Economic Update

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International Scene

Slump in Q2 GDP figures highlights pandemic fallout

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Highlights

- **A batch of awful GDP figures for the second quarter across the US and Europe highlighted the stunning fallout from the Covid-19 pandemic. The worst of the declines are in the past, but concerns remain about the pace and durability of the recovery.**
- **US GDP contracted by an annualized 32.9% in Q2. A strong rebound is expected in Q3, but a surge in virus cases since mid-June, the weak labor market and political haggling over fresh stimulus are driving fears that the recovery could stall.**
- **Eurozone GDP fell at an even worse rate of 12.1% q/q in Q2. While fears of a virus second wave have grown, optimism about the medium term has been helped by the EU's agreement of a €750 billion jointly-financed recovery fund.**

A batch of awful GDP figures for the second quarter of the year across the US and Europe revealed the stunning fallout from widespread business closures and travel restrictions aimed at containing the Covid-19 pandemic. Although the worst of the output declines are now surely in the past, concerns remain over the pace and durability of the recovery – especially in the US where a renewed surge in virus cases has caused a halt to reopening measures in some states, and where Congressional haggling is generating uncertainty over fresh fiscal stimulus. Meanwhile, ultra-loose monetary policy continues to help insulate equity markets from these worries, with the S&P500 up 5.5% in July and now just shy of its February all-time high. Low interest rates (as well as weak growth) are also anchoring long-term bond yields, with the US 10-year treasury yield edging down to just 0.5% in early August, also feeding dollar weakness.

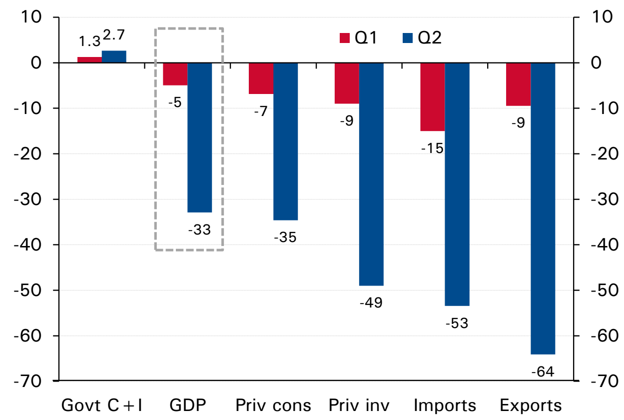
US suffers historic drop in GDP in Q2

As expected, the US economy in Q2 suffered a contraction of historic proportions due to virus-related containment measures, with GDP growth at an annualized -32.9% (-9.5% q/q) following a 5% fall in Q1. (Chart 1.) Leading the drop was a 35% decline in private consumption (including a 44% drop in services spending), while private investment (including inventories) plunged 49%. Government spending was the one segment that managed to eke out a rise at 2.6%.

The bulk of the contraction in output came early in the quarter, with business activity improving in May and June as "stay at home" orders were eased and government stimulus programs kicked in. This points to a large rebound in GDP in Q3, and the Atlanta Fed's nowcast estimate is currently running at around 20%. However the surge in virus cases since mid-June, the subsequent pausing or reversal of some reopening plans and also the expiration of the expanded unemployment benefits scheme in July (and failure so far by Congress to agree on a fresh stimulus package – President Trump's recent executive orders are an attempt to bypass congress and initiate a smaller stimulus package of his own) are driving fears that the recovery could stall. While ISM activity indices have for now rebounded back above the 'no change' 50 level, consumer sentiment slipped back in July as optimism about the next six months retreated.

