Activity shows tentative signs of revival as lockdown measures start to ease

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Highlights

- **Financial markets enjoyed another strong month in May, buoyed by a gradual easing in coronavirus-driven lockdowns and travel restrictions, fresh policy stimulus announcements and slightly more positive – if still very weak – economic data.**
- **Despite the recent spread of riots and protests linked to racial tensions, a degree of optimism surrounding the US economy has returned, helped in particular by a surprise rise in jobs in May that has fed hopes of a rapid recovery.**
- **Europe's economy has also shown signs of revival, with activity surveys improving slightly and unemployment for now barely rising. The ECB has expanded QE and the EU has proposed to issue bonds to finance a region-wide recovery plan.**

Financial markets enjoyed another strong month in May, buoyed by a gradual easing in coronavirus-driven lockdowns and travel restrictions, fresh policy stimulus announcements and slightly more positive – if still very weak – economic data. The US S&P for example surged nearly 5% in May and is now just 6% off its mid-February peak – a rally strong enough to feed perceptions that stocks have become disconnected from economic fundamentals that are still poor. Meanwhile key government bond yields remained very low amid central bank buying aimed at supporting the recovery. Oil prices have also continued their strong recovery from April lows, with Brent reaching above $40/bbl helped by improved sentiment on demand but more importantly aggressive OPEC+ supply cuts in effect since May and which were extended in early June.

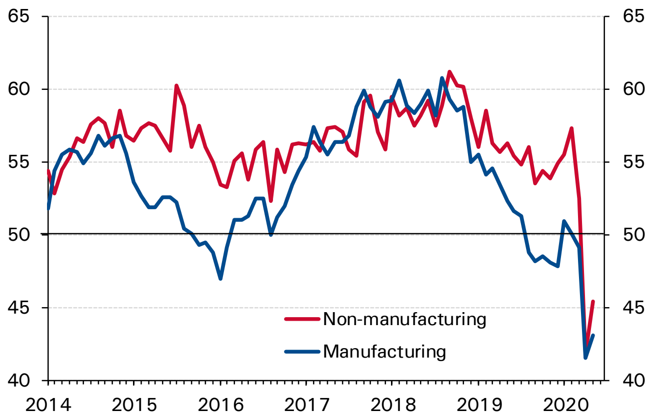
US activity crawls back, employment surprisingly rises

Notwithstanding the riots and protests linked to racial tensions that have spread across the country since late May, a mild degree of optimism surrounding the economy has returned as lockdown rules are gradually lifted, businesses reopen, policy stimulus measures take effect and some economic data has surprised to the upside. ISM activity surveys have shown both the manufacturing and non-manufacturing sectors starting to recover, though at 43 and 45 respectively in May, both remain at levels consistent with a steep economic downturn. (Chart 1.)

There were also surprisingly upbeat signs from the labor market, with non-farm payrolls *rising* 2.5 million in May, confounding expectations of a massive 8 million fall, and clawing back some of the 20.7 million collapse in jobs seen in April. The unemployment rate declined to 13.3% from 14.7% the previous month. Although some analysts have highlighted possible flaws in the survey, the figures at face value point to furloughed employees returning to work at a decent rate as businesses reopen, especially in the badly-hit recreation and leisure sector.

Chart 1: US ISM activity indices

(50=no change on the month)



