Letter n°17

Reasons for hope ?

« Every life is an adventure navigating between the unexpected and the unforeseen». François Cheng

After the unexpected Covid-19 and the ensuing unforeseen rapid stock market recovery, the words of ***François Cheng***, from page 34 of his beautiful book "***De l'Âme***" find an improbable illustration. Encouragingly, Germany, France and Great Britain are exhibiting less-than-expected GDP declines. According to the IMF, the decline in US GDP is expected to be only -6.6% this year, and the German government anticipates a decline limited to 5.8%, surprisingly comparable to the 5.7% recorded in 2009. The manufacturing PMI confidence indices in the US, China and Germany show improving signs. The measures to compensate for partial unemployment have been effective since the unemployment rate is only 6.3% in Germany. The IPO scene has seen much activity this year with $70 billion raised in the US, more than last year over the same period. The Paris Club has agreed to a debt service suspension of some 30 African countries, after the $160 billion in financing promised by the World Bank and the $80 billion in emergency aid granted by the IMF. There has been a decline in mortality despite a resurgence in Covid-19 cases. The world has joined in the race for a vaccine with several laboratories in phase 3 trials. "***Hope feeds hope***" wrote ***Seneca***. As the summer vacation draws to a close, let's examine the situation from monetary, budgetary, consumption, companies and stock market perspectives.

Monetary and budgetary: the strong point, two taboos fall.

From a monetary perspective, the total balance sheet of central banks rose from $3 trillion in 2007 to $21 trillion, an illustration of the central role taken by these institutions in economic policy. The annual Jackson Hole summit of central bankers, once again met investors' expectations. The ***Fed*** has given up making a 2% inflation rate the primary objective of its policy. In other words, a sustained period of inflation below 2% can be followed by a phase of inflation above 2%. Employment takes precedence in the Fed's objectives, with the Phillips curve defining the inverse relationship between unemployment and inflation forgotten. In recent years, it is true that everyone has been able to observe low unemployment rates without wage increases and without pressure on inflation. From Powell's speech, everyone can anticipate a long period of low rates. Christine Lagarde went even further by announcing a "strategic review" of the ***ECB***'s policy, and we can anticipate an announcement in December of a new injection program. These developments come as no surprise, because as we have often stressed, the priority in an indebted world is to keep rates low, which is the key to the solvency of governments and companies. This is not surprising, in view that the US inflation rate has exceeded 2% in only 15% of the months since 2012, a negative inflation rate of 0.2% in Europe in August, and a Japanese inflation rate that has never reached 2% in the eight years of massive expansionary monetary policy.

From a budgetary perspective, countries are continuing to deploy the measures announced, equivalent to 13% of GDP in the US, 12% in Japan, 9% in Germany, 6% in Great Britain and nearly 5% of GDP in China. The idea mentioned in one of our April notes is gaining ground, that of distinguishing between current and capital expenditure. In a context of negative interest rates, the paradox is that the debt reduction is made possible by more debt if it allows potential growth to be raised. ***Germany*** has clearly understood this, forgetting about budgetary rigor, to project itself into the future and invest in promising sectors, EUR11 billion for renewable energy, EUR50 billion for R&D and substantial amounts for infrastructure. The vice of the deficit thus becomes a virtue! In ***Italy***, according to Unicredit, paying the interest on the debt mobilizes 7% of tax revenues, compared to 30% in the 1990s, and the government is taking advantage of this to revive the economy in defiance of current debt. At the beginning of June, a 10-year EUR14 billion issue was eight times oversubscribed, despite the prospect of public debt at 160% of GDP at the end of the year. One could multiply the examples. According to ***Olivier Blanchard***, former IMF economist, public debt is a bad thing but it is not a catastrophe. We should not focus on the ratio of public debt to GDP, that is to say a flow on a stock, but we should consider the debt service on GDP, which in 2019 was half of its 1995 level.

Consumption: the point of comfort.

