Everybody hurts

65 – 26 October 2020

Key points

- The pandemic second wave is nasty enough for the trend towards more stringent restrictive measures to continue. Data already suggests the deterioration in confidence goes beyond the most exposed sectors.
- Don't overstate China's capacity to kick-start the global economy. Imports remain unfortunately subdued.
- The ECB meets this week. Expect hints at a December move, but no hard announcement this time.

Focusing on the number of cases to gauge the strength of the second wave of the pandemic relative to the first one is probably misleading given the increase in testing capacity. Still, the high ratio of positive cases to the number of tests, as well as the hospitalization rate suggest that the virus continues to propagate at a fast clip, albeit in a less explosive manner than in March and April. The trend towards more stringent Covid-suppression measures will continue, at a growing cost to the economy.

The services sector is specifically struggling, but we find quite concerning that, even if the most exposed industries such as hospitality are softening more than the others, there are growing signs that all sectors are hit. Settling in a "90% economy", with large sectoral divergence, would not be a benign outcome. Given the unavoidable spill-over effects, via the labour market or the financial industry, aggregate output would fall by more than the direct contribution from the exposed sectors.

During the last recession, export-reliant developed countries had benefited from China's strong, stimulus-driven recovery. A year after the trough in the global economy in 2009 Chinese demand had contributed more than 2 percentage points to the overall growth in German exports, boosting GDP by 1%. We are not counting on a replication. While Chinese exports have resumed their pre-pandemic strong pace, with market-share gains in Europe, the rebound in Chinese imports has been much less pronounced. Whoever wins the US elections, Beijing will remain under pressure to open more to foreign trade, but this may be done by selectively raising imports from the US – as per the logic of the current agreement. Europe may not benefit much.

The ECB's September economic outlook is looking increasingly over-optimistic. We are not counting on any hard announcement by Christine Lagarde at this week's press conference though. We continue to expect an extra layer of accommodation in December, to which the ECB President should hint in generic terms on Thursday.

Gauging the second wave

Across most of the developed world, Covid suppression measures are getting more stringent without reaching the levels of activity restriction seen in early spring. Quite often, regional approaches rather than blanket national strategies are favoured. Still, there are few signs that the pandemic is abating in the developed nations thanks to this new strategy. Looking at the change in the new number of cases – especially when comparing with the first wave – is increasingly misleading given the huge increase in testing capacity but looking at positivity rates (ratio of positive cases to the total number of tests), the virus circulation continues to accelerate in most countries (Exhibit 1).

True, even when using this metric, propagation continues to be less explosive than in the first wave. Moreover, younger people are hit this time, which reduces the morbidity and mortality of the virus. However, in key European countries, hospitalization rates are rising, albeit at a slower pace than in the first wave (Exhibit 2). This is not happening in the US, but what is striking there is that although it never peaked as high as in Europe, equally since April the hospitalization rate has never fallen to the "near zero" levels seen in Europe between May and the end of the summer, consistent with the high cumulated mortality rate (695 per million in the US, still below Spain's 743 but now above France's and Italy's at 532 and 618 respectively).

Taking these various indicators into consideration, while slower propagation in this second wave combined with higher healthcare capacity and better treatment may validate the governments' relatively "lighter" touch on activity restrictions for now, **additional steps towards more stringency remain the most likely scenario for the coming months.** The measures taken by Spain and Italy this weekend on a national basis – while still protecting work commuting – are probably not the last ones, unfortunately.

In addition, even if governments were to reject any further intensification of their current suppression policies, they would probably need to accept that the existing measures would have to be maintained for a very long time (possibly until a vaccine is not only available, but also widely distributed). There may not be that much of a trade-off in terms of aggregate output loss between short "full lockdowns" acting as circuit-breakers, and long "partial lockdowns".

