Thinking out loud

From recession to recovery

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The purpose of this note is to offer a framework for thinking about the severity of the current global economic recession and the possible path to recovery. With few precedents of the shock to the global economy from the coronavirus pandemic, it is intended to highlight some of the key uncertainties influencing the economic outlook and our current thinking on the shape of the recovery.

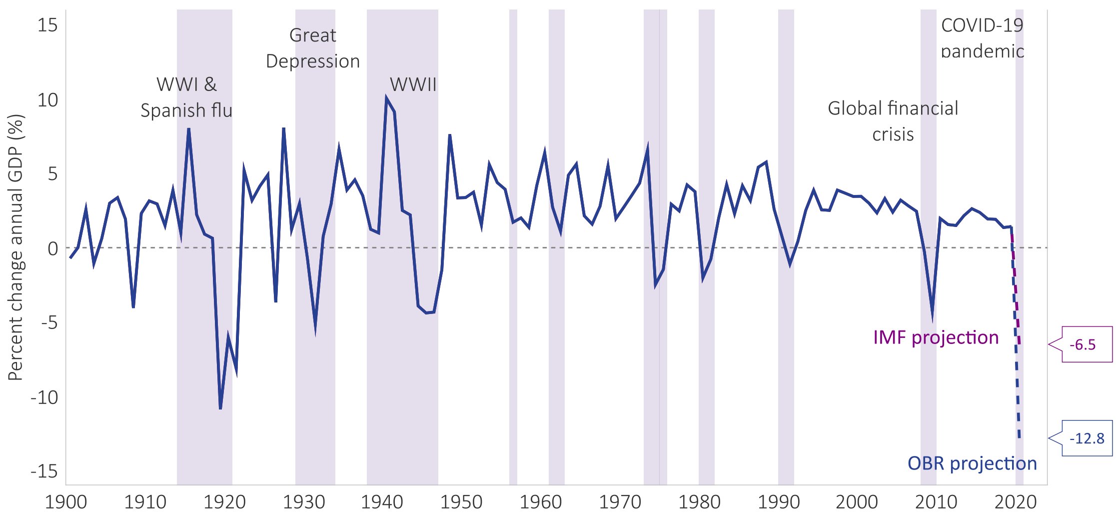
The only certainty now is that the current recession will be the sharpest and deepest in modern history. Everything else is speculation.

Deep and sharp

The severity of the shock to the global economy of the coronavirus pandemic and efforts to contain it is without precedent. Starting in China and then spreading to other countries in Asia before the epicentre moved to Europe and North America, lockdowns to contain the spread of the virus have resulted in a collapse in consumption and output with all but essential workers required to stay at home.

The latest economic data suggest economic activity is around two thirds of its normal level through each month of virus-related lockdowns, implying an annual loss of output of around 3% for every month of lockdown. Under the scenario whereby economic activity through the second quarter is severely curtailed by measures to contain the virus, the implied decline in output in the first quarter could be 25% or more – equivalent to a 6% decline in annual GDP. The recession will therefore be sharper and deeper than during the global financial crisis and closer to the downturn experienced during the Great Depression and Spanish flu pandemic at the end of the 1st World War (WWI).

FIG 1: PROJECTED 2020 DECLINE IN UK GDP IN HISTORICAL PERSPECTIVE



Note: UK Office for Budget Responsibility (OBR) baseline scenario for 2020, 14 April 2020;
IMF World Economic Outlook 2020 growth forecast for UK, 15 April 2020. Shaded columns denote UK recessions
Source: Maddison Historical data, UK Office for National Statistics, UK Office for Budget Responsibility; IMF; latest actual annual data for 2019

Our current assessment is that there will be a gradual and progressive relaxation of restrictions on people and businesses beginning in May, as infection and fatality rates decline to levels that rising health-care capacity can absorb

The scale of the output collapse implies double-digit increases in the rate of unemployment. The actual increase in unemployment will likely be less due to government support in the form of wage subsidies and loans to businesses, but the unemployment rate will exceed 10% by the end of the second quarter (Q2) across Europe and North America. Encouragingly, initial indications are that many lay-offs will be temporary (workers furloughed rather than employment terminated). Combined with more extensive unemployment insurance, the decline in household incomes, in aggregate, will also be less than implied by the decline in output and consumption.

