Flattening the Curves

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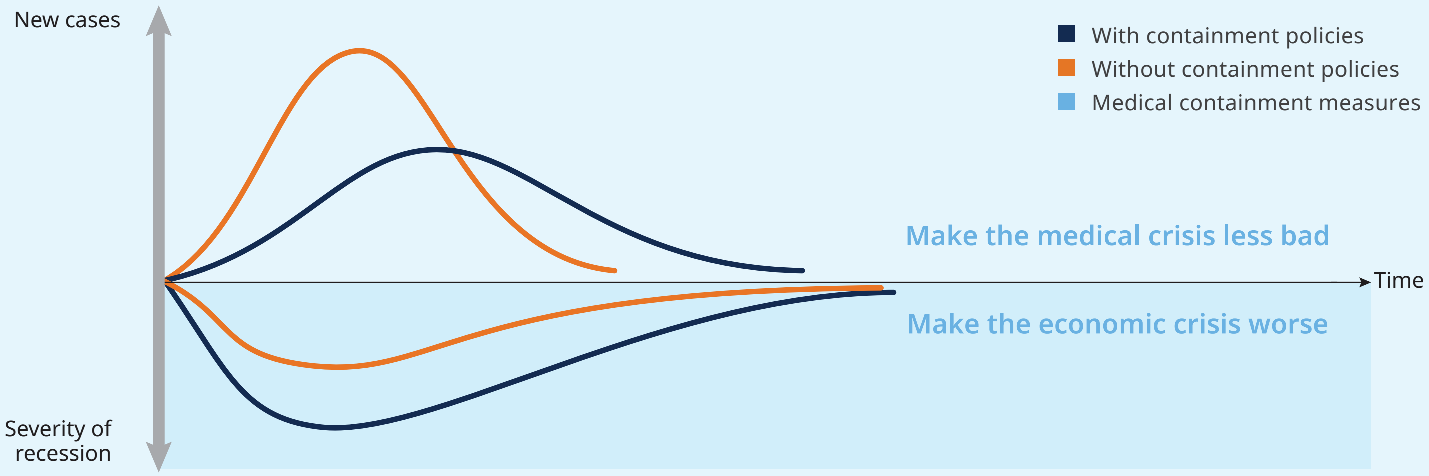
Summary

- Stopping the pandemic spread while minimizing the steep economic cost is the key policy challenge
- Policymakers have acted quickly with strong measures to backstop the economy and credit markets
- Policy stimulus should strive to prevent a further deterioration in demand and unemployment, but policymakers cannot offset the negative supply-side impact of a prolonged economic lockdown
- The macro outlook depends on the duration of social distancing to contain the epidemic
- Long horizon investors should continue periodic portfolio rebalancing and ensure adequate liquidity to avoid selling assets at distressed prices

Stopping the spread of the COVID-19 epidemic will come at a steep economic cost. Medical experts argue that "flattening the infection curve" through stringent social distancing can save lives and avoid overwhelming the healthcare system. However, these measures also steepen the recession curve with the economy in lockdown (Figure 1). This sudden stop in economic activity is leading many US forecasters to expect a sharp contraction in GDP during April to June with estimates ranging between 12% and 25%.[1]