Chart 1: US GDP in Q1 and Q2 2020

(% q/q annualized)

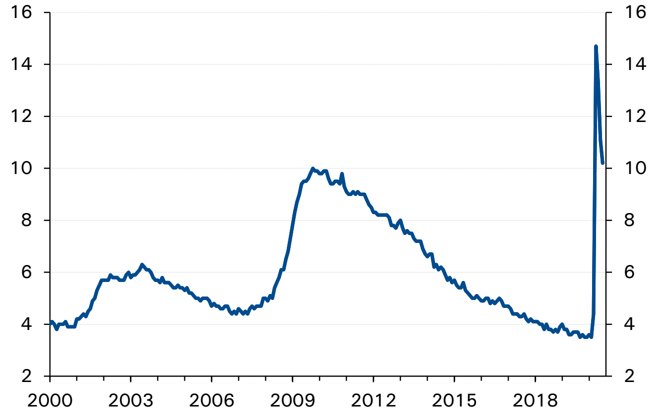


Source: Refinitiv / BEA

One factor weighing on the outlook is the continued dire state of the labor market. Although employment rose a better-than-expected 1.8 million in July, the pace slowed from June and the unemployment rate remains very high at 10.2%. (Chart 2.) High unemployment, combined with a potential loss of income from reduced benefits could together provide a sharp shock to consumer spending, which in June had recovered to -4.8% y/y from a nadir of -16% in April if still 7% below pre-pandemic levels. One hope is that household savings built up during recent months of reduced outlays will be used to temporarily finance spending until Congress agrees a new stimulus package potentially in August.

Chart 1: US unemployment rate

(%)



Source: Refinitiv

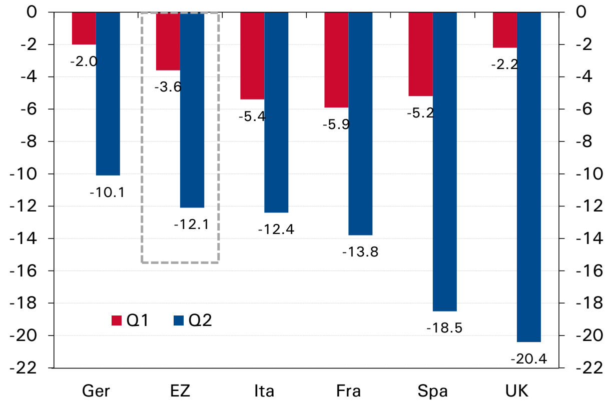
The Federal Reserve as anticipated kept policy unchanged at its July meeting, leaving the Fed Funds rate in the 0.0-0.25% corridor, maintaining open-ended QE and a pledge to keep policy loose until the crisis has passed and even loosen further if the recovery falters. Fed chair Jay Powell continued to warn of the risks from the early withdrawal of fiscal stimulus measures and urged Congress to approve fresh support. Meanwhile, the Fed's commitment to loose monetary policy – together with renewed virus fears and the unwinding of earlier 'safe haven' flows – has also been a factor contributing to the recent slide in the US dollar, which fell another 4% on a trade-weighted basis in July and now sits 9% below its March peak. With growth weak and inflation very low – just 0.9% y/y in June on a core PCE basis – a weaker dollar is not a major policy issue for the Fed. But a further sharp drop could cause concerns given its status as a reserve currency and the headwind a weak dollar would provide to global growth.

Eurozone Q2 GDP also plunged, but outlook improving

Second quarter GDP figures across the Eurozone provided an even more dismal picture than in the US. Regional output fell a massive 12.1% q/q following a 3.6% drop in Q1. (Chart 3.) Some countries saw much steeper declines, notably Spain (-18.5%) and France (-13.8%), while the contraction in Germany was comparatively modest (-10.1%) helped by the authorities' relative success in containing the spread of the virus. Figures for the UK show output down 20% q/q – worse than other countries partly explained by the UK's smaller contraction in Q1.

Chart 3: GDP across Europe

(% q/q)



Source: Refinitiv

While a recent pick up in virus cases in some countries and the possibility of a substantial second wave in the winter are clouds hanging over the outlook, survey data continue to indicate near-term recovery with economies now largely reopened. The composite Eurozone PMI bounced back into expansion territory at 54.9 in July – its fastest pace in more than two years – from 48.5 in June, with especially strong gains in France and Germany. Meanwhile, retail sales rose 5.7% m/m in June and returned to pre-pandemic levels. These data put the economy on a much stronger footing going into Q3 and imply that GDP could recover at least as fast as in the US this quarter. Prospects after the initial rebound are more uncertain, with high unemployment likely to weigh on output for a long time and the possibility that countries with more policy space and who avoid large virus outbreaks will outperform the others.

