Rebound from the Lockdown

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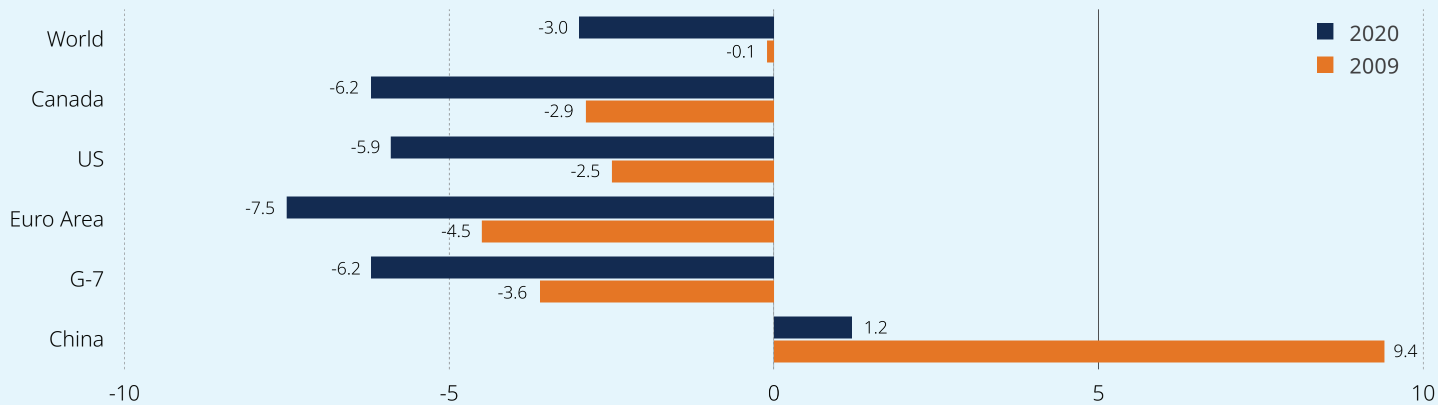
In this month's note, we provide an update on the economic outlook and discuss why financial markets appear optimistic despite an unprecedented economic slowdown. We believe that forward-looking investors are looking past current economic weakness to focus on a potential peak in new cases and deaths from the pandemic, the expected re-opening of major economies and robust policy measures to replace lost incomes. Persistently low interest rates and a gradual rebound in corporate earnings once the pandemic has been resolved would also support higher long-term fair values for equity markets. Inflation will be a critical indicator to monitor once the crisis has been resolved.

Macro outlook: Short-lived lockdown or prolonged slump?

The expected recession this year is on-track to be the worst economic crisis since the Great Depression in what the International Monetary Fund (IMF) has called the "Great Lockdown". In Canada, the employment report in March indicated over a million unemployed workers and the consensus forecast for April points to an additional 4.25 million unemployed workers to bring the expected unemployment rate to about 18%. In the US, an estimated 30 million workers or about 18% of the labour force lost their jobs since the shutdown began in mid-March. The IMF expects the sudden stop in economic activity to result in a sharp drop in global growth this year by -3%, far exceeding the 2008-09 contraction of -0.1%. The Canadian and US economies are expected to contract by about 6% in 2020 while some eurozone countries could face even sharper declines (Figure 1). The impact is likely to be greatest in the second quarter as most major economies have imposed an economic lockdown. The Bank of Canada estimates that the second quarter contraction will range between 15% and 30%.

Figure 1. | Expected economic growth in 2020 vs. 2009
(average % growth in real GDP based on IMF forecasts)



Source: IMF World Economic Outlook (April 2020)

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The key issue looking ahead is whether the contraction will be a severe downturn followed by a quick rebound – like an "economic hurricane" – or continue in a prolonged slump. The current downturn is unlike previous economic recessions that resulted from traditional causes, such as an over-heating economy, excessive borrowing or banking failures. While the lockdown has supported social distancing to flatten the infection curve, it also resulted in a sudden stop in substantial economic activity.

The depth and duration of the slowdown depends on three key factors:

- **Lockdown duration:** A longer shutdown would lead to larger economic losses and cash shortages, resulting in a messier re-opening as otherwise viable businesses fail, destroying jobs and organizational capital;
- **Behavioural changes:** After the lockdown ends, households may cut spending to boost savings and businesses may restrain investment given greater uncertainty; and
- **Macro policies:** Government and central bank policies will need to be effective in putting a floor under demand to prevent a further deterioration in unemployment and business failures.

