Economic recovery hopes tempered by renewed virus concerns

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Highlights

- **Despite generally encouraging economic data, a rise in global Covid-19 cases and uncertainty about the easing of lockdown measures weighed on financial markets in June. The IMF downgraded its 2020 global growth forecast again to -4.9%.**
- **The US saw another huge rise in employment in June, but the underlying labor market picture remains blurred. Still, improved recent data have seen some estimates for the drop in Q2 GDP reined back in to 'only' -15%.**
- **Sentiment in Europe has been helped by a fall in virus numbers, business re-openings and new policy measures. This includes in Germany, where the government announced a fresh fiscal stimulus package worth 4% of GDP.**

Despite recent economic data generally pointing to a decent pace of recovery, a steady rise in global Covid-19 cases and fresh uncertainty about the easing of travel and business restrictions in some countries provided for a mixed but more subdued backdrop for financial markets in June. The US S&P for example rose a modest 2% after a 17% rally between March and May, though European stocks performed better. The IMF downgraded its already-weak forecast for global GDP growth in 2020 further to -4.9%, and warned both about continued uncertainty and that financial markets may have got ahead of themselves, risking a retightening of financial conditions in future. Meanwhile, the oil price rally continued into June with Brent settling at above $40/bbl as OPEC+ announced an extension to supply cuts. However this recovery also ebbed later in the month as concerns over the demand outlook reasserted themselves.

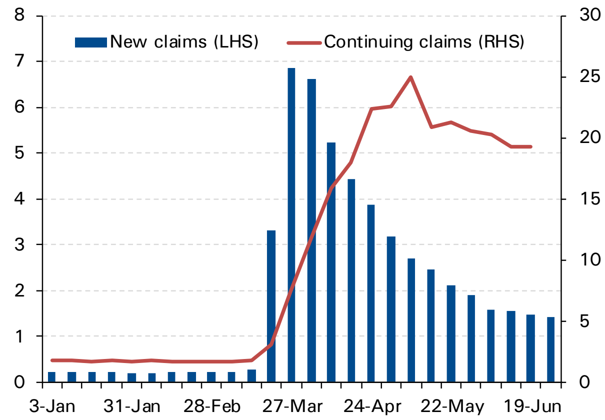
US recovery hopes tempered by renewed virus threat

A largely positive run of economic data in recent weeks boosted hopes of a robust US recovery, albeit increasingly qualified by the renewed rise in Covid-19 cases that has seen some states reverse earlier lockdown-easing measures. ISM activity surveys bounced back strongly in June, with the non-manufacturing index hitting a four-month high of 57.1 (45.4 in May) on a surge in output and new orders.

Labor market data has also surprised on the upside, with non-farm jobs surging 4.8 million in June following a surprise 2.5 million jump in May and unemployment falling from 13.3% from 11.1%, as previously furloughed or temporarily laid-off employees returned to work as businesses reopened. However, the underlying picture remains blurred by the unprecedentedly large and volatile numbers, data classification issues, the potentially distorting impact of government support programs and the fact that weekly initial jobless claims remain extremely high at 1.4 million in the week-ending June 27 (continuing claims also rose slightly). (Chart 1.) The scheduled expiry of the enhanced unemployment benefit scheme at end-July could be crucial in testing the labor market's resilience, with millions of people likely to seek work more urgently as their incomes drop.

Chart 1: US jobless claims

(millions per week)



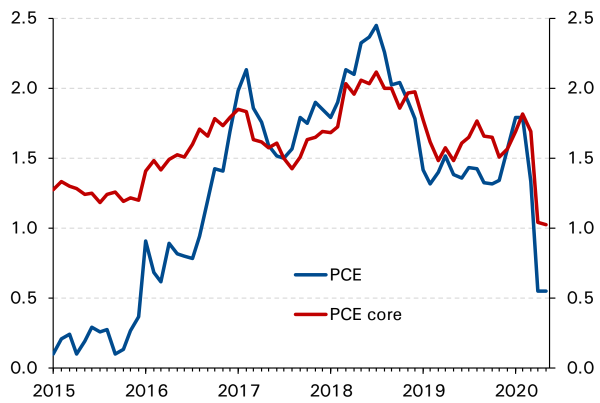
Source: Refinitiv

Still, the improved overall recent economic data have seen some forecasts for the inevitable plunge in Q2 GDP reined back in. The New York Fed's Nowcast now projects a decline of 'only' 15% on an annualized basis, though the Atlanta Fed and the consensus sees a bigger drop of 35% or so – but even this is less steep than a few weeks ago. GDP contracted 5% in Q1.

Given the uncertainties, some attention is now being paid to what further stimulus measures the Federal Reserve might adopt if economic data starts to disappoint and the recovery ebbs – especially with interest rates already at zero, the Fed already having pledged virtually unlimited QE and providing support for business through various loan and financing programs. Minutes of the Fed's June meeting show that members debated the potential benefits of yield curve control, which could see for example the bank intervening to cap yields on government debt (similar to the Bank of Japan's 0% target for 10-year government bonds). The bank recommended further analysis of the policy's potential impact, but a number of analysts see it being implemented before year-end, particularly given recent downward pressures on core inflation which stood to just 1% in May. (Chart 2.)

