Investment Managers

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Research & Strategy Insights

Waiting for the parachute to open

55 – 20 July 2020

Key points

- Given Europe's still daunting economic challenges ahead, long-haul "federal" fiscal support is crucial. Unfortunately, we are still waiting for the outcome of the Recovery and Resiliance Fund negotiations. The European Central Bank – as usual – needs to plug the policy gap.

Although in relative terms Europe appears to be in "a good place" at the moment, to borrow words from Christine Lagarde, daunting challenges still abound. The virus is much better controlled than in the US, but given the lower European risk tolerance, supply-side restrictions could be re-imposed faster than in the US for any given pace in the propagation of the virus. The news from Barcelona are a case in point. Looking ahead, the perspective of the window for state guarantees on business loans closing could trigger a tightening in banks' credit standards, while we continue to worry about the shape of the labour market once the emergency support measures are scaled back. This is why "federal" fiscal support for the long haul is so important. Unfortunately, as of this morning, no agreement has been found on the Recovery and Resilience Fund (RRF).

A positive outcome is still possible. Still, at some point, if the normal unanimity-based EU process is closed, a "coalition of the willing" could go down the enhanced cooperation route and set up a RRF mechanism outside the EU budgetary framework, under a traditional international treaty. This would reassure the markets in the short run, and it would be better than nothing, but this solution would still dent the solidity of European process in our view. If some countries can reap the benefits of the EU's single market without sharing in all the financial responsibilities, at some point free-riding temptations would become too high.

In the meantime, as usual, the European Central Bank (ECB) is there to keep things together. Christine Lagarde stated last night that a far-reaching agreement was better than a hasty, sub-optimal one, even if that takes more time. This may be a signal that the central bank is ready to deal with the volatility the absence of success over the weekend may create. The Pandemic Emergency Purchaise Programme (PEPP)'s flexibility has now been tried and tested. This makes us go back to one of the inconsistencies of the "frugals": they usually favour an orthodox monetary policy. They can't have it if they block progress on the fiscal side. Still, beyond the short-term volatility, continuing to rely too much on an already very stretched ECB is risky. The ruling of the German Constitutional Court probably was among the reasons Germany now support the RRF – monetary policy has limits. This awareness does not seem to be shared everywhere.

The “good place” or “everything is relative”

Christine Lagarde, while highlighting the downside risks and the need for sustained policy stimulus (from both the monetary and fiscal authorities), also stated last week that the Euro area is *“in a good place”* at the moment. This is a relative position of course: while the US is facing a rebound in the pandemic’s first wave with a more and more visible impact on the recovery in activity, the Euro area, in spite of the emergence of significant clusters, has so far been much better at keeping the virus in check, allowing for a decent catch-up in data.

True, in the US there are tentative signs the propagation of the virus is slowing down in some of the “new hotspots” (in Texas for instance the rolling 7-day growth rate fell below 30% on 15 July for the first time since 21 June) but it is not verified everywhere (in Florida the 7-day growth rate has been staying on a high pace of about 35%), and some new hotspots continue to emerge. The weekly growth rate has increased in 35 States between from the week ending on 9 July and the one ending on 16 July, with 21 of them where it exceeds 10%.

Still, **Christine Lagarde certainly did not sound complacent**. She reassured on the European Central Bank (ECB)’s commitment to spend the envelope of quantitative easing they had pre-announced (the recent slowdown in purchases was justified by the improvement in market conditions but it is still the central bank’s baseline that the package quantum is well calibrated on the macroeconomic shock). The ECB is enjoying a bit of summer rest, but they are keenly aware of how precarious the situation of the Euro area is.

The ever-present possibility of a re-acceleration in the pandemic in Europe calls for caution. Spain has been forced to reimpose a lockdown in parts of Catalonia and Galicia. Things need to be kept in perspective: although the weekly growth rate in cases at the national level accelerated from a recent trough at 0.7% on 5 July to 2.3% on 16 July in Spain (Exhibit 1), this was still six times slower than in the US (+14.7% in the 7 days to 16 July). We have made the point several times: the pandemic was much more under control in Spain, just like in the rest of Europe, when the lockdown was relaxed, than in the US. At no point during the deceleration phase in May and June did the US growth rate fell as much as what it had done in Italy and Spain.

