Don’t underestimate the multiplier effect

Over the last few weeks, significant stabilisation plans have been announced across advanced economies and in addition true stimulus plans are now under consideration. Recent empirical studies show that fiscal multipliers could be much larger in the current depressed context than during normal times. We believe this could boost the recovery path of corporate dividends going forward, in Europe in particular.

There is near consensus among economists on the need to stimulate growth once the epidemic is under control. Numerous hysteresis effects will hamper the recovery (affected sectors, lack of confidence, and increase in household savings during the lockdowns). Stabilisation plans will therefore gradually have to give way to growth stimulation plans, if only to anchor expectations of a recovery. Moreover, the conclusions of the empirical literature on the scale of the multiplier effects have changed considerably since the early 2000s. Prior to the GFC, most estimates gave multipliers of the order of 0.5x. Many empirical studies have shown since then that fiscal multipliers are likely to be larger when economic activity is very depressed.

Assessing fiscal multipliers

The rationale is quite straightforward. When economic activity is depressed and unemployment is high, household consumption depends more on current income than on future income, while business investment depends more on current profits than on future profits. Therefore, the multipliers are higher than in normal times and, in this case, are likely to be much higher than 1x. This is especially the case when banks restrict credit and when households seek to reduce their debts quickly (Eggertsson and Krugman, 2012). In addition, multipliers are found to be significantly greater than when policy rates are at their zero lower bound – see Michael Woodford (2011), Christiano, Eichenbaum and Rebelo (2011). Authors have shown, using a dynamic stochastic general equilibrium model (DSGE), that under such conditions, budget multipliers can exceed 3x. Using US data, Auerbach and Gorodnichenko (2012) found that fiscal multipliers for government spending range from zero in normal times to about 2.5 during recessions.

If the fiscal multipliers are larger than in normal times while growth projections implicitly assume they are the same, then economists, and investors with them, might underestimate the strength of the recovery in 2021-22. Although the shape of the recovery is more likely to be a U with a long base than a V, the subsequent growth trend might be stronger than expected due to the leveraged effect of multipliers on budgetary measures.

Corporate dividends recovery pace

This could have implications for corporate earnings in two or three years, and on the recovery path of stock dividends. Among identified market dislocations, forward dividends have actually been the most affected by the recent sell-off, particularly in Europe. Dividends have been under significant pressure since the outbreak of Covid-19 for fundamental and technical reasons. The most obvious factor is the massive revision of corporate earnings, which has led to dividend cuts or cancellations. Yet, historically, DPS are far less volatile than EPS, and tend to fall by about half during recessions. In Europe, however, banks have been asked by the regulator to cut their 2020 dividends (based on 2019 profits) in order to increase their capital base. Moreover, companies that have benefited from state guarantee schemes as well as those in directly exposed sectors have also cancelled their dividends. Market implied dividends have been hurt by selling flows from investment banks on forwards during the more acute phase of the equity crash.

Consequently, expectations for European stock dividends look like an L-shape scenario that is far darker than Amundi’s downside scenario on earnings. If multiplier effects lead to a stronger scenario, chances are that corporations will resume their dividends earlier than expected. We believe that income strategies that are actively focusing on dividend recovery will provide an interesting risk/reward profile over the next two to three years.

Finalised on 24/04/2020
Emerging markets, navigating among several shocks

When we analyse emerging markets in the context of the Covid-19 pandemic, we need to assess not only the impact on growth and the policy mix in place to drive its recovery, but also the vulnerabilities that the same policy mix is breeding, through capital outflows and currency depreciation. The following analysis will help to navigate the different situations in a number of emerging markets, and will offer a more granular country view.