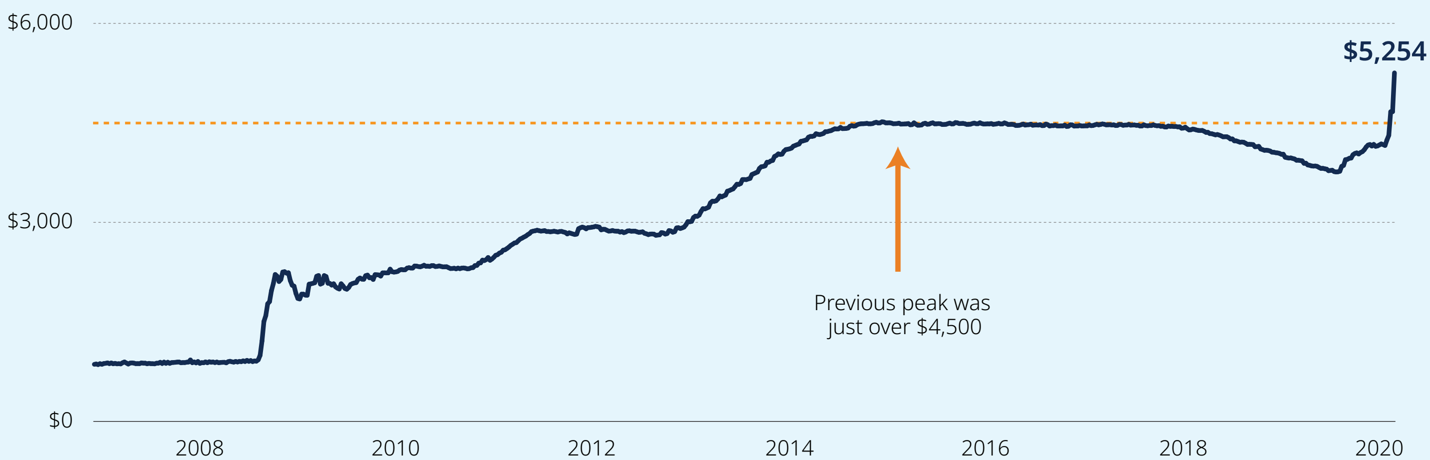
Figure 1. Flattening the Infection Curve Steepens the Recession Curve
Containment policies flatten the medical curve, but steepen the recession curve



Source: https://voxeu.org/content/economics-time-covid-19-0

Policymakers have acted quickly to implement measures of unprecedented size and scope to "flatten the recession curve". Major central banks have moved quickly with larger measures in many cases than during the Global Financial Crisis in 2008 so that the expected economic slowdown does not become a financial crisis. Central banks have eased rates, injected liquidity in money markets, launched new lending facilities to unlock credit markets and expanded Quantitative Easing (QE) to tackle illiquidity (Figure 2). Governments have also announced fiscal packages of unprecedented size, including tax deferrals, cash transfers to households and backstops for business credit. The US stimulus package of about US $2 trillion amounts to about 10% of GDP. Germany is considering a package of a roughly similar magnitude. In Canada, the announced measures of $82 billion are more modest at just over 3% of GDP. Critically, global policymakers are striving to avoid a temporary cash squeeze leading to business insolvencies and higher unemployment. Failure to prevent insolvencies from a temporary and deliberately induced economic slowdown would likely lead to a much slower recovery when the epidemic is resolved.

Figure 2. Total Assets of the US Federal Reserve Surpass Previous Peak
(in billions of US dollars)



Source: Total Assets of the US Federal Reserve as of March 25, 2020. Data provided via Bloomberg.

The policy toolkit has been largely borrowed from measures taken during the Global Financial Crisis, but the current crisis is different in important ways. The Great Recession in 2009 stemmed from sharp deleveraging by the private sector following a confidence crisis and financial sector failure, which led to a sharp decline in aggregate demand and a recession. The priority in that crisis was to boost aggregate demand by rebooting credit markets and providing liquidity. The current economic downturn is primarily a supply-driven shock as policymakers deliberately induced a sharp slowdown to contain the COVID-19 outbreak. The crisis also resulted in a large decline in aggregate demand, pushing expected inflation even lower (Figure 3).

Policymakers should compensate for the decline in demand but not try to over-compensate for the decline in aggregate supply. Monetary and fiscal policy can play key roles by preventing a further deterioration in demand causing higher unemployment.[2] Policies can also backstop credit markets and the financial system to avoid bankruptcies simply due to the short-term liquidity crunch rather than long-term insolvency. In contrast, lower central bank rates and cash transfers from the government cannot offset the large loss in production and incomes due to business closures and quarantined workforces. However, we believe policymakers cannot restore demand to its pre-crisis level while the economy remains in lockdown as the economy would be unable to meet that higher level of demand.

Figure 3. Decline in Market Pricing of 10-year US Average Inflation
(breakeven US inflation rate based on 10-year TIPS)

Source: Market data provided via Bloomberg as of March 25, 2020

Looking ahead, the macro outlook depends mainly on the duration of the economic lockdown to contain the pandemic spread. President Trump indicated that the US economy could return to work as early as Easter. Several European countries have only partially shut down economic activity. In Canada, the federal and provincial governments appear to be preparing for a prolonged shutdown. While the duration of the lockdown is uncertain and likely to differ across countries, the global economy is expected to experience a contraction in the second quarter that extends into the third quarter. Based on the early experience of China, the recovery appears to be U- or even L-shaped after the prolonged lockdown of Hubei in early 2020 (Figure 4). Once the epidemic is behind us in North America, the speed of the economic bounce will depend critically on our success in preventing business failures during the temporary liquidity squeeze so that unemployed workers can quickly return to work, allowing income and production to normalize. The next few months could include both upside and downside surprises, ranging from new medical innovations to treat the virus to potential secondary waves of infection.

