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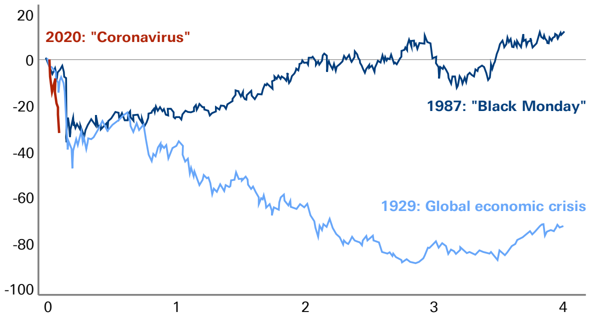
Coronavirus: Two possible scenarios for the global economy

The global economy and the financial markets have deteriorated rapidly in recent weeks and concerns about a new global economic crisis have grown significantly. We are now looking at two possible scenarios for the global economy and the equity markets:

Performance of the Dow Jones index
in % and years



Source: wellenreiter-invest.de

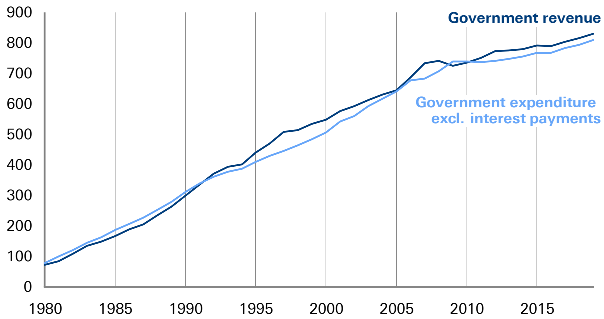
The negative scenario paints a picture similar to the Great Depression in the 1930s. In this scenario, the health crisis would lead to a financial market crisis because governments would no longer be able to prevent a tidal wave of corporate and private household bankruptcies. This would most likely lead to a sovereign debt crisis. Particularly in the euro zone, people are worried the sovereign debt crisis might return because countries like Italy are likely to suffer a massive slump in GDP in the first quarter of 2020 while being forced to significantly increase government spending at the same time.

In our positive scenario, we assume that the number of infected persons will start to decline in mid-April and that economic policy will have been able to prevent a wave of bankruptcies. In May, the quarantine regulations would be relaxed again and the global economy would have a good chance of recovering noticeably.

We must prevent the sovereign debt crisis from returning to the euro zone

In a monetary union with a common monetary policy but independent fiscal policies at national level, it's always possible that one country with excessively high government spending could cause a blow to the monetary union at the expense of the other member states. Greece was a good example of this. It was therefore the right thing to do when Greece was asked to either save money or give up the euro. Italy, on the other hand, has proven to be a fair member state since the beginning of the European Monetary Union. Since the mid-1990s, government revenue in Italy has been higher than government expenditure (excluding interest payments).

Italy: High national debt until the end of the 1980s – responsible policies since the mid-1990s
in EUR billions



Sources: Thomson Reuters Datastream, Metzler; as of December 31, 2019

In this environment, sovereign debt would normally trend downwards, but the weak nominal growth of the Italian economy was not sufficient to cover interest payments. These interest payments stem from debt having piled up in the past, the ECB's monetary policy and the risk assessment of financial market players – and are therefore beyond the Italian government's control. Since Italy cannot be considered a country with excessive government spending, there is every indication that it will receive all kinds of support from the EU and the ECB in the current crisis.

The current crisis is forcing Europe to make far-reaching political decisions that will either ensure the survival of the EU and the European Monetary Union and result in a stronger Europe – or they will cause Europe to collapse.

In the weeks to come, the question of whether to mutualize debt will surely be back on the agenda. Of all the proposals presented so far, I believe the following points are the most convincing:

- The sovereign debt of all member states in the euro zone shall be reduced to 50% of GDP.
- All debt beyond that shall be incorporated into a vehicle that issues euro bonds fully guaranteed by all countries.
- Banks shall only invest in euro bonds and shall no longer hold national government bonds.
- In this fashion, remaining sovereign debt can be restructured in an orderly manner at any time using the Collective Action Clauses without burdening the banking system.

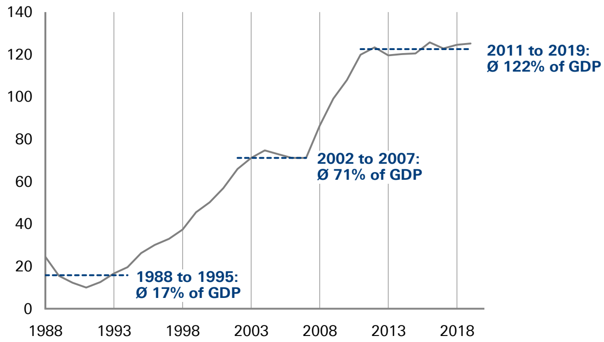
The bottom line: any country with currently high sovereign debt would be able to make a fresh start and confidence in the stability of the monetary union would be restored.

Europe is thus probably facing its biggest challenge since World War II.

A tidal wave of corporate and private household bankruptcies can be prevented

The governments in Europe and the USA have recognized that fiscal policy must be applied at all cost in order to prevent a tidal wave of corporate and private household bankruptcies. Therefore, in the current environment, only a serious policy error could result in the negative scenario. The question is, however, do governments have sufficient financial resources or could we be facing a global sovereign debt crisis? Japan's experience in recent years can certainly offer some useful insight; here we saw the country’s net sovereign debt (sovereign debt minus public financial assets) rise while the government was fighting major crisis.