Exhibit 1 – US not necessarily a guide to the Spanish relapse…

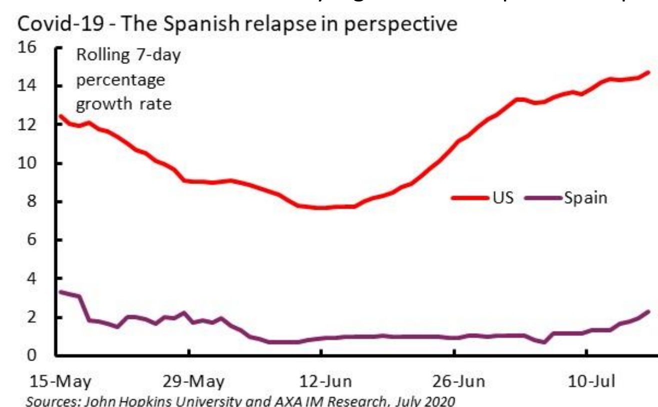
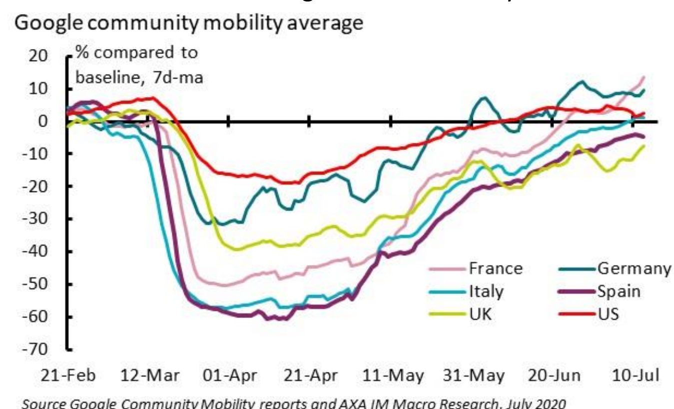


Exhibit 2 – …but it is starting to show in activity data



It is not therefore straightforward to infer from the recent US experience that Europe is going to go through a generalized relapse imminently. Still, **negative confidence effects could impair demand even if the pandemic remains more controlled in Europe**. **And given the lower European tolerance for taking risks with the pandemic, supply-side restrictions could be re-imposed faster than in the US for any given pace in the propagation of the virus.** The announcement last Friday by the regional government of Catalonia of a 14-day “voluntary stay at home” order for Barcelona is a first warning shot. The measures are much less stringent than last spring, but we note that Google mobility reports marginally relapsed in the last few days in Spain, while they were still improving in Germany and France, continuing to exceed the US level (Exhibit 2).

Even without adverse news on the European pandemic front, if the US relapse continues Europe will be hit by a deterioration in foreign demand. While the share of the US in world GDP has been falling on trend, the share of the

US in world imports of goods and services has marginally increased on trend, from 12.5% in 1980 to 14.3% in 2018. The world economy cannot easily offset a stuttering US demand. **A recent paper by Banque de France suggests that another "lockdown shock" in the US would reduce total French output by 0.5%.**

We are already intrigued by some of the features of the ongoing "mechanical rebound" in Europe. The recovery in consumer spending has been swifter than expected, even in May when lockdowns were far from being comprehensively lifted. It is the behaviour of the manufacturing sector which remains more depressed. Industry is more dependent on exports and on the global investment cycle than services. While the focus so far has been on the services sector hard hit by the pandemic shock, manufacturing could be another, and possibly lasting victim of the current cycle.

Two policy-related cliffs

Other risks pertain to the policy framework. Christine Lagarde warned governments against a "cliff" as the window is closing on the state guarantees for corporate loans, potentially triggering a backlash in credit origination we already explored in Macrocast. There may even be a "double cliff": the expiry of the state guarantees will occur roughly at the same time as a roll-back on the generosity of the part time unemployment schemes and the beginning of mass lay-offs.

Let's start with the first one. A few weeks ago, we made the point that – contrary to the Great Recession of 2008-2009 – monetary policy transmission had so far been swift in this crisis, with record flows of new loans to the business sector from March to May, banks responding without tightening their credit standards to the huge rise in business demand. This is changing. **The latest ECB bank lending survey (BLS) point to some expected decline in credit demand from corporations (Exhibit 3), as firms are probably in general happy with their level of liquidity as cash flows are improving, but a more problematic development is the expected tightening in credit standards (Exhibit 4).**