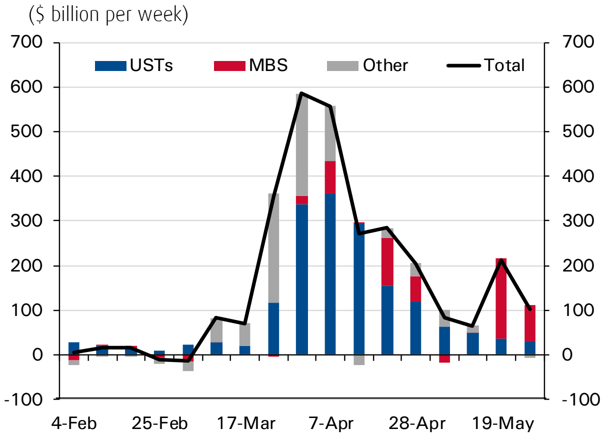
Source: Refinitiv

However, the strength and durability of the recovery remains uncertain. One fear is that unemployment could linger at very high levels due to the US policy of making transfer payments to individuals (and not just to employers), which may discourage people from returning to work and also weaken ties with their former firms. Such concerns could escalate if a proposal by House Democrats to extend unemployment benefits as part of a new stimulus package is adopted – though the same measures would in theory secure spending power to help the recovery. GDP is still seen contracting an historic annualized 40% or more in

2Q20, following a 5% drop in Q1.

The Federal Reserve left policy on hold in June, preferring to allow some time for its previous stimulus measures – including cutting its policy rate to 0-0.25%, offering cheap loans to businesses and continued QE with no specific end date – to filter through and judge their effectiveness. Indeed the Fed's dramatic balance sheet expansion has slowed recently implying an easing in market conditions. (Chart 2.) However the pace of the decline in price pressures if sustained could at some point force the Fed's hand on further loosening, especially if the economic recovery disappoints: core PCE inflation plunged by the most in nearly 20 years in April to 1.0% y/y from 1.7% in March and well below the 2% target. One option that the Fed has is to push interest rates into negative territory, though various officials have expressed aversion to this including due to the impact on money markets (which would face negative returns). More plausible could be a move towards stronger forward policy guidance.

Chart 2: US Fed balance sheet change in assets

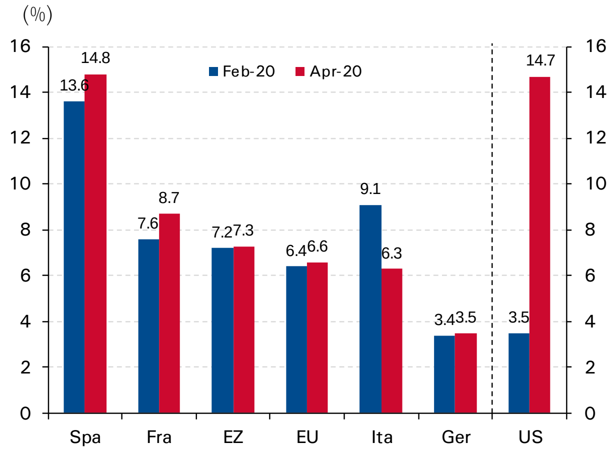


Source: Refinitiv

Europe takes fresh policy action

Activity across Europe also shows signs of stirring as lockdowns are eased, with the Eurozone composite PMI rebounding from an astonishing low of 13.6 in April to an improved but still weak 31.9 in May. There has also been good news so far on the unemployment rate, which – despite GDP plunging 3.8% q/q in Q1 and a projected -10% or more in Q2 – ticked up only fractionally in April to 7.3% from a pre-crisis 7.2% in February. (Chart 3.) In Italy it even fell, though this merely reflected a large number of people leaving the workforce. One explanation for the resilient labor market is the effectiveness of wage-subsidy programs across the region, which have allowed firms to sustain their workforces despite plunging revenues. However the risk is that if demand for the same jobs does not return, the support money will have been misallocated.

Chart 3: European/US unemployment rates



Source: Refinitiv / Eurostat

There are signs that economic policy is becoming more active. The ECB announced in June that it would expand the size of its €750 billion PEPP QE program to €1.35 trillion and extend its purchases until at least June 2021 (previously end-2020) – a move aimed at reviving growth and keeping borrowing costs especially for vulnerable countries such as Italy and Spain low. The bank justified this by slashing both its growth and inflation projections: regional output is now seen contracting 8.7% this year (+0.8% in March) and not recovering to pre-Covid levels until 2023. Inflation will plunge to just 0.3% this year and 0.8% in 2021, well below the near-2% target. The policy loosening suggests the ECB is undeterred following a ruling by the German constitutional court in May that the bank may have overstepped its mandate with an earlier (but still active) QE program, which if not adequately rebutted could ultimately lead to a fracturing of support for the single currency.

