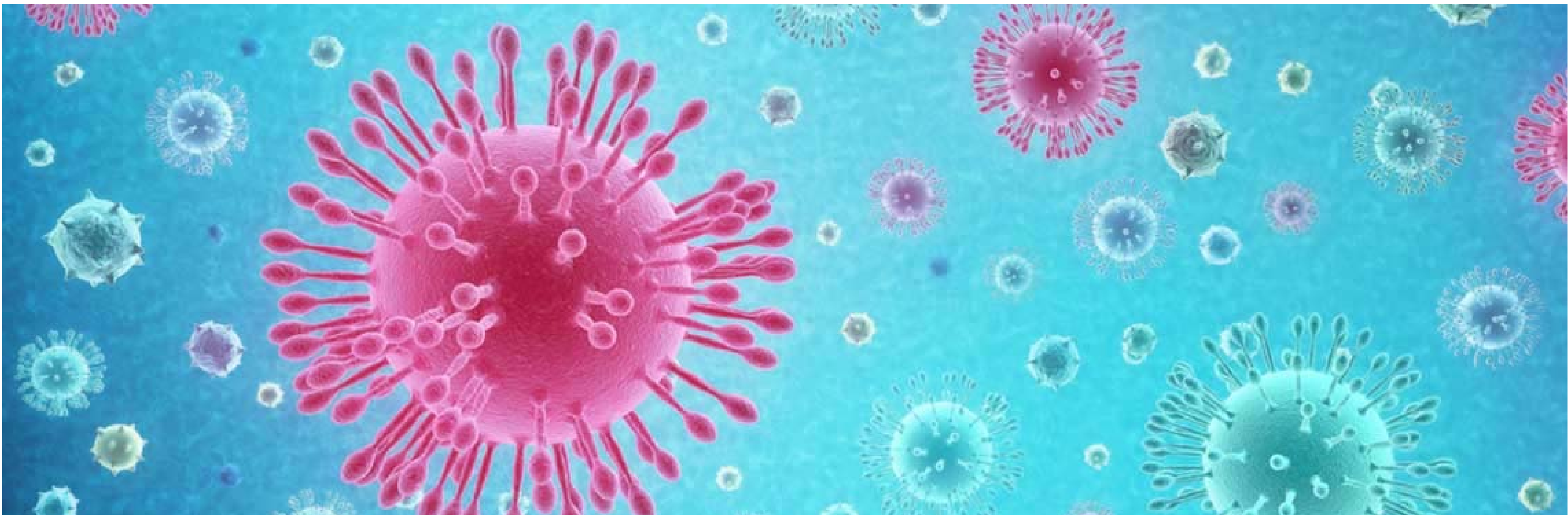

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Life after the Coronavirus - back to normal or not?

Bernhard Eschweiler, PhD
Senior Economic Advisor

Bernhard advises ZAIS on macroeconomic risks and prospects related to credit markets and is a regular contributor to ZAIS Insights.

Life after the Coronavirus - back to normal or not?

- Corona crisis could change economic and financial market trends
- Extent of dislocation plus fiscal and monetary consequences matter most
- The next 1-2 weeks are critical

While people around the world battle the medical, social, economic and financial fallout of the corona pandemic, we also need to look beyond the immediate crisis.

Most people we talk to view the crisis as a temporary shock and expect a return to normal by the end of this year. This is not unreasonable, but the crisis could also trigger lasting fundamental changes.

We have no definitive answer to this question and much will depend on how the crisis plays out in the very near-term, which remains uncertain.

Below, we outline our views of the areas where change could occur and the potential implications for financial markets.

Especially, could the economic trends that have shaped financial markets over the last decade shift in a different direction?

These changes are unlikely to be just caused by the corona pandemic itself. Change will in particular be the result of the environment in which the crisis occurs.

Political and social climate

As investors, our first instinct is to look at the economy and financial markets. However, an important background factor is the political and social climate, which could change in at least two ways:

- The crisis and its aftermath could leave more people struggling and frustrated, further strengthening the appeal of populist and nationalist movements.
- Moderate political forces could handle the crisis well and manage to unite people and interest groups both inside and across national boundaries in the face of a common threat.

The US election will probably be an important signal for which way the political and social climate will turn.