In order to assess where we are with the Covid-19 pandemic and its economic impact on the emerging markets universe, we should firstly highlight the sequence of outbreaks across the world. The first outbreak episode in mainland China in January 2020 was followed by a second outbreak in South Korea and in Western countries (Europe and the US) in the second half of February. Finally, over recent weeks, we have been seeing a sort of third wave that has increasingly impacted the emerging markets and frontier countries. Among the emerging markets, in terms of the infection curve, Turkey, Brazil and Russia seem to be the most affected countries so far, with India and Peru following some way behind (source: Worldometer’s Covid-19 data). However, at this point it is fair to highlight that the death toll is still small in comparison with the situation in Western countries. With regard to this third outbreak, the good news is that emerging markets and frontier countries can heed the early warnings and benefit from the best practices implemented in countries that experienced the pandemic earlier. On the flip side, the bad news is that the healthcare systems in most emerging markets are ill-equipped to handle the kind of severe outbreak seen in the hardest hit countries in the West.

In terms of economic impact, no country will be spared. The combination of a domestic outbreak and the related lockdown measures implemented to contain it (the cure of the disease), together with the external shocks materialising due to weaker demand from abroad and lower tourist flows, will not spare anyone. As we speak, emerging markets are falling into recession, the depth and the length of which will mainly depend on the infection curve, the length of lockdowns and how soon global treatments (accessible to the poorer countries as well) for the virus and/or a vaccine become available. The struggle in terms of domestic demand will be much more widespread in the most open economies, the ones that are well integrated into the global supply chain or are commodity exporters, as well as in smaller economies that are highly dependent on tourism.

Compared to the consensus, Amundi’s emerging market growth forecasts appear slightly less negative for 2020, but weak economic performance is expected to continue for longer, resulting in a U-shape rather than a V-shape recovery with less robust growth levels until 2021. Barring the impact of base effects on next year’s economic growth forecasts, we do expect that economic activity will continue to recover in China and the authorities’ efforts will be focused on putting the country back on track towards the economic moderation envisaged before the crisis.

Overall, emerging market authorities have adopted a much bolder easing mode. At this point in time, the stimulus is still primarily being driven by monetary policy rather than fiscal authorities, with very few exceptions implying a more balanced mix. The role of monetary policy as the leading force in the policy accommodation mix is reflected by the actions of many central banks at unscheduled meetings, as was the case very recently in South Africa, India and...
Mexico, to name just a few examples. This is even more revealing in the case of Mexico, where the Banxico still has a reputation of being a very orthodox central bank. Among the few exceptions to policy mix being driven by monetary policy, the Bank of Indonesia and the Ministry of Finance recently announced a more coordinated effort to adopt a three-year fiscal plan, which goes well beyond the fiscal deficit’s legal limit of 3% (at 5.1%) in 2020 and is not expected to drop back below the limit before 2023. In our interpretation of the events, at the latest monetary policy meeting, the Bank of Indonesia held steady, favouring macro prudent measures to monetary policy easing as a sign of coordination with a more proactive fiscal authority. A controversial aspect to monitor going forward is the incremental number of emerging market central banks that are adopting quantitative easing and getting ready to buy bonds on the primary market (in some cases amending their constitutions to do so).

In order to reach a more balanced policy mix, we do think that more stimulus should come from the fiscal side.

Having said that, within the EM universe, beyond the direct assessment of the stimulus as being enough to put the different countries back on track, we do have to consider some side effects related to policy easing where there is little policy room and high levels of vulnerability. The combination of recessionary growth rates, a strong USD (or weaker local currencies) and very low oil prices can trigger rating downgrades (which have increased sharply in recent weeks), currency/balance of payments crises and defaults in the worst cases. In order to assess the risks emerging markets are experiencing, we need to evaluate their fiscal fragility and their external vulnerability. As a simple matter of fact, fiscal metrics in 2020 are going to deteriorate due to recessionary growth levels and expansionary fiscal measures implemented to combat the COVID-19 crisis, while at the same time a strong USD or weak local currencies are increasing external vulnerabilities. Combining all these factors, we came up with a stress rank that puts countries like South Africa, Colombia, Hungary and Malaysia as the countries that are more exposed on both sides. Adding the many contingent liabilities to the Central Government’s fiscal position would worsen the ranks of countries such as Mexico and others. The framework presented is going to evolve according to factors that are not easily predictable. In the middle of the crisis we need to monitor the changes to lockdown measures, whether they become stricter or more relaxed, and the subsequent impact on the growth. On the other side, we need to assess the incremental fiscal supportive measures implemented and the resulting deterioration of fiscal metrics. Finally, the advent of a treatment or vaccine could quicken the return to a pre-crisis lifestyle and speed up the economic recovery.