Europe's medium-term prospects have however been helped by a landmark agreement among the EU-27 on a €750 billion jointly-financed recovery fund aimed at tackling the effects of the crisis. The fund will be paid out through 2021-23 at an average of more than 1.5% of GDP per year. While its amount is not that large measured against the scale of the drops in output, its significance is that a) more than half of the funds will be distributed as grants rather than loans, b) it will be allocated not according to members' contributions but to the scale of the economic hit from the crisis and c) the fund will be financed from EU-issued debt repayable partly from countries' membership fees (as well as new taxes). In this sense it moves Europe a step closer to the cross-country fiscal transfers that are essential to underpin the long-term integrity of the single currency zone. Italy and Spain are the countries likely to see the largest payouts.

Japan’s external sector continues to face headwinds

Japan’ exports and imports continued to fall in June amid ongoing weakness in both domestic and global demand. Exports fell sharply again, by 26% y/y (versus -28% in May), as shipments to the US almost halved due to weaker demand for cars and car parts and as Chinese demand remained subdued. Imports declined by 14% in June (albeit an improvement from the 26% drop in May) on weak domestic demand, which helped narrow the country’s trade deficit to ¥269 billion from ¥841 billion. The slump in the external sector is likely to weigh heavily on the overall economy. According to a recent Reuters poll, GDP is expected to contract by 23.9% (annualized) in Q2 – its worst contraction on record – versus the 2.2% decline in Q1.

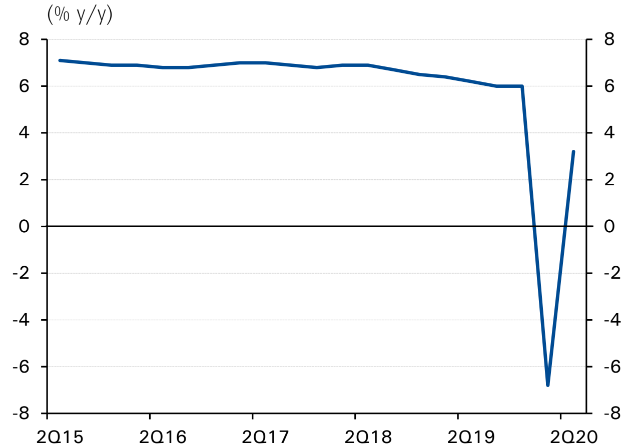
Following a similar move by rating agency S&P last month, Fitch also lowered its outlook on Japan’s sovereign credit rating from stable to negative, citing a grim economic outlook and heightened concerns about a widening fiscal deficit and rising debt. Nonetheless, the Bank of Japan (BOJ) once again held monetary policy steady in July and reiterated its belief that deflationary risks are absent and that the country will gradually recover from the effects of the pandemic in the second half of this year. Inflation (excluding food and energy), a preferred measure by the BOJ, was steady in June at 0.4% y/y, but remains far below the central bank’s target of 2%.

Chinese economy recovering but demand woes persist

Chinese GDP growth witnessed a decent recovery in Q2, expanding by 3.2% y/y as mobility restrictions eased and with the support of monetary and fiscal measures after the country’s worst contraction in decades in Q1 (-6.8% y/y). (Chart 4.) Indeed, recent high frequency data, including manufacturing and non-manufacturing surveys, confirm the post-lockdown recovery in activity, albeit gradual and with lingering downside risks stemming from lackluster demand. While newly-released official and Caixin manufacturing PMI data continued to trend upwards, to 51.1 in July (50.9 in June) and to 52.8 (51.7 in June), respectively, export orders remained down against a backdrop of subdued global demand. Services activity, in contrast, eased slightly during the same period, but remained reasonable at 54.2 in July (54.4 in June), according to the official services PMI.

Meanwhile, core inflation (excluding food) remained subdued in June, easing to 0.9% from 1.1% in May, reflecting in part the continued softness in domestic demand. Producer prices fell for a fifth straight month (-3.0% y/y) on the back of continued weakness in commodity prices. The subdued inflationary environment should help the central bank maintain an accommodative monetary stance: the benchmark lending rate was unchanged for a third consecutive month in July given signs of the economy’s improvement. Separately, the yuan strengthened by 1.3% m/m versus the US dollar in July, thanks to an improved economic outlook and dollar weakness.