International efforts to resolve trade tensions, combat climate change and resolve geopolitical conflicts as well as the refugee crisis will depend on whether populism and nationalism gain ground or not.

Extent of the dislocation matters

The size and the impact of the near-term dislocation will largely determine whether, how and when a return to normal is possible. This, to us, seems to be currently the biggest uncertainty.

- How soon will the containment measures slow the spread of the virus in Europe and the US? If no progress is made over the next two weeks, we see the contagion reaching a momentum that will be difficult to contain.
- Will containment measures get eased quickly once the spread of the virus has been slowed? In Asia, the virus has been largely contained yet many restrictions remain in place to prevent a renewed outbreak.
- Activity looks to contract sharply between the first and the second quarter. Will fiscal and monetary measures be sufficient to cushion the impact of the downturn and prevent the negative feedback loops of a credit and liquidity crisis?
- An additional uncertainty is the collapse of oil prices, which is caused by weaker demand and supply increases from Saudi Arabia and other large oil exporting countries. Could the downturn in the US oil industry and the negative feedback loops to the rest of the economy do much greater damage than the positive price effect?
- Finally, there is the risk that dislocations in the rest of the world have negative repercussions for the US. A big concern is the stability of the Euro-system and emerging-market economies with large external deficits.

The view we hear the most is that the economic contraction in the first half will be severe, but not cause a similar deterioration in business bankruptcies and unemployment, as activity is expected to rebound immediately in the second half.

We hope this view is right. If not, bankruptcies and unemployment are likely to surge and the dislocation may depress potential growth over the next business cycle.

Undoing globalization?

The coronavirus has pushed the interdependent global economy to a near standstill in just a few weeks. This is unprecedented, at least in post WW-2 history. Could this have adverse effects for trade and globalization?

At a minimum, countries will likely have to think about bringing the production of critical medical supplies back home. Health standards for travel and tourism could also tighten and reduce traffic.

The critical question is whether the international division of labor and goods production will change materially, especially whether supply chains will unravel.

To be sure, de-globalization is unlikely to happen overnight. The interdependence is too high and there are no ready alternatives at home or elsewhere. Furthermore, most firms with global production structures sell their goods world-wide, as well.

Thus, untangling supply chains would more likely be a subtle force, but compounded by increased protectionism; more tensions between the US and China could still weaken the power of globalization and, with it, a key foundation of the high profitability of many US corporates.

Important for the direction of globalization is probably the outcome of the US election. A president Biden, in our view, most likely will mean less protectionism, but possibly at the price of more regulatory restrictions for US corporations at home, which would hurt profitability as well.

Spiraling public debt

The corona crisis is set to have a big impact on the US fiscal deficit.

No fiscal package has yet been passed as of this writing, but the plans discussed in Washington are likely to boost the federal deficit by at least 5% of GDP.

The uncertainty is that even more may be needed if the crisis gets worse and that would come on top of the existing 5% of GDP deficit at the end of last year.

The concern is that this leads to a permanent and potentially escalating deterioration of the US fiscal position and spiraling public debt similar to the development in Japan over the last two decades.

- First, the bigger the dislocation caused by the crisis and the longer the adverse impact on unemployment and potential growth, the larger and more lasting the negative impact on the budget deficit.
- Second, the aging of the population and new health-care programs that could emanate from the corona crisis may compound the structural deterioration of the fiscal position.
- Third, the government may fail again to consolidate the budget once the economic situation improves. Despite more than 10 years of uninterrupted growth, a decline in the unemployment rate to record-low levels and very low interest rates, the US government failed to consolidate the budget, leaving the level of government debt today 43% of GDP higher than before the financial crisis.[1]

The monetary and debt cycle

Over the last three decades, the traditional business cycle has increasingly become a credit cycle. Credit expansions drive growth and credit contractions lead to recessions.

In the 1990s, it was corporate credit, which ended with the dot-com crisis. In the 2000s, it was housing loans that led to the financial crisis.

The current crisis was not caused by credit, but it revealed that credit had again become a problem, especially in the corporate sector and with the use of the USD as a cross-border funding currency.

We believe the Fed and other central banks are right to fight the acute liquidity and credit squeeze with rate cuts (where possible) and large-scale liquidity injections and bond purchases. However, we should be clear where all this may lead.