Levels and change

A key uncertainty is how long current lockdowns will remain in place and the extent and pace of the subsequent relaxation that will differ across sectors and countries. The public debate across many countries currently in lockdown, including in the UK and US that implemented restrictions later than much of Western Europe, is shifting towards what should be the 'exit strategy' for the gradual return to work and opening the economy.

Our current assessment is that there will be a gradual and progressive relaxation of restrictions on people and businesses beginning in May, as infection and fatality rates decline to levels that rising health-care capacity can absorb. Social distancing, consumer behaviour and business will not quickly return to normal.

Nonetheless, it is not unreasonable to consider that by the beginning of the third quarter, restrictions on economic activity will be much less severe, assuming no renewed spike in infection rates.

The unprecedented sharp and deep decline in Q2 output implies an initial bounce from a very low base as economies get back to work, led by construction and manufacturing while the consumer services sector will probably continue to be subject to restrictions. The rate of growth in Q3 will likely be correspondingly impressive, but we anticipate output will not recover in full to 'normal levels' and employment will lag.

It is important to distinguish between change in output – the quarterly rate of growth in GDP – and the level of output. An initial V-shaped recovery in terms of the rate of growth does not imply that economies will quickly return to their pre-crisis levels of output.

To illustrate this point, figure 2 is taken from the latest UK Office of Budget Responsibility analysis of the economic and fiscal impact of the health crisis and lockdown. It shows the estimated output loss by sector of the lockdown using estimates of the share of key workers (those continuing to go to work) and share of home working. It implies a 35% drop in output during the UK lockdown, like that estimated for the French economy by INSEE.

FIG 2: UK OUTPUT LOSSES BY SECTOR

Sector	Weight in whole economy value added	Effect on output Q2, relative to baseline%	Effect on output Q3, % relative to baseline	Effect on output Q4, %relative to baseline
Agriculture	0.7	0	0	0
Mining, energy and water supply	3.4	-20	-7	-3
Manufacturing	10.2	-55	-18	-9
Construction	6.1	-70	-23	-12
Wholesale, retail and motor trades	10.5	-50	-50	-25
Transport and storage	4.2	-35	-12	-6
Accommodation and food services	2.8	-85	-85	-43
Information and communication	6.6	-45	-15	-8
Financial and insurance services	7.2	-5	-2	-1
Real estate	14.0	-20	-7	-3
Professional, scientific and technical activities	7.6	-40	-13	-7
Administrative and support activities	5.1	-40	-13	-7
Public administration and defence	4.9	-20	-7	-3
Education	5.8	-90	-30	-15
Human health and social activities	7.5	50	17	8
Other services	3.5	-60	-20	-10
Whole economy	**100.0**	**-35**	**-17**	**-8**

Source: UK Office of Budget Responsibility, April 2020

In the short-term, activity will rebound as this supply shock dissipates with the relaxation of lockdowns, but a key uncertainty over the medium-term will be the impact of the crisis on demand

The third column of figure 2 shows a stylised estimate for Q3 output – assuming that there is a uniform two-thirds easing on activity restrictions across sectors, except for wholesale and retail activities that are assumed to remain in lockdown. It interesting to note that the sector breakdown of GDP for the US is similar to that for the UK. Output would be 17% below its pre-crisis level, but such an outcome would still imply a quarter-on-quarter growth rate between Q2 and Q3 of 28%. Assuming a further halving of the restrictions on work in the final quarter of the year across all sectors, output would be 8% below pre-crisis level and the quarter-on-quarter growth rate would be 11%.

This is not a forecast: no adjustment is made for when the lockdown began in Q2 and for its actual duration, which will likely be less than three months. It does, however, highlight that even a strong initial rebound in growth as supply constraints are relaxed still implies a very large shortfall in output relative to pre-crisis levels.

The initial shock is primarily from the supply-side – the restrictions on going to work and forced closure of many businesses. In the short-term, activity will rebound as this supply shock dissipates with the relaxation of lockdowns, but a key uncertainty over the medium-term will be the impact of the crisis on demand.

