Back to square zero?

66 – 2 November 2020

Key points

- Joe Biden is the clear favourite to win the US elections, with in addition a fair chance of a "blue wave". In the short run, given the need of another fiscal push, it is probably the optimal outcome for the market especially if the results come quickly. Questions on the long-term US policy stance will come later. Meanwhile, Europe is facing another contraction in GDP which we attempt to quantify. More policy support is needed, which the European Central Bank (ECB) is clearly ready to provide.

Of course, the impact of next week's elections in the US goes well beyond the economic and financial realm, but from our narrow angle, we will follow the results across two dimensions. One is volatility: whether a winner emerges quickly with a margin wide enough to dispel the uncertainty which would come along a drawn-out contestation process. The other is directionality – whether Congress is politically aligned with the White House, so that we can have visibility on the policy stance in the world's biggest economy.

A victory by Joe Biden is clearly the likeliest scenario at this stage, with a better than even chance for the Democrats to win the Senate as well. We think the equity market has reconciled with the "blue wave", preferring to focus on a quick and powerful fiscal push in 2021 which will come handy given the deterioration in the macro outlook, rather than on the tax hikes. Meanwhile, the bond market is clearly pricing in a very significant rise in the funding needs of the federal government. In the medium-term, once the pandemic crisis is over, investors would probably become more sensitive to the capacity of a Biden administration to resist the pressure from the more radical elements of the Democrats if his party controls the three centres of power.

Donald Trump also can win this race, with a probability estimated at 10% by Nate Silver's 538, nearly three times less than in 2016. But even in this case it would be highly unlikely for the Republicans to re-take the House of Representatives. This would be the status-quo outcome, which in the current circumstances would be equivalent to policy paralysis. Not necessarily a great configuration for markets in the current challenging macro environment. In any case, we may need days, and possibly weeks, for the dust to settle on this election.

Meanwhile, with large swathes of Europe returning to national lockdowns, a relapse in GDP contraction in Q4 in the Euro area is a done deal in our view. We explore ways to quantify this (with an activity impairment of roughly half of what was seen in the first wave, Q4 GDP could decline by 4 to 5% qoq). The second leg of the "W" would thus be much shallower than the first. Still, beyond the new shock, we think the entire trajectory for 2021 could be softer. Fortunately, this has been immediately recognized by the ECB which is explicitly readying what we think could be a very decent additional package for December.

Decision time (hopefully…)

Unlike in 2016, there hasn't been any last-minute decline in the lead the democratic opponent to Donald Trump enjoys in the polls (Hilary Clinton was hit in the last days by a return of the "private emails saga"), and since the number of votes already cast is as of Sunday above two third of the total ballots cast in 2016, it would take an absolute catastrophe for Joe Biden in the last two days of the campaign to alter the race (see Exhibit 1). Polls can be wrong, but we make the same point we have made before in Macrocast: the proportion of undecided voters in 2020 has been steadily falling and is now half of what it was in 2016 (see Exhibit 2). The Republican campaign is counting on a "shy Trump" effects, i.e. voters who are unwilling to state their preference for the incumbent when asked by pollsters. Logically, one would expect these "shy Trumpers" to declare themselves undecided instead of pretending to lean towards Biden. We note that the average Biden lead exceeds the average for "don't knows", which was not the case – by far – for Clinton in 2016, whose lead was thus significantly more fragile than what the headline number suggested.

Of course, the US presidential race is a cumbersome affair and a lead in national polls is not enough – after all Clinton won the popular vote in 2016. By and large, given the features of the electoral college, a democratic candidate needs at least a 2% margin in the popular vote to secure the presidency, but even this would not completely insure against a "freak distribution effect" with narrow defeats in too many states. Clinton lost because she failed to win in blue-collar, mid-western/Great Lakes states, although polls still gave her a small lead there just before the election. Still, pollsters have learned from their mistake. The issue then was an under-weighting of non-college educated white voters in the samples (reflecting a greater reluctance by this demographic to take part in polls). This has normally been corrected. Biden's lead in the rustbelt should thus be more solid than Clinton's. Nate Silver's website 538 is currently giving the Democrat a 90% chance of winning. Their last forecast in 2016 had Clinton's chance at only 71%.