2/ External vulnerability index and central bank credibility

The third risk factor under scrutiny is the exceptionally low oil prices we have seen recently. In an already depressing environment of significant oversupply, a technical incident based mainly on positioning at the time contracts were rolled over from April to May triggered negative oil prices for the first time in history. In our opinion, the latest price movement has
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On a more positive note, we have seen international institutions like the IMF and the World Bank stepping in.

The current environment will continue to favour the second group of countries such as India/Turkey or even China, improving their external positions and decreasing the oil related fiscal costs. However, it will negatively impact Russia, Colombia, Mexico and the Gulf countries.

Having said that, among the oil producers and exporters, there are countries that will suffer more than others if we look at different oil price levels as a fiscal breakeven in the budget or the different costs of production. When we consider this, Russia comes out as better positioned in comparison with most of the Gulf countries.

4/ Assessing the emerging markets three dimensions risk

On a more positive note, we have seen international institutions like the IMF and the World Bank stepping in. In recent weeks, the Fund has received several (around one hundred) requests for disbursement or debt relief and has been quickly processing them. In the last couple of weeks, many of them have been approved: on Monday, 13 April, twenty five countries received debt service relief for an initial six months under the Catastrophe Containment and Relief Trust (CCRT), among them DR Congo, Gambia, Mozambique, Nepal and Afghanistan, to name a few.

Regarding the tools used, the IMF has many different options in its portfolio. There are two emergency financing facilities with less stringent conditions than a proper IMF programme: the Rapid Credit Facility (RCF) and the Rapid Financing Instrument (RFI), which are both accessible by the poorest countries. These two facilities can be used on top of a pre-existing IMF programme, as was the case with the disbursement under the RCF approved for Niger.

Moreover, the IMF has different credit lines, such as the Flexible Credit Line (FCL) for pre-approved countries with minimal vulnerabilities and strong institutions (recently extended for Colombia) or the Precautionary Liquidity Line (PLL) for countries with moderate vulnerability.

In the current environment, the point is less to do with the availability of instruments and more the increase in lending capacity. What the IMF is trying to do is revamping its instruments to increase the resources it can allocate. It is thanks to the recent support from the UK and Japan that the Catastrophe Containment and Relief Trust (CCRT) was able to provide US$ 500 million in debt service relief to the 25 of the IMF’s member countries. The IMF has asked its members for more resources to provide additional debt service relief under the CCRT for a full two years. Instruments such as Special Drawing Rights are sizable in the context of frontier countries like the small countries of Sub-Saharan Africa, which are in need of reserve buffers, but they become less adequate in size if we consider emerging markets and frontier countries as one universe. More resources are necessary.

One last point to take into consideration when we assess the impact of debt relief/cancellation for the lower income countries is the role of China. In recent years, China has become an increasingly relevant creditor for small (resources rich) economies around the world. When we talk about debt relief, we must not underestimate the importance of this non-institutional creditor and the commercial nature of its loans. China’s massive presence can act as a limit to the effectiveness of the IMF initiatives and curb the US’ ability to obtain more resources.

Finalised on 23/04/2020
Fed’s QE: the next phase

The Federal Reserve has bought US Treasuries at an unprecedented pace since it started its QE programme on 16 March. As volatility and liquidity on Treasury markets continue to improve, the Fed is expected to slowly taper its purchases that were aimed at maintaining proper market functioning. However, uncertainty around the extent of the recession the Covid-19 has caused and strong Treasury issuance to fund the fiscal stimulus could discourage the Fed from slowing the pace of purchases too rapidly. In particular, if the supply shock in the Treasury market triggers liquidity tensions, the Fed will increase its pace of purchases. On top of this, the Fed is likely to fine-tune its management of financial conditions with yield curve control (YCC).

