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Thinking about second round effects

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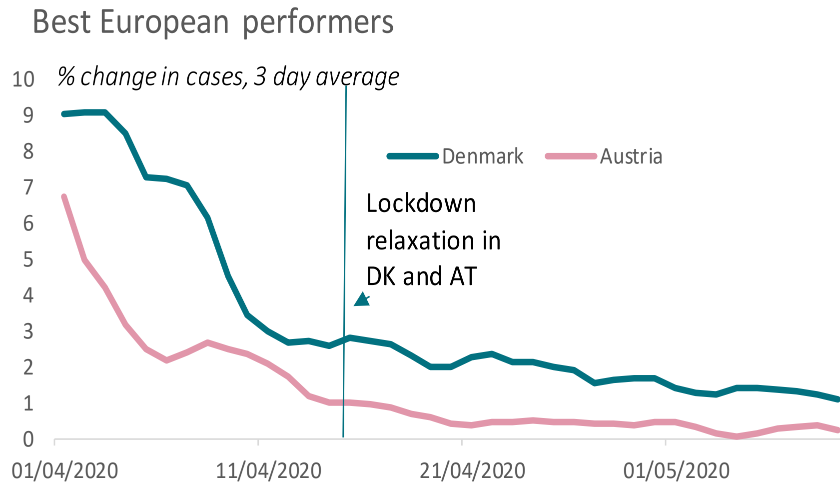
Slowly progressing to the exit

First indications from lockdown relaxation positive – but prudence is essential

Singapore has been able to contain its new clusters. In Europe we focus on Denmark and Austria which relaxed in mid-April. There has not been any rebound in the propagation of the virus so far. Elsewhere we are seeing some "spontaneous relaxation" which may jeopardise the process. Germany – where the "r" ratio is rising again – has to be closely monitored.

No sign of relapse in the European early exiters



Source: John Hopkins, AXA IM Research, 10 May 2020

But Germany needs to be monitored

Today's estimate of the reproduction number R is above 1. Any interpretation of this number needs to take into account that the estimate is linked to a degree of uncertainty that is reflected by the prediction interval published daily alongside the actual number. A low number of case reports could increase the statistical variation. Thus, it is too early to infer whether the number of new infections will continue to decrease as in passing weeks or increase again. The increase of the reproduction number R necessitates a close monitoring of the situation in the coming days.

Source: Robert Koch Institut, 10 May 2020

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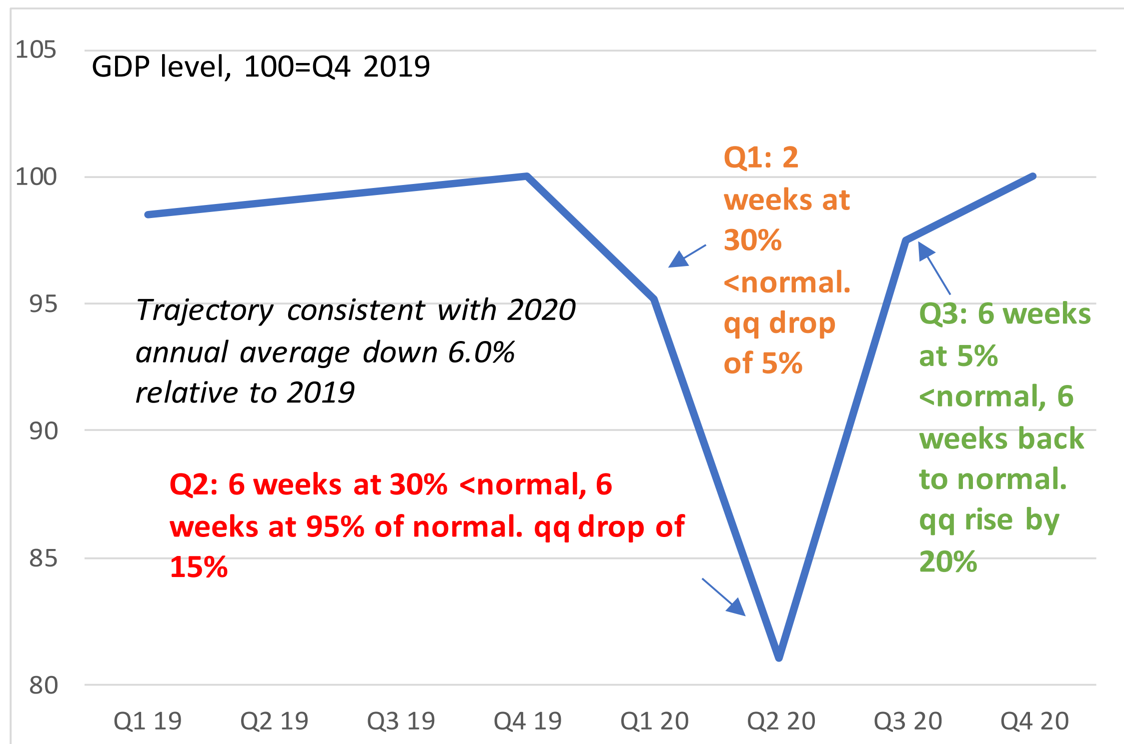
What can happen to GDP post lockdown (1)?

