الوطني NBK

Major economies see activity plunge as lockdown measures take their toll

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Highlights

- **Equity markets made major gains in April helped by hopes that the lockdowns that have slowed the spread of Covid-19 but crippled economic activity will start to be eased. Economic growth is unlikely to rebound with the same vigor, however.**
- **US GDP fell an annualized 4.8% in Q1, but a much steeper drop will be seen in Q2. The policy response has been very large, including a more than $2 trillion fiscal stimulus package that will support demand but put huge strain on the fiscal position.**
- **Europe's economy has if anything been hit harder, with Eurozone GDP already falling 3.8% q/q in Q1. While the ECB has loosened policy aggressively, the coordinated fiscal response across the Eurozone has been underwhelming.**

Volatility across financial markets continued in April, with equities staging a strong rally after March's huge declines, helped by massive policy support measures and growing hopes that lockdown measures that have slowed the spread of Covd-19 will start to be eased. The US S&P index racked-up its best month since 1987, up nearly 13% after a similar-sized drop in March, while major equity markets elsewhere rose a more modest 4-7%. Despite market buoyancy however, there are few signs that global economic activity will stage anything like as vigorous a comeback and indeed estimates for the scale of the contraction in output this year have if anything become larger. In its latest World Economic Outlook, the IMF forecasts an historic 3% fall in global GDP this year, far worse than in 2009. Meanwhile, nowhere has volatility been more pronounced than in the oil market, with the price of a benchmark US WTI futures contract astonishingly turning negative mid-month reflecting the sudden flood of excess crude on the market and a shortage of storage capacity.

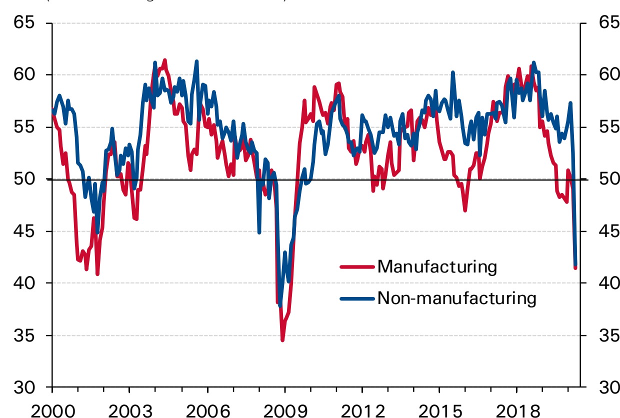
US GDP plunges, jobless total surges

High-frequency indicators have started to reveal the massive hit taken by the economy from a combination of 'stay at home' orders, business closures and supply chain disruption that began mid-March. Most remarkable has been the surge in new jobless claims, which have risen a staggering 30 million (cumulative) in the six weeks to April 24. This looks consistent with a rise in the unemployment rate to above 15% from 4.4% in March, and potentially heading towards the 25% peak recorded during the Great Depression. These figures include a large number of furloughed workers and those forced to work part time, so the hope is that they will fall back quickly once businesses reopen.

Meanwhile, survey activity indicators have plunged to multi-year lows. Both the manufacturing and non-manufacturing ISM indices – which had held up surprisingly well in March – sank to just under 42 in April (50=no change), consistent with a deep economic contraction across the economy. (Chart 1.) Even these scores likely overstate economic conditions, with lengthening supplier delivery times – ordinarily signifying suppliers struggling to keep pace with demand – contributing positively to the headline index but in reality a source of economic disruption. Various index sub-components paint a much gloomier picture however, with production in the non-manufacturing survey collapsing to just 26, new orders at 32 and employment at 30 – all series lows.

Chart 1: US ISM activity indices

(50=no change on the month)

