Macro-Rates Flash

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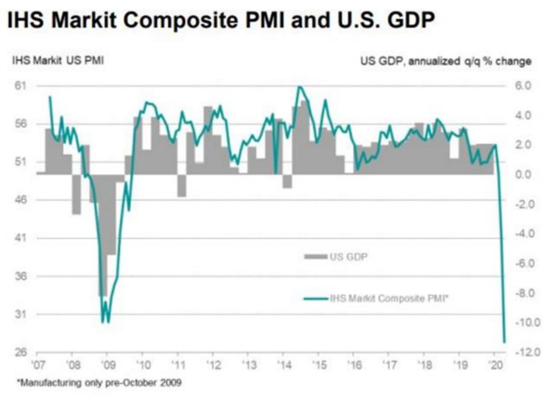
UNPRECENTED CRISIS … EXCEPTIONAL RESPONSES

The Covid-19 crisis will unquestionably have major economic impacts. Unlike previous crises, the world is facing a slowdown and numerous health uncertainties which will impede a rapid return to normality. Various segments of our economies will remain lastingly affected. The IMF now expects a global recession of 3% in 2020 and a rebound of 5.8% in 2021. Each month of confinement erases 3% of global growth and we do not expect a strong rebound in Q2. At this point, only China and India would narrowly avoid a recession. For several developed countries, the rebound will not allow a return to Q4 2019 levels, particularly because productive investment of companies, whose financial leeway will remain very limited, will be durably impacted by the containment measures. To a lesser extent, there is some concerns regarding the level of consumer confidence in governments' post lockdown sanitary measures, the deteriorated state of the labour market and, consequently, the resumption of normal consumption behaviours. Faced with these impacts, which for the time being are hard to quantify(the forecast are regularly revised downwards given the extension of the confinement period and a further deteriorating balance of risks), governments as well as central banks have acted quickly and strongly, in a coordinated manner, and will continue to adjust their bailouts to best preserve employment and protect companies.

Macroeconomic analysis by region

In the United States, the contraction in GDP in the second quarter is thus expected to reach -35% on an annual basis, with retail sales and industrial production in March recording their worst month since 1992. The latest PMI figures released on 23/04 show a crisis of an immediate magnitude greater than that of 2008. The composite PMI came out at 27.4, the lowest figure since these indicators have been calculated. Growth in 2020 is expected to be around -6% and rebound to almost 5% in 2021.



Sources: IHS Markit, U.S. Bureau of Economic Analysis

With regard to U.S inflation, a drop of 100 and 200 bps in core and headline inflation respectively in 2020 is plausible. The amplitude is substantial and notably results from the high level of correlation between this index and the price of oil, which has been free-falling; It also stems from the decrease in flight prices in march (the virus halted the airline industry). Nevertheless, this sharp fall in inflation will most likely be followed by a strong rebound, triggered by an increase in price levels across the aforementioned sectors.

In the Eurozone, PMI surveys recorded the sharpest fall in their history in March and are expected to fall even further in April: Italy is the most affected country, followed by Spain, France and to a lesser extent Germany and Ireland. The shock is expected to be much stronger than in 2008. GDP growth is estimated at around -7% for the year 2020 (rebound of 5% in 2021), which we believe is consistent with the leading indicators and, as a result of sectoral biases such as the weight of services in GDP, the Eurozone will ultimately be more impacted than the United States.

IHS Markit Eurozone PMI and GDP

Sources: IHS Markit, Eurostat.

In this period of confinement, the consumer inflation basket has been totally transformed, to the benefit of food and to the detriment of leisure for example. However, the European Institute of Statistics ''Eurostat'' recommends that national institutes do not amend the weights of the various goods and services which constitute this basket, and ensure that obtaining a price for each product, regardless of the information channel, remains a priority. Core inflation is expected to gradually fall to 0.5%, due to the decrease in the price index of the services sector, which will only be partially offset by food inflation; while we estimate that headline inflation will fall into negative territories from next month, for a period of one year. Inflation is expected to return to pre-crisis levels from April 2021 onwards.