Chart 2: US PCE inflation*

(% y/y)



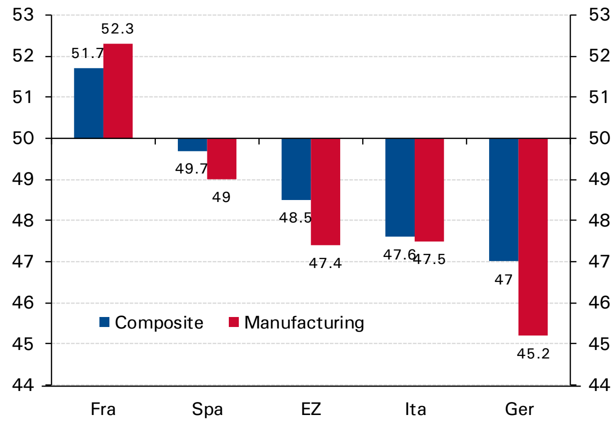
Source: Refinitiv *PCE=Personal consumption expenditures

Eurozone economy shows early signs of revival

A mild degree of economic optimism has returned to Europe amid signs that new Covid-19 cases have fallen to a sustainably low level, economies are reopening and greater activism on the policy front including the EU's planned €750 billion Recovery Fund, which is still under negotiation. Composite PMI activity indices remain below the 'no change' 50 mark, but are nevertheless well up from their sub-20 lows of April. (Chart 3.) The more internationally-exposed manufacturing sector continues to lag the rest of the region's economy, which in turn is weighing on conditions in Germany despite its relative success in containing the spread of the coronavirus. The German government has discarded its traditional caution and announced a new fiscal stimulus package worth €130 billion (4% of GDP) including a 3% point cut in VAT from July to December, cash handouts for parents and investment in green energy. The package will be financed by extra borrowing and reduce the hit to GDP this year by 1.3% according to the DIW institute, though GDP could still contract 8% in 2020.

Chart 3: European PMIs for June 2020

(Index, 50=no change)



Source: IHS Markit

Meanwhile, the Eurozone headline inflation rate ticked up in June but remains perilously close to zero at 0.3% y/y (and was negative in nearly half of all Eurozone countries), while the core rate edged down to 0.8% – well below the ECB's 'close to but below' 2% target. The central bank will meet in mid-July and having increased the size of its PEPP asset purchase program from €0.75 trillion to €1.35 trillion in June, may be tempted to wait and see how lockdown easing measures and fiscal stimulus programs play out before loosening policy further (perhaps September). Tensions arising from the ruling by the German Constitutional Court in May – which threatened to undermine Germany's participation in an earlier asset purchase scheme – appear to have been eased by the German parliament's sign-off on the policy's efficacy. But the newer PEPP plan could still be the subject of a legal challenge, which could by extension lead to hesitation over future expansions of the scheme.

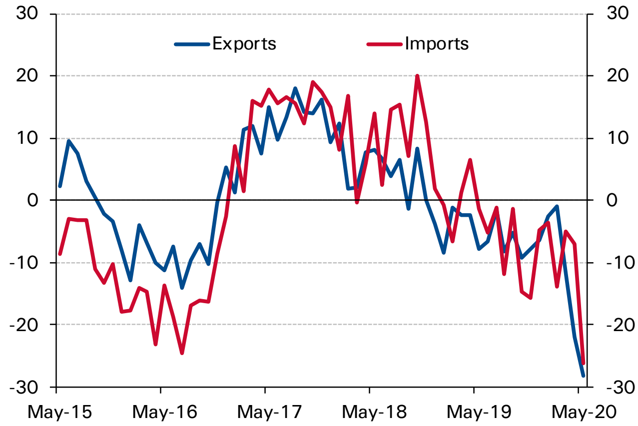
Japan's external sector remains fragile

Japan's exports and imports both plunged in May, reflecting continued weakness in the external sector. Led by a drop in car shipments to the US and sluggish Chinese demand, exports fell a huge 28% y/y in May (22% in April), the biggest decline since the 2009 financial crisis, while imports fell by a comparable 26% (7.1% in April) on the back of subdued domestic demand and lower commodity prices. (Chart 4.) Japan's economy slipped into recession in 1Q20, after contracting by a revised 2.2% (annualized, versus 7.2% in 4Q19), not least because of the weakness in the external sector and sluggish domestic demand.

That said, the Bank of Japan (BOJ) stood pat on its monetary policy but did increase the size of its lending package for financially-constrained companies from the $700 billion announced in May to $1 trillion. The BOJ added that it still expects the economy to gradually recover from the virus outbreak this year thanks in part to the generous stimulus packages announced over the past couple of months.