For the moment, in China, as in Europe and the United States, the recovery in consumption is timid, but the potential is there, and a confidence boost is needed. The exit from confinement had given way to some spending, but the reality is, depending on the country, a wait-and-see attitude, apprehension about the end of partial unemployment compensation measures and built-up of precautionary savings. In the ***United States***, the special allocation of $250 billion to increase unemployment insurance to 100% of the salary lasted four months and the $500 billion set aside to pay a check of $1200 to each adult and $500 per child came into effect in the spring. Only a fraction of this money has been spent and consumer confidence has not yet stabilized, even though the unemployment rate fell from 15% to 10.2% between April and July. It is now comparable to the October 2009 rate of 10%, which had remained at 9% for two years but is much higher than the 3.5% in February. In the ***European Union***, the unemployment rate in July deteriorated from 7.7% to 7.9%, and in Germany, consumption in July decreased after an increase in June, all of which are factors of uncertainty in the short term.

In ***China***, a recovery in car sales is recorded, real estate sales for the first seven months of the year are up 0.4%, but consumption, 40% of GDP, is still down 1.1% year-on-year, which is logical in view of unemployment and precautionary savings.

With confidence back, consumption could boost the recovery. In ***France***, additional savings for the year 2020 as a whole are estimated at EUR100 billion, nearly 4% of GDP, so there is potential for growth.

To restore household confidence and encourage them to reduce savings, it is essential for a rapid reduction in unemployment, and have tax incentives for consumption, such as a scrappage bonus for cars, deductions for energy-saving investments. In the meantime, ***Germany*** is extending the protection of 12 million workers on short-time work until the end of 2021, up from just under 2 million in 2009, a measure in addition to compensating the 2.8 million unemployed. Other countries are likely to take similar measures.

Reasons for optimism are that a number of households are benefiting from the crisis, taking advantage of lower mortgage rates, stock market appreciation and even partial unemployment compensation. According to the Wall Street Journal, half of the newly unemployed in the US are earning more than before, thanks to the $600 bonus and even before the $1200 check. The current account savings in the US this year has increased from $2.5 trillion to $3.5 trillion, compared to less than $600 billion in 2008. The European Union has increased public spending less than the US, but the countries can count the EUR4 trillion in social protection spending (half of the world's spending) as a shock absorber.

For companies: the consolation point.

We have recently seen an improvement in manufacturing PMI confidence indexes in major countries, with the United States at 56 in August, China at 53 and Germany at 52. In China, the year-on-year increase in July industrial production was 4.8%. In France, a survey by Bpifrance among mid-sized companies shows that more than 70% of companies anticipate a rapid return to normal. While it is very local, this is nevertheless a good reflection of expectations on a western scale. At the same time, a downturn is recorded in countries affected by a resurgence in the virus, such as Spain and the Philippines. As one can see, a containment of the spread of the virus is necessary to free economic players.

Of the $2 trillion in the US aid plan, $420 billion has been allocated in the form of loans to large companies and $360 billion in loans and aid to small and medium-sized companies. In addition, as indirect beneficiaries of cash injections and debt buybacks by the Fed and the ECB, companies have multiplied bond issues and accumulated cash. Overall, US companies have raised $2 trillion in bonds this year compared to $600 billion last year over the same period, and according to Refinitiv, companies classified as "junk rate" have issued $220 billion this year. Non-financial companies in the S&P 500 have $1.35 trillion in cash, a level never seen before, and according to the firm Preqin, buyout groups have $806 billion in cash.

Admittedly, the injections will have prevented a sudden increase in default rates and bankruptcies, but the economic recovery is likely to be slower because defending doomed companies is a short-term calculation.

The stock market: the relative point of discomfort.