Exhibit 1 – No last-minute stumble for Biden

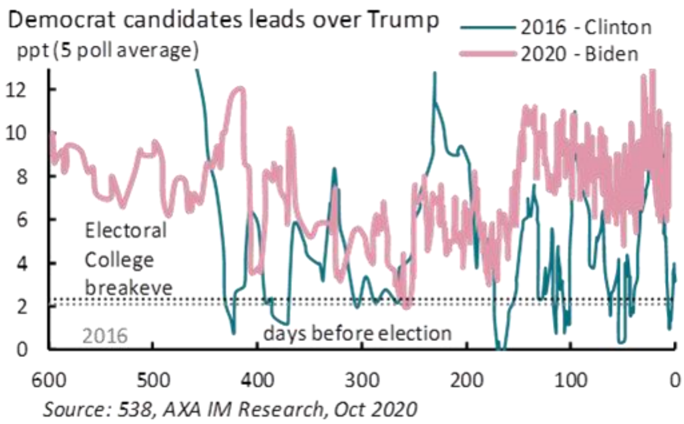
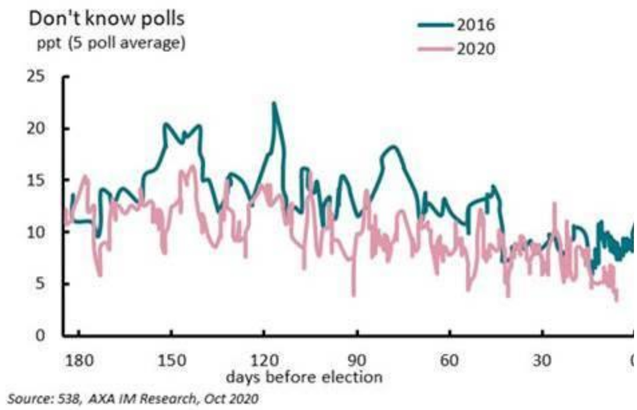


Exhibit 2 – Minds are made up



Markets have become increasingly focused on a "blue wave" with the Democrats winning the Senate on top of the White House. Currently the Democrats control 47 seats (counting two independents who caucus with them) against 53 for the Republicans. The Democrats are very likely to lose one of their incumbents, widely expected to be defeated in the Alabama seat which he won in a special election three years ago against a very controversial opponent. If Joe Biden becomes President, Vice-President Kamala Harris will give the Democrats a tie-breaking vote. They thus probably need to win four new seats. According to the polls, they are widely expected to win in Arizona and Colorado. Two more seats need to swing. Using the Economist forecasts, these could be found in Maine and North Carolina, with Iowa and Georgia also in play (see Exhibit 3).

A blue wave would vindicate and probably prolong the rebound in US long term interest rates which has so far been resilient to the generally worse economic dataflow. We estimate where the US 10-year yield "should be" according to fundamentals by regressing it on the New York Fed's Weekly Economic Indicator, the level of the Fed Funds rate and the Fed's purchases of government securities. Using this simple model, the US long term rate is now roughly 20 basis points above its "fundamental" level. There has been no correlation between this residual and the gyrations in Biden's lead in the polls since he won the primaries (see Exhibit 4) which has been relatively stable. We think the recent rebound in US long term rates reflects the market's growing focus on the chances of a major fiscal push under Biden, rather than a change of opinion on whether he would win – this has been the most likely outcome since pandemic started.