Exhibit 3 – Less, but still positive expected demand for business loans

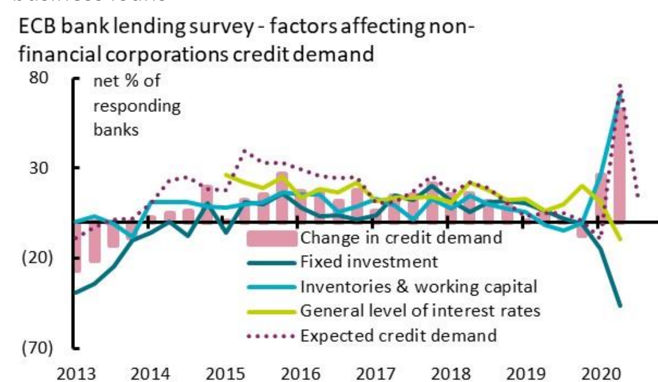
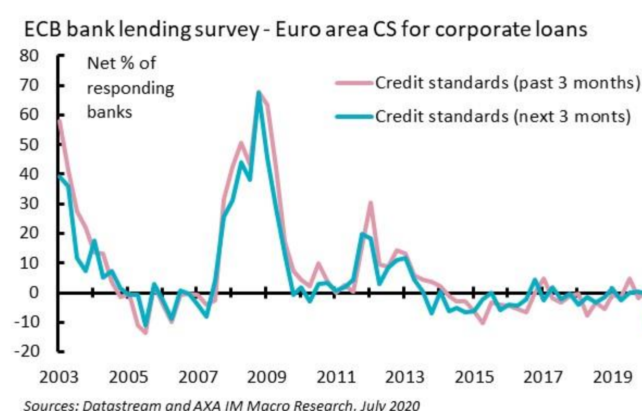


Exhibit 4 – Banks expect their credit standards to tighten



Unfortunately, the BLS does not provide data on the reasons behind banks' expected tightening in credit standards. But looking at their answers on past credit standards is interesting. Indeed, even though banks did not resort to more stringent lending criteria over the last three months, they were reporting a further deterioration in their perception of the macroeconomic outlook relative to the April 2020 survey, as well as a worse assessment of the borrowers' creditworthiness and a lower tolerance for risk. This makes us conclude that **the only reason why their overall opinion on credit standards have not changed much so far is because of factors which are not directly reported in the BLS, namely the guarantees provided by governments**. The perspective of losing this essential support is now making them re-think their lending strategy. This seems to be the ECB's analysis as well, to quote Christine Lagarde last Thursday: *"banks are anticipating a net tightening on the back of what has been a clear loosening of credit terms before that […] we also believe that this anticipation by the banks is clearly related to maybe the fear of a cliff effect in case the guarantee schemes that have been extended by governments to banks were to expire".*

"TLTRO fatigue" may be another factor to consider. Indeed, in order to qualify for the most favourable conditions – a cost of -1% on the facility take-up – banks need to maintain their overall volume of lending at least unchanged from 1 March 2020 to 31 March 2021. Given the massive lending flows seen since March, a lot of banks won't need to do much more lending to qualify (the ECB brought forward the starting date of the assessment period from 1 April to 1 March to make this easier). In other words, the "nudge" aspect of the Targeted Longer-term Refinancing Operations (TLTRO) may be behind us. A lot of banks can afford to be choosier now.

Governments may have to re-think their timeline on accessing the guarantees. To some extent, akin to the feedback loop between the fiscal stance and the potential cost to public debt of the guarantees we discussed recently, governments face a complex decision on whether to extend such support. Of course, too long an extension would fuel free-riding behaviour (i.e. putting governments on the hook for loans which would always have been granted in the first place, or conversely generating a distribution of credit to blatantly insolvent borrowers which should never have been supported to begin with). But if the looming "cliff" leads to a catastrophic contraction in the availability of credit towards the end of the year, the ensuing economic disruption could actually end up raising the probability of the guarantees already granted being triggered.

We note that a similar debate in the US, on the Pay check Protection Programme (PPP), is likely to have some ripples in Europe. Indeed, last week Treasury Secretary Mnuchin mentioned, on top of another (third) helping of PPP, the possibility to offer "blanket forgiveness" to the "small" loans granted under this scheme. This would address some of its shortcomings: the system favours relatively big companies with little difficulties to keep their workforce unchanged – which would then see their loan automatically turned into a subsidy – to the detriment of smaller, more fragile businesses which would remain saddled with more debt. Mnuchin did not elaborate on what kind of financial threshold he had in mind, but this could end up being quite costly for the US federal budget. Electoral considerations may be at play here…. But such a move could trigger some "forgiveness envy" in Europe.