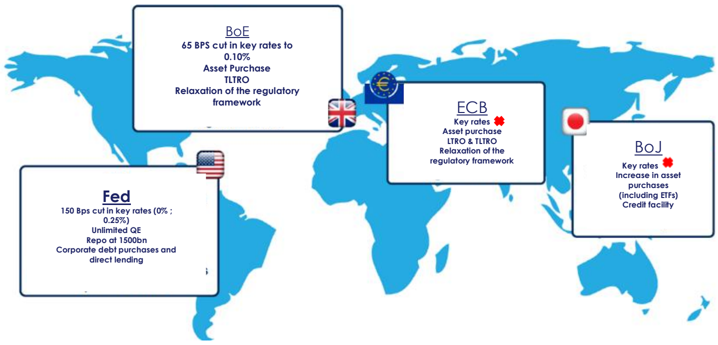
The situation is significantly different in **China** since the confinement was ended as early as March (with the exception of Hubei and Wuhan, epicentre of the pandemic). The contraction in GDP in the first quarter thus stands at -6.8% yoy, a figure which must be analysed with some level of scepticism as difficult to reconcile with the macroeconomic data available to us. The deconfinement in this region, preceding that of developed countries, indicates that the recovery will be long and very gradual. Thus, retail sales fell by 16% YTD (as at the end of March 2020), highlighting the difficulty of Chinese consumers to return to a normal life. In addition, the collapse in global demand will hinder the recovery of the Chinese industrial activity for several months.

Emerging countries are particularly affected because of the conjunction of the health crisis, the slowdown in world trade, and the historic fall in commodity prices.

Moreover, some of these countries do not have the resources to implement stimulus plans or Quantitative Easing as developed countries do. The macroeconomic outlook is poor, with a level of growth that will be strongly impacted by the decline in tourism, trade, and exports (commodities). Thus, growth is expected to be around -1% across the region (including China), -4.5% in LATAM and -5.3% in EMEA (source: JPM, April 17).

Central banks and governments' interventions

Central Banks acted in a concerted and convergent way facing the Covid-19 shock. They have flooded markets with cheap liquidity; they have pushed their key rates towards zero, unveiled huge asset purchase programs, expanded their eligible asset universe by incorporating multiple corporate bonds, relaxed collateralization rules and regulatory constraints for banks.



Source : CM CIC, April 2020

In the United States, The Fed initially lowered its rates, and then unveiled an unlimited Quantitative Easing programme, with no expiration date. The pace of the Fed's purchases is already significantly higher than it was in previous programs.

The main elements of Quantitative Easing are:

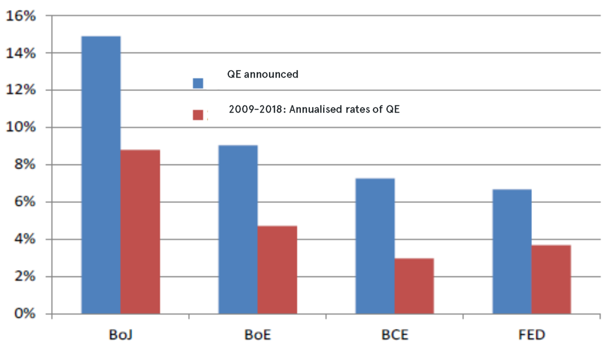
- Purchases of ''treasuries'' and « agency MBS »
- Resumption of the TALF program to improve the ABS market by providing $100 billion over three years to companies purchasing new ABS. These ABS will also be guaranteed via car and student loans as well as credit cards.
- Introducing a credit facility through its primary (PMCCF) and secondary (SMCCF) programmes. $10 billion will initially be spent on these programs with a 10x leverage, which will represent nearly $100 billion available to purchase Investment Grade securities on the secondary and primary markets.

On April 9, the Fed announced that its purchasing programme will include companies whose credit ratings were recently downgraded from Investment Grade to High Yield.

The Fed's next move could be introducing Yield Curve control (example: the Fed will intervene to ensure that the 5-year rate does not exceed a certain level), already implemented in Japan and more recently in Australia. Negative rates are currently not envisaged, the dynamics being very difficult to reverse afterwards.

