Global Strategy

Market Focus

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Analysis and data provided by
WilmotML

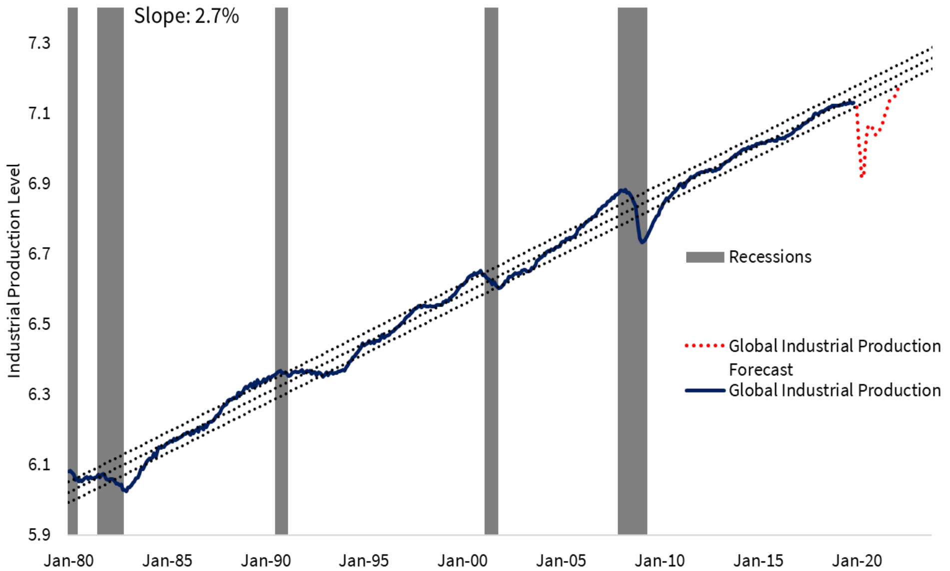
Getting Ready to Roll

This may be the craziest forecast we have made in 40 years of research. Arguably wilder than our view in early 2009 that global IP growth would rebound strongly from the GFC; or our argument in the early-1990s that global bond yields would fall back to their record lows of the 1890s and 1930s. But then this crisis is like nothing we've seen before. We should expect the sequel to confound expectations.

The COVID-19 related lockdowns will likely shock Global IP down by roughly 20% in just 3 months (February to April). That's not a recession it's a crash. We currently expect an explosive initial rebound over the summer, followed by a setback or pause next winter and boom like growth in 2021/22. Even so, it will likely be around 2 years before global production returns to trend, by which time global supply chains will be changing fast. Indeed, almost nothing will feel familiar, except perhaps that global equity markets will once again be making a string of new highs.

Figure 1 shows what the rolling recovery scenario for Global IP might look like in level terms. Figure 2 shows the wild ride that would imply for momentum, which we expect to trough in April at around minus 40-50% per annum, followed by a peak 5-6 months later at plus 40-50% per annum! Taken literally that would point to new lows for global equities around mid-April, followed by a big rebound through the summer. Despite the big bear squeeze this week. But if investors become confident that lockdowns can end quickly, that's another story. Ultimately we think it is better information about the virus, especially the arrival of serological testing, that will let the world return to work this summer, and create the rolling recovery shape pictured below. And where the global economy goes, so will markets.