Exhibit 3 – Where the "blue wave" could be brewing

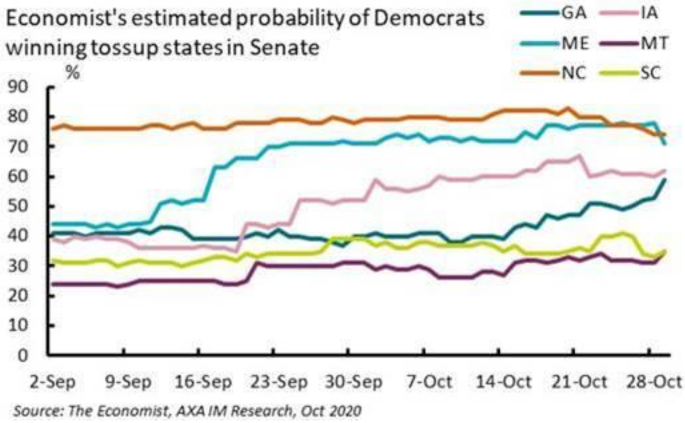
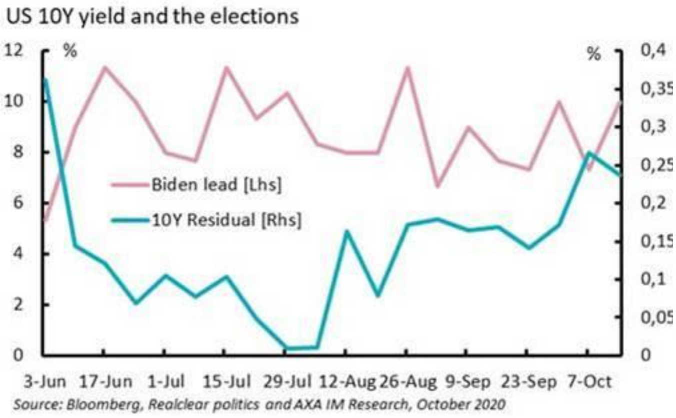


Exhibit 4 – US yields grinding higher



Earlier in the race, the prospect of a Biden victory was widely seen as a dampener for the equity market, given his tax-heavy platform. Today, with the Biden team moving to more sequencing – a quick, powerful fiscal spending push in 2021, with tax hikes probably brought back to a later stage **– the equity market has probably reconciled itself to a Biden victory**. It's uncertainty on the final result and concerns about political stability which could trigger a risk-off move. The S&P 500 lost 6% during the 2000 "recount in Florida" affair. This time there is a risk that contestations would run wild in several states, while public opinion is much more polarised than 20 years ago, thus raising the prospect of street protests amid protracted legal wrangling. In 2000 Al Gore conceded defeat after a very close Supreme Court decision (5-4), which sheds a specific light on the intensity of the recent dispute on the nomination of another Justice to the Court.

Given the rise in postal votes in the US and the time it will take to receive and count them, a final result is likely to take weeks. However, if one of the two camps seem to win by a wide margin in the exit polls on November 3rd, the market would probably be reassured. The race in North Carolina may well be the bellwether for election night. Voting in this eastern seaboard state will end at 7.30 pm local time. The state has invested heavily in vote-counting capacity, which suggests reliable partial results could come out quickly. A win there for the Democrats for both the Presidency and the Senate could give an early indication of the final outcome. For the presidential race alone, Florida will be as usual a key state, and normally there preliminary results come out relatively fast, but as we learned in 2000, if the result is close, this would not ensure against days and even weeks of uncertainty (December 14th and the meeting of the electoral college will be a key date).

One aspect of the race which we think is often ignored by the commentariat is **the possible absence of federal policy response to any further deterioration in the sanitary and economic conditions in the United States until the end of January.** Technically, Congress could reconvene immediately after the elections to pass emergency measures ("lame duck session"), but for this there would need to be a modicum of cooperation between the two parties. Traditionally, the incumbent and the President-elect cooperate during the transition period. If we are in the middle of legal wrangling, it is difficult to expect much success on this. Symmetrically, if Donald Trump were to win the presidency while failing once again to secure a majority of the popular vote, what cooperation could he expect from a House which would still be very likely to be controlled by the Democrats? Even if ultimately the market gets some visibility on what could be achieved from the end of January onwards, investors may find the next three months particularly long.