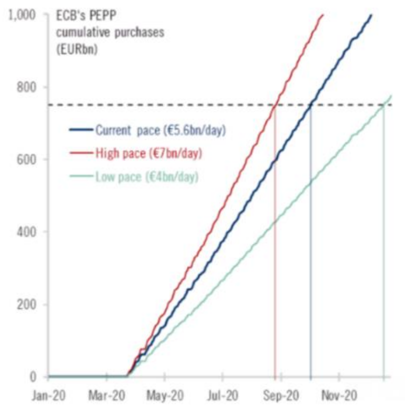
The last meeting (April 29) did not introduce any significant changes to the U.S monetary policy. The Fed reiterated its intentions to use any available tools to support the economy, whilst emphasising the substantial medium-term risks it is currently facing.

In this context, budgetary support in the broad sense (including bank guarantees) is massive (more than 10% of American GDP), with support measures that are fairly well distributed among the various economic agents consisting of small and large companies (40 %) and individuals (30%). The package comprises unemployment benefits, checks to households, funding to the health sector, financial aids to SMEs, businesses in difficulty and to communities / agencies.



Within the Eurozone, the European Central Bank launched its asset purchase programme on March 12 by announcing an injection of a considerable amount of liquidity and a temporary easing of financing conditions for one year. This overall and temporary package amounts to 120 billion euros. In order to ensure the transmission of those aids to the real economy, the ECB announced an easing of solvency and liquidity constraints for banks. Only seven days after its first announcement, the ECB revealed the implementation of the ''Pandemic Emergency Purchase Programme" for an amount of 750 billion euros, which places heightened importance to flexibility. The capital key will continue to prevail for the purchases of public sector securities, but it will be applied flexibly across the various asset classes and countries. Greek government bonds are included in this asset purchase program. Commercial papers representing 5% of the bonds issued by Investment Grade companies are included in the corporate sector purchase programme (CSPP). The institution seeks to soften the rules regarding the securities it accepts as collateral for its lending operations to broaden and notably include more corporate debt. Thus, the central bank announced the week of April 20, that it authorized as a collateral, securities whose ratings deteriorated from Investment Grade to High Yield within the BB rating limit. Finally, during the ECB meeting of April 30, the refinancing conditions for TLTRO3 operations have been further relaxed, new PELTROs operations have been announced, with less advantageous conditions but without conditionality and on shorter maturities.

At this rate, the PEPP programme will be completed by mid-October, suggesting that additional measures are likely to be taken. This is the interpretation of Ms Lagarde's communication during the April 30 press conference, during which it was understood that the PEPP is, in their view, the most effective tool available to fight the crisis.



Source : CACIB (estimating that the ECB currently purchases assets at a daily rate of €5.6bn, or a monthly rate of €118bn, since the PEPP's launch on March 26

SMEs lie at the heart of German and French accommodative plans. In France, a system of partial unemployment, subsidies for small businesses and deferred taxes has been put in place. State guarantees on loans have been implemented in France (€ 300 billion) and Italy (€ 350 billion) but also in Belgium, Germany and Spain. Italy notably favours a moratorium on loan repayments. Self-employed workers, freight and health systems are supported in most European states, as well as the most vulnerable households (€ 100bn of subsidies voted in Spain). All these measures in the euro zone states represent 15% of the GDP and mainly include direct support to the economy and loan guarantee mechanisms. These represent almost 80% of the overall plan (37% in the US) and a recovery plan would be welcome, this is the subject of discussions of the Eurogroup which has already announced a stimulus packaged of € 540 billion in emergency aid on April 23, to support the member countries most vulnerable to the health crisis

The European Commission must now develop this plan, within the framework of the next European budget 2021-2027 and its future proposal must specify the details of integrating a rescue fund into this budget, as well as its financing.

The announcement by the Eurogroup of the implementation of such a plan would be a decisive element for the recovery. Indeed, the rebound in growth in Q2 will not allow a return to normal; among the components of aggregate demand, investment is permanently hindered by the current adverse impact of the crisis on companies' balance sheet and rooms for manoeuvre. A major European investment plan financed by Eurobonds would be positive for the European economy but will also constitute a founding act of European solidarity

In Britain, the government has decided on a £ 50bn tax relief and business subsidies and is offering £ 330bn in state guarantees. The United Kingdom is expected to record growth close to -6.5% in 2020, with a budget deficit above 8%. The Bank of England has lowered its key rate to 0.10% which seems to be the low point, the marginal success of negative rates seems to have been be dissuasive for the British. It also launched a new QE program of £ 200 billion (8% of GDP). The BoE will also support credit through purchases of commercial papers.