A simple illustration with "permanent loss"

Our baseline forecast is based on the assumption that we manage to avoid a return to lockdown in 2H (if we don't we would then find ourselves in our "adverse scenario". On the basis of GDP at 30% below normal in lockdown in advanced economies, and 5% below normal in the transition phase (zero output in hospitality and collective recreational activities until the middle of Q3), the graph here illustrates what could be the generic trajectory for quarterly GDP in 2020. The magnitude of quarterly growth rates would be very unusual, both in negative and positive territory. On an annual average basis, GDP would fall by 6% in 2020 relative to 2019.



Source: AXA IM Research, April 25th 2020

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What can happen to GDP post lockdown (2)?

"Permanent loss" is consistent with forced saving remaining unspent

But the illustration on the previous page is purely "mechanical" and is consistent with "permanent loss", i.e. what was not spent during the lockdown is not "caught up" later in the year. Some of it will, even if quantifying this at the current juncture is impossible.

The table here illustrates what would happen to the household saving ratio if consumption follows the quarterly growth rate of GDP in the "mechanical forecast". That **income is falling less than consumption is plausible because fiscal policy is providing massive support.** In this illustration, where at trough income falls by 10%, half of the decline in consumption, and taking the saving ratio of the end of 2019 as the reference, households would accumulate "excess savings" to the tune of 30% of their income by the end of the year. Some of this is likely to be spent.

An illustrative trajectory for the savings ratio

	Income level	Delta consumption %	Consumption level	Saving Rate	Cumulated assets>target (% of income)
q4 19	100		85.0	15.0	0.0
q1 20	98	-5	80.8	19.6	4.6
q2 20	90	-15	68.6	34.8	24.5
q3 20	95	20	82.4	18.6	28.1
q4 20	100	2.5	84.4	15.6	**28.6**

Source: AXA IM Research, April 25th 2020

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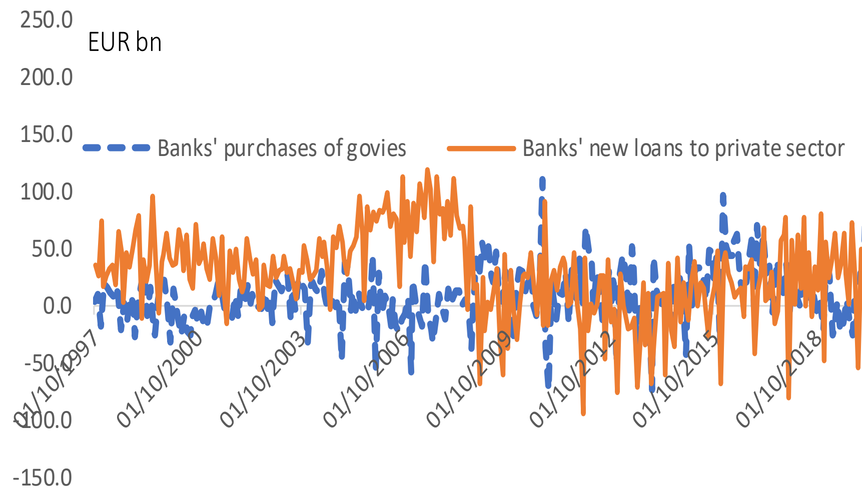
Loan supply is responding