Looking ahead, in case of a "blue wave", we are quite convinced that after some early enthusiastic response to the promise of a fiscal push, investors would gradually want to focus on the medium-term policy stance of a Biden administration.

Even if some radicals have grabbed media attention, the intake of Democrats to the House in 2018 was dominated by moderates, and the same would probably happen with new Senators turning the majority around. Combined with Biden and Harris's own moderate leanings, the electoral platform of 2020 – quite heavy on tax and re-regulation – should probably be taken with a pinch of salt. However, **even moderate Democratic parliamentarians may find themselves dealing with what has been the curse of moderate Republicans in the last 20 years: an activist base pushing them further away from the centre**. This could be a key development to monitor in the next two years (if Biden wins).

The shape of lockdowns 2.0

While the US is by far the main source of global uncertainty at the moment, it is almost certain Europe is now contributing negatively to world growth. More and more European countries are shifting from a regional approach to suppressing the pandemic to national lockdowns, which mechanically raises the economic cost. We explore here how we could quantify it.

We need to start with a caveat. Just as the news of the lockdown resumptions hit the screens, the first estimate for Q3 GDP for Euro area countries came out with positive surprises in most cases, sometimes by a large magnitude (e.g. in France). This is going to affect positively the annual averages for 2020 and 2021, blurring the impact of the likely relapse into recession in Q4 and ahead. As an illustration, if we kept our latest forecast trajectory unchanged, just taking on board the figures for Q3 2020 would mechanically raise annual GDP growth by roughly 1% in the Euro area in 2020 and 2021.

Forecasting a new Q4 2020 now entails making a judgement call on the stringency of the second lockdown relative to the first one, and its duration. We can begin the exercise with France, where INSEE provided a wealth of real-time indicators during the first wave.

At "peak lockdown" in the second half of March and April, activity was 30% below normal there. The most exposed sectors – hospitality, cultural activities, a substantial share of retail trade – will face the same administrative measures as in the first wave and we would expect near zero output there, as in March and April. However, the rest of the economy should be better protected in lockdown 2.0. Schools remain open, making it easier for parents who can't work from home to commute and "sanitary protocols" in the sectors which are not directly hit by the mandatory shutdowns are already in place. According to INSEE at the beginning of May activity in construction was still only 25% of the normal level, and 62% in manufacturing. We would not expect to see a similar quantum of contraction in those sectors this time. The immediate reaction of the chairman of the construction employers federation to the government's lockdown announcement was quite positive (he publicly expressed his relief that his industry would be able to maintain its activity). Finally, it is likely that the transition of many services to remote organization triggered some transitory adaptation issues impairing output in the first wave. Adaptation should be easier this time.

If we posit an activity impairment of 15%, applied on 7 weeks, followed by some minor improvement in the run-up to Christmas, this would be consistent with GDP falling in France by 7 to 8% quarter-on-quarter in Q4 (to compare with -13.7% in the second quarter), and by c.10% in annual average in 2020 (not too far from the estimate given by the French finance minister upon the release of the Q3 numbers).

How to extrapolate this to the rest of the Euro area? Italy seems to be moving towards a similar path to the French one: hospitalisations continue to rise and the latest restrictions (e.g. a 6 pm curfew on restaurants and bars, as well as a closure of cultural activities) are already quite tough. There seems to be a tentative stabilisation of the pandemic in Spain, but again, the level of restriction is already high in parts of the country. We would be tempted to apply the same approach we used for France in these two countries (half of the activity haircut which was seen at the peak of the first lockdown). Germany is problematic because the first lockdown was remarkably lenient, which suggests the loss of activity in the second one could be quite close to what was seen in Q2 (the only major difference is that more non-essential shops can remain open). **All in all, we think a 4 to 5% shock to Q4 GDP in the Euro area as a whole – against -11.8% in Q2 - would be a reasonable assumption.** This would put the overall decline in GDP in 2020 to c.-8%, but **it would still be a very special form of "W" trajectory, since the second leg would be significantly shallower than the first one**. The best analogy we would find is with the Greek letter µ.