Exhibit 1 – Not just higher testing

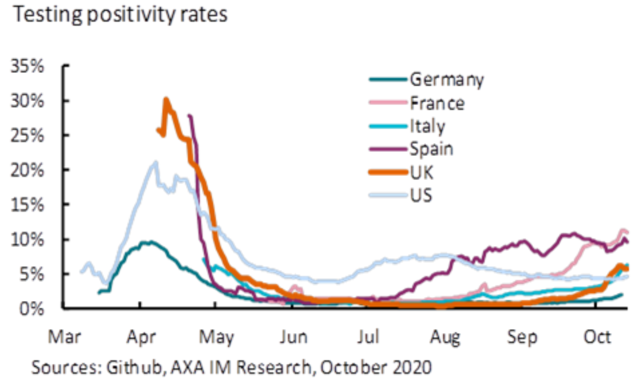
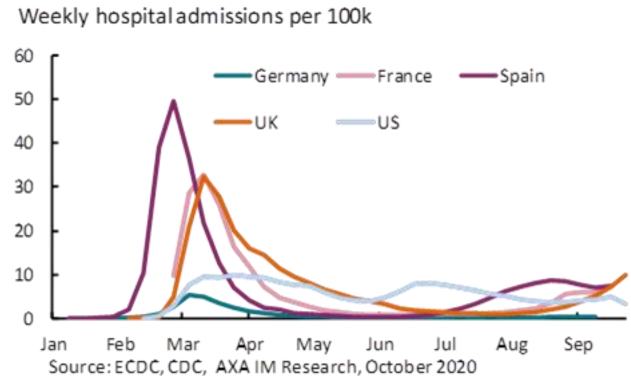


Exhibit 2 – Hospitalisations creeping up



Services are struggling, and it is spreading

In such a configuration, the services sector would continue to be the main victim of the pandemic, and evidence of further softness continues to accumulate, at least in Europe. The flash Services PMI came out in contraction territory again in October in the Euro area at 46.2, below expectations (47.0). Two weeks ago, we discussed the discrepancy between PMIs and national surveys, the latter looking more resilient. Our point was that this was only temporary as the forward-looking components of the national surveys were also pointing to a softening, so that the PMIs were merely reflecting the inflexion faster. If we look at the French INSEE survey for October which came out last week (we focus on France because of the availability of fresh data, we will take a hard look at Germany's IFO next week), our point seems to be validated. The deterioration in the headline services business sentiment index in

October has been significant (drop from 94 in September to 89, the long-term average standing at 100). The PMI is not an isolated, overly bearish indicator. It simply moved earlier.

What we find particularly concerning is that such softness is not limited to the sectors which are the most exposed to Covid-suppressing restrictions. True, the survey unsurprisingly reflects a particularly depressed level of expected activity in hospitality, but *all* sectors are reporting a deterioration in sentiment (Exhibit 3). Manufacturing is struggling less, but the normalization there may also be stalling. Again focusing on France, the collapse in demand during the first wave triggered an involuntary inventory build-up. Expected demand started recovering the summer but in October order books turned south again and inventories rebounded (Exhibit 4).

Exhibit 3 – everybody hurts…

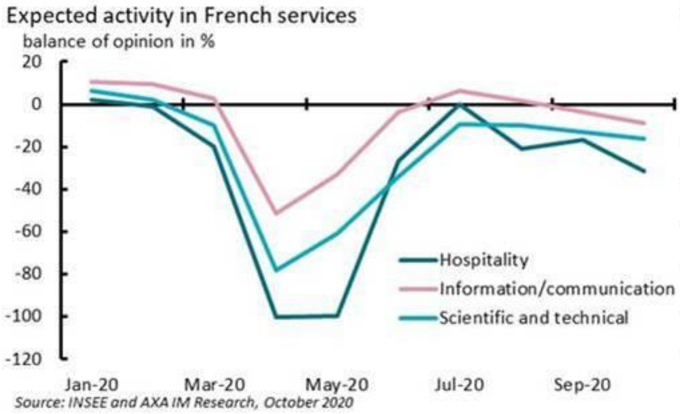
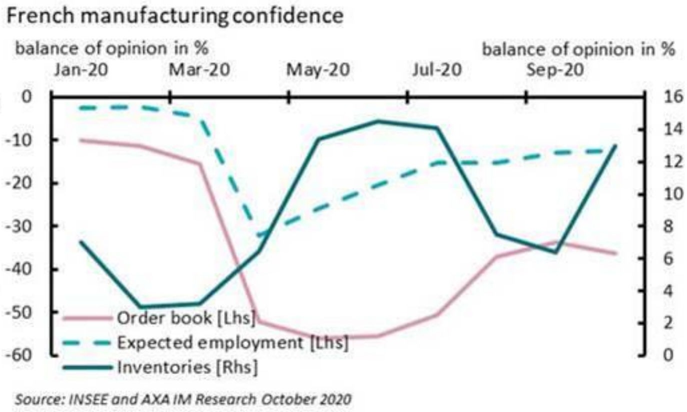