FIGURE 1: GLOBAL INDUSTRIAL PRODUCTION VS TREND



Source: WilmotML

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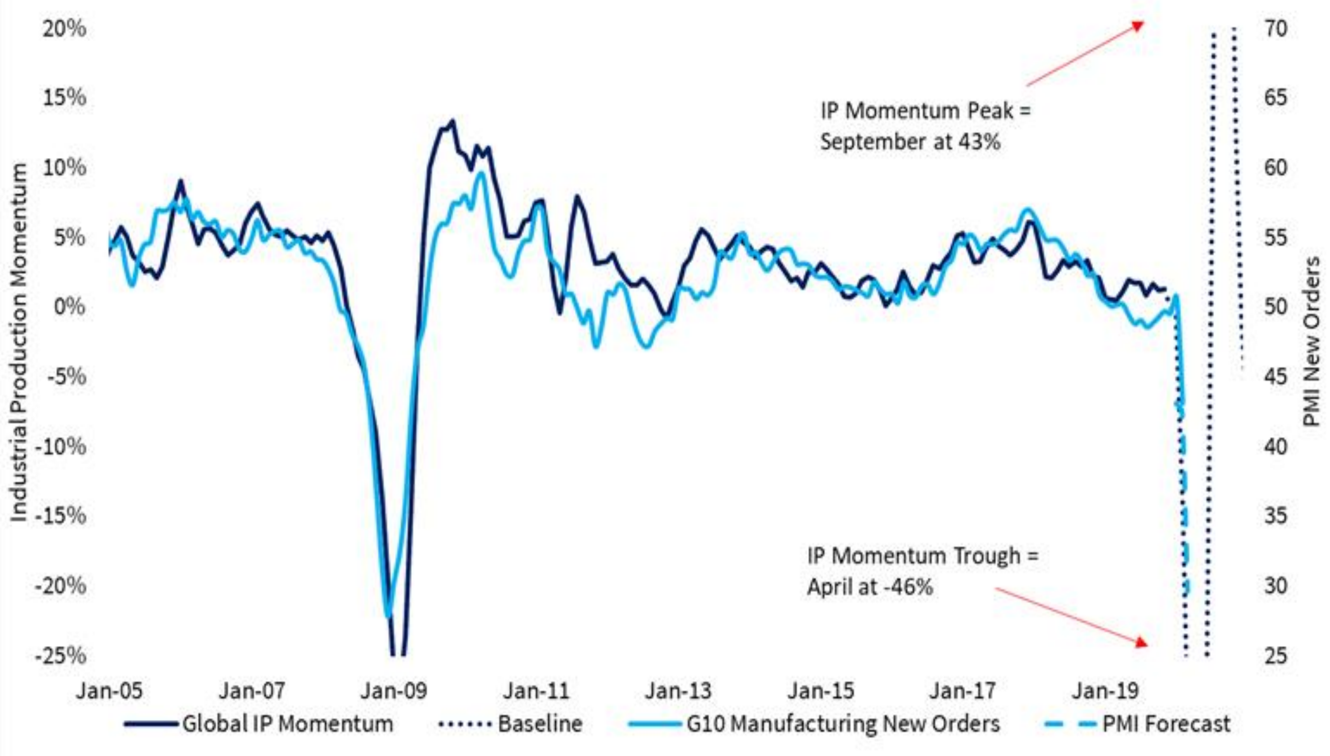
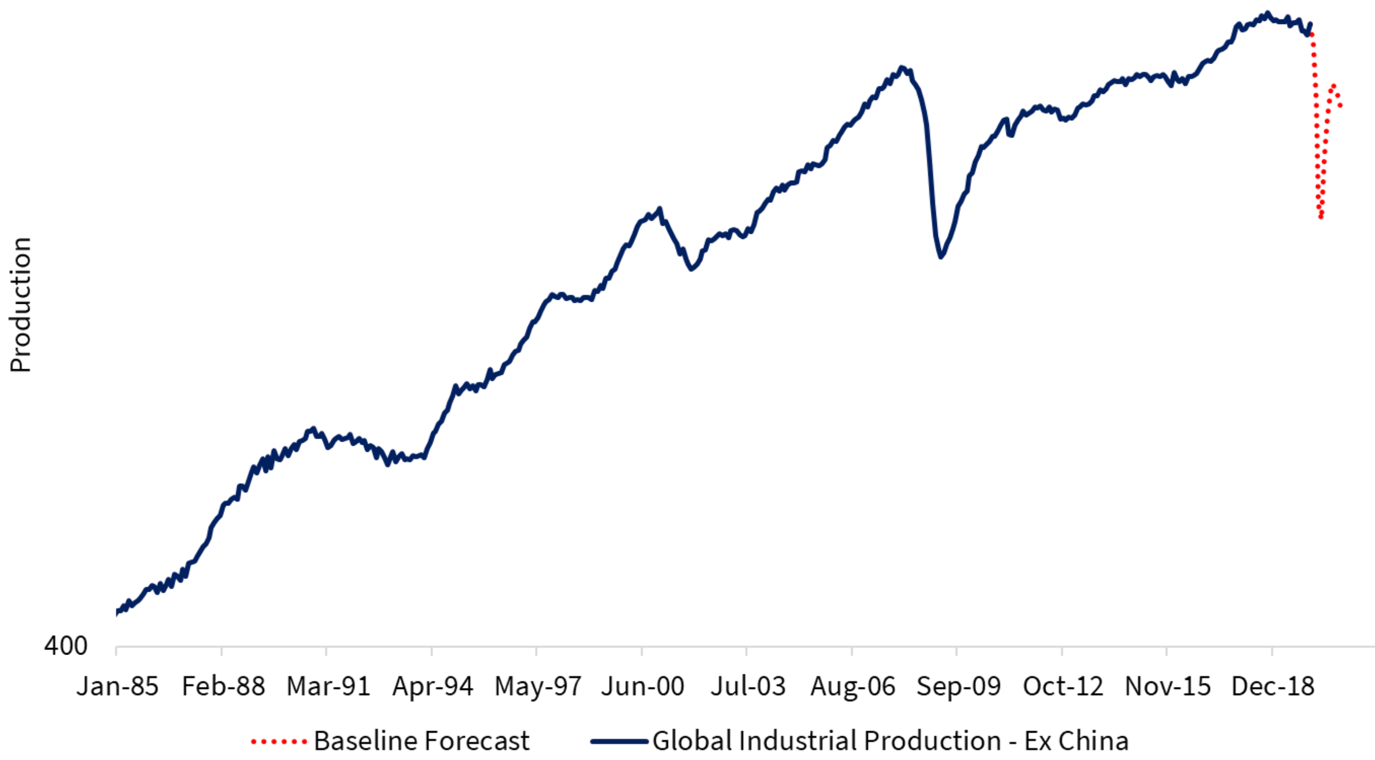
FIGURE 2: G10 PMI NEW ORDERS VS GLOBAL INDUSTRIAL PRODUCTION MOMENTUM