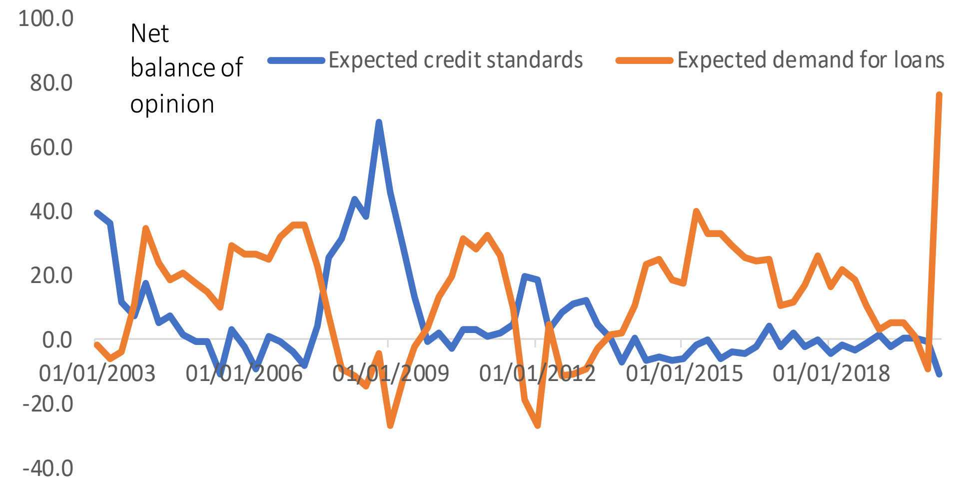
The opposite of the GFC: supply of lending highest on record

The flow of new loans to businesses has hit a record in the Euro area in March. The Bank Lending Survey suggests banks are maybe counter-intuitively loosening their credit standards. This is probably the result of the wide-ranging start guarantees lowering banks' final exposure.

Banks never lent so much



The opposite of the GFC: banks are loosening their credit standards



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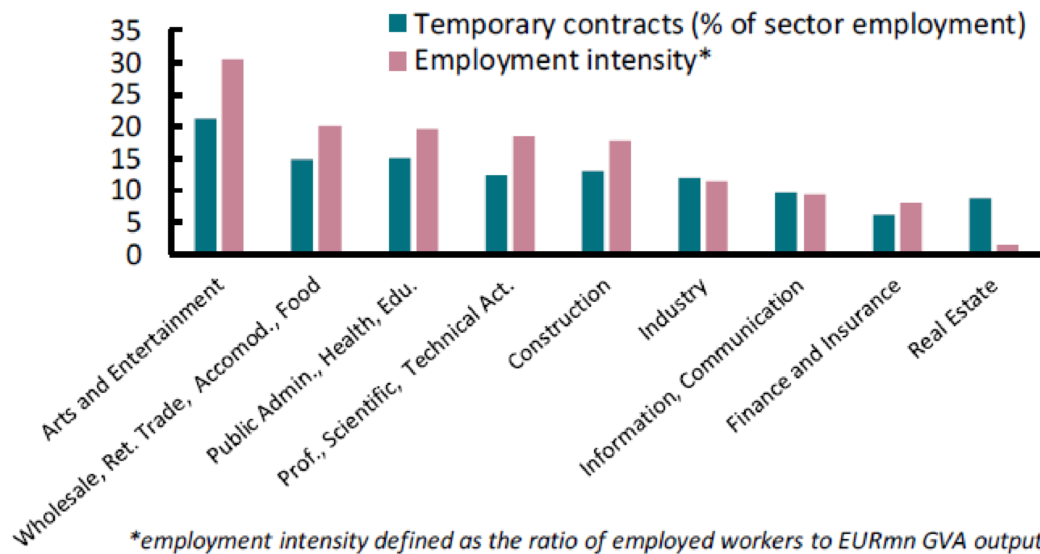
Second round effect #1: job losses

The policy stimulus cannot stop all job losses

Markets are focusing on the spectacular US figures, but the labor market is turning south in Europe as well. A source of vulnerability is that the sectors which are the worst-hit by the lockdown also tend to be labour intensive, and rely a lot on short-term contracts which are going to be the “first to go”. This will dampen the catch-up process on consumption in 2H 2020 as forced saving will find opportunities to spend again,