Exhibit 4 - …including manufacturing



This gets us to a more general issue: the sustainability of a "90% economy". In such a "model", some sectors of the economy are permanently impaired while the rest continues to grow on trend. In this case, after the initial shock – the loss of activity in the most exposed sectors – the economy takes a very long time to fully recover to the previous level, but without necessarily going through many episodes of contractions in aggregate activity. However, we **think that a permanent impairment of a significant share of the economy would have some nasty spill-over effects to the better protected sectors.**

First, unfortunately the most exposed sectors happen to be labour intensive, i.e. their share in total employment exceeds by far their share in aggregate output**. A large segment of the workforce remaining unemployed, thus facing a decline in income, would have a direct detrimental effect on aggregate consumption, reducing activity in all the sectors of the economy**. To make this point very concrete, an employee of a cinema house being laid off is not necessarily going to upgrade his or her Netflix subscription. As a second-round effect, this unemployed segment of the workforce would have to be reallocated to the rest of the economy. Beyond the unavoidable frictions due to skills mismatch for instance, at least transitorily this labour market slack would depress wages for the entirety of the workforce, also affecting aggregate consumption.

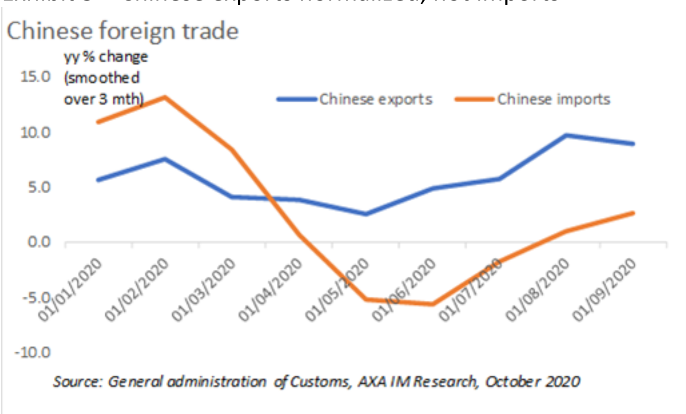
Second, permanently impaired industries would generate "stranded assets", with adverse consequences for the banking sector for instance (faced with high provisioning costs, banks would be reluctant to raise their overall lending capacity). In a nutshell we believe it would be very difficult to experience a "k-shape" trajectory – i.e. growing sectoral divergence - without at the same time dealing with a contraction in *aggregate* output which would exceed the direct contribution of the most exposed sectors in the economy.

In a nutshell, we do not think there is scope for "micro-surgery" for economic policymakers at the moment. Allowing some sectors to "sink" cannot be done without seriously affecting the rest of the economy at the same time. We have already expressed our scepticism about the notion of "zombification" in the current environment because it is impossible to know at this stage of the crisis which businesses and sectors may be made permanently obsolete after the pandemic. Another argument is that giving those "zombies" mercy could make the aggregate rebound more difficult.

Gauging China’s traction

The data flow on both the pandemic and the economy may be generally concerning in the developed world, but at the same time China continues to do well on both fronts. The number of notified Covid cases remains very low and the country seems to be far away from any re-imposition of restrictive measures weighing on supply. True, preliminary data for Q3 GDP came out below expectation at 2.7% quarter-on-quarter (market was counting on 3.3% according to Bloomberg) but the higher-frequency indicators are still perky: industrial production and retail sales both beat expectations in September. Still, **the key China-related question at this stage is whether the country can generate enough traction on global trade to kick-start the global economy. For the time being, the answer is “no”.** When smoothing Chinese trade data over three months to control for volatility, the picture in Exhibit 5 is clear: export growth is now back at its pre-pandemic pace, while imports are barely in positive territory.