Source: WilmotML, Refinitiv

FIGURE 3: GLOBAL INDUSTRIAL PRODUCTION EX-CHINA



Source: WilmotML

Please Don't Call it a Recession

In our view the corona virus crash in world output is **not** a recession in the conventional sense and using that word is lazy shorthand for something unique in modern times.

Recessions are a largely endogenous process, reflecting past over-confidence, investment and leverage; this is a huge exogeneous shock to growth, happening at speed. Recessions are primarily demand shocks that winnow out excess capacity; this is a sudden supply shock with potentially massive demand and credit implications.

Left untreated it would spiral down into a depression not just a recession - but of course it won't be left untreated.

The idea that the policy reaction to it should be thought of as economic stimulus is also bizarre. It's a massive exercise in social insurance, vitally needed to prevent a slump and preserve capacity for the future. Call it stabilisation policy if you like but not stimulus. Almost by definition it will not be fully successful in offsetting the initial hit to private sector revenue and cash flow, but it should help the system to rebound strongly once the virus permits.

Equally, the debate about whether recovery will be V, U or L shaped feels largely sterile to us. The recovery process will probably be a mixture of all three, depending on which sector of the economy you are talking about. But for industrial production – as opposed to travel, tourism, leisure and hospitality – the initial rebound will almost certainly be a V. The more important question is when and from what level that rebound can start.

For obvious reasons precision isn't possible, but numbers help focus the mind so here is our base case. We expect global industrial production to plunge roughly 20% in 3 months (February to April 2020) and then surge around 15% between May and September. During this period we expect supply chains to be significantly restored, and companies to try and stock up to guard against another virus outbreak in the winter. Some companies will be trying to make up for lost output during the shutdown period too. Though demand should also be recovering, production will likely run well ahead of global goods demand for several months.

We then pencil in a setback over the winter months, as the restocking effect fades and/or new social distancing measures become needed to contain the virus. From the Spring of 2021 we expect boom like growth rates as final demand starts to normalise, a viable vaccine comes into view and economic stimulus continues. Hence the rolling recovery hash tag.

Note that Chinese IP fell by 28% in January/February but is now growing again. We project a rebound of 5-7% in March /April, with further big gains in the summer. Our projection for Global IP ex-China is a drop of roughly 20% in March and April and a rebound of around 10-15% over the summer.

In short, we think that global IP will trough in April, begin to recover in May and be explosive over the summer. But will still take years not months to return to trend.

The Bull Case

A (relatively) positive outlook for global growth and markets requires one to believe the following four things:

1) Policy makers *will* do "whatever it takes" to stabilise the real economy in the face of the lockdown shock and retain critical capacity for future growth;

2) The Fed now has the tools to stabilise the US corporate bond market and the ECB and ESM will do the same for the European banking system and Italian debt;

3) The lockdowns in Europe and the US are already starting to work; peak pressure on critical care systems should be reached within 2-4 weeks;

4) It will be possible for most of the major developed countries to *start* returning to work almost immediately after that without new infections spiralling back upwards, following the pattern in China with a roughly 2-month lag.