But beyond the dent to Q4 and the 2020 figure, it is the whole trajectory for 2021 which we now need to question. Indeed, **we don't think we should expect the same spectacular rebound after the new lockdown as what we had in May and June**. Lockdown 2.0 would end in winter-time, with the possibility of the flu epidemic adding to the pressure on the healthcare system. We will have learned from the summer experience: normalising too fast after a lockdown would raise the probability of a third wave before a vaccine is widely available. So, we would expect a significantly smaller rebound upon exiting from the new lockdown.

Beyond the government measures affecting supply, demand conditions could also be more deeply impaired than during the first wave. Olivier Blanchard developed this bearish case in a twitter thread last week. One of his points is that the materialisation of the second wave will raise the level of uncertainty for private economic agents (who now know the pandemic is not a one-off) who would curtail their spending more drastically. We agree with this view. Investment in particular is likely to be further postponed. We would add that the longer the economy is impaired, the higher the "hysteresis" effects materialise. More new entrants on the labour market are not hired, eroding their human capital. More university students must make do with remote learning which may not be ideal for the quality of their training. More occasions of innovation are wasted. More capital expenditure is postponed, depleting the capital stock.

Blanchard calls on governments to step up their stimulus. In the first wave, focus was on granting emergency loans and providing "tax holidays". This approach is less productive if the crisis drags on: businesses cannot indefinitely raise their debt, and more proper transfers become necessary. Beyond the need to counteract a more acute contraction in demand, there is a good argument for governments to take the risk of further jeopardizing their debt trajectory. **Even if the current sanitary conditions are obviously very challenging, at least the probability of a vaccine becoming available before a third wave strikes is rising** (to a large extent it is question of time: proper tests need to be conducted, especially given the rising distrust in large segments of the population against vaccination). Governments can therefore agree on more spending now on a fair probability that this would be "the last effort" before a medical solution is found.

Still, this "extra effort" needs to be made financially sustainable, and this is why the ECB's signals last week were important.

Recalibration

The latest macro developments are hardly consistent with the ECB's macro baseline as it had been presented in their September forecasts. Even when taking on board the significant positive surprise of Q3 2020, our first sketch of projections incorporating the relapse in Q4 would leave 2022 GDP a good 1.5% below 2019, without factoring in any third wave, whereas the ECB had it back to an inch of the 2019 level by then. This would call for a re-calibration of the stimulus, and as we expected, **the ECB last week signalled they would move in December, and did so very powerfully, even if they did not shed much light on the instruments they would use**.

They did not wait for the press conference to send a dovish signal. By adding a paragraph to the monetary policy decisions statement *("The new round of Eurosystem staff macroeconomic projections in December will allow a thorough reassessment of the economic outlook and the balance of risks. On the basis of this updated assessment, the Governing Council will recalibrate its instruments")* the ECB unambiguously committed to further action in December. President Lagarde strongly emphasized during the press conference than this pre-commitment was unanimous, even if the extent of the recalibration will depend on the evolution of the pandemic, the economic costs of the containment measures and the fiscal responses from governments.

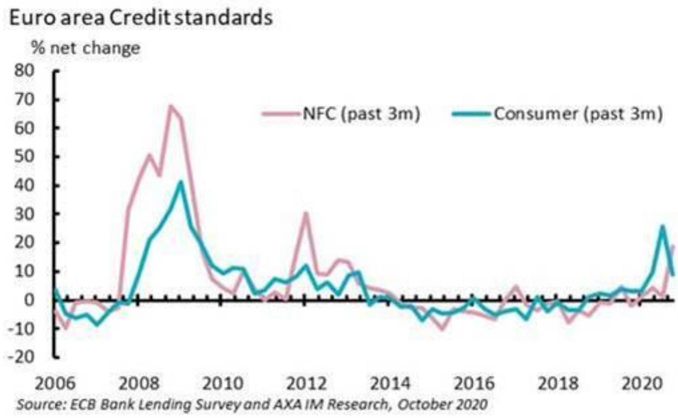
President Lagarde insisted that December action is going to be a package. The ECB will look at all instruments and their various combinations to get an optimal outcome, but from the Q&A here is the ranking we have in mind.