Exhibit 5 – Chinese exports normalized, not imports



The strong showing of Chinese exports is probably surprising given the state of the global economy, but the country has been able to offset a decline in aggregate foreign demand by gaining market share. This is manifest for Euro area countries as reflected in Exhibit 6, but the same was observed in the US. The phenomenon owes a lot to the necessity for many advanced countries to source medical supplies from China when the pandemic hit. It is also possible that given the low level of supply disruptions locally – having got the epidemic back in control quickly - Chinese exporters were able to replace competitors dealing with higher level of restriction for longer.

Exhibit 6 – China gained market share

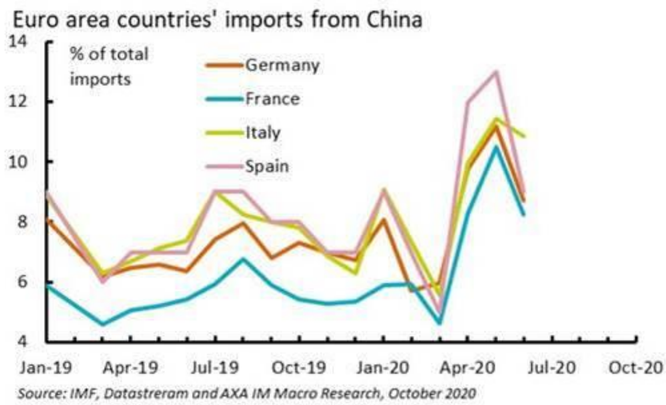
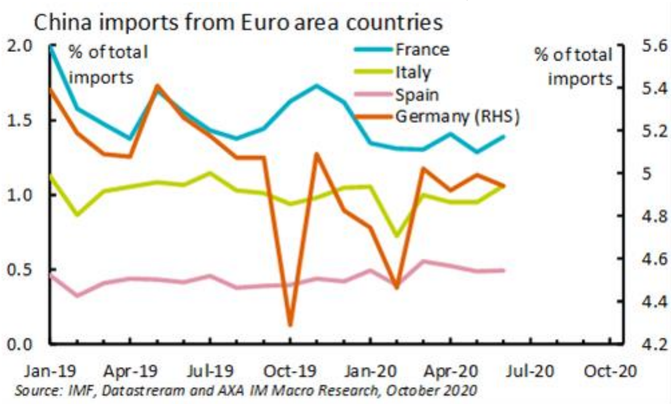


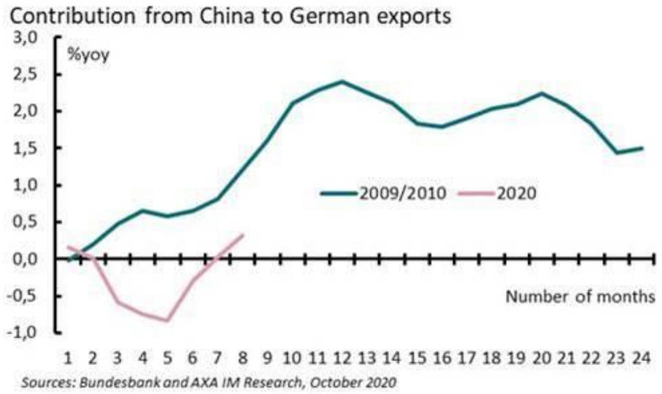
Exhibit 7 – No market share offset for Europe



The normalization in Chinese import growth may be impaired by the softer pace of consumer spending there – unlike in the West Beijing has not sought to protect household income at all cost – but symmetrically some substitution to domestic sources might be at play given the disruption in some foreign suppliers of China, although the data is not yet precise enough to substantiate this. In any case, European exporters to China have not improved their share on the Chinese market (Exhibit 7).

During the last global recession China had played the role of "consumer of last resort" in the world economy, making massive use of its untapped stimulus capacity to reflate its economy far beyond the initial loss in output triggered by the collapse in foreign demand. This provided crucial help to export-reliant advanced economies such as Germany. A year after the 2009 recession trough, the Chinese market contributed more than 2 percentage points to the overall growth in German exports (Exhibit 8), i.e. boosting GDP by roughly 1% before considering second round effects. **China's cautious approach to its stimulus suggests we may not be able to count on similar traction this time.**

Exhibit 8 – Unlikely to be 2010 redux



Political considerations may start playing a role there, though. Indeed, irrespective of who wins the US elections, pressure on Beijing to open more to foreign exporters is going to be relentless. We have already made the point that Joe Biden – the likely election winner judging by the polls – may change the tone of the conversation with China, but not the substance. **A crucial issue for Europe is whether China will respond to this pressure by raising the import intensity of its domestic demand in aggregate terms, or if it will choose to merely address the US recriminations by selectively raising its imports from the US –** which by the way is the logic of the deal agreed between Beijing and Washington.