The political imperative to cushion the extreme pressure on private sector cashflow from the lockdowns, despite the eyewatering fiscal "cost", is much more evident than it was a week ago. But perhaps the most critical short-term factor for global markets is that the Fed will now have now the ammunition to stabilise the corporate bond market, breaking the death spiral that had holders of risky and illiquid bonds shorting shares as a hedge. The fact that the ECB has moved to shore up all sovereign borrowers within the eurozone also greatly reduces systemic risks to the financial system. With a big assist from the expected pension fund rebalancing out of bonds into equities, those are the main factors driving this week's bear squeeze.

But for a more sustainable turn round in markets the single most important issue is growth: can it soon resume without an unmanageable resurgence in new infections?

To address that question we first need to backtrack a little.

The Moral Equivalent of War

It should be clear by now that this new corona virus is an existential threat to our health care systems, our economies and our way of life. China got that message in late-January and other Asian countries shortly thereafter. But it didn't really hit home in the west until last week – which turned into one of the worst weeks ever for global equity markets. The S&P 500 closed down 15%, though "only" 8% below the prior week's low. (A week can be a very long time in markets).

Epidemiological studies of this particular coronavirus are a (rapidly) evolving science but so far have by necessity been based upon incomplete and often unreliable data. Despite extraordinary progress over the past few weeks, there's still a great deal we don't know. Which means that there is a broad spectrum of possible outcomes, some of them extremely bearish for the world economy. Especially since no vaccine will be available at scale for 12-18 months and better therapeutics (antibody treatments, or effective cocktails of already existing drugs) can't happen overnight.

The bearish narrative really took hold after publication of the MRC report from Imperial College at the beginning of last week. That study argued that mitigation strategies designed to build up herd immunity, as initially proposed by the UK government, were bound to fail, and there was no rational choice other than to aggressively suppress the virus for several months. And moreover, even if that succeeded, seasonal waves of new infections would force governments to continuously reintroduce suppression measures after brief intervals of normality. At least until a viable vaccine became available.

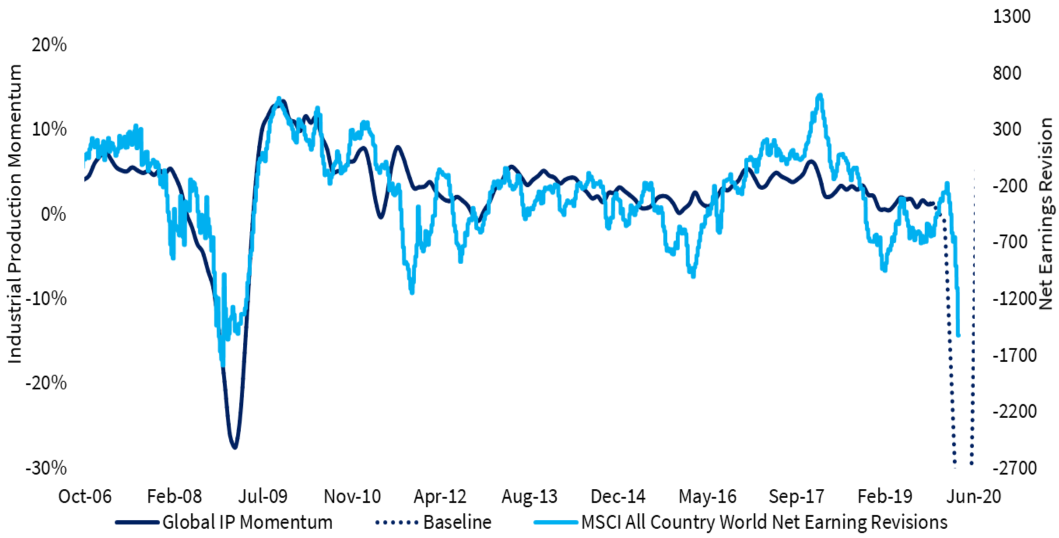
The implication was that the world economy would likely face a devastating rolling recession. On the day that report was published US equities fell by 10%. Since then there have been numerous academic critiques of the Imperial College paper, but no one really disputes the initial message, which is that a strong suppression strategy must come first to stop our health care systems being overwhelmed. The UK has shifted its strategy towards suppression as a result. And by now there are some 20 countries around the world on lockdown, including significant parts of the US.

These lockdowns make a massive near term drop in global activity outside China inevitable. We radically adjusted our forecasts for global IP growth in late-January but it’s only recently that Wall Street houses have officially come clean about the near-term threat to growth. Goldman Sachs, for example, have shifted from forecasting that Q2 US GDP would fall by 5% per annum to roughly 5% in absolute terms (24% per annum). That’s much more realistic and larger than the entire peak to trough drawdown in real GDP during the GFC.

