

THEMATIC



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The alphabet is not enough to picture the recovery

Write hard and clear about what hurts*

Economists have frequently used the alphabet to characterize the profile of the recovery. But one letter does not fit all. It is the duration of the epidemic which will ultimately determine the shape of the recovery. The desynchronisation of cycles should open the door to traditional geographic diversification.

Which profile for the recovery: U, V, W, L, K? What else?

Economists have frequently used the (Latin) alphabet to characterize the profile of the post-Covid-19 recovery. The letters U, V, W, L, and, more recently, K have been (and still are) widely used, often without specifying the horizon of the analysis or the underlying assumptions on the duration of the epidemic, and in any case without discriminating between economic variables (are we talking about GDP, GDP per capita or employment?).

Let's try to clarify. In terms of GDP, V characterizes the recovery in China rather well, and more generally in North Asian economies. U (the shape of a bowl) aims to characterize a slow recovery (as opposed to V), which does not allow for a rapid return to pre-crisis GDP levels. The W refers to the possibility of a "double dip" generated by a second wave. L indicates a definitive loss of potential output. Some also referred to the square root (i.e. a long plateau for GDP after the technical rebound observed in Q3), or even – in a more poetic way – to a "bird's wing" recovery profile. Finally, a K shape designates a recovery characterized by a (definitive?) increase in existing fragmentations: an increase in inequalities and lasting sectoral divergences.

The problem with K...

More precisely, K is meant to highlight diverging trends among regions, countries, and sectors where some are recovering and even thriving while others are not and might even collapse. This can be a temporary pattern of the post-Covid-19 world, with severe consequences for financial markets. In fact, there is a big difference between lagging and diverging, with little hope of catching up.

For decades, the global business cycle has evolved through lags and leads among Europe, Asia and the US. However, regions and sectors are linked with one another, and so are fiscal and monetary policies and financial markets. A K-shaped scenario is a very different story, as prolonged diverging nominal growth paths could break the link between international business cycles. This would eventually mean diverging market behaviours with a particular impact on bonds and foreign exchange.

A second important aspect of a K-shaped scenario is that *winners take all*. Since capital flows into higher growing segments, without policies to rebalance it, financial bubbles and misallocation of resources are likely over the long run. A prolonged K is a risk, as it cannot be a sustainable scenario since it is suboptimal from a policy standpoint to witness without acting. Yet, sharp but temporary divergences described by the K letter will make factor investing strategies less efficient, and investors will come back to classic geographical allocation strategies.

One letter does not fit all

The Covid-19 crisis will leave scars that are all the more lasting and deep in the economy as the epidemic will last for a long time. There is empirical evidence that epidemics with a high mortality rate have a direct impact on potential growth (due to the demographic shock) and little impact on inequalities. Conversely, a "mild epidemic" such as the Covid-19 – which has a low fatality rate compared with past epidemics – has no impact on demography but tends to increase inequalities, which may indirectly weigh on potential growth. It is the duration of the epidemic (which is an exogenous variable) that will ultimately determine the shape of the recovery, and the alphabet letters can be misleading. Our working hypothesis is that no vaccine and/or treatment will be available before H2 2021, which leaves the door wide open to an erratic growth profile in the short term and ultimately tends to confirm our central scenario of a slow, uneven and multi-speed recovery depending on the country and sector.

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