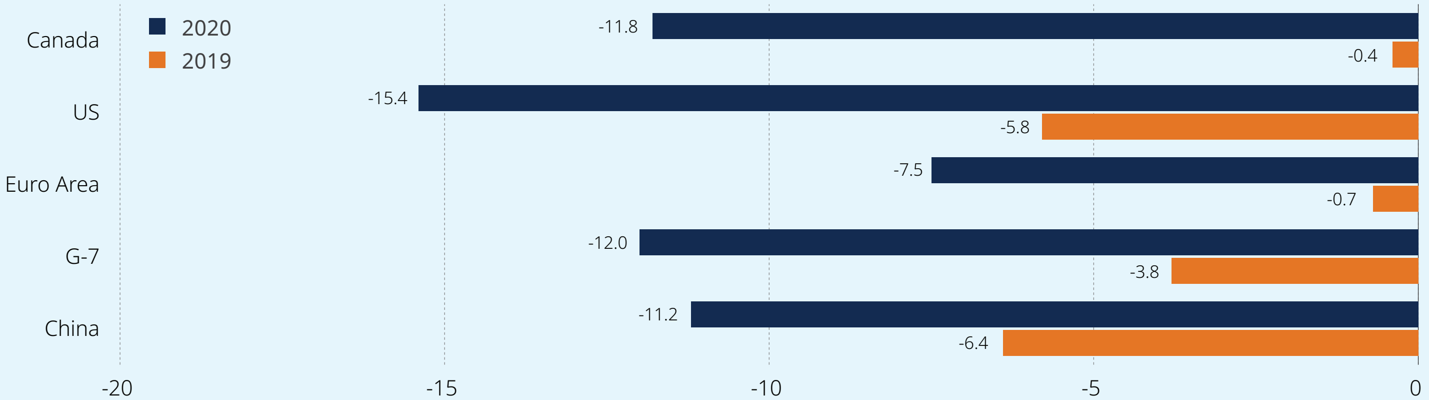
With an apparent peak in new pandemic cases and deaths, many major economies and US states have already announced plans to re-open their economies gradually in May and June. Macroeconomic policies in major economies have also played a critical role in bridging lost income during the shutdown and backstopping financial markets, especially credit markets.

- **Government fiscal policy:** Fiscal measures can bridge the most severe part of income losses but only partially and not indefinitely. The US government initially announced about US $2.2 trillion (about 13% of GDP) in tax deferrals, transfers and loan financing to replace lost income. The package was followed with US $484 billion in additional measures. In Canada, the federal government's pandemic relief package has an estimated fiscal cost of about C$193 billion (about 8.4% of GDP) of which C$105 billion will be provided as aid to households and firms via wage subsidies. Other major economies announced programs with similar objectives, resulting in substantially larger estimated budget deficit in 2020 compared to last year (Figure 2).
- **Central bank programs:** Major central banks have reduced policy rates to about zero, implemented large-scale direct asset purchases of sovereign debt and new lending facilities to support corporate credit. The US Federal Reserve's balance sheet is set to expand dramatically, potentially by over US $4.5 trillion (about 20.9% of GDP). Similarly, the Bank of Canada's program of sovereign debt purchases could amount to C$200 billion (about 8.6% of GDP).

The macro outlook for the remainder of 2020 remains highly uncertain. Aftershocks from the current lockdown-related slowdown remain possible this year, amplifying the initial economic shock. For example, an important factor in the recent oil price collapse into negative territory was very weak demand conditions due to the lockdown. Global spillovers from the lockdown could also slow the recovery process, such as emerging markets facing weak external demand, low commodity prices and capital flight. High yield credit and other forms of leveraged securities also remain vulnerable. Ultimately, the lockdown stems from a healthcare crisis and the global economy needs medical solutions to bring the crisis to a full resolution. As a result, we expect a prolonged period with policy interest rates at their lower bound to support a gradual economic recovery towards the pre-pandemic trend. Corporate earnings are expected to recover gradually towards the long-term average.