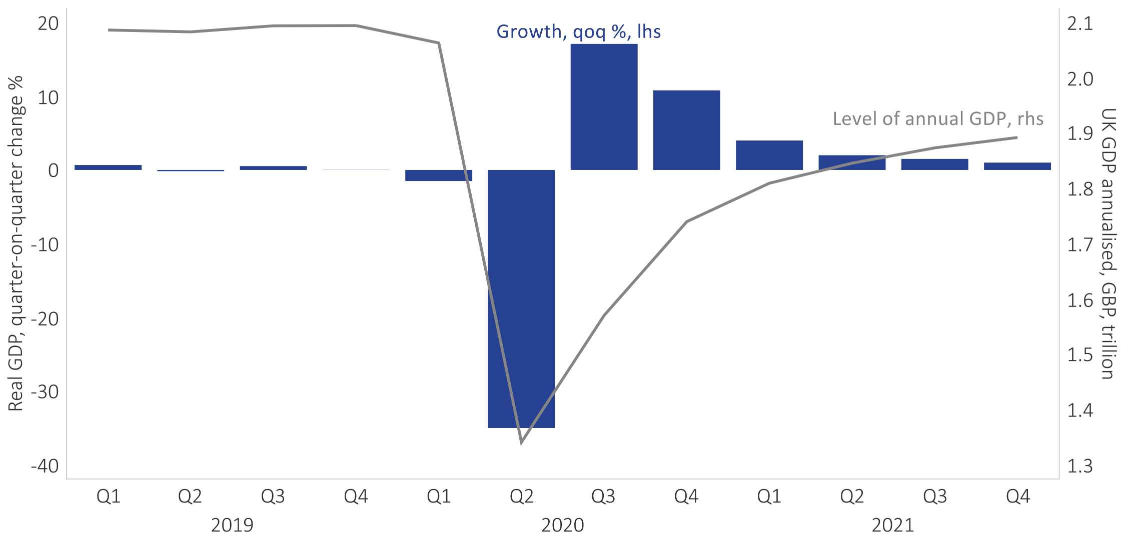
Even without a renewed surge in the virus, business investment is likely to be very weak in the face of heightened uncertainty, excess capacity and balance sheet damage. There will be pent-up demand from consumers, but the rise in unemployment and the shock of lockdown may prompt a sustained rise in savings and a weaker-than-expected rebound in consumption, even over the medium-term.

The policy response will also influence the path of recovery. Some governments, notably in the US and China, may provide fiscal stimulus to support the recovery even as they unwind some of the extraordinary emergency support measures, while others may focus on reversing record-sized budget deficits and rising public debt.

Even more speculative is assessing the extent of the permanent economic damage from the crisis that will arguably depend more on the duration of the recession rather than the output collapse during the lockdowns. The longer the recession, the greater the permanent loss of productive capacity as businesses close and workers become detached from the labour force.

The huge support packages by governments and central banks are intended to limit the permanent damage to the economy by providing a financial bridge to the other side of the health crisis. Such measures should help mitigate the damage, but

FIG 3: STYLISED PATH FROM RECESSION TO GROWTH – UK EXAMPLE



Note: stylised projection of UK quarterly GDP growth and implied level of GDP
Source: UK Office for National Statistics; BlueBay projections; latest actual data for Q4 2019