Understandably, it’s also taken a while for analysts to take on board what all that means for corporate earnings in 2020 and beyond. But they too have been catching up very fast so that net earnings revisions (globally) have plunged towards their GFC low. Given our outlook for global IP momentum that process probably isn’t over yet.

Nor is the GFC precedent very reassuring. Back then this earnings revision metric (the net balance of analysts revising their estimates for earnings over the next 18 months up versus down) started to trough in October/November of 2008, well ahead of the ultimate low for global IP momentum and global equity markets in March 2009. We also know that in October 2008 US equities S&P 500 staged a bear market bounce that stretched 25% from intraday low to intra-day high. The equivalent today would take the S&P500 back to 2740. That highlights the risk that new lows for equities remain entirely possible, or at the least, a retest of recent lows. Major equity market lows are usually a process not a single event: can this time really be different?

FIGURE 4: MSCI ALL COUNTRY WORLD INDEX NET EARNINGS REVISIONS VS GLOBAL INDUSTRIAL PRODUCTION



Source: WilmotML, Refinitiv

Better Information Can Save the Day

We know that three things *are* different. First, that this crisis is a uniquely brutal supply shock that has already led governments to break all their established fiscal rules. Second, that the top priority for policy is to preserve the financial and real capacity of the economy to recover, and that has already led to unprecedented changes such as Germany suspending their Constitutional Debt brake. And third, that there is no real political opposition to doing "whatever it takes". So even more measures are possible if needed.

But we also know speed is of the essence to prevent more lasting damage to both supply and demand since governments and central banks cannot fully insure the private sector against the loss of cash flow and customers.

So the capacity to recover depends critically on two other things: quickly suppressing the spread of COVID-19 to stop local health care systems being overwhelmed; and finding a way for the economy to resume work sooner rather than later. Ultimately, we think both those requirements will be met as we explain below.

Tomas Pueyo and colleagues have a cogent article arguing that the brutal lock down period can be short – several weeks rather than several months – if governments in the west heed the lessons of East Asia: most importantly efficient testing, efficient tracing, travel bans, efficient isolating and efficient quarantining.

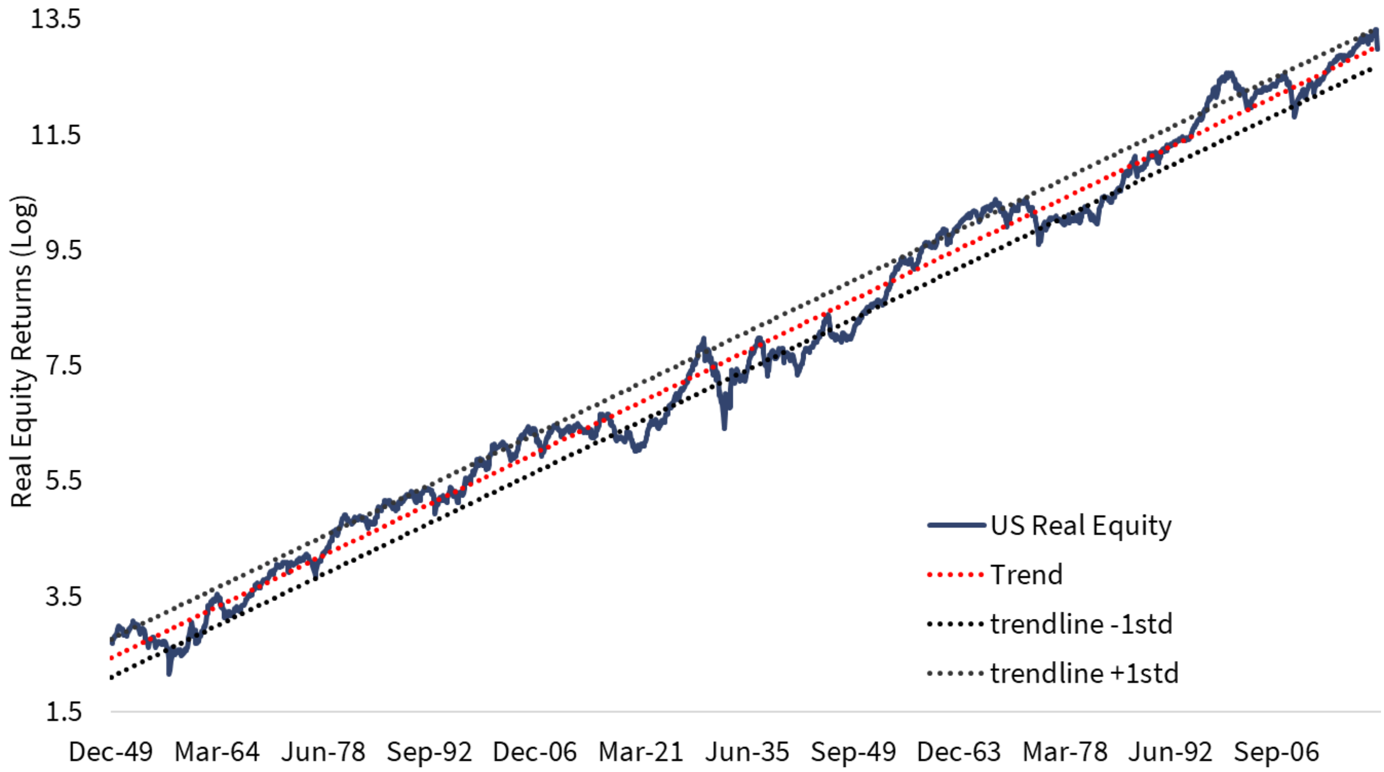
The details are complicated but the structure of the argument is simple: first you have to hit the virus over the head with a hammer, even at huge economic cost, and second you have to rapidly move to measures which can limit virus spread even as the economy gets back to work.