Exhibit 5 – Businesses employment expectations point to deteriorated labour demand

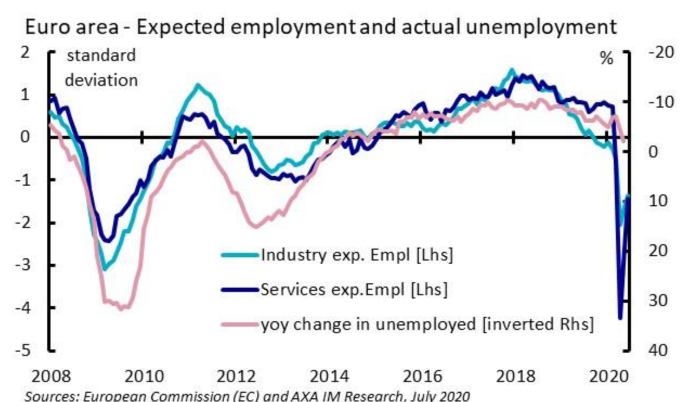
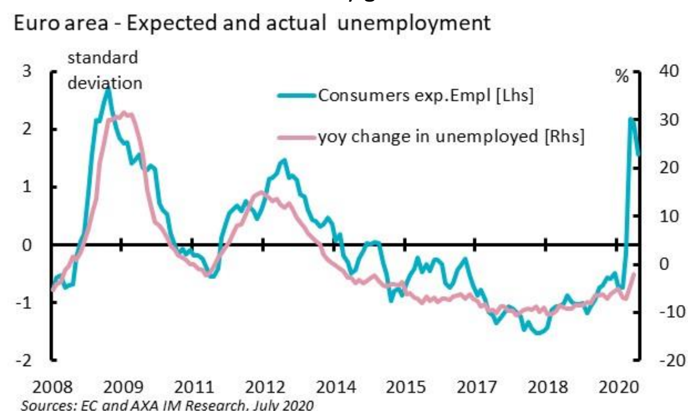


Exhibit6 – Households are well aware the current labour market conditions are artificially good



The second "cliff" is the labour market "thawing" in the coming months. Indeed, thanks to decisive government action, with very generous part-unemployment schemes, European labour markets have for all practical purpose been "frozen" since the beginning of the pandemic crisis. In the Euro area, the unemployment rate in May, at 7.4%, was at the same level as in January 2020. To gauge the extent to which this is an artificially low figure, we can look at survey data. They are less reliable than usual, because significant non-linearities are at play, but despite an uptick in the June batch, the level of employment expectations in the business sector (c. 2 standard deviations below their long-term average) is very similar to what prevailed at the time of the Great Recession (Exhibit 5). Non-linearities were rife at the time as well, and the surveys failed to reflect the entirety of the job slump, but at the very least the current level of business employment expectations is consistent with a 10% rise in the number of unemployed, and up to 30% if we replicate the "forecasting error" of 2009. The gap between the business expectations and actual unemployment is likely to shrink as the labour market is allowed to "thaw", i.e. benefits from less extraordinary support from the governments.

Households seem to be aware of this gap between the headline unemployment figures and the underlying strength of the labour market. The 12-month ahead unemployment expectations component of the consumer confidence index is usually quite tightly correlated with the year-on-year-change in the number of unemployed people (Exhibit 6). This is consistent with an adaptative expectation behaviour: households merely extrapolate from what they perceive of the current state of the labour market to form their forecasts. Not this time. The gap between the survey and the actual unemployment numbers has never been as wide. This is our main concern now: that consumers (probably correctly) anticipate such a steep deterioration in unemployment that they start closing their wallets again after the current spending catch-up.

Should we go Dutch?

Given those risks it is unsurprising that the ECB is calling for a continuation of policy stimulus. **Christine Lagarde was quite explicit about the centrality of the Commission's 'Recovery and Resilience Fund' last week**. To quote her precisely, *"we very much hope that the RRF in the amount of €750 billion that comes on the top of the €540 billion associated with the three programmes already decided and approved by the European Council, will come to support the recovery and to look into the future with a view to greening and digitalising the European economies*".

The least we can say at the time of writing those lines (uncomfortably early on a Monday morning) **is that this is not proving easy.** Our impression was that enough concessions had been offered before the summit to the "frugals" to secure a deal on at least the *principle* of the Recovery and Resilience Fund last weekend. They received a guarantee that the rebates to their contribution to the EU budget would be maintained, and Charles Michel proposed to postpone of the allocation of 30% of the envelope to 2023 to take into account the relative impact of the pandemic crisis on the national economies, instead of distributing the funds according to the pre-pandemic GDP per head and unemployment rate (which would remain the basis for the remaining 70%).