Restoring liquidity and smooth bond market functioning with quantitative easing

The Fed launched QE, in its words, to support the smooth functioning of markets for Treasury securities and agency mortgage-backed securities that are central to the flow of credit to households and businesses. At the peak in late March, the Fed was buying $75bn in Treasuries every day when liquidity deteriorated strongly on the Treasury markets. It has since gradually decreased its purchases of Treasuries, buying only $10bn per day this week. For comparison, the earlier pace of quantitative easing (QE) was $35bn per month during QE1 (Q4 2008 - Q2 2010), then $75bn per month for QE2 (Q4 2010 – Q2 2011), and $45bn per month for QE3 (Q3 2012 – Q4 2014).

Indeed, this unprecedented pace of Treasury purchases has helped stabilise Treasury markets. Yields are starting to settle into a range; realised volatility has calmed down; the bid-offer spread has started normalising although it remains wider than before the crisis; and real yields have retreated after their spike, as seen on the graphs below.

It is worth noting that, despite the fact that Fed has been buying Treasuries across the curve, it has focused the largest part of its purchases on the short end of the curve. This highlights that the underlying goal was essentially to address the Treasury market’s liquidity problems. As seen on the graph below, 55% of Treasury purchases planned recently were in the 0-4.5Y maturity range and only 13% in the 20-30Y maturity range. By purchasing Treasuries at the front end of the curve, the Fed has been supporting the markets’ need to raise cash ahead of the coming recession. In a deleveraging context linked to a rise in risk aversion, investors sold short-term Treasuries to fund their cash needs. The large asset purchases also helped free dealer balance sheets from USTs and MBSs, allowing them to pursue more funding intermediation, thereby improving liquidity on the markets.

Taking into account the purchases of Treasuries ($1.42bn) and MBS ($268bn), the Fed’s balance sheet has expanded by $1.68tn since 16 March.

So, what’s next?

As liquidity improves, the Fed is expected to move towards a more classic version of QE, consisting of a much lower and regular pace of buying, focused on longer-term maturities to stimulate the economy.

QE will aim to easing financial conditions to support growth and inflation working through two main channels:

- Portfolio balance channel: this works by removing duration risk from the Treasury market, pushing investors to bid up the

1/ Daily purchases of Treasuries ($bn)

2/ Planned Treasury Operations*Breakdown by maturity

[Graphs and charts showing daily purchases of Treasuries and planned treasury operations by maturity]

Source: NY Federal Reserve, Amundi Research - Data as of 24/04/2020

DELPHINE GEORGES
Fixed Income Strategist
QE is expected to be maintained until the recovery is on track and might have to be supplemented by Yield Curve Control.

**QE should be maintained until the recovery is on track**

The future pace of QE is dependent on how fast the economy recovers. The exogenous nature of the coronavirus shock blurs the outlook on the depth and the duration of the recession. The Fed could gradually decrease the pace of purchases to $150bn per month. In that case, the QE purchases over the year would total $2.6tn. If the recovery is strong enough, the Fed might slow further to a pace of $100bn per month; in that case the total amount of Treasury purchases could be close to $2tn over the year.

QE should absorb a large part of the deficit. On the back of the government actions to counter the economic recession, the massive fiscal response is going to trigger a deluge of Treasury issuance in the coming months, on the front end of the curve in particular. The deficit is expected to exceed $3.5tn for 2020 with a net increase of $1.6tn coming from the Coronavirus Aid, Relief, and Economic Security Act (CARES). This is a massive supply shock that is in the making.

Half of the deficit should be funded by Treasury bills. If this supply shock triggers problems on the bond market, the Fed is likely to increase the pace of QE once again.