ECB to wait until December

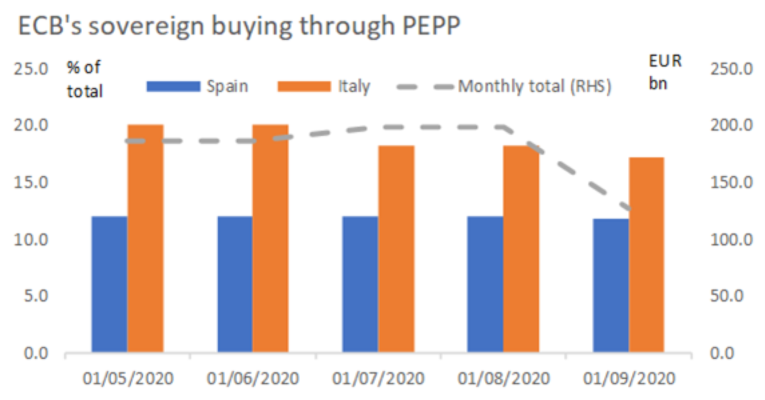
The European Central Bank (ECB) is meeting this week facing a deteriorated outlook. Inflation continues to disappoint relative to both their target and their latest forecast, and the combination of bad news on the pandemic side and soft economic data – materializing faster than in our already quite bearish baseline **–** would normally call for more policy action quickly. **Several elements still make it likelier the governing council will prefer to wait until December for its next move.**

First, by December the central bank will have more visibility on external risks. The governing council is probably largely agnostic on how the victory of any of the contenders to the US presidential elections would affect the European outlook, but the volatility and added uncertainty which would come with a contested result would matter. Moreover, by the 10 December meeting, we will know if a deal has been agreed between the UK and the EU.

Second, market conditions have improved, allowing the ECB to significantly reduce the pace of its Pandemic Emergency Purchase programme in September. With the Italian sovereign spread falling, the central bank has even felt comfortable enough to reduce the share of its purchases going to this crucial peripheral sovereign (Exhibit 9). This mechanically reduces the pressure on the ECB to reveal how it intends to recalibrate the Pandemic Emergency Purchase Programme (PEPP) – at the current pace the envelope would not be spent before the end of the summer of 2021). We note also that the appreciation in the euro has stalled, reducing the pressure on the ECB to adjust monetary policy quickly.

Still, we think the market would be disappointed this Thursday if it does not get a clear hint at more action in December. The deterioration in the economic outlook will mechanically push public deficits up, via automatic stabilizers and the necessity to prolong costly emergency fiscal support schemes. Sovereign issuance will rise sharply which would normally call on the ECB to increase its own absorption capacity. Maybe more fundamentally, given Christine Lagarde reaffirmation, in her speech at the ECB Watchers Conference, of the absolute necessity for the central bank to do whatever is needed to fulfil its mandate, a downward revision in the outlook cannot be left unaddressed without another tweak in the policy stance.

Exhibit 9 – slower PEPP pace provides the ECB with breathing space

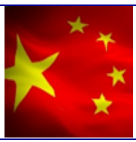


Source: ECB, AXA IM Research, October 2020

At this stage we don't think Christine needs to elaborate much on the instruments the ECB would use in another layer of accommodation. The mantra on "all instruments can be adjusted" will very probably stay without much additional detail. In the current circumstances a recalibration of PEPP would be the most natural avenue, but we would be surprised if it came alone. We argued in Macrocast two weeks ago that it would make sense to complement action on quantitative easing with another reduction in the interest rate on Targeted Long-Term Refinancing Operations.