There was also important news on fiscal policy, the response of which until now had been disappointingly timid due to constraints facing more financially-constrained countries and a lack of region-wide tools and coordination. The EU has proposed that it be allowed to issue its own bonds for the first time worth €750 billion (around 3.5% of GDP) to finance a regional recovery plan benefitting particularly hard-hit countries and crucially, €500 billion of this will be allocated as grants rather than loans. The approval of Germany – previously reluctant to consent to debt sharing – represents a landmark step on the path to further European integration, which could also be accelerated by the UK's departure in January if this improves regional cohesion.

The plan could still take months to approve and some 'frugal' northern countries are opposed to the idea, though they will be under huge pressure to yield in the circumstances. Meanwhile, Germany – breaking from its normal conservative fiscal stance – announced a €130 billion (4% of GDP) stimulus package of its own, to include a temporary 3% point cut in VAT to encourage consumers to bring forward purchases and kick start demand.

Japan falls into recession, unveils second stimulus

The Japanese economy contracted by an annualized 3.4% in 1Q20 (-7.3% in 4Q19), as a global slowdown weighed on exports, firms cut back on investment and as consumers limited spending to essential goods amid the Covid-19 pandemic. Japanese exports saw their biggest drop since the 2009 global financial crisis in April, falling 22% y/y (-12% in March), affected mostly by weaker global demand for cars and industrial materials. Imports also remained in decline, falling 7.2% reflecting continued weakness in domestic demand as well.

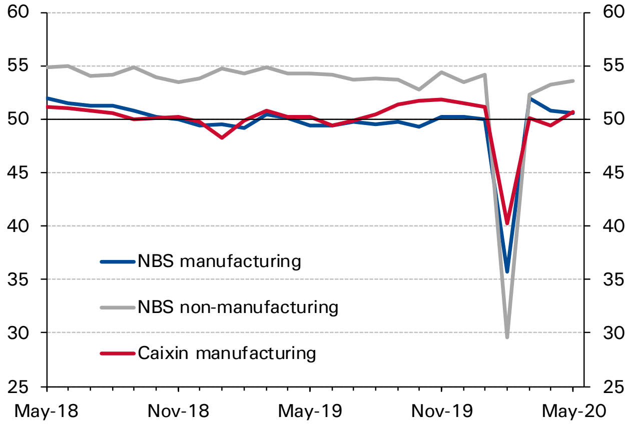
To help mitigate the recessionary impact of the pandemic, the government in May finalized its second economic stimulus package in as many months. The package, which matches April's package of ¥117 trillion ($1.1 trillion) brings total stimulus measures unveiled by the government to around ¥234 trillion ($2.2 trillion), one of the world's largest, and equal to around 40% of Japan's GDP. The additional stimulus will be funded by a second record budget, of ¥31.9 trillion ($290 billion), and from other sources including loans and investments from government-backed lenders worth around ¥39 trillion ($350 billion). These will be used to ramp up medical spending, provide financial aid to struggling firms and support students who have lost their part-time jobs.

Chinese recovery weighed down by weak global demand

Latest survey and high-frequency data depict a tepid economic recovery in China. The official manufacturing PMI slipped slightly to 50.6 in May (50.8 in April). (Chart 4.) Gains in industrial activity remain weighed down by continued contraction in export orders, a reflection of weak external demand. This has in turn weighed on the labor market, with companies continuing to shed jobs.

Chart 4: Chinese PMIs

(indices, 50=no change)



Source: Refinitiv

Separately however, the official non-manufacturing PMI ticked up to 53.6 in May (53.2 in April) on a rise in construction activity. Concern for the job situation was behind the authorities' decision in May to drop hard GDP growth targets for the year. Instead, the authorities' focus will shift towards job creation through more targeted fiscal and monetary stimulus. The aim will be to create at least 9 million urban jobs in 2020 (the lowest target since 2013 and down from 2019's target of 11 million).