**Forward guidance + QE + Yield Curve Control for a fine-tuning of financial conditions**

With inflation and inflation expectations at low levels and unemployment surging, the Fed will ensure that financial conditions remain exceptionally accommodative. A state-contingent forward guidance could be supplemented by front-end yield curve control, while the traditional QE would still be used for the long end of the curve. Yield curve control extends the maturity of interest rates that the central bank directly targets. With yield curve control, the Fed can limit yield increases by purchasing as many bonds as necessary when yields rise over a certain rate to bring them back down to its target.

**The Fed has maintained a constructive view of the possibility of front-end yield curve control**

In January 2020 Ben Bernanke, the former Chair of the Fed, recommended including YCC in the list of new monetary policy tools: “The Fed has not used new tools other than QE and forward guidance, but, within the bounds of its legal authorities, it should not rule out other options. The Fed’s use of yield curve control could be substantially different from the BoJ’s as it will most likely focus on controlling the short end (below the 2-year horizon) of the curve to augment the Fed’s forward guidance. This has been explicitly suggested recently by Fed Governor Lael Brainard in a speech in February”.

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Yield curve control could be a useful tool with the prospect of surging government debt issuance at the front end of the curve. YCC could help ensure that front-end rates remain low and stable. Fed Governor Lael Brainard refined its potential use in advocating for yield curve control as a tool for strengthening the credibility of the forward guidance and as the way to reinforce the Fed’s commitment to maintaining exceptionally accommodative financial conditions. She was considering the possibility of capping interest rates on the short-to-medium segment of the yield curve.3

3 Lael Brainard: Monetary policy strategies and tools when inflation and interest rates are low, February 2020

In this environment, the US Treasury yield curve is expected to be under continuous flattening pressure with short-term rates near the effective lower bound and an increase demand for duration from the Fed. This environment should be supportive for longer-term investment grade corporate bonds.

Finalised on 28/04/2020

The Fed’s response to the Covid crisis is much larger than its QE. The Fed is deploying its tools and weapons around two intermediary objectives. The first one is to ensure smooth functioning of the Treasury market, which is key for the US economy and financial markets overall, and to provide exceptionally accommodative financial conditions, both through QE. The second objective is to combat the disruption of the credit channel caused by the Covid crisis. The Fed has shown its commitment to supporting households, employers of all sizes, state & local governments through programmes and facilities of unprecedented scale and scope.

The table below summarises the programmes and facilities deployed by the Fed in response to the Covid crisis:

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<thead>
<tr>
<th>Treasuries and MBS - QE</th>
<th>Agency MBS &amp; CMBS</th>
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<tr>
<td>Treasuries</td>
<td>Purchases of Treasury securities through Open Market Operations</td>
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<tr>
<td>Agency MBS &amp; CMBS</td>
<td>Purchases of Agency securities and MBS trough Open Market Operations</td>
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<th>Funding/ Money Markets Facilities</th>
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<tr>
<td>PDCF - Primary Dealer Credit Facility</td>
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<td>PPPLF - Paycheck Protection Program Lending Facility</td>
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<tr>
<td>Central bank liquidity swap lines</td>
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<tr>
<td>FIMA Repo Facility</td>
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<td>MMLF - Money Market Mutual Fund Liquidity Facility</td>
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<th>Credit Facilities</th>
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<td>CPFF - Commercial Paper Funding Facility</td>
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<td>PMCCCF - Primary Market Corporate Credit Facility</td>
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<tr>
<td>SMCCCF - Secondary Market Corporate Credit Facility</td>
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<tr>
<td>TALF - Term Asset Backed Securities Loan Facility</td>
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<td>MSLF - Main Street Lending Facility</td>
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<td>MLF - Municipal Liquidity Facility</td>
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* SPV = Special Purpose Vehicle. The Fed and the Treasury (via the Exchange Stabilisation Fund) set up investment an investment vehicle

Source: Amundi Research

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In this environment, the US Treasury yield curve is expected to be under continuous flattening pressure with short-term rates near the effective lower bound and an increase demand for duration from the Fed. This environment should be supportive for longer-term investment grade corporate bonds.

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