It would not take much to deliver such hints. Unambiguously acknowledging the data flow is disappointing would be a weak form of "telegraphing" more action. At the other end of the spectrum, explicitly mentioning the high likelihood of a significant revision in the December forecasts, immediately followed by a re-statement of the ECB's readiness to adjust its stance, would be a powerful signal.

We note that in the absence of very clear signals this Thursday, it might be a mistake for investors to react immediately. Indeed, we have learned since March to "cross check" the communication in the press conference with the message sent by Philip Lane in his blog the following day, together with whatever Isabel Schnabel could say.

Country/Region	What we focused on last week	What we will focus on this week
	• 2nd TV debate passes without real impact, Biden's poll lead slips a bit nationally. • Virus cases growing, partic Mid West. • Senate Committee approves Judge Barett. • Stimulus talks persist • Jobless claims fall sharply, continuing claims down one-third (4m) in a month • Housing market indicators robust activity.	• US polling, Clinton saw support collapse from here in 2016. We do not expect same. • Q3 GDP. Expect growth much softer than consensus on lower inventory and trade. • Sept income and spending to gauge saving and momentum for Q4. • Senate to approve nomination of Judge Barret to Supreme Court.
	• EA Composite PMIs fell to a four-month low and below the 50-threshold on weaker services • EA October consumer confidence dropped to the lowest since May • France INSEE business climate declined on both services and industry, with expectations deteriorating further	• ECB expected to provide a dovish message, paving the way for action in December • Check details of EA consumer confidence, in particular savings intentions • M3, loans to NFC and Q3 ECB BLS worth watching to see if further signs of expected tightening in credit conditions • EA Q3 GDP to rebound to 10.5%qoq
	• UK-EU resume negotiations over trade deal with mid-November deadline in mind. • Chx Sunak increased support for Tier 2 areas • Retail sales beat consensus as we expected, up 1.5%mom in Sept, upside lift to GDP • CPI inflation rose to 0.5%yoy from 0.2% • Manu PMI dip in Oct, services slow to 52.3	• Spread of virus, looking for any signs of moderation in virus growth rate • UK-EU trade negotiations to continue, Barnier suggesting deal by end of week, but mid-November more likely • Nationwide house prices and mortgage lending figures to point to ongoing surge
	• September trade balance improved with rising exports to -4.9%yoy from -14.8% while imports stabilised at -17.2%. • Sept new core CPI is stable at -0.1%yoy. • October Flash manufacturing PMI rose to 48 from 47.7 but still points to a contraction	• The BoJ holds its meeting on October 29 but we don't expect any changes. • Retail sales will fall, distorted by last VAT hike • September IP should continue to normalise • Unemployment rate should rise slightly to 3.1% • Consumer confid. is likely to keep recovering
	• Q3 GDP (4.9%yoy) shows China's economic recovery has gained further strength and balance	• The government is due to unveil the details of China's 14th Five Year Development Plan
	• CBRT decided to keep the policy rate unchanged at 10.25% and adjusted the Late Liquidity Window rate to 14.75% from 13.25%. The CBRT will continue to use all instrument to keep the price stability. • Korea first 20 days export fell 5.8%yoy on the back of less working days due to full-moon holidays	• Central bank meetings: Brazil – we expect the Copom to keep the rate unchanged as the current economic conditions require strong monetary stimulus and inflation path remains consistent with CB baseline scenario • Industrial Production in Korea (Sep) • GDP Growth Advance in Korea (Q3)

Upcoming events		
	US:	Tue: Durable goods orders (prel.), Conference Board consumer confidence; Wed: Goods TB (adv.), Wholesale invent (prel.); Thu: GDP (adv.); Fri: Core PCE price index, perso income & spending
	Euro Area:	Mon: Ge iFO busi climate index; Tue: EZ M3 ms, Sp unemp; Wed: Fr Insee cons confi; Thu: ECB announcement, Ge HICP (prel.); Fri: EZ GDP (prel.), HICP est, Ge, Fr, It, Sp GDP (prel.), It unemp
	UK:	Tue: CBI Distributive Trade Survey, BoE Chief Economist to appear in an online event; Thu: Mortgage approvals, M4 ms, consumer credit, net mortgage lending
	Japan:	Mon: Lending index (final); Thu: BoJ announcement, consumer confidence, unemployment; Fri: Housing starts
	China:	Tue: Industrial profits

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