In line with our long-held expectation, we think that an extension in time and duration of the Pandemic Emergency Purchase Programme (PEPP) will be the piece de resistance of any package. True, for now the ECB has just spent EUR 616.9bn in PEPP purchases and at the current pace the 1.35trn envelope would not be depleted before early September. But we think that 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. This is already happening: Italy submitted last month a draft budget with a EUR33bn fiscal expansion for 2021, and this number has already been revised up to 39bn. Sovereign issuance will rise sharply, which would normally call on the ECB to increase its own absorption capacity.

We interpret the emphasis on PEPP flexibility by Lagarde as a signal that the pace of purchases under PEPP could increase in the coming weeks (a slight acceleration reported already over the past few weeks) should there be a market deterioration.

We also continue to think that action on the Targeted Long-Term Refinancing Operations (TLTROs) will be part of the package. Lagarde elaborated at length on this instrument during the Q&A, insisting on the role played by the TLTROs in ensuring smooth credit flows to the economy. At the same time, she mentioned the tightening of credit conditions expected by banks in the latest ECB Bank Lending Survey, on the back of weaker outlook, higher credit risk and uncertain fiscal support (see Exhibit 5). Several parameters could change on this instrument. We would expect to see both a lower dual rate (currently already 50 basis points below the deposit rate) and a longer discount period (currently 24 June 2020 to 23 June 2021) until the end of 2021 at least.

Exhibit 5 – Tightening already happening



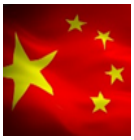
Beyond these two "high ranking candidates" for action in December, there is also a list of runners-up. In order of plausibility we would start with an increase in the tiering multiplier, which provides some protection to banks against the direct impact of the negative rate on their excess reserves. This would be a natural response to the rise in liquidity triggered by another expansion in TLTROs. The share of excess liquidity exempts from the 0.5% deposit rate levy stood at 27.2% in early October compared to 46.4% when the tiering system was introduced. A minimum increase of the tiering multiplier to 8 from 6 is thus likely.

We think the inclusion of Fallen Angels in PEPP – i.e. allowing some signatures losing their investment grade to remain eligible to the programme– is also plausible, especially is there is a deterioration in markets confidence. We think we would need to see a bit pressure on the credit market in coming weeks for the ECB to take such a decision.

We still find another cut in the deposit rate unlikely. Even though President Lagarde stated that no tool was excluded, the fact that depo cut was not at all mentioned during the Q&A strengthened our view that in the current environment it is not the most appropriate instrument. Even in the context of euro appreciation, recent ECB publications suggest that QE is actually more powerful in easing financial conditions, including the exchange rate. **In any case, the onus right now is not on reducing further the yield on the reference risk-free asset** (the German Bund), for which the market-expected ECB deposit rate seems to act as soft floor. At -0.6% on a 10 year the German government is handsomely paid to raise its spending – which it is finally doing with the enthusiasm of the beginner. What matters is to keep spreads as tight as possible in the more fragile countries and moving the deposit rate would not change anything to this. We would add that while the ECB has found ways to mitigate the cost of negative interest rates for banks via the tiering system and generous TLTROs, no such relief is available to institutional investors. The ECB cannot be blind to the financial stability risks that this could create.

We also think it is still be too early to envisage a recalibration in the ECB's "ordinary" quantitative easing the Asset Purchase Programme (APP). If some of the impact of pandemic is becoming permanent, changing the parameters of the APP to incorporate the flexibility granted to the PEPP would send a powerful signal. Yet, this is a highly political decision, and one that is possibly better addressed as an outcome of the "strategy review".

