Investment Insight

May 2020

Recovery in second half year

Economic data for the 1st quarter was extremely weak; 2nd quarter data will be devastating. However, lockdown measures are increasingly being eased worldwide. If the fight against the virus is successful, recovery could begin in the second half of 2020, with the slump offset by the end of 2021.

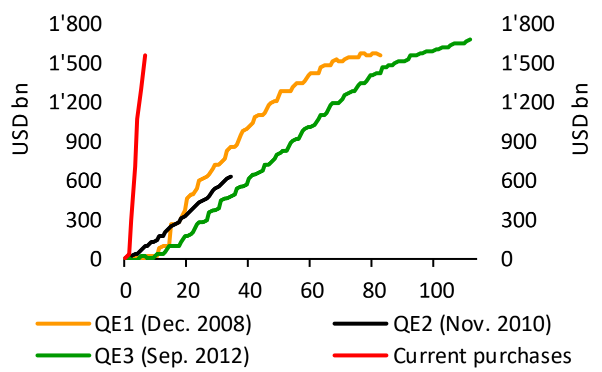
The Chinese purchasing managers' indices painted a mixed picture in April. While a decline was reported for the manufacturing sector (from 52.0 points to 50.8), the service sector index rose (from 52.3 points to 53.2). It appears that service providers in particular benefited from the domestic economic recovery following the easing of government restrictions on physical contact. But this recovery is only occurring with the handbrake on, because the restrictions imposed by authorities are only being lifted slowly in many places, and in some cases have been ramped up again.

Almost all major manufacturing companies have resumed near 100% production, while smaller companies are operating at 85%. However, the manufacturing industry is now facing foreign trade headwinds, due to the collapse in demand from industrialised nations. This is indicated by the sub-indices on export orders in the manufacturing purchasing managers' surveys, which fell sharply again in April after a brief temporary high in March. However, when the global economy eventually gets back on track, this should ease the pressure on Chinese exporters. China's domestic economic recovery could then be accompanied by a revival of foreign trade in the months to come. The economic outlook for the second half year remains positive.

The outlook for H2 also looks positive for the USA, despite the fact that economic activity is still far from bottoming out. The initial estimate for GDP growth in Q1 offered a glimpse of what is in store for Q2. Down to -4.8% from +2.1% in Q4 2019 (annualised quarter-on-quarter), US GDP has fallen more sharply within a quarter than at any time in the past eleven years. The biggest damper on growth was private consumption, which at -7.6% (down from +1.8%) slumped the furthest in 30 years. Current quarter consumer spending will slow even more drastically with a major decline in housing construction investment also in sight. Experts consequently expect US GDP to contract by 40% (annualised quarter-on-quarter).

However, given increasing control of the coronavirus pandemic, significant catch-up effects are likely in the coming months, particularly in private consumption. The recovery should also benefit from government stimulus packages. In addition to current economic stimulus packages totalling at least USD 2,500 billion, there are already signs of additional spending plans, such as for extended unemployment benefits, for the assumption of healthcare expenditure and for financial support to the states. The US Federal Reserve is also maintaining its extremely expansionary monetary policy without any tightening. The FOMC target range for the federal funds rate remains at 0.00% to 0.25%; purchases of US Treasuries and mortgage-backed securities will continue without any time or volume limits. The Fed's strong response is not only reflected in the large package of emergency lending facilities to banks and companies, the extent and pace at which it intends to buy Treasuries and MBSs is also unprecedented. Within a few weeks, the Fed has purchased as many assets as in the previous three QE programmes, although under those programmes the purchases were spread over a period of several months (see figure below).

US: Bond purchases at unprecedented pace



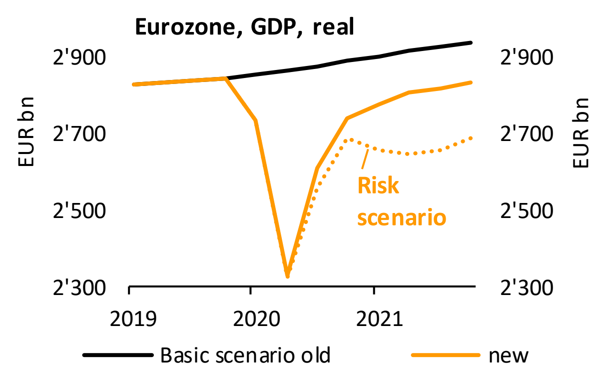
Sources: Federal Reserve, BANTLEON

Note: Development of Treasury and MBS holdings in the Fed balance sheet since start of the respective purchasing program

The Eurozone already suffered greatly in the first quarter from the effects of the coronavirus pandemic. According to Eurostat's flash estimate, GDP shrank by 3.8% quarter on quarter, although the lockdown only affected the last two weeks of March on average. The sharpest decline of 5.8% was recorded in France and the smallest, of 2.5%, in Austria. The figures for Germany will not be published until mid-May. On the basis of the available data, however, a decline of »only« around 2% can be assumed.

Although the decline in Eurozone GDP in Q1 was already the sharpest observed since records began in 1995, the real plunge is yet to come. We anticipate growth shrinkage of about 15% for the current quarter. We then see a countermovement for the second half of the year, with strong growth in economic output in Q3 (double-digit) and in Q4 (around 5%) – quarter on quarter in each case. This would still put GDP at the end of 2020 around 5% lower than at the end of 2019. We do not expect this starting level to be reached again until the end of 2021 (see figure below). However, this would require a vaccine to be available.

Eurozone: Full catch-up not until end of 2021



Sources: Eurostat, BANTLEON

The bond and equity markets have recently been in good shape. Numerous positive reports relating to the coronavirus pandemic spurred the buoyant sentiment regarding equities. For example, the drug *Remdesivir* could significantly reduce COVID-19 symptom duration in patients. With pandemic fears muted, the likelihood that the economy will return to normal over the next few months is on the rise. This would have a positive effect on corporate earnings.

Despite investors' increasing risk appetite, high demand for safe havens such as German government bonds persisted thanks to the tailwind from central banks. Italian government bonds, on the other hand, are in troubled waters. After Moody's, Fitch was the second rating agency to place Italy just one notch above non-investment grade. In the medium term, however, spreads on Italian, Portuguese and Spanish government bonds can be expected to narrow again.

At present we see a good chance of gradual economic recovery

The main question at the moment is whether the recent equity market rally is sustainable. Given that we are faced with the sharpest economic slump since World War II, many observers feel that the recovery of the MSCI World Index by almost 30% since 23 March is too hasty. A second wave of the coronavirus pandemic, overly optimistic earnings estimates and excessively positive investor sentiment are considered sources of danger. From our point of view, everything depends on whether there is a clear upturn in the economy in the second half year. At present we see a good chance that the economy will gradually pick up, thereby providing the basis for a cyclical revival. In this case, the earnings outlook for 2021 would improve and give investors a tailwind. We therefore assume that the volatile upward trend on the stock markets will continue. Bund yields should remain at their current low level for the time being thanks to ECB policy, but with limited potential for further declines. If the economy picks up in the second half of the year, this will weigh on government bond markets in the medium term.

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