With inflation less of a concern, the Fed and other central banks focused in recent years more on financial stability to ensure the smooth functioning of the credit markets and, thus, safeguard growth.

Monetary policy intervened at the first signs of market stress. In this way, monetary policy has become "procyclical" as it encourages rather than controls the use of credit. The boom in corporate equity buybacks funded with cheap credit is the latest example.

In combination with bloating government deficits, this dynamic may lead to an increasing monetization of public debt. The Fed appears to have rejected the principles of "Modern Monetary Theory", but effectively may be moving in that direction, as is already the case in Japan.

The risk we see is that government and private debtors become comfortable with a monetary policy that focuses on financial stability at any price, while the Fed becomes a hostage of its own policy.

In Japan, rising public debt and its monetization has not created acute problems. However, this is not proof that we should not be concerned. Japan is a current account surplus economy, and the US is not.[2]

Policy could well lose control and the public could start to doubt that rising fiscal debt and its monetization are sustainable and anticipate higher inflation.

Financial market implications

What could all these issues and potential changes mean for financial markets? For the last decade, the foundation of financial markets was built on three pillars:

- Moderate growth and low inflation
- Strong corporate profits
- A low-yield environment with the Fed focused on maintaining financial stability

This environment seems to have been conducive for using leverage to enhance financial performance and to have resulted in ever higher valuations.

The current crisis could be short-lived with little lasting damage, policymakers staying in control and markets soon returning to business as usual. Another low-yield and rising-debt expansion could unfold. Financial markets would probably cheer until the next unforeseen shock occurs, leaving the economy even more leveraged and vulnerable.

However, the foundations for financial markets could also look quite different post-corona. Here is an example we could see:

- Economic growth and profits could weaken as a result of the dislocations caused by the crisis, tighter regulations, more protectionism and less globalization.

- Inflation could rise as expansionary fiscal policy boosts demand, but structural rigidities constrain supply and the public loses faith in the monetary system.

- The Fed has to respond to inflationary pressures, yet the government absorbs more funds, while weaker income growth generates less private savings. This would curtail private credit and push bond yields higher.

- Volatility would also rise as the Fed must focus more on inflation and has less room to maintain financial stability.

In short, we could shift into an environment of higher yields, lower earnings growth, less leverage, lower valuations and more volatility.

We find it impossible at this point to say what is more likely. Moreover, there are probably several scenarios in-between.

The next days and weeks are critical

However, the next days and weeks will probably decide which way we will move.

At the current virus expansion rates in Europe and the US, several million people look to become infected in just two weeks.

It seems to us that the pandemic would then have reached a point where it is unlikely to be contained. And then lasting change is more likely.

Public authorities have become acutely aware of the need to contain the virus very quickly. Thus, if progress is not made very quickly, ever more drastic measures are likely to be imposed, which could also have lasting implications.

Some good news last

Finally, and given all the uncertainty and concerns, it is important to highlight some positive developments that could emanate from the corona crisis.

- The crisis has highlighted the power of the digital economy. This could result in more flexible work and communication processes, improve the reach and impact of education and advance medical practices.

- Encouraging, also, is the dramatic impact of virus containment measures on CO_2 emissions in places where pollution is usually high. This may open minds and lead to more efforts to reduce emissions more rapidly than previously thought possible.

- The health system was not well prepared for the pandemic. But the speed and energy with which the medical sector is responding is impressive and could lead to fundamental improvements in the health system and the rapid development of a vaccine.

- Humanity usually rises to the challenge when in crisis situations. While keeping physical distance, it is good to see how people have moved closer together to support each other. There is hope that this will have lasting effects and unite society more than polarizing it further.

More information

As always, we are available to discuss our views with you. Please contact your Client Relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com

[1] Federal Reserve Bank of St. Louis and U.S. Office of Management and Budget, Federal Debt: Total Public Debt as Percent of Gross Domestic Product [GFDEGDQ188S], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GFDEGDQ188S, March 18, 2020.

[2] U.S. Bureau of Economic Analysis, Balance on current account [IEABC], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/IEABC, March 20, 2020.

International Monetary Fund, Balance of Payments: Total Net Current Account for Japan [JPNBCAGDPBP6PT], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/JPNBCAGDPBP6PT, March 20, 2020.

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