Source: Eurostat and AXA IM Macro Research, May 2020

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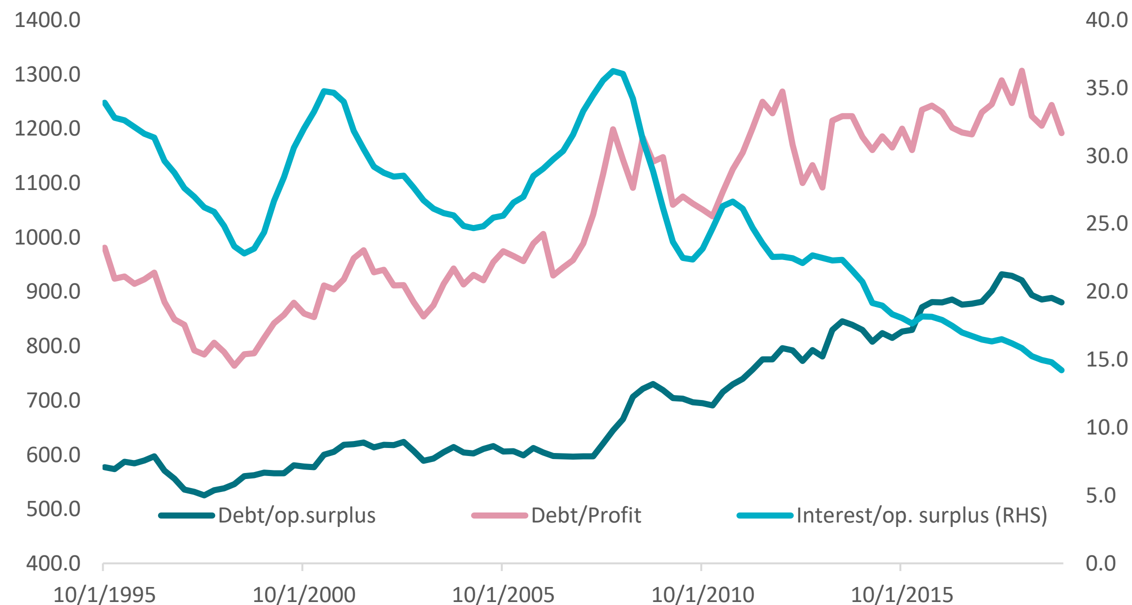
Second round effect #2: Corporate cash flows will suffer

Debt is rising – and needs to be kept sustainable

Fiscal support to corporates is mostly taking the form of loans. This will constrain future cash flows, especially in the countries where the level of corporate debt is already very high.



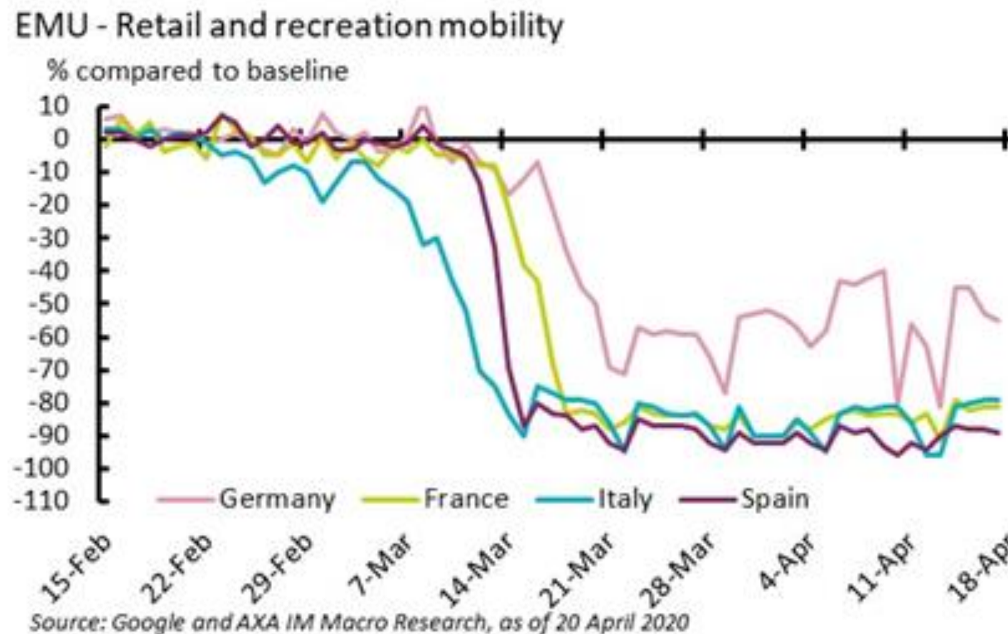
Sources: INSEE, Banque de France, AXA IM Research May 4th 2020

Asymmetry # 1: How severe is the lockdown?