Paradoxically, the number of companies listed on the stock exchange has been falling steadily over the last twenty years, almost halving in the US, but the stock exchange's valuation in relation to GDP has never been so high. The capitalization of the Wilshire 5000 index, America's largest index, is close to $37 trillion, versus the country's GDP of $22 trillion, a ratio higher than that in 2000. A few months after the low point of the market, winning markets such as Nasdaq, S&P500 (28%), MSCI China (40%), have found a high concentration of technology-related stocks. The losing markets are the "frontiers markets" from emerging countries, temporarily deprived of oil revenues, tourism and migrant workers' income. European indices, sandwiched between the winning and losing markets, are finding hard to catch up as they lack the high concentration of technological stocks as that of the S&P500. Even in the US, while "growth companies" were up 25% at the end of August, "value stocks" were down 11%. Our buy recommendation on Europe results from the expected fruits of the EUR750 billion recovery plan, amounting to 5% of GDP, whose implementation in 2021 will complement ambitious national plans and the injections of the ECB amounting to EUR1.35 trillion, i.e. ~10% of Eurozone's GDP.

For the first time in years, many companies are going public in the US – such as ZoomInfo, Warner Music; in China with the emblematic Ant Group, a fintech subsidiary of Alibaba, and Xpeng Motors, the Chinese Tesla. In the US, it is estimated that there are more than 200 "unicorn start-ups", i.e. private companies with a valuation over $1 billion. This segment is worth more than $650 billion, and constitutes a reservoir to animate the market and take advantage of the attractiveness of technology. Encouraged by a surprising resurgence of interest from individuals to invest in the stock market, companies are multiplying their capital raising.

Conclusion: « And this strange world continues to turn over ». Paul Auster

We therefore remain overweight in equities and underweight in bonds, whose performance has been astonishing since the beginning of the year, as the US 10-year treasury rate has tumbled from 1.92% to 0.68%, and the German 10-year government bonds fell from 0.22% to -0.42%. We maintain our recommendations to long EUR, gold and CHF (GDP should not fall by more than 5% in 2020), and advise prudence on the USD, GBP, currencies of emerging countries with current account deficits such as Brazil, Turkey and South Africa. Only the CNY, at 6.83, is appreciating against USD because the rate differential plays in China's favour, as does the current account surplus. We also remain optimistic about a gradual recovery in oil prices.

From a budgetary and monetary perspective, this crisis shows the need for virtue in times of prosperity. Germany, thanks to lower public debt and debt costs, can spend more to support the recovery and will increase its advantage over the southern countries. Other countries have no choice but to allow their deficits to worsen, but fortunately the risks associated with high debt levels are small compared to the damage that deficit reduction would cause. Nevertheless, failing to reduce cash injections in 2021 would risk instilling market mistrust on debt, could push up interest rates, maintain the survival of "zombie" firms and thus deflationary pressures, as well as to increase the debt burden to be paid by future generations.

If we need to temper the prevailing optimism, let's look at two figures. Central bank injections in 2020 will total $10 trillion and yet global GDP will decline by approximately $4 trillion. Let's not ignore the worsening public debt this year, 10% of GDP in the major emerging countries, and 15 to 20% in developed countries. Let's not expose ourselves to the poorly-controlled debt of emerging countries like Brazil (soon at 100% of GDP) because a decline of the highly indebted countries is expected. Let's not ignore the sustained challenges of important sectors such as tourism, catering and culture. Let's not underestimate a sudden increase in unemployment with the end of partial unemployment compensation, because it would hamper consumption. Let's not neglect the negative impact on international trade due to poor management of the crisis in large countries like India or Brazil with expected declines in GDP of 10% and 6%. Let's not forget the difficulties of young people around the world to find a job in the coming months. In China, for example, the June unemployment rate for graduates was already 19.3% compared to 6% for all working people and 9 million young people will be looking for a job in September. The same observation could be made in other countries.

Let's not hide the worsening poverty in the world. According to the World Bank, the number of people living on less than $1.90/day had fallen from one-third of the world's population in 1990 to less than 10% in 1995 (or 750 million) but the number could increase by 100 million this year. These are all potential factors of destabilization and social unrest.

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Geneva, September 4th, 2020

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