Japan passed its second 'extra budget' in two months in June, in a desperate bid to counteract the economic fallout from the Covid-19 outbreak. The extra budget, worth a record ¥31.9 trillion ($298 billion), will help provide funding to struggling companies and the health system. However, it also adds to Japan's already high public debt levels (the government is expected to increase its debt issuance by ¥59.5 trillion to help fund the extra spending), which prompted S&P to lower its outlook on the country's sovereign credit rating outlook from positive to stable.

Chart 4: Japan international trade



Source: Refinitiv

Chinese manufacturing recovery remains tepid

The latest manufacturing survey data continue to point to a slow economic recovery in China due to ongoing weakness in external demand. While both the official and Caixin manufacturing PMI both edged up in June to 50.9 (50.6 in May) and 51.2 (50.7 in May), respectively, they remained weighed down by a continued slump in export orders. In contrast, services activity witnessed stronger gains, with the official services PMI climbing to 54.4 in June (53.6 in May) and the Caixin services PMI jumping from 55.0 in May to 58.4 in June – a more than 10-year high – led by increases in new business activity. With the services sector making up 60% of the Chinese economy, the continued recovery in this sector no doubt bodes well for growth overall.

Meanwhile, China's producer prices fell by a sharper 3.7% y/y in May (-3.1% in April), led by weakness in commodity prices. Consumer price inflation eased from 3.3% in April to a more-than-one-year low of 2.4% in May, on the back of lower food price inflation. The continued moderation in inflation gives the central bank more room to ease its monetary policy if need be.

Tensions between the US and China continue to escalate over the recently passed Hong Kong security law by the Chinese authorities. The US House of Representatives passed new sanctions that will penalize banks that do business with Chinese officials. The yuan did, however, manage to eke out gains in June, rising by 0.9% against the US dollar to RMB7.07/$1, which reflects in part the economic recovery, albeit a slow one.

India posts first current account surplus in 13 years

India's current account balance recorded a small surplus of $0.6 billion or 0.1% of GDP in 1Q20 (calendar year), marking the first quarterly surplus since 1Q 2007. This contrasts with a deficit of $4.7 billion in 1Q19 and $2.6 billion in the previous quarter. The surplus was due to a lower trade deficit, mainly on account of weaker domestic demand coupled with a large drop in oil import costs, which typically comprise the bulk of India's imports. The lower trade deficit came despite a drop in exports due to the Covid-19 induced slow-down in global demand. The current account surplus reflects weakened economic activity, with GDP expanding at the slowest pace (3.1% y/y) in 1Q20 since the financial crisis, and expected to contract in 2Q20.

Latest business activity readings confirm this weakness, with the services PMI recording the fourth month of contraction in June at 33.7 on low new orders and hiring, although recovering from May's historical low of 12.6, reflecting some form of stabilization. With new Covid-19 cases on a consistent rise in India (22,771 on July 4, 653,000 total) and given the highly uncertain outlook regarding the pandemic's longevity, weak demand and business activity will likely continue to be a drag on the Indian economy in the coming quarters. The consensus estimate is that GDP growth will contract by 0.2% in FY2020, but rebound sharply in 2021 (7.2%) as the pandemic subsides and business conditions improve. However, the IMF's latest forecast is for a steeper contraction of 4.5% in 2020 and a rebound of 6% in 2021.

Oil rally cools on resurgent Covid-19

May's oil rally continued into June, with prices topping three-month highs on reduced pessimism about the economic outlook and confidence that the oil market was tightening thanks to OPEC+ supply curtailments. Brent reached a high of $43 before closing the month up 16% at $41.0/bbl. (Chart 5.) However, anxieties about the pace of the oil demand recovery have resurfaced of late as Covid-19 infections surge in post-lockdown US states. Adding to this, there are concerns that global oil demand will never recover to pre-pandemic levels of 100 mb/d in the context of the clean energy transition. Nevertheless, the International Energy Agency (IEA) is still sticking by its forecast of pre-pandemic levels being reached in 2022: in its June oil market report, the agency expects oil demand to contract by 8.1 mb/d this year – one of the most severe contractions on record – before rising by 5.7 mb/d in 2021 to 97.4 mb/d.

Chart 5: Brent crude oil price

($ per barrel, end of month*)

Source: Refinitiv * Latest figure is for July 3

On the supply side, OPEC+ in May (the first month of cuts) notched up a reduction of 8.44 mb/d versus the group's target of 9.7 mb/d, which represents a compliance rate of 87%. The oil producers' group agreed to extend the two-month duration of these maximum cuts for a further month to end-July, after pressuring serial non-complier Iraq, which only achieved 46% of its target cut, to compensate the group with deeper cuts over the next few months. Supply-side tightness was also helped by further declines in US shale production. Output as of 26 June was estimated at 11 mb/d, down an incredible 2.1 mb/d (16%) from its late February peak. This has coincided with US oil rig counts plummeting to an 11-year low of 185.

Overall, following June's supply-side curtailments, the narrative has now switched back to oil demand. For oil to break through the lower $40s resistance level, demand will need to recover more quickly. And for that to happen, the global corona pandemic will need to be brought fully under control.

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