THEMATIC

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EU and UK would probably agree on temporary shock mitigation measures

You asked, we answer

Our Global Views team attempts to answer some of the questions often asked by our clients

Brexit : what will happen if there is no deal between UK and Europe?

What happens after the end of the transition period (31 Dec 2020) is a major political uncertainty. As we write, a number of EU-UK divergences must still be cleared before a trade deal can be secured. Moreover, tensions have recently flared up over the UK's Internal Market Bill.

While we acknowledge that the "no-deal" risk has risen and can rise further in the coming weeks, our base **case remains a suboptimal trade deal** (an FTA for goods and some provisions for services) before year-end. With no customs union, this deal would not prevent trade frictions.

Should they fail to reach a trade deal, the EU and UK would probably agree on temporary shock mitigation measures, so that all trades are not conducted under a "raw" WTO regime in all sectors as soon as 1 Jan 2021. However, there would still be a major hit to trade and growth, and probably more severe for the UK than for the EU. As such, we see no-deal Brexit as a negative for the GBP.

US elections: what scenario after Joe Biden or Donald Trump ?

While national and "swing-states" polls show Biden leading, the confidence margin is thin, especially judging from the experience of 2016. Regarding Congress, the House of Representative is likely to retain its Democrat majority, but the Senate race is too close to call.

Short term, **markets may worry first and foremost about the risk of a disputed election.** There may be no clear winner on 3 November. We expect a record turnout, with the highest number on record voting by mail which the incumbent President considers unreliable. There is no fully predictable legal process to sort the issue; given the backdrop of extreme polarisation, political uncertainty may remain very high in the weeks after the election.

There are three main themes in **Trump's campaign: law and order, China, and Biden's fitness for office. Biden is campaigning on economic policy** (Build Back Better), **healthcare, racial justice and morality.** Biden is planning another fiscal stimulus package to address economic issues tied to the pandemic. Also, he has plans for a major infrastructure investment and supports Green New Deal. Biden plans to boost Obamacare and prescription drug reform. Both candidates will have to deal with the long-term issue of rising inequality.

For markets, Trump supports tax cuts while Biden backs higher spending and tax hikes. As such, there is a near consensus among investors that a Trump victory would be beneficial for equity markets in the short run, while a Biden presidency would cause a market correction. But this may well be a short-sighted view. Their proposals will only be able to pass through Congress if the House of Representatives and Senate are of the same colour, which seems rather unlikely. On the other hand, the macro-financial context is very different from what it was four years ago.

In addition, the US elections will have geopolitics implications. In particular, the relationship with the European Union could evolve in case Joe Biden is elected. (For more details see: *US election: how it will impact the economy and financial markets*)

Europe: is there a risk of another European debt crisis?

This is very unlikely in the short term. A consequence of the crisis is that both public and private debt levels are rising (corporations account for most of the rise in private debt). But **public debt is for the most part absorbed by central banks'** purchase programs, meaning no additional net supply of bonds in the short term.

This **additional public debt held by central banks doesn't lead to short term sustainability issues** either: interests (when positive) remain in the public sector i.e. they contribute to central banks capital, in general a property of the Treasury, and the central bank has the option to rollover the securities at maturity. So that there is neither reimbursement constraint for the government nor a need for market net incremental refinancing.

However in the long term, Europe needs a combination of higher nominal growth, balanced budgets and debt mutualisation for the debt risk to dissipate. High debt ratios are not a short-term risk, but diverging debt trajectories among European countries could lead to renewed tensions within the EU, especially when all countries return to pre-crisis GDP and unemployment levels. A (new?) **framework for the fiscal rules** that each country commits itself to respect will then have to be established at some point. It is therefore essential that the additional debt be used to finance not only investment projects but also reforms that improve productivity growth in the medium term.

As far as the incremental **private debt** is concerned, it is mostly backed by state guarantee schemes for at least two years.