In Hong Kong, alternative measures have been used. Expansionary fiscal measures were set up and $ 1,200 was paid to all adult permanent residents. In addition, the government has suspended rent for one month for public housing.

In Emerging Countries, several central banks have announced that they will cut their key rates, which have reached historically low levels, at 4.2% on average.
In addition to these rate cuts, some central banks have launched their own quantitative easing programs (Chile, Hungary, Israel and Poland) along with bond buyback programs and important tax measures (notably Indonesia, India, Turkey, South Africa, Brazil and Mexico), whose impact on budgets will depend on the implementation of these stimulus measures (guaranteed loans, unemployment benefits, tax deferrals ...)

Our convictions on rates

Core debt:

We do not anticipate major movements on key rates for the main G7 central banks. A drop is highly unlikely in the short term in the United States and cannot be completely ruled out in the Euro zone but, if it does occur, would only represent 10 bps. Monetary expectations close to zero will therefore not be likely to change rates. Compared to the US where the action of the FED quickly allowed the normalization of real rates, those of the Euro zone remain on high levels, which will not indefinitely suit the ECB, as it wishes to lower them thanks to the `` Pandemic Emergency Purchase Program '' (PEPP).

Peripheral debt:

Official sources do not, at this stage, provide projections on debt / GDP ratios or deficit levels at the end of the year. But there is no doubt that the unprecedented measures taken by governments will impact the debt trajectory. The decisions taken by the Eurogroup and the total absence of conditionality with respect to countries' eligibility to the ESM mechanism are factors to be monitored in their implementation. The PEPP program remains a strong support and limits any significant widening of spreads.
The Economic recession and the degraded debt trajectory are putting pressure on the ratings of these countries, which could lead to rating downgrades in the medium term, further penalizing them. Let us note that S&P maintained the rating of Italy on April 24 at BBB (negative outlook) but that Fitch did not wait for its next review to lower the rating to BBB- on 04/28 (stable outlook). We believe that the ECB will take all necessary measures to limit the significant spreads of those countries which are under fiscal stress. Future announcements from the European Commission will be decisive.
Given the current levels, and the now almost unlimited commitment of the ECB, we maintain a positive view on these spreads

Inflation:

It is currently difficult to make projections on inflation over a 1-year horizon; this depends on the trajectory oil prices, potential issues surrounding data collection from statistical institutes, and the duration of the health crisis. However, we believe that the market does not correctly price forward inflation, ie 1y1y or 2y1y, the levels remaining extremely low even though the base effects should be at least neutral. We are therefore positive on inflation in the US and the Eurozone, via short maturities.

Fixed Income Allocation

Numerous assets display attractive valuations and benefit from credible monetary and fiscal responses, which are improving visibility.
This translates as follows. It is now sensible to partially reallocate from peripheral risk to credit risk whose valuations seem much more appealing. The Investment Grade segment offers attractive entry points as it is protected by the ECB's asset purchase programme, as do financial subordinated bonds, as they were not affected by the fall in dividends (continuation of AT1 coupon payments) and since balance sheets are now much stronger. If the situation of the peripheral countries deteriorates, they will however be severely impacted. It is necessary to remain cautious on the High Yield market in the short term because the current crisis should force several companies to default and / or restructure their debts.

Main risks

Emerging countries are particularly vulnerable in this context as a result of, concerning health situations, economies highly dependent on global trade, historically low oil prices and the halt of tourism. Besides, central banks and governments are less able to support their economies. Faced with this alarming finding, the G20 granted a moratorium on the debt of the 77 poorest countries until the end of the year.

The second source of concern relates to **the peripheral countries** of the Euro zone With the economic slowdown and rising unemployment, there are few solutions available to the peripheral countries. Indeed, the pooling of debts and the issuance of "Coronabonds" have been rejected by the northern countries. Consequently, there is only one possibility: to rely on the ESM.

Political risks could be added to the economic and financial ones.

We will be particularly attentive to the situation in Italy and especially to the next rating reviews.

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