Finally, we were intrigued by Lagarde mentioning the possibility of "new instruments". This may not mean much – the central bank needs to show it keeps an open mind and that its arsenal is never empty – and we think the list of options above is already quite ample. There is an avenue though we mentioned at the beginning of the first wave: getting the ECB to buy corporate loans from banks outright. It is quite cumbersome operationally and would imply quite some risk taking by the ECB, but this would be very powerful, especially if the state loan guarantee programmes are phased out. Still, we don't think it's for immediate consumption. This will be for another Macrocast…

Country/Region	What we focused on last week	What we will focus on this week
	• US polling, marginal narrowing in Biden lead, but he maintains pole position. • Senate appoints Judge Barret to Supreme Ct. • Q3 GDP records 33.1%, versus expectations for 31.9% annualised and our own expectations for something softer. • Sept income rises by 0.9%, and spending by 1.4% - saving rate falls to 14.3% from 14.8%	• US election. Chances of quick election result have risen, but risks of contested outcome remain real. Expect a Biden win, and, on balance, a Dem majority in Hse and Senate. • FOMC meeting on Thursday evening. No policy action expected. • Non-farm payrolls for October • ISM indices for October
	• France and Germany announced new 1-month lockdowns, lighter than in March (schools, factories, offices remain open) • ECB BLS shows further tightening in credit conditions • ECB pre-commits to a dovish package in December, with generous TLTRO and PEPP • EA Q3 GDP beats expectations at 12.7%qoq	• Final October PMIs to confirm widespread decline in services sentiment • Germany factory orders to gauge the strength of the manufacturing recovery • German and Spanish IP, with the former to post a rebound after disappointing last month • Check whether new restrictions are announced
	• Developments of UK-EU trade meeting following intensification of negotiations and Barnier continuing discussions into this week • UK housing market activity remains robust with Nationwide house price indices firm at 5.8%yoy and mortgage approvals elevated	• Two weeks after Tier 3 for many regions, we look for signs of virus rate slowing • Signs of breakthrough in EU-UK trade discussions • MPC meeting and Monetary Policy Report. Expect £100bn extension of QE and downgrade of growth outlook
	• The BoJ kept its monetary policy unchanged • Sep retail sales are stable (-0.1% mom) • Sept IP progressed by 4% mom, outlook points to a slowing recovery in the coming weeks • Unemployment rate is stable at 3% • Consumer confid is improving (33.6 from 32.7)	• Suga is likely to unveil a third supplementary budget, focusing on the employment subsidy scheme extension and private consumption support such as "Go to" campaign. • October manuf and services PMI releases
	• The CCP's 5th Plenum outlined some broad directions on economic development for the coming 5 years, with more details to be released next week and quantitative targets in early 2021	• PMIs to show continued solid expansion in both manufacturing and services sector activities • More details on China's 14th Five Year Plan
	• Last week, central bank of Brazil kept policy rate unchanged at 2% as expected, acknowledging that the policy stance is consistent with the current environment; forward guidance unchanged. Singapore and South Korea released Q3 GDP, -7%yoy and -1.3%yoy respectively. • Malaysia is experiencing a 2nd wave of new cases, averaging 900 per day in the past week	• Central bank meetings: Poland • PMI for EM (Oct) • Industrial production in Brazil – should increase as activity recovers amid Covid-19 decline (Sep). • CPI inflation in Taiwan (Oct)

Upcoming events		
	US :	Mon: ISM mfg PMI; Tue: Presidential & Congressional (etc.) elections; Wed: TB, serv, ISM non-mfg PMI, FOMC announcement; Fri: Non-farm payrolls
	Euro Area:	Mon: EZ, Ge, Fr, It, Sp mfg PMI; Tue: EZ Eurogroup meeting; Wed: EZ comp, serv PMI (final), Ge, Fr PMI (final), It, Sp PMI; Thu: Retail sales, Ge new mfg orders; Fri: Ge, Sp IP
	UK:	Mon: PM speaks, mfg PMI (final); Wed: Comp, serv PMI (final); Thu: MPC decision and MP report, MPC vote – QE, Bank rate, Construction PMI
	China:	Mon: Mfg PMI (final); Thu: Serv PMI;
	Japan:	Mon: Caixin mfg PMI; Wed: Caixin Serv PMI (final)

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