Using real time data

All countries are not equal in the face of the lockdown. Germany is the "odd one out" according to Google trends. Phone localisations suggest movement is 50% below normal there, against 80 to 90% in Italy, Spain and France. This would be consistent with a lesser decline in GDP in Q2 in Germany.

Mobility trends for place of work - Europe



Source: Google trends,, April 17th 2020

Source: Google trends April 17th 2020

Asymmetry # 2: How big are the stimulus packages across countries?

Show me the money!

Germany is also the odd one out in terms of the magnitude of the fiscal support: 4.5% of GDP. It is possible that the other countries are "internalising the financial constraint" and refrain from being as generous for fear of triggering a negative reaction from investors, in spite of the ECB support. So, in a nutshell, the country which seems the less affected by the lockdown is also the one which is stimulating the most its economy.

Counting the billions

	Liquidity measures			Job and income support measures			Discretionary	
	State loans/Credit guarantees	Tax deferrals	Debt repayment holidays	Social security deferrals or subsidies	Income subsidies for workers	Moratorium on mortgage payments and utility bills	Discretionnary measures	Fiscal package
Germany	€500bn of state-backed guarantees €400bn fo a new special fund called WSF that could provide guarantees for outstanding credit payments by the corporate sector for up to 60 months €100bn for a capital injection fund	✔	✗	✔	€10bn in reduced threshold for firms to apply for the government's reduced-hours subsidy (from 30% of the workforce to 10%) €50bn for hardship fund for SME and self- employed	✗	€7bn for the health system	**€156bn or 4.5% of GDP**
France	€300bn of state-backed guarantees	€32bn split between deferred corporate taxes and social security charges	✗	€32bn split between deferred corporate taxes and social security charges	€8.5bn for 2 months of state payments to workers temporarily laid offs (chomage partiel) €2bn solidarity fund for SMEs and self employed	✗	c.€2bn for healthcare spending	€45bn or 1.9% of GDP
Italy	€5bn of state-backed guarantees, leveraged to c. €350bn	Deferral for corporates and self-employed taxes until May 31	✔	✔	€5bn for government funded temporary layoffs €4bn for subsidy/wage supplements for people forced to stop working	✔	€3.5bn for health system and civil protection	€25bn or 1.4% of GDP
Spain	€100bn of state-backed guarantees €10bn of liquidity lines	✔	✔	3-month moratorium on social security payments	Easing of the conditions for temporary suspension of employment	✔	€3.8bn for healthcare spending	€17bn or 1.4% of GDP

Source: Bruegel, AXA IM Research., April 2020

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Asymmetry # 3 : Is the pandemic the "great leveler"? Well, no!

Social inequality will shape the medium term fiscal response

The workers in relatively high-pay industries are over-represented among those working from home (with unchanged pay). The workers in relatively low-pay industries are over-represented among those being furloughed. Since the income replacement rate is below 100%, they are the net losers of the pandemic. This will force income support to be maintained for long after exiting the lockdown. Fiscal policy will remain generous – at a potential cost in terms of financial conditions.

Labour reaction to the pandemic is very unequal across sectors

Activity of employees on March 31st (% of total employees)

	Total	Sectors	
Working from home	26	Information and communication	63
		Financial activities and insurance	55
		Construction	12
		Hospitality	6
In-work unemployment	25	Hospitality	67
		Construction	49
		Energy	10
		Food processing	9
On site	26		
Sick leave/child minding	13		
Holiday	9		