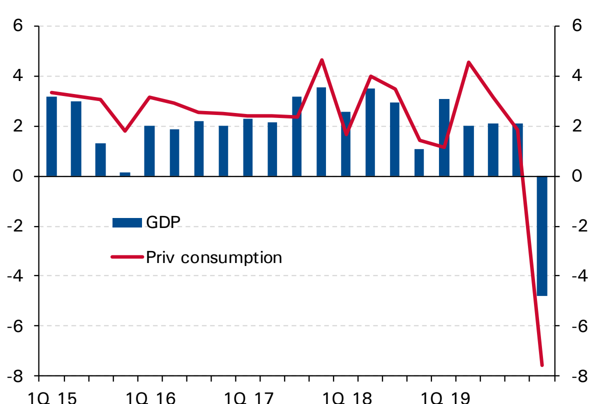


Source: Refinitiv

Official GDP figures released for 1Q20 reveal only the front end of the pandemic's impact, but nevertheless were strikingly bad. GDP fell at an annualized 4.8% rate, worse than the consensus and the fastest drop since the financial crisis. (Chart 2.) Consumer spending – worth around 70% of the economy – fell a huge 7.6%, with investment down a more modest 2.6% helped by strong residential investment early in the quarter. Net exports were a positive thanks to a huge 15% plunge in imports. A far bigger hit will be seen in the Q2 GDP figures, which will incorporate at least one full month of lockdown measures. The forecast range is broad (especially given the annualized nature of the data, which exaggerates q/q changes), but some analysts see a drop of as large as 40%. A sharp rebound is likely in Q3, but even if the virus is effectively contained, GDP is likely to register a hefty drop of 5-10% in 2020 overall and the pace of recovery beyond this is extremely uncertain.

Chart 2: US GDP

(q/q annualized, %)



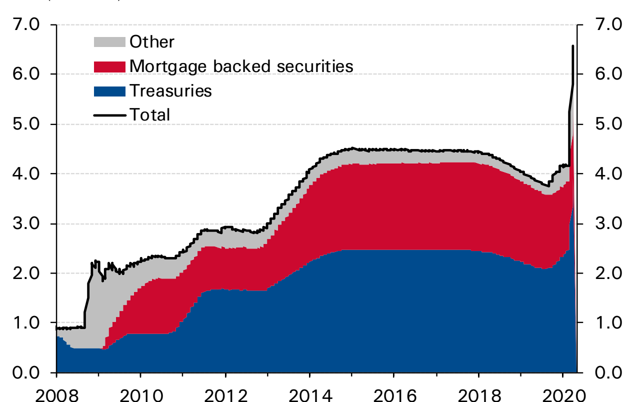
Source: Refinitiv

Policy measures targeted at supporting the economy have been vast in scale. The Fed slashed interest rates twice by a cumulative 150 bps through March, returning the target rate to 0-0.25%. It also restarted quantitative easing (incorporating purchases of treasuries, mortgage-based securities and even corporate bonds) and introduced a plethora of extraordinary programs aimed at boosting liquidity and encouraging credit. These measures have seen the size of its balance sheet surge to more than $6.5 trillion, smashing through the previous $4.5 trillion post-financial crisis peak seen a few years ago. (Chart 3.) The Fed's steps, together with market expectations that both growth and inflation will remain weak for the foreseeable future, have pushed yields on 10-year government bonds to just 0.6%.

Fiscal policy has also been dramatically loosened, with the Whitehouse and Congress eventually agreeing in late March a $2.2 trillion (11% of GDP) stimulus package with several components. These include loans to SMEs that turn into grants if workers are kept on the payroll ($350bn, since expanded by a further $310bn), loans and loan guarantees for hard-hit industries, states and cities mostly channeled through the Fed ($500bn), one-off checks of $1,200 to qualifying adults ($300bn), expanded unemployment benefit ($250bn), and extra spending on health ($150bn). Clearly these vast sums will help support demand and limit the scope of the economic downturn this year – but the strain on the fiscal position will be immense. According to the Congressional Budget Office, extra spending combined with the impact on revenues of the steep drop in economic activity will push the fiscal deficit this year to $3.7 trillion (18% of GDP), falling to $2.1 trillion (10% of GDP) in 2021. This compares to a peak of $1.4 trillion (10% of GDP) recorded in 2009.

Chart 3: US Fed balance sheet assets

($ trillion)



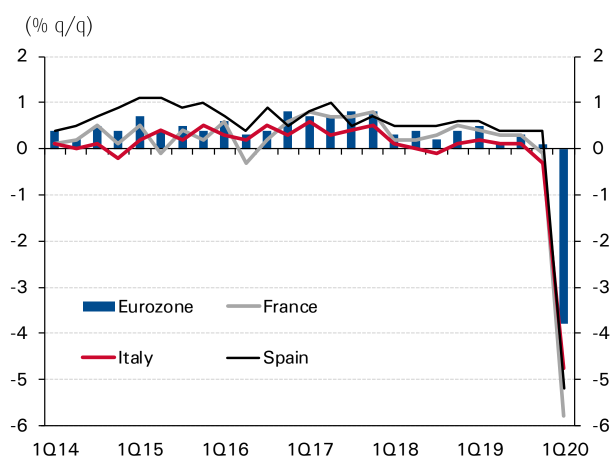
Source: Refinitiv

Eurozone GDP sees record decline in Q1, worse to come

Europe's economy has been hit, if anything, even worse than the US due to a combination of a high number of infections among its largest countries, strict lockdown measures that have devastated business activity and a slightly earlier spread of the virus. GDP across the Eurozone fell by an alarming 3.8% q/q in Q1 (roughly three times the 1.2% rate recorded in the US if calculated the same way), which captures only the initial impact of the lockdown measures introduced in March. (Chart 4.) This included record declines in France (-5.8%), Spain (-5.2%) and Italy (-4.7%). Figures for Germany have not yet been released.