Governments seem to have listened: the hammer part is now being implemented in 20 countries around the globe and nearly a 1/3rd of the world's population is subject to lockdown of some sort. And wherever strong social distancing takes hold the transmission rate of the virus (R) will start to decline very rapidly from the initial level (R0) of around 2.5. Once R falls below 1 new infections will start to fall quickly, though there will be a lag before that shows up in the published data.

So in our view, lockdowns will almost certainly bring the spread of the virus under control in other countries, as they did in China. Indeed, it is likely that R has already fallen below 1 in virtually all places where stringent measures have been taken. That includes Italy and Spain, and possibly even NY city. But because there has been a delay in implanting such measures, it will take longer for reported cases to reach a peak and start declining. And that the peak number of cases per head of population will be higher, which means it could take longer to bring the number of cases into line with the acute care capacity of local health systems. (Though there is plenty of innovation going on in the dash to raise that capacity quickly).

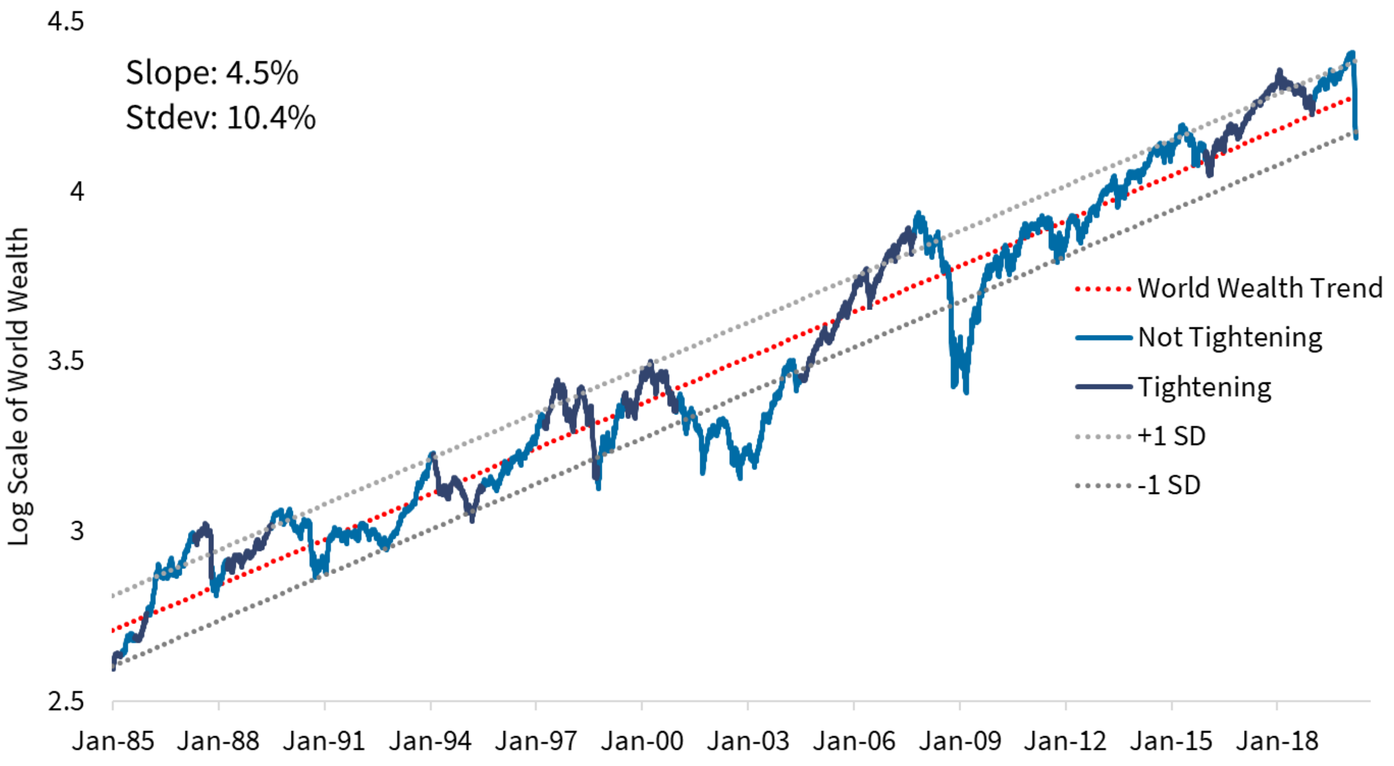
In Hubei it took 4-5 weeks for reported cases to plateau and about 7 weeks before they started to trend slowly downwards. In most of Europe, reported cases should peak 2-3 weeks from now. In the UK it might take until early-May. In the US, there will be huge regional variation but mid-April to mid-May might be a plausible range. As that happens, we think private behaviour will start to change almost immediately.