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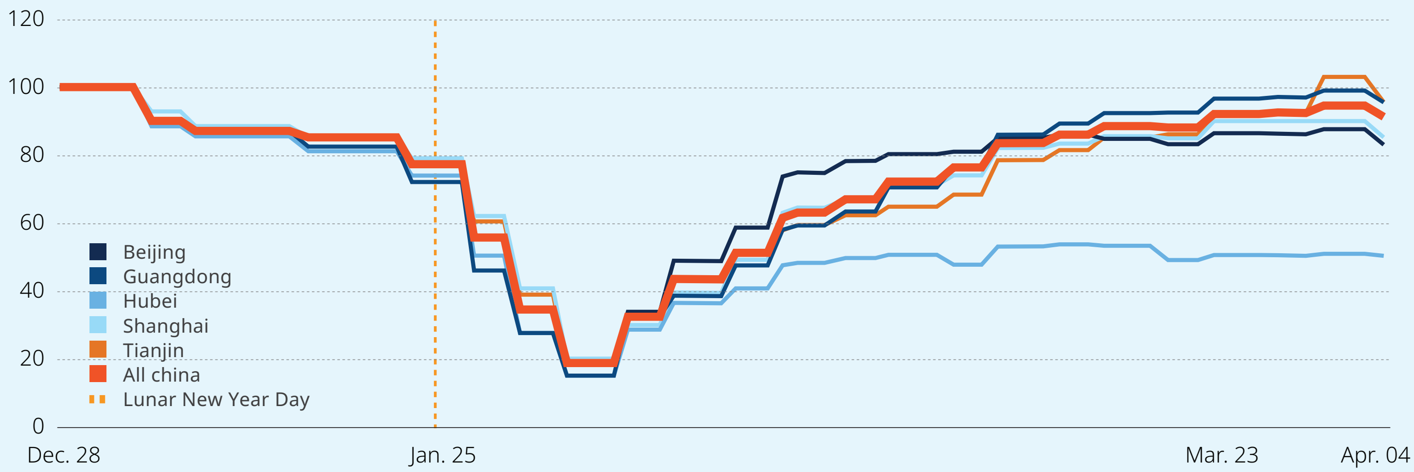
Figure 4. Economic Activity Indicators in China

Job offers: Hubei Province, other selected Provinces and China, one month prior to and after Lunar New Year Day, December 28, 2019 - March 23, 2020 (December 28, 2019 = 100, jobs data as of 8:00 Beijing time March 24, 2020)



Source: DeepMacro

For long horizon investors, cheaper equity valuations following the sell-off point to higher long-term expected returns. Attempting to time asset mix allocations tactically based on views about the epidemic outlook is inherently difficult. However, following a disciplined investment process can help investors:

- **Investment horizon**: The intrinsic valuation of risk assets like equities is lined to long-term fundamentals, such as earnings growth and real interest rates. We believe, cheaper stock valuations today after the sell-off imply a higher long-term average expected return.
- **Portfolio rebalancing**: For investors with a long-term asset mix, periodic rebalancing to target has historically helped to reduce total fund drawdowns in periods of market stress and contributed to a faster rebound in portfolio value. Generally, rebalancing can also help to ensure the factors driving portfolio risk and return remain aligned with the target long-term asset mix.
- **Liquidity**: Maintaining sufficient allocations to liquid high-quality assets is critical to cover short-term financial commitments and avoid sales of distressed assets at inopportune times to raise cash.

[1] Goldman Sachs is predicting a contraction in real GDP by 24% in 2020 Q2. Oxford, JP Morgan and other forecasters are forecasting declines of about 12% to 14%. Top Economists See Some Echoes of Depression in U.S. Sudden Stop, Bloomberg (March 22, 2020).

[2] Paul Krugman expressed a similar view on March 22, 2020: https://twitter.com/paulkrugman/status/1241690862448529408

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