The flash composite PMI confirmed that economic conditions were even uglier at the start of Q2, collapsing to a shocking 13.5 in April from an already weak 29.7 in March and analysts expect GDP in the quarter could contract by as much as 10% q/q. While lockdown measures were gradually being eased at the start of May and businesses were starting to reopen, the path back to normal looks set to be a long one given the scale of damage to household, corporate and government balance sheets, the fragility of economic performance pre-crisis and also a less comprehensive region-wide policy response compared to the US (see below). The IMF forecasts Eurozone GDP will slump 7.5% this year overall and rebound 4.7% in 2021.

Chart 4: Eurozone GDP



Source: Refinitiv

In terms of monetary policy, the European Central Bank (ECB) has responded quite aggressively. Key policy interest rates were already at or even below zero, so room for maneuver was limited. But the bank boosted the size of its quantitative easing program (which it had already restarted last November) by around €1 trillion, to be completed this year and to include both sovereign and corporate bonds, lifted the cap on bond purchases from individual countries, and has cut the interest rate on its long-term (TLTRO) loans to banks who meet business lending targets. ECB president Christine Lagarde said that the bank will "explore all options" to help the economy through the shock.

But the region-wide fiscal response has been underwhelming, bogged down by policy coordination issues and continued resistance from some member states to pan-European funding mechanisms particularly sought by more hard-pressed countries including Italy and Spain. So far, a limited €0.5 trillion (4% of GDP) has been committed mostly through a combination of potential extra government borrowing for health spending from the European Stability Mechanism and loan guarantees for SMEs from the European Investment Bank. This falls well short of the amount needed to absorb the cost of the downturn (though individual countries have implemented some separate measures of their own), with much of the money anyway unlikely to be utilized partly due to the stigma attached in obtaining contingency funding. Beyond the immediate question of cushioning the near-term shock to demand, the lack of EU-wide effective action risks generating deeper questions over regional cohesion and solidarity.

Japan unveils record stimulus

Japan unveiled a record ¥117 trillion ($1.1billion, 20% of GDP) stimulus package in April that will include a ¥100,000 cash-handout for every citizen and of which ¥48 trillion will be fiscal, in a desperate bid to prop up the economy. Meanwhile, during its policy meeting, the Bank of Japan (BoJ) left its policy rate unchanged at -0.1% but announced that it would remove limits on government bond purchases to keep borrowing costs low. It also vowed to sharply increase the level of corporate bond and commercial paper purchases from around ¥7 trillion ($65 billion) to ¥20 trillion ($186 billion) in an effort to target financial support towards struggling companies.

The BoJ's quarterly Tankan manufacturing survey index slipped into negative territory in 1Q20 (-8 versus 0 the previous quarter) for the first time in seven years amid weak demand. Indeed, Japanese exports fell by 12% y/y in March, the biggest decline in almost four years and significantly sharper than the 1% decline in February. Imports also fell in March (-5%), and are likely to take a further hit as Japan enters a state of emergency.

In its monthly economic report for March, the Japanese government downgraded its assessment of the economy for the second time in three months. The postponement of the Olympic games by a year is also likely to add further downward pressures on the economy this year. The IMF's expects Japan's economy to contract by 5.2% in 2020. Underlying conditions were weak even before the pandemic hit, with growth a mere 0.7% in 2019. The IMF expects the economy to rebound 3.0% in 2021.

Chinese GDP plunges in Q1

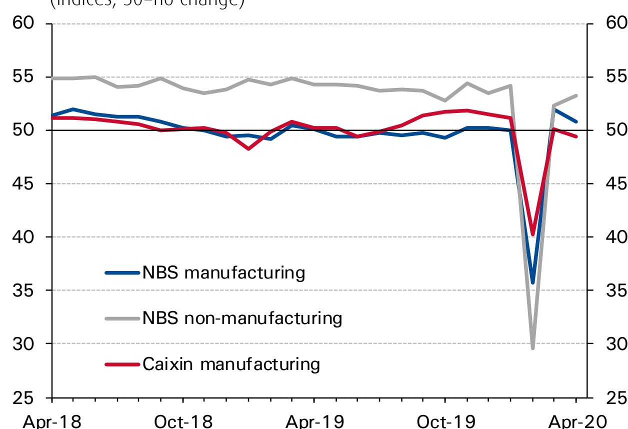
GDP in China contracted by 6.8% y/y in Q1 (versus +6.0% in 4Q19), the largest fall in decades, as the virus outbreak weighed on demand and amid large-scale travel restrictions and factory shut downs, particularly during February. According to the IMF, growth in China will slow from 6.1% in 2019 to just 1.2% in 2020 before rising sharply to 9.2% in 2021.