FIGURE 5: US REAL EQUITY RETURNS VS TREND



Source: WilmotML, Refinitiv

FIGURE 6: WORLD WEALTH VS TREND



Source: WilmotML, Refinitiv

So we strongly suspect that the peak in reported cases will correspond quite closely with the absolute trough in economic activity. But what really matters for recovery is how soon governments can ease off on their drastic social distancing policies.

This is where having better information and using it well is crucial. South Korea in particular has shown the way, and managed to control the outbreak without drastic social distancing measures. Large scale testing and efficient isolation polices have been the leading edge of their response. Using mobile data to find out where infected people have been, and providing real time information to the public about where clusters of infection are, has also been instrumental. Better information always improves the trade-off between health goals and economic imperatives.

Governments elsewhere will do their best to imitate those policies, knowing how urgent it is to restart the economy. And there is now a ton of innovation going on in the West that will improve information flow about the location of infections, and help businesses to overcome their supply or demand challenges.

We also think that manufacturing will benefit more quickly from a peak in infections than the most affected parts of the service sector. Large public events will not restart soon. Nor will travel, tourism and restaurants suddenly return to normal. Sales of autos, appliances and new homes won't immediately rocket either. But equally there will plenty of pent-up demand, and once there is an expectation of future demand manufacturers will try to build up inventory to satisfy that demand.

Beyond that, however, there is one particular innovation which should be transformative. Developments in serological testing mean we will soon be able to identify individuals who have already recovered from COVID-19, by identifying virus specific anti-bodies in their blood. And this can be done quickly and safely via a home testing kit. It's still not clear how quickly and widely these tests will become available, but it will be a game changer when they do.

The first priority for most governments will be to test health care staff and identify who can safely deal with new coronavirus patients. But the even larger public policy question will be to find out what proportion of the population have already had the virus and recovered. For that we need a series of well organised randomised trials – conducted in different regions by reputable hospitals or universities. As this recent Oxford paper showed, the pre-lockdown death rates in Italy and the UK are consistent with the notion that the virus has been present for longer than previously thought, and has already infected 30-70% of the population. If that turns out to be true, it will be possible for most of the country to return to school or work – and shopping –without new infections soaring out of control. Even if the number of infected and recovered people is still well below 50% of the population – these tests should make it possible for large numbers of people to return to normality. And probably by May or June at the latest.