Figure 2. | Expected government budget deficits in 2020

(% of GDP of general government sector based on IMF forecasts)



Source: IMF Fiscal Monitor (April 2020)

Financial markets rally despite the weak economy

Despite severe economic stress, risk assets have rallied sharply from the low point in March. As of late April, equities in developed market have rebounded by over 25%, US high yield credit spreads have narrowed by about 3.5% and the market's estimate of stock market volatility has dropped sharply from unprecedented levels in late March. Investor optimism appears to reflect three factors: a tentative peak in new cases and deaths from the pandemic in major markets, the expected re-opening of the global economy and the unprecedented size and breadth of government policies to stabilize incomes and backstop credit markets. Three market developments are particularly noteworthy:

- Global equity markets rallying despite the currently severe economic contraction
- Low long-term interest rates despite a flood of government bond issuance this year
- Low expected inflation despite massive central bank liquidity

In principle, lower long-term interest rates are accompanied by higher equity market valuations. In this way, the sharp decline in interest rates may have supported the rally in stock markets by boosting long-term fair values. Table 1 provides a stylized example of how changes in interest rates are associated with changes in the long-term fair value of an equity market based on the present value of future expected dividends, which can be calculated using the classic Gordon growth model:

$$P = \frac{D}{R - G}$$

The hypothetical stock market in Table 1 provides a dividend (D) of $50 that is expected to grow (G) over the long term at an average real rate of 1.5%. The required return (R) consists of the risk-free interest rate and an equity risk premium. Table 1 varies R in each column to show how small changes in rates can lead to large changes in long-term fair values (P). A lower rate by 25 basis points implies a higher long-term valuation by 14.3% and a decline by 50 basis points implies a higher valuation by a third. In this context, the rally in equities despite the current economic lockdown may reflect in part that investors are pricing-in continued low rates.

Table 1. | Lower discount rates are accompanied by higher long-term equity valuations

	Starting Fair Value	Fair Value Rises as R Falls	
		R Falls by 0.25%	R Falls by 0.5%
Dividend (D)	$50.00	$50.00	$50.00
Growth (G)	1.50%	1.50%	1.50%
Return (R)	3.50%	3.25%	3.00%
R-G	2.00%	1.75%	1.50%
Fair Value	**2,500**	**2,857**	**3,333**
Valuation Gain		**14.3%**	**33.3%**

In addition to the rally in global equity markets, government interest rates remain low despite enormous bond issuance. In Canada and the US, government debt levels are expected to rise sharply in 2020. In contrast, long-term interest rates remain near historic lows. A large flow of private savings is expected to help fund the additional debt issuance as households reduce spending and businesses cut investment due to heightened uncertainty. With borrowing rates expected to remain low relative to average economic growth, debt ratios should remain under control. Central bank purchases of sovereign bonds provide a backstop should investors lose appetite for absorbing more bonds. Japan illustrates that high government debt levels can coincide with persistently low interest rates.

A key risk scenario is not lack of confidence in sovereign credit but an increase in inflation when the economy recovers. Newly printed money to fund sovereign bond purchases and lending facilities could potentially flow from financial markets into the real economy. As supply-side capacity remains constrained, financing higher demand via money printing could boost prices once the economy recovers. Central banks can manage this scenario by unwinding emergency support. However, raising policy rates or selling assets would tighten financial conditions. Markets are not currently anticipating inflationary pressures. Deflationary forces are currently dominant due to weak demand in the lockdown. Inflation-linked bonds indicate that 10-year expected inflation in the US is about 1.15% and it is even lower in Canada. For this reason, monitoring inflation trends for signs of a shift higher will be important.

Summary and implications

Economic outlook: The potential peak in new cases and deaths from the pandemic, the expected re-opening of major economies and robust economic policies set the stage for a gradual recovery after a short and severe economic contraction in the second quarter.

Low interest rates and equity valuations: Low long-term interest rates and a gradual rebound in corporate earnings growth to its long-term average would be associated with higher long-term equity valuations. Stock markets are driven in the shorter term by the uncertain cyclical outlook and investor sentiment. As upside and downside scenarios appear roughly balanced at current market prices, we maintain a close to neutral position in our asset allocation for equities relative to government bonds.

Monitoring inflation: Higher inflation once the crisis has been resolved could lead to higher long-term rates, weighing on asset valuations. As the economy recovers, monitoring inflation for signs of a shift in trend will be important.

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