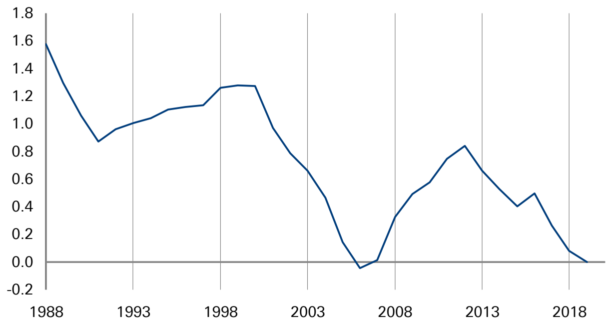
Japan: With interest rates at zero, only fiscal policy is effective
in EUR billions



Sources: Thomson Reuters Datastream, Metzler; as of December 31, 2019

Despite high sovereign debt, there has not been a sovereign debt crisis in Japan because interest payments have not burdened the Japanese government excessively. If Japan had had to use an ever larger share of its budget for interest payments – financed by an increasing amount of debt – we would have seen a downward spiral to a debt crisis. But in 2019, the net interest rate burden for the Japanese government was, according to OECD data, only 0% of GDP due to low interest rates. Furthermore, the Japanese central bank's purchases of government bonds ensured sufficient demand for government bonds. However, generous direct and indirect government financing was only possible due to low inflation.

Japan: No debt crisis thanks to low interest burden
Net interest payments in % of GDP



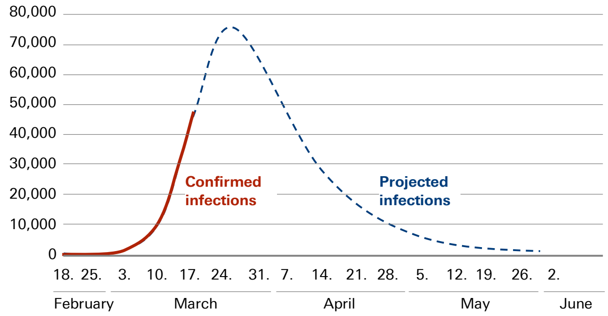
Sources: Thomson Reuters Datastream, Metzler; as of December 31, 2019

In a first step, countries should therefore be able to prevent a tidal wave of bankruptcies and, as soon as the coronavirus infection rate starts to decline, they should be able to launch economic stimulus packages.

Duration of the pandemic

Of course, no one can reliably predict when infection rates will subside. However, there are models that can be used to estimate scenarios. Assumptions have to be made as to how many infected people will recover each day and how many infected people will have contact on any given day with people who are not yet infected. According to JP Morgan, a glance at data from Asia paints the following picture for Europe:

JP Morgan's model forecast for Germany, France, the UK, Italy and Spain



Source: JP Morgan; as of March 16, 2020

In Europe, the number of infected persons could peak at almost 80,000 in late March. According to JP Morgan's analysis, it is even possible that Italy will reach its peak within the next seven days. However, this model estimate is greatly uncertain and could turn out to be false. At the very least, the estimates can serve as a benchmark to assess whether developments in Europe are in line with Asia's surprisingly positive path.

Moreover, the key challenge for governments will be to find an appropriate middle ground after the peak has been passed. They will seek to relax quarantine regulations without allowing the number of infected persons to rise again, thus continuing the downward trend. Looking at Asia, there is cause for hope. Economic data from China, for example, shows surprisingly rapid normalization in March with very low infection rates. The Chinese government is monitoring developments closely, has apparently found an effective combination of measures, and the people are still very cautious.

Outlook for the financial markets

Should the number of infected persons actually decline in Europe starting in early April and somewhat later in the USA and should the governments have reacted accordingly with an expansive fiscal policy, strong recovery of the equity markets could be expected in the coming months, but it's impossible, of course, to predict when the trough will be reached. In addition, government measures to prevent credit defaults are likely to benefit corporate bonds, and those in the euro zone should also benefit from increased purchasing by the ECB. Furthermore, spreads have reached attractive levels.

Should it take longer to overcome the crisis because the number of infected persons doesn't decline or it rises again after a short decline, this would result in a longer dry spell on the equity markets lasting until next year.

Should there be a wave of bankruptcies or a sovereign debt crisis, we would likely face a long downslide on the equity markets.

In the current environment, central banks will likely aim to stabilize government bond yields and anchor key interest rates at zero for the foreseeable future. A monetary policy of "yield curve control" is thus becoming increasingly likely. Despite high volatility, equities will thus remain an indispensable asset class. Equities with solid cash flows and steady dividends as well as companies with an attractive business model and high growth rates are likely to be among the beneficiaries. Due to a likely declining (negative) correlation with government bonds, good risk management will be increasingly important.

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For a summary of key points, please see the next page.

Key points regarding the financial markets

- The equity markets have probably not bottomed out yet; the crisis will probably not be overcome before April or May
- Equity market recovery is likely to hinge on an expansive fiscal policy combined with declining infection rates
- Valuations are currently very attractive again
- The rising yields seen in recent days are somewhat worrying. However, QE programs by the central banks should ensure that yields remain low
- The crisis is likely to be a mostly deflationary shock, thus allowing central banks to pump liquidity into the financial markets regardless of any potential inflation risks
- After the crisis, there will be a high risk that government bond yields will rise fast – central banks are likely to react with "yield curve control"

Key points regarding the economy

- It is currently impossible to predict GDP growth
- Base scenario: severe recession until April/May, followed by strong economic recovery
- US consumption is a key risk factor because of its role as a pillar of the world economy
- Risk scenario: the health crisis could turn into a financial crisis due to loan defaults
- Monetary and fiscal policy cannot fight against the coronavirus epidemic, but it can prevent loan defaults
- Italy will probably need financial aid from Europe
- The crisis won't end before infection rates decline
- Until then, ongoing stress on the financial markets can be expected

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