Committing to its repeated pledge to remain supportive of the virus-hit economy, the government unleashed a slew of monetary and fiscal stimulus measures in March and April. The central bank delivered a cut in required reserves for small banks, a reduction in its one-year medium-term lending facility and a cut in its benchmark rate. It also injected at least RMB150 billion ($21 billion) into the banking system. Separately, the Ministry of Finance announced that it is planning to sell RMB1 trillion ($141 billion) in local government special bonds to support infrastructure spending.

While survey and high-frequency data now point to some improvement in economic activity as more and more firms return to work following an ease in lockdown measures, the recovery remains tepid at best, not least because of the slump in global demand. The official manufacturing PMI slipped from 52.0 in March to 50.8 in April, while the Caixin/Markit manufacturing PMI slipped back into contractionary territory, falling from 50.1 to 49.4, as any gains in domestic demand were offset by continued weakness in external demand. (Chart 5.) Meanwhile, the official non-manufacturing PMI picked up from 52.3 in March to 53.2 in April on a rise in construction activity.

Chart 5: Chinese PMIs

(indices, 50=no change)



Source: Refinitiv

Economic activity in India also weakens sharply

After a mild pickup in India's GDP growth to 4.7% in 4Q19 (Q3-FY19/20), output is expected to contract in 1Q20, as previously weak business activity, consumption, exports, and overall confidence weakens further on coronavirus pressures (approaching 50,000 cases in early May) and the national lockdown which commenced on March 25. Recent data has indeed been weak: private sector activity slowed to a 5-month low in March, with the services PMI falling sharply to contraction territory (49.3) from 57.5 in February. More recently in April, the manufacturing PMI saw the sharpest contraction since the inception of the index, plummeting to a record low of 27.4 versus 51.8 in March. The deterioration in business activity was driven mainly by weak demand, which in turn led to weak output and payrolls, with the unemployment rate reportedly surging to 25% in April.

With global and domestic demand likely to remain subdued as coronavirus pressures persist and as lockdowns and restrictions on movement possibly continue for several more weeks or months, economic activity in India will likely remain lethargic going forward into Q2 and beyond. The downturn may be eased slightly by recent policy measures, including the announcement of fiscal stimulus amounting to 1% of GDP, looser monetary policy, and the easing of restrictions on selected sectors, including agriculture, effective from April 20. The consensus estimate is for growth of 1.7% in FY2020, revised down from 5.6%, and a rebound to 6.7% in FY2021.

Oil prices find slight relief after tumultuous April

Oil prices closed out April on a relative high, with markets less pessimistic about the outlook with OPEC+ production cuts set to go into effect in May and amid tentative signs of recovering oil demand. Brent crude closed at $25.3/bbl, up 11% following March's colossal 55% decline and from a mid-month 22-year low of $19.3. (Chart 6.) April saw even more astonishing developments in the US WTI benchmark, which turned negative for the first time in history. Its collapse to -$37.6 was sparked by a massive panic sell-off ahead of the deadline for the expiry of the May futures contract, with contract holders desperate to avoid taking physical delivery of crude due to a lack of storage facilities.

Chart 6: Brent crude oil price

($ per barrel, end of month)

Source: Refinitiv

The event sent shock waves through the oil sector and focused minds on rapidly-dwindling global storage brought about by a combination of collapsing demand and oil producer-orchestrated oversupply. The IEA estimated that global oil demand fell by an unprecedented 29 mb/d in April (and by -9.3 mb/d y/y for 2020) to a level last seen twenty-five years ago (around 71 mb/d).

On the supply side, OPEC+ was reconstituted in April to secure a historic global production cut deal, its inability to do so a month earlier having triggered the initial price collapse. Under the new deal, OPEC+ will cut output by a historic 9.7 mb/d from May and will be joined by several oil producers from the G20 group, including the US and Canada, whose production has, and should continue to, fall organically due to low oil prices. Producers will be able to increase output slowly through to April 2022 as global demand improves. Combined OPEC+/G20 cuts could total between 15-20 mb/d (15-20% of total global oil demand), which, though nowhere near the extent of the drop in global oil demand, do represent a meaningful base from which to slow down the rate of global inventory accumulation. Most estimates place global demand growth and oil prices on an upward trajectory in the second half of the year.

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