Covid-19 Economic Impact - Chapter II: Authorities act promptly to soften the blow

Since we published our last asset allocation report on March 9th, Covid-19 has led to tragic consequences to say the least. Trials for a vaccine have started. It will take close to a year to manufacture it at the global level once health experts find an efficient one. This leaves governments with no choice but to impose drastic containment measures across Europe and North America such as borders, schools and shops closures. Social distancing is embraced. The empirical objective is to bring the basic reproduction rate (R0) below 1 and to flatten the coronavirus spread curve. The Imperial College London's COVID-19 Response Team calls it "suppression", a worth read given how much epidemiologists' views matter at this time. Depending on the seriousness of the situation, the idea of a shelter-in-place order considered by NYC could be implemented across several cities.

Clearly, capitalism is more than just irritated by Covid-19. The production/consumption and credit/savings cycles we have always taken for granted are partially broken. Involuntary and voluntary isolation are currently leading to a massive cut back on household spending. The list of sectors severely or moderately affected is long: air transportation, aerospace, hospitality, tourism, restaurants, retail excluding groceries, sports, culture, manufacturing, education, trucking, oil, etc. A large loss in output and productivity is thus inevitable in March and April because an important share of the workforce is forced to stay home, a situation significantly reinforced by school closures. Canada's employment rate, which stood at a 10-year high of 62% in 2019, is poised to plunge during the next few months.

Turning off the lights implies that the economic contraction in March and likely April could turn out to be sharper than anything we've seen before. Real GDP in U.S. and Canada will unambiguously decline in 2020Q1 because of the fallout observed in March. Real GDP in 2020Q2 is poised to fall to a greater extent. The jury is still out on the magnitude of the 2020Q2 contraction because it will depend on the duration of isolation measures. Under the best case where production resumes and people massively return to work in May, real GDP for the entire second quarter could fall more moderately. If shutdowns continue in May and June, real GDP will contract at a double-digit pace.

Canada's economic contraction amplified by the oil shock

The economic shock to Canada is amplified by the Saudi Arabia-Russia oil price war dragging down nominal GDP, federal bond yields and the Canadian dollar. As of writing, WCS and WTI traded near $US10 and $US20 per barrel, respectively. Several companies have announced cutbacks in capex spending, a sign that crude oil hedging strategies are not sufficient. A new round of layoffs in Alberta will mildly increase the unemployment rate at the national level. As a result, the economic rebound in the second half of 2020 could be weaker than in the U.S. Similarly, the TSX could underperform the S&P 500.

Governments, regulators and central bankers soften the blow

Fortunately, the governments' fiscal response across the world is going to be larger than during the 2008-09 financial crisis. They will also be more efficient to preserve companies' solvency and provide income support to individuals. Already, several countries have been cutting down capital buffer rates requirements in the banking sector to free up billions in lending capacity. Central banks are bringing down their policy rates to zero and announcing various forms of QE. Central banks are also putting in place several facilities to preserve financial markets' functionality and to keep credit markets flowing. The U.S. Federal Reserve has restarted QE, buying commercial paper and providing funding facilities for financial institutions. Furthermore, the White House seeks a US$1.3T fiscal package (6% of U.S. nominal GDP) that will help Corporate America and households immediately. First, it would send direct cash to all Americans, not just the unemployed. Second, the White House proposes to provide financial bridges to companies, particularly in sectors that are shutting down. In the grand scheme of things, there is nothing wrong to go beyond targeted measures considering that U.S. Treasury Secretary Steve Mnuchin told Senators that the U.S. unemployment rate could jump to 20% without appropriate actions. As a comparison, the U.S. unemployment rate soared to 24% in 1933 during the Great Depression and peaked to 10% in late 2009 during the financial crisis.

In Canada, we expect the BoC to bring down its policy rate from 0.75% to a record low 0.25% before the end of the month rather than at its scheduled policy meeting on April 15th. The BoC will also begin to purchase Bankers Acceptances as of next week to ease banking short-term funding stress. CMHC will purchase more insured mortgages from lenders and OSFI will cut the capital buffer for domestic banks. Furthermore, the federal government announced measures representing $27B in direct support to households and businesses and $55B in tax deferrals. The $82B package represents 3% of nominal GDP. For example, Canadians who do not qualify for EI or do not have access to paid sick leave programs such as self-employed workers will receive compensation. Also, an enhancement to the Canada Child Benefit will bring more money into the pockets of Canadian families. Most of the measures are effective in April or in May, which will mitigate financial stress for individuals, namely contributing to taper off credit arrears and ultimately defaults. We see yesterday's measures as a first step from the federal government. Additional assistance in the form of financial bridges for companies could be needed soon. Also, there are talks, which are premature at this stage, of temporarily bringing down the GST rate to zero. This measure would be appropriate to promote an eventual recovery, after the virus is contained. Finally, in Quebec, the government has already announced a non-taxable financial assistance to workers who need to self-isolate and do not qualify for EI or other programs offered by their employers.

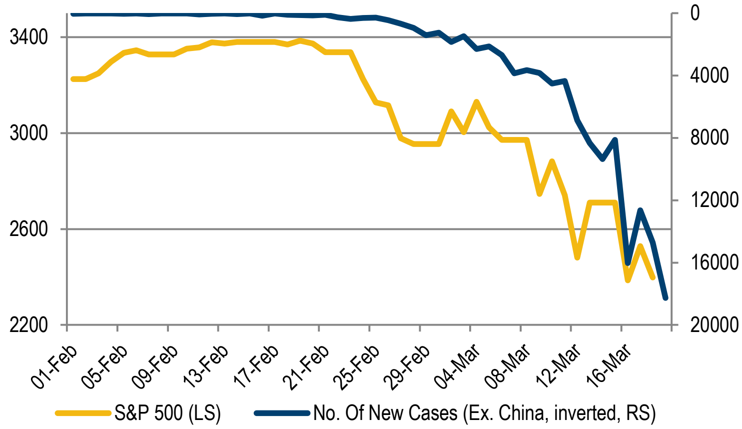
No change for now to our constructive base case scenario

In summary, any progress in limiting the spread of the disease, most particularly a topping in the number of new daily cases in Europe and North America, is the number 1 key priority to restore confidence in financial markets. The world is going through an atypical economic downturn. It is going to be sharp in March and April but it would be premature to call for a deep and long lasting recession. Our base case scenario continues to assume a peak in the number of new coronavirus cases in Europe and North America sometimes in April. China is apparently turning the lights on slowly, indicating an eventual recovery could be slow in Europe and in North America. Under a more severe covid-19 scenario, governments could become a payer-of-last-resort, and could take equity stakes in companies and bring universal basic income. The Federal Reserve could also ask U.S. Congress to buy equities.

Too early for firm tactical investment strategies, preferable to focus on viable sectors post-virus

Heightened market volatility is expected to continue as long as investors try to assess how deep and how long this recession will be. The severe stock market crash, the Canadian dollar depreciation and the steep decline in North American risk free bonds yields observed since mid-February could turn out to be overblown under our base case scenario. Swift macro policies interventions will help companies and households to go through this crisis, but it is too early to tell how and when things will turn out for the better. In the meantime, investors should start to identify companies' business models that will remain largely intact in the long run, with similar corporate structure, once the virus is contained. For instance, housing and agriculture are sectors with low exposure to Covid-19 in the long run.

Financial markets react to the number of new cases



Source: Refinitiv, European Union.

Sébastien Lavoie | Chief Economist
514 350-2931 | lavoies@vmbl.ca