Meanwhile the government has penciled in a budget deficit of at least 3.6% of GDP in 2020, up from 2.8% in 2019. It also increased the quota on local-government special bond issuances to $527 billion (up from around $300 billion) to support infrastructure spending. The PBOC is also supporting the economy by guiding lending rates lower and helping struggling private firms to raise money via equity financing and bond sales. Subdued inflationary pressures will help the central bank maintain its accommodative monetary stance.

Tensions between the US and China continue to escalate over the Hong Kong security law imposed by the Chinese authorities. The US said it would start revoking its trade and travel agreements with Hong Kong and threatened to impose sanctions against China. In retaliation, China banned the import of some major US farm products, which were part of its commitment to the Phase-One trade deal with the US. Reflecting these dynamics and the authorities' wish to boost exports amid the weak global economic backdrop, the yuan depreciated 1.1% in May against the US dollar to a low of RMB7.13/$1.

India's economic growth slows in Q1

India's GDP growth fell to 3.1% y/y in 1Q20 (4Q of FY19/20), the lowest pace of expansion since 2009, and bringing growth in the full financial year to a modest 4.2% from 6.1% in FY18/19. Economic activity has suffered due to the coronavirus and a national lockdown that commenced in late March. While weakness was visible across the board, investment and consumption have suffered the most, contracting by 6.5% and 2.7% y/y respectively in 1Q20. Weak demand and extended lockdowns have had a severe impact on business activity, with the services and manufacturing PMIs still deep in contraction territory in May at 12.6 and 30.8 respectively, although rising modestly from the previous month. On the other hand, the GDP figures showed government spending held fairly steady at 1.2%. Meanwhile, the fiscal deficit came in at 4.6% of GDP in 1Q20, missing the revised target of 3.8% mainly due to lower tax revenue following some tax breaks in 4Q19.

Looking forward, the biggest downside risk for India's economy is a prolonged lockdown, especially with the recent spike in confirmed cases that has seen India overtake Italy as the sixth worst hit country by the pandemic. High unemployment and inflation coupled with low wages suggest that weak consumption may take time to recover. India's twin fiscal and external deficits pose a further challenge, and imply that further bids by the government to boost the economy, including extra spending or tax cuts will be financially difficult without incurring additional debt. GDP is forecasted to contract by 0.2% in FY20/21, revised down from 1.6%, and expected to rebound to 7.2% in FY21/22.

Oil's rally continues on tighter oil supplies

Oil prices appear to be capitalizing on signs of tighter OPEC+ supplies and slowly recovering oil demand, notching up a sixth consecutive week of gains in early June. Brent reached $42/bbl on June 5, 67% higher than at the end of April. (Chart 5.) The supply side of the equation has reacted far more quickly than the demand side, thanks to 9.7 mb/d of OPEC+ cuts, which went into effect in May and which were extended in early June for an additional month to August (after which they will be gradually tapered off). Saudi Arabia, Kuwait and the UAE have been instrumental in speeding up the rebalancing by agreeing to deepen production cuts over and above their quotas in June by 1 mb/d, 80 kb/d and 100 kb/d, respectively. So has the US, through market-led rather than orchestrated declines of at least 1.7 mb/d from peak output of 13.1 mb/d in early March.

Chart 5: Brent crude oil price

($ per barrel, end of month*)

Source: Refinitiv   * Latest figure is for June 5

Oil demand – despite a prospective boost from strong US jobs numbers for May – remains lackluster, however, with major economies only tentatively emerging form Covid-19 lockdowns, and it has been reliant on Chinese consumption to help it gain traction. Nevertheless, the outlook has significantly improved even in the span of six weeks, with the International Energy Agency revising up its estimate of oil demand growth in 2Q20 (+3.2 mb/d) and for 2020 as whole by 700kb/d to 91.2 mb/d. This is still a sizeable contraction from 2019, though.

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