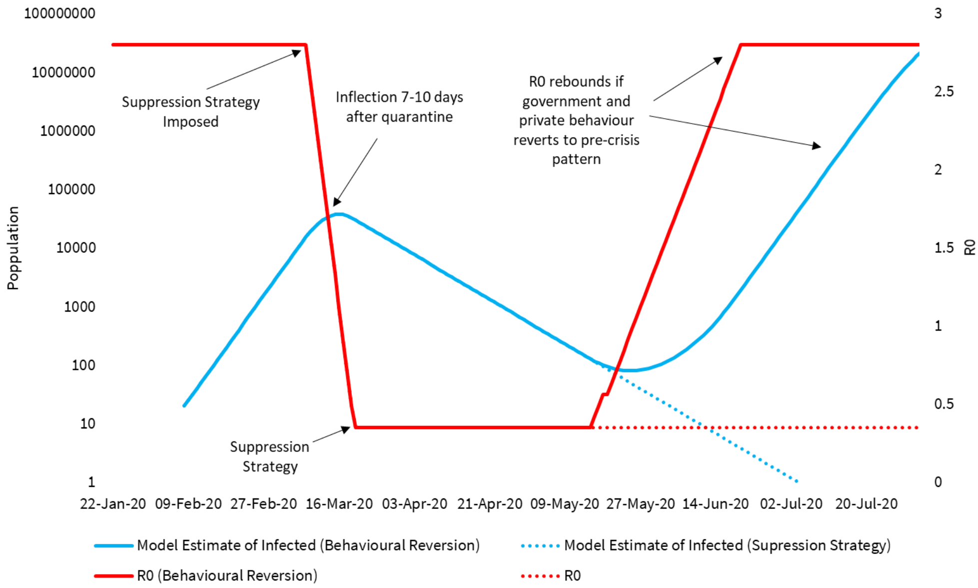
Note, however, that we are assuming that everyone who has recovered from the virus is both unlikely to recontract it (immune), and no longer infectious to others. Neither of those things seem to be known with absolute certainty but both are highly plausible. Much less certain is whether having had COVID-19 this year will protect you from next year's strain. So there will still be a need to prepare for the possibility that the virus returns next winter – and possibly in a new and more virulent form. And it is that possibility which helps drive the shape of our rolling recovery scenario for global production. So we don't expect a slump. We do expect a jump in the summer. And then a pause. In short, the recovery is getting ready to roll.

Appendix: Managing a Return to Work.

To visualise what a return to work might look like we have utilised a simple SIR model to project numbers of infected. The base numbers used to compute the R0 (recovery time x infectiousness x number of daily interactions) are taken from the MRC report. As can be seen in Figure 2, if there was a complete return to "normal" behaviour then we would expect a surge in cases greater than or equal to current levels. Figure 3 however shows how behavioural changes, aggressive testing and other mitigation strategies could in principle be used suppress R and keep it below 1, even as countries return to work.

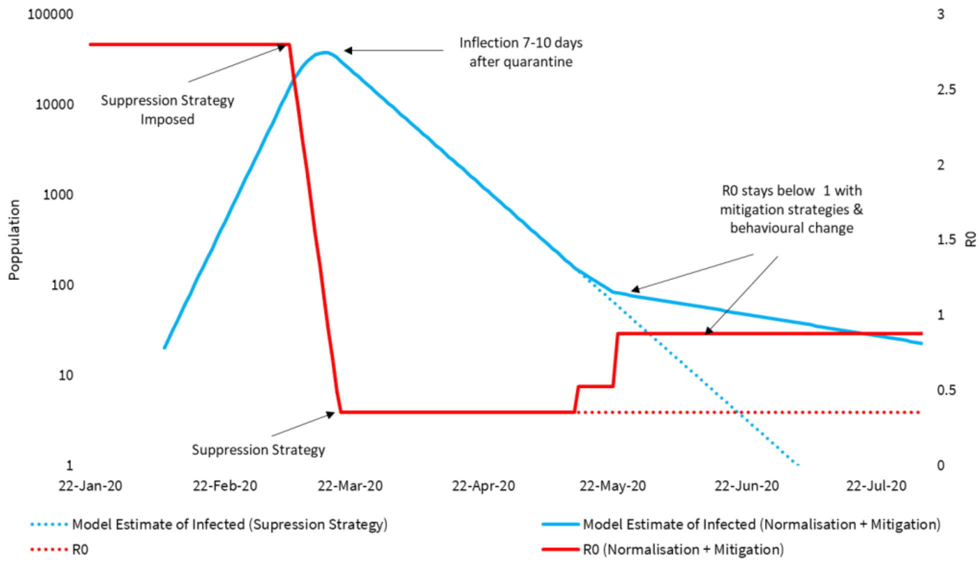
That will be even more credible once serological tests became widely available.

FIGURE 7: ITALIAN SIR MODEL ESTIMATES- GOVERNMENT AND PRIVATE NORMALISATION OF BEHAVIOUR



Source: WilmotML

FIGURE 8: ITALIAN SIR MODEL ESTIMATES – MITIGATION STRATEGIES AND PUBLIC ADOPTION OF BEHAVIOURAL CHANGE



Source: WilmotML

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