Unfortunately, while the idea of EU issuing debt to help the member states is now consensual, three issues continue to impair the negotiations: First, the balance between transfers and loans. Second, the economic governance of the scheme – i.e. what kind of conditionality in terms of fiscal stance and/or structural reforms would have to be met in exchange for those transfers, and how would such conditionality be scrutinized and sanctioned. Third, the "rule of law" conditionality, i.e. whether states veering far away from the EU's political and legal principles would be able to tap the scheme.

An optimist may argue that it is not be so surprising that the negotiation is so difficult given how radical the proposal is – in principle. Indeed, so far macroeconomic conditionality has always been central to the crisis busting systems the EU has painfully created. What the frugals want is essentially a replication of the European Stability Mechanism (ESM), where support cannot be granted without some assurance from the borrowers that the same mistakes won't be committed in the future – hence the need for pre-agreed, closely monitored fiscal and structural reforms programmes – while loans, rather than transfers, were there to make sure than the recipients of the support would have "skin in the game". The RRF represents such a major shift in the way the EU operates that thorny discussions are unavoidable.

A pessimist would counteract that the governments bear no responsibility for the economic damage triggered by the pandemic – if one wants to discuss pandemic-fighting strategies, some of the frugals (e.g. Sweden) do not necessarily come out as the best in class**. Since solidarity across member states is a principle of the EU, which is a political process at least as much as an economic one, it should be less difficult to accept that conditionality is kept to a minimum, with the balance between net payers and net beneficiaries of the scheme would be based on each member state's contributive capacity, just like national fiscal systems always incorporate some measure of redistribution**. This logic is not new in the EU: this is the principle under which structural funds have always been distributed. The difficulty to come to an agreement this weekend would then reflect a deep misunderstanding on what the EU actually is.
A 2013 paper by Caroline de Gruyter for Carnegie Europe (*"The Dutch are Trapped in Europe"*) grabbed our attention. She argues that the Netherlands fundamentally pursue an Atlantic and global free trade strategy. The

Hague was a founder of the EU out of pragmatism – as an accelerator of those fundamental goals – but did not necessarily share the *political* aims of the EU which is so central to France and Germany. Its usual approach in EU negotiations was to stay inside to apply the brakes on more political integration, favouring the free trade aspects of European unification, aligning itself very closely to the UK when they were in the club. Another feature of the Dutch approach however was to always "yield in the end", after securing concessions, because as a small open economy the Netherlands can even less than the UK "push things too far" and ultimately destroy the framework.

Still, this time it seems that the Netherlands needs a lot before "yielding in the end". Caroline de Gruyter wrote her piece well ahead of the British referendum on the EU, but interestingly she made a parallel between the Dutch approach and David Cameron's. With the benefit of hindsight, the former British PM's strategy was counter-productive because (i) at some point the rest of the EU resists and the capacity to secure concessions diminish, eroding the leverage of the "complicated partner" while (ii) the constant wrangling with the EU makes the issue even more prominent to national public opinion, fuelling more Eurosceptic feelings in the population.

We note that a thorny issue France and Germany also need to deal with is that the frugals are not the only source of resistance. While a compromise on governance with the frugals may be found by allowing a qualified majority of the Council to freeze transfers to a member state which would be seen as "free riding", this is bitterly opposed by some Eastern member states (Hungary and Poland) which are concerned this rule would allow the Western members to punish them for diverging on the rule of law.

What we find frustrating is that, while we acknowledge that the RRF is a big step for some of the member states, the overall numbers remain small. At the time of writing this note, the latest compromise offered a 50%-50% split of the overall envelope, keeping only EUR 375bn in transfers. This is 3% of the Euro area GDP. Distributed over the 7 years of the multi-annual budget framework, this would represent less than 0.5% of GDP of additional "fiscal push" per year. Technical constraints would make it difficult to get any significant payments through in 2021, at the moment of highest need.

It is the political aspect of the RRF which is key to market attitude in our view. After an initial wobble, investors did not mix the "existential issues" of the monetary union with their assessment of the post-pandemic economic situation in Europe. The RRF is a clear embodiment of Europe's collective action capacity in times of need. Prolonged bickering would of course be seen as the first symptom of a lack of solidarity which would mechanically deteriorate the relative position of the most fragile members, i.e. the peripherals.