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Additional public debt doesn't lead to short-term sustainability issues

It is the long-term equilibrium rate that has fallen

Therefore, if the economy rebounds, corporate leverage should shrink. Many corporations have also built important cash buffers during the crisis. For those who do not have access to capital markets, banks interest rates are very low and state support of viable corporations reduce solvency risks. Nonetheless, we expect rising defaults from companies that were fragile before the crisis and whose business models will continue to struggle in the coming months.

Are Central Banks out of ammunition? How does the ECB policies compare with the Fed's?

We believe that **Central banks are far from being out of ammunition** (For more details see: New frontiers for central banks) but they are trapped in their QE policies. CBs have de facto entered in fiscal dominance where, in the absence of inflation, they need to maintain low bond yields to ensure that both public and private debts remain sustainable.

The **relationship between the money supply and inflation levels** (on goods and services) **has been broken** for more than 25 years. Monetary expansion causes inflation on financial and real assets. Asset price bubbles are therefore perhaps more to be feared than a real return of inflation in the current environment (For more details see: Inflation persistent headwinds but a possible inflationary cocktail).

As a result of its strategic review, the **Fed changed its 'reaction function'.** Now, the FOMC will seek to stabilize inflation around 2% on average over an entire economic cycle, most likely over a 4 to 8-year period. In practice, this will allow the Fed to avoid rate hikes at the first signs of accelerating inflation. Rate hikes will require that the recovery is firmly anchored and that inflation remains above 2%. These two conditions will not be met before 2024 according to most FOMC members (only 4 out of 17 members anticipate a first rate hike in 2023, despite having recently upgraded both their growth and inflation forecasts). In doing so, the Fed will anchor the short end of the yield curve and support the economic recovery. In a very uncertain environment, it is essential to reassure investors that monetary conditions will remain very accommodative during the recovery phase. Also, this strategy will help contain interest costs and postpone the debate on rising federal debt.

As for the ECB, it is far from having completed its strategic review. In the meantime, its communication is clear: contrary to the Fed, **all the tools are still on the table** i.e. including a rate cut if necessary; the ECB is firmly committed to maintaining very accommodative monetary conditions in the recovery phase. Given the shortfall in global demand, the risk of a further slowdown in inflation in the Eurozone is undoubtedly perceived as greater at this stage than that of a sudden and self-sustaining acceleration of inflation.

What are the implications of low long-term interest rates?

First let's recall that **the fall in real interest rates is not only related to monetary policies. There is a broad consensus that it is the long-term equilibrium rate that has fallen. As a result the equilibrium valuation of risky assets has increased. All other things being equal, this factor should encourage savers to switch to equities from bonds.** That being said, rising costs related to value-chain disruptions, deglobalisation, re-onshoring, and the aspirations of a growing share of the population for wage rises are likely to push up inflation expectations at some point. Moreover, real interest rates have fallen into negative territory and are now below their equilibrium level. In the short term, if inflation expectations rise, real rates may fall even more sharply, temporarily supporting growth stocks.

However, it should be remembered that the Fed is not committed to maintaining long-term yields at their current level. In particular, **if growth and inflation pick up simultaneously and more sharply than expected, the Fed may want to let market forces play their role, leading to a rise in long-term Treasury yields and to a steepening of the yield curve.** This is a potential source of volatility and correction in the stock market that will need to be monitored very closely.

What policy mix should we expect in case of a new downturn?

This is a difficult question to answer given the lack of visibility. We're in uncharted territory. Moreover, we still don't have enough information of the impact of announced fiscal and recovery plans.

Yet one could assume that **in case of new downturn, monetary support will be increased** (CBs balance sheet expansion, negative interest rates, helicopter money), and **government will step in again** to protect the economy. Policymakers are far from having exhausted their room for manoeuvre. But the bar is probably high to experiment new policies (the policy mix would be more reactive than proactive). However, it's clear that if those stimulus/ stabilisation plans are launched during phases of uncertainty and low confidence (like a 2nd wave), **the multiplier effects will be much lower** than in a "normal recovery cycle". Therefore the policy mix could be different on the fiscal side and we could even see nationalisation of struggling but strategic corporates at least partially or temporarily.

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