Source: DARES, AXA IM Research,, April 17th 2020

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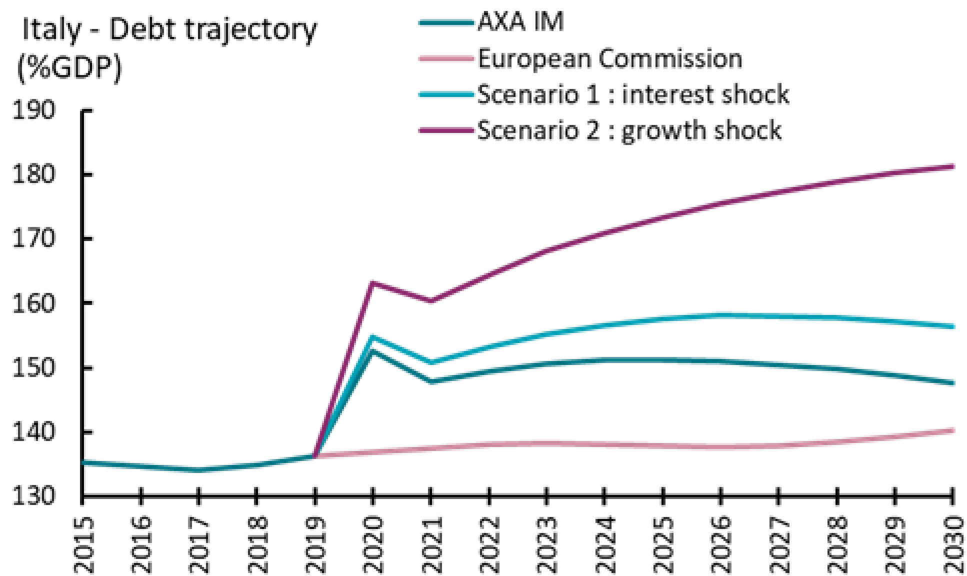
Focus on peripheral spreads

Italy at risk of an "explosive debt trajectory"

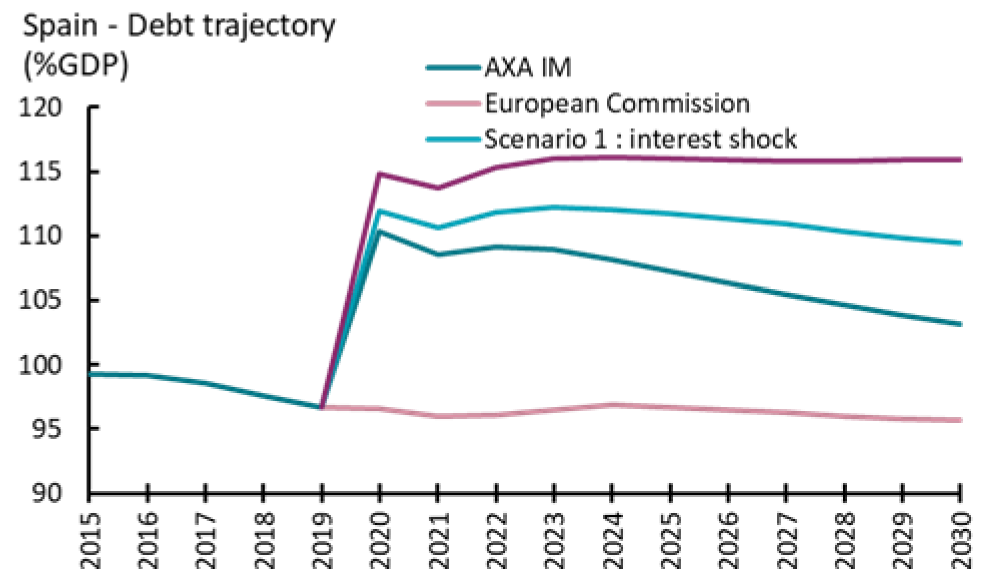
We think that Italian public debt will exceed 150% of GDP this year, and with the current interest rate dangerously close to trend nominal GDP growth, it will be very difficult to reduce it post-pandemic. It would not take much to send it on an explosive trajectory. Spain looks more protected (thanks to its higher nominal GDP growth rate in particular). Rating agencies seem to behave "responsibly" for now but they seem to count a lot of massive central bank support. It is here for now. We need to take a closer look at that though.

Stress- testing Italian public debt



Source: AXA IM Research, April 2020

Stress-testing Spanish public debt



Source: AXA IM Research, April 2020

Second round effect #2: Euro area tension

More constraints on the ECB

- The German Constitutional Court is ordering the Bundesbank to stop participating to the ECB's Public Sector Purchasing Programme if the ECB does not demonstrate the proportionality of its action within the next three months. .
- The ECB cannot respond without endorsing the notion that a national Court can control ex post its monetary policy decisions.
- Germany could be sued for treaty infringement
- **Technically, the ECB can continue PSPP without the Bundesbank. But the political message would not instil trust in the solidity of the monetary union**
- More progress on fiscal mutualisation would be a solution to relieve the ECB, but so far it has been too slow.

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