The negotiations are continuing as we write, so a positive outcome is still possible. Still, at some point, **if the "normal", unanimity-based EU process is closed, a "coalition of the willing" could go down the enhanced cooperation route and set up a RRF mechanism outside the EU budgetary framework, under a traditional international treaty.** This would reassure the markets in the short run, and it would be better than nothing, but for our part we would still see this as denting the whole European process. If some countries – the "frugals" – can reap the benefits of the EU's single market without sharing in all the financial responsibilities, at some point free-riding temptations would become too high.

In the meantime, as usual, the ECB is there to keep things together. According to press reports, Christine Lagarde stated last night that a proper, far-reaching agreement was better than a hasty, sub-optimal one, even if that takes more time. This can be interpreted as a signal from her that the central bank is ready to deal with the potential volatility the absence of success last weekend may create. The PEPP's flexibility has been tried and tested over the last few months. This makes us go back to one of the inconsistencies of the "frugals": they usually favour an orthodox monetary policy. They can't have it if they block progress on the fiscal side. Still, beyond the short-term volatility, continuing to rely too much on an already very stretched ECB is risky. The ruling of the German Constitutional Court probably was among the reasons Germany now support the RRF – monetary policy has limits. This awareness does not seem to be shared everywhere.

Country/Region	What we focused on last week	What we will focus on this week

- Average daily growth rates in key US states remain elevated for now
- Retail sales posted a 7.5% monthly rise in June, following 18.2% in May
- July Fed surveys solid, Philly index retracing
- Annual CPI inflation rose to 0.6% from 0.1%
- Biden posted 15pt poll lead over Trump

- Deceleration in virus growth following restrictions, new cases still likely to rise
- June's home sales to gauge net effect on housing market
- Initial jobless claims following the recent faltering of improvement in the weekly figures

- ECB meeting was uneventful, no change to monetary policy decision but clarification that the PEPP envelope will be used in full, except if there are significant upside surprises
- The ECB Q2 BLS shows banks expecting a significant tightening of credit conditions to corporates in Q3 as the end of the state

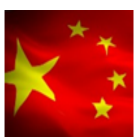
- Light week on the data and event front: the EA July flash PMIs to bounce above 50 on the back of economies reopening. But we stress the limited predictive power of these surveys in times of Covid-19 crisis.

- GDP rose by 1.8% in May, manufacturing and construction up 8%, but services just 0.9% – some downside risk to our -20% Q2 outlook.
- Unemployment remained at 3.9% in May, but payrolls fell 650k March to June.
- UK CPI inflation edged higher to 0.6%yoy (1.4% core) from 0.5% (1.2%)

- June's retail sales to gauge scale of impact of re-opening non-essential retail
- Preliminary PMI estimates due, although mindful of deterioration of signal
- Public finances for June
- Further negotiation of post Brexit UK-EU trade treaty

- The Bank of Japan didn't modify its monetary policy, reiterating confident in the latest policy measures.
- July Reuters Tankan Diffusion Index on 400 major manufacturers remains depressed at -44 from -46

- June trade figures
- June CPI is likely to remain flat after reaching -0.2%yoy in May.
- Manufacturing PMI flash will be crucial as June was very disappointing.
- July chain store sales should confirm the gradual recovery in private consumption



- Q2 GDP growth beats expectations, confirming a v shaped recovery.

- May IP strong in Turkey and Romania. Russia June IP fell 9.4%yoy (after -9.6% in May).
- Policy rates unchanged in Chile, Korea and Poland; unconventional support stays.
- Singapore Q2 GDP -12.6%yoy below expectations. India's trade balance in surplus, first time since 2002.

- Q2 GDP in Korea
- Central Bank meetings: Turkey, Hungary
- June IP in Poland and Taiwan.
- June retail sales in Poland and Russia
- Korean first-20 days exports in July

Upcoming events

US: Wed: FHFA house price index, Thu: weekly jobless, leading index, Kansas City Fed survey; Fri: prel. mfg and services PMIs, new home sales

Euro Area: Mon: Ge PPI; Thu: Ez consumer confidence, Fr INSEE mfg confidence; Fri: EU budget meeting, Ez, Fr, Ge, prel. composite, mfg, services PMIs; It ISTAT business, consumer confidence

UK: Tue: PSNB; Thu: CBI industrial trends survey, BoE's Haskel webinar: Fri: retail sales, prel. comp, mfg, services PMIs

Japan: Mon: trade balance, BoJ meeting minutes; Tue: CPI ; Wed : prel. mfg, services, PMIs

China: Mon: Loan Prime Rate decision

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