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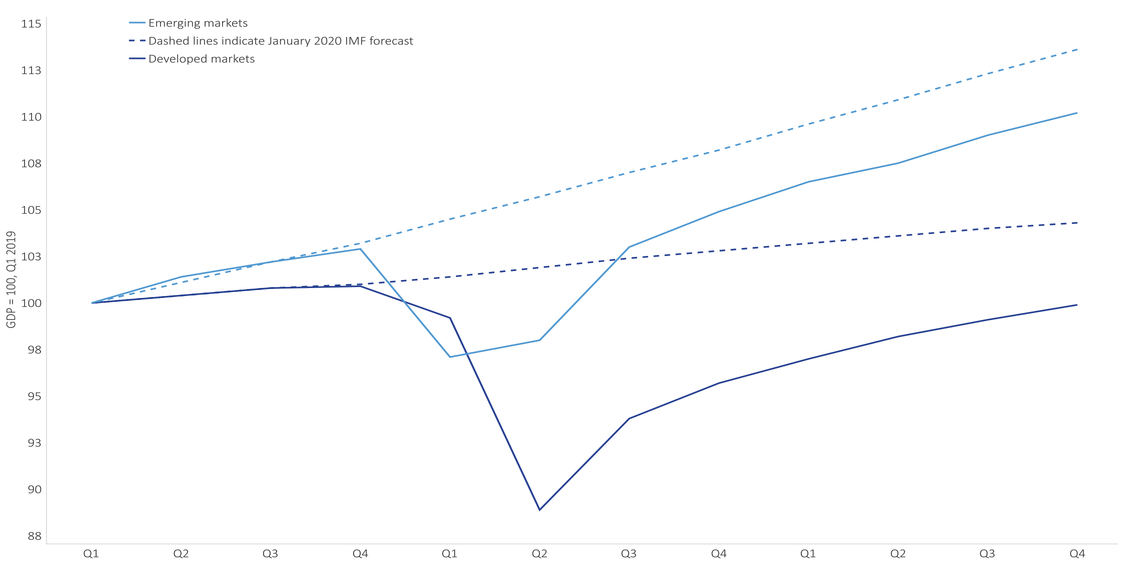
it is uncertain how effective this support will be for small and medium-sized business. Some industries such as transport, leisure and retail, will likely be profoundly reshaped by the crisis and its aftermath.

Exploring the unknown

The recession has arisen from government-mandated lockdowns in response to a global pandemic, rather than unsustainable private sector imbalances or excessive tightening of financial conditions by central banks. In the aftermath of the global financial crisis, deleveraging and regulatory tightening constrained the availability of credit. In this crisis, banks are conduits for policy support to the real economy rather than amplifiers of the economic downturn as they were in the great recession.

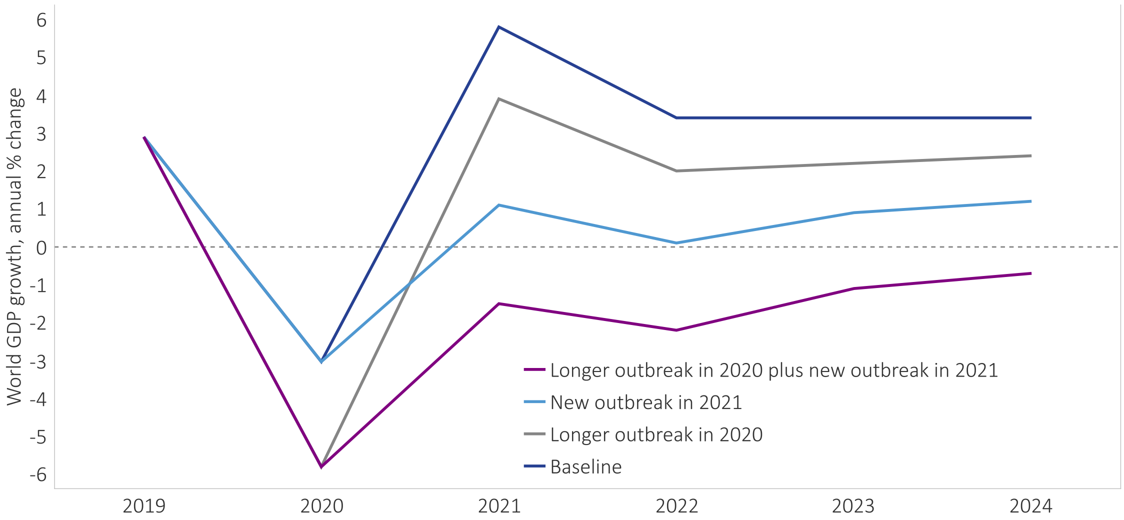
Fiscal policy arguably became too restrictive too soon, forcing central banks to keep interest rates lower for longer while households and companies were focused on balance sheet repair. Inasmuch as private sector imbalances were moderate entering this recession, despite relatively high corporate indebtedness, the capacity of the economy to rebound should be stronger, in our view. Hopefully the lessons from the post-financial crisis recovery have been absorbed by policymakers.