Chart 4: China GDP



Source: Refinitiv

Activity in India remains weak as virus cases rise

India’s GDP is expected to have contracted sharply in 2Q20 (1Q of FY20/21) due to the national lockdown, which is still effective in some parts of the country. The composite PMI measure of business activity, after improving in May/June, remains in contraction and in fact edged down to 37.2 in July from 37.8 in June. Weak activity caused public revenue to contract by 6.9% y/y in June, led by a major drop in corporate receipts (-19.1%), the steepest on record. In a bid by the government to counter weak activity, growth in government spending reached a 10-year high of 19.6% y/y, which will undoubtedly put further pressure on the fiscal deficit; the rolling 12-month deficit reached 5.7% of GDP in June and is expected to reach 12.1% in 2021 (IMF). This will push debt to a steep 84% of GDP in FY 2020 and further to 86% in FY 2021. Against this backdrop, Fitch recently lowered the sovereign debt outlook to negative from stable while keeping the rating unchanged at BBB-.

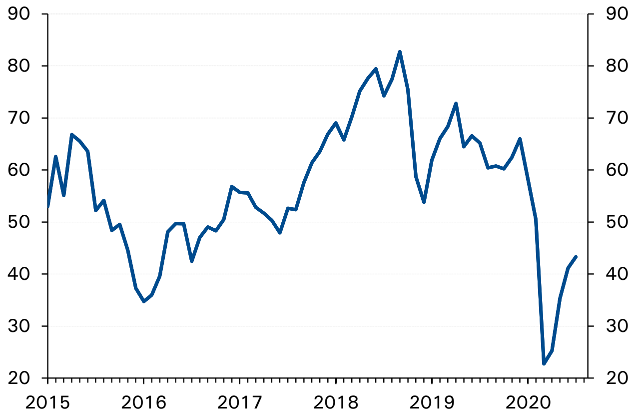
Looking forward, the biggest downside risk for India’s economy is a prolonged coronavirus situation. The pandemic has shown few signs of abating given that new cases had increased to above 50,000 per day by early August, which does not augur well for business activity. With demand likely to remain lethargic in the near term, pressure on revenue collection and the public finances will increase. The IMF forecasts that GDP will contract by 4.5% in 2020 and rebound by 6% in 2021, assuming the virus is contained and restrictions are lifted, though other analysts project a steeper downturn.

Oil prices rangebound amid resurgent coronavirus

Brent crude oil prices closed out July up 6% at $43.3/bbl having traded within a tight $42-$44/bbl range throughout the month. (Chart 5.) Only after the explosion in Beirut on August 4, which rekindled regional geopolitical risk fears, did Brent break out, setting a new five-month high of $45.2/bbl. Prices have been broadly supported by: (1) OPEC-13 crude production falling to a three-decade low of 24.3 mb/d in June and aggregate OPEC+ compliance reaching 110%, up from 85% in May; (2) involuntary declines in crude output from US shale (around -2 mb/d from February's 13.1 mb/d); (3) falling US commercial crude inventories; and (4) the upward revision to 2020 global oil demand growth (+360 kb/d to -7.9 mb/d) by the International Energy Agency in its July report.

Chart 5: Brent crude oil price

($ per barrel, end of month)



Source: Refinitiv

Nevertheless, headwinds, in the form of uncertain and inconsistent oil demand due to resurgent coronavirus infections, which have raised the spectre of a return to mobility restrictions, have the potential to darken the oil market's mood. Moreover, from August, OPEC+ has begun tapering its 9.7 mb/d worth of production cuts (to 7.7 mb/d), bringing with it the prospect of additional supplies adding to still elevated global inventories. The volumetric impact on oil demand-supply balances will be about half as much as initially scheduled, however, since producers such as Iraq, Nigeria and Angola will have to continue to make deeper cuts to compensate for not meeting their targets in earlier months. While much of this has already been priced in, a more pronounced bearish turn for oil prices could materialize were oil demand growth to weaken in the next few months.

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