Cap, MSCI World ex UK Small Cap, MSCI World ex UK Value, MSCI World ex UK Growth, MSCI World, MSCI World Equal Weighted, MSCI World High Dividend, MSCI World Minimum Volatility, MSCI World Momentum, Financial Analytics (4) MSCI World Consumer Discretionary, MSCI World Consumer Staples, MSCI World Financials, MSCI World Health Care, MSCI Industrials, MSCI World Materials, MSCI World REITs, MSCI World Technology Hardware & Equipment, MSCI Telecommunications Services, MSCI World Utilities, Financial Analytics (5) SPDR FTSE UK All Share ETF, SPDR S&P 500 ETF, SPDR MSCI EMU ETF, SPDR MSCI Japan ETF, SPDR MSCI Emerging Markets ETF, SPDR Barclays Gilt, iShares Index-Linked Gilts, iShares Global Corporate Bond ETF, iShares Global High Yield Corporate Bond ETF, Mixed Assets assume separate equal weighted parcels of equity and bond exposure (6) Financial Analytics, overseas exposure assumes equal weight in US, Europe, Japan and Asia (7) Reference National Life Tables, Office for National Statistics, sustainable income assumes life expectancy, a gross 5 percent growth rate, annual income paid out at the start of the period.

www.townclosefp.co.uk

Suite 2, 258a High Road

Loughton

IG10 1RB

Tel: 020 7993 4898

Email: advice@townclosefp.co.uk