FIG 4: QUARTERLY WORLD GDP, IMF PROJECTIONS



Source: IMF, World Economic Outlook, 14 April 2020

FIG 5: ALTERNATIVE SCENARIOSF OR EVOLUTION OF COVID-19



Note: longer outbreak assumed lockdowns last 50% longer than in baseline; outbreak in 20201 assumes a more mild virus outbreak in 2020; the third scenario combines longer lockdown plus an outbreak in 2021
Source: IMF World Economic Outlook, 15 April 2020

The IMF projections, especially for developed markets that have experienced severe virus outbreaks and lockdowns, may prove too optimistic

It is evident that there are many more unknowns than knowns regarding the outlook for the global economy. Our current thinking is that after an initial bounce as lockdowns are eased, the recovery will be moderate with output and employment not returning to pre-crisis levels until late 2021 at the earliest. Such an outcome would still be earlier than the return to pre-crisis output in the aftermath of the global financial crisis.

The latest IMF global economic forecasts illustrate a flat V-shaped recovery, with GDP in developed economies shrinking by just over 6% in 2020 as a whole and only reaching pre-crisis output levels in Q4 2021, despite assuming above-trend growth through next year.

Major emerging market economies are forecast to contract somewhat less than developed markets, with annual declines of around 5% on average, while China and India post growth of between 1% and 2%, albeit five percentage points or so below pre-crisis forecasts.

The IMF projections, especially for developed markets that have experienced severe virus outbreaks and lockdowns, may prove too optimistic in our view. The Office for Budget Responsibility projection is for a 13% fall in UK GDP in 2020 compared to the IMF forecast of -6.5%, underscoring the huge uncertainty regarding even the near-term economic outlook. Nonetheless, even in the IMF baseline forecast, global growth is -3% compared to zero in 2009 during the global financial crisis and 6.5% below the pre-crisis trend level of output.

Virus containment measures will likely stay in place for some time, limiting any rebound in consumption and could once again be tightened if there is a 'second wave'. A renewed virus outbreak and/or an acceleration in infections to those emerging markets that have so far been spared the worst of the outbreak could lead to a 'W-shaped' path for the global economy. Figure 5 shows the IMF's alternative scenarios assuming measures to contain the virus extend through Q3; another virus outbreak in 2021; and a third scenario that combines a prolonged initial lockdown and virus outbreak in 2021. These scenarios illustrate the sensitivity of the economic outlook to the evolution of the virus and the efforts to fight it.

The scale of policy interventions, especially by central banks directly in financial markets, render it difficult to gauge the nature of the recovery currently being 'priced' by markets. Forward price-earnings ratios and dividend futures suggest that equity markets are discounting a full V-shaped recovery. In contrast, 'safe' government bond markets appear much more pessimistic with negative real (inflation expectation-adjusted) yields and flat curves implying a more prolonged 'U' or even 'L-shaped' path for the global economy.

The credit market sits somewhere between the equity and core government bond markets in terms of the economic outlook. Corporate credit spreads are consistent with meaningful damage to corporate balance sheets, a wave of credit-rating downgrades and 'fallen angels' (companies falling out of investment grade into the high yield market) and high single-digit default rates amongst highly leveraged companies. In our view, the credit market is broadly in line with our current assessment of a sharp and deep recession followed by a 'tick-shaped' moderate recovery.

Stepping back, thinking ahead

The incoming data confirms that the recession will be the sharpest and deepest in modern history. The duration of the recession will be a key factor determining the extent of economic scars from the crisis and permanent loss of productive capacity. The containment of the virus and risk of a 'second wave' will be crucial, as well as the extent that social distancing measures will continue and curtail economic activity.

The economic policy response to the crisis is unprecedented in scale and breadth, with policies to support and sustain the recovery being critical. Consumer behaviour and business models may or may not return to pre-crisis norms, with potentially important implications for the recovery path and for the longer-term structure of the global economy.

Investment is at its heart the management of risks that arise from an uncertain future. The lack of precedents for the current crisis renders the economic outlook arguably as uncertain as it has ever been. Nonetheless, investors benefit from stepping back from the daily noise of market fluctuations and framing their decisions in the context of uncertainty and the balance of risk. Hopefully this note offers some help in that regard.

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