the day after

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“Learn the rules like a pro, so you can break them like an artist”

Amundi
ASSET MANAGEMENT

*"Learn the rules like a pro,
so you can break them like an artist"*

Quote attributed to Pablo Picasso

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“Historically, pandemics have forced humans to break with the past and imagine their world anew. This one is no different. It is a portal, a gateway between one world and the next.”

Arundhati Roy
Indian novelist and political activist
Financial Times, April 3rd, 2020

Without a doubt, the coronavirus is shaking the financial industry like never before. This is not the first time the world has faced a pandemic of this scale, nor is the first time that policy makers, business leaders and pundits have asked: “Is it different this time around? Are we at a turning point?”

After the first paper “Covid-19 The Invisible Hand Pointing Investors Down The Road To The 70s” setting the scene for some of the key themes investors will face in the aftermath of the Covid-19 Crisis, in this second paper of “The Day After” series, we would like to highlight one crucial consequence of the crisis: the vanishing – and probably for long – of most of the established economic rules liberal democracies were living by since the advent of the “Washington Consensus” and the ideological revolution of the 1980s.

Economic crises often lead to a reshuffling of the economic and political ideological corpus. The Great Depression gave birth to the modern Welfare State, a hallmark of most liberal democracies until the oil shocks in the late 1970s. The 2008 crisis demonstrated the limits of traditional central bank policies, paving the way for the progressive revision of their independence. In such historical moments, rules previously believed to be immutable are abandoned. The coronavirus crisis is no exception. The suddenness and the depth of the economic shock caused by the coronavirus is challenging the rules that underpin the way our economies and societies function and interact with each other. One could even advocate that the coronavirus has shattered our dominant corpus more massively than in 2008 in less than a month. This is particularly obvious at the European level.

If we want to design some short-, medium- and long-term perspectives on the “Day after” the crisis, we first need to understand how this corpus is challenged, at least from a highly stylised perspective, to make a general point about the impacts of the pandemic. We are not implying that they apply in the same manner (or at all) to all stakeholders across the globe.

Rule #1

Governments should care about the magnitude of deficits, even when rescuing the economy

In Europe, the budgetary rules, enshrined in the Stability and Growth Pact, came under fire from critics over the past decade. The tenacity with which northern European countries have defended fiscal rules has long suggested that they will remain rigid under all circumstances. In the United States, fiscal hawks have often prevented the federal government from adopting sufficiently large fiscal measures to rescue the economy.

Nevertheless, governments have launched unprecedented fiscal measures to support health systems, businesses and workers. The U.S. Congress approved a $2.1trn stimulus package (around 10% of GDP), and will probably go further. On March 23rd, the European Council activated the 'general escape clause' of the European Union (EU) fiscal framework, enabling European countries to implement massive fiscal support measures. The suspension of budgetary rules gives governments "the needed flexibility to take all necessary measures for supporting our health and civil protection systems and to protect our economies, including through further discretionary stimulus and coordinated action". Additional measures from the European Council are expected On April 23, the European Council reached an agreement on a €540bn package: 100bn for the temporary "Support to mitigate Unemployment Risks in an Emergency" (SURE), 200bn of lending guaranteed by the European Investment Bank and 240bn of credit lines provided by the European Stability Mechanism. European leaders also agreed to work on a "recovery fund", which may amount to €1.5trn. In Germany, a defender of budgetary orthodoxy on the continent, the Bundestag approved a supplemental budget allowing €156bn in additional spending for the year 2020 (4.5% of GDP) and the government will guarantee loans to businesses. In the United States, China and elsewhere, similar fiscal stimulus packages are being implemented. At the end of March, G20 governments pledged to inject over $5trn (around 6% of world GDP) into the global economy, "as part of targeted fiscal policy, economic measures, and guarantee schemes to counteract the social, economic and financial impacts of the pandemic[1]".

At the very least in the short term, it is clear that governments no longer consider themselves bound by any budgetary rules, and the question of public debt sustainability is no longer on the table.

"The suspension of budgetary rules gives governments «the needed flexibility to take all necessary measures for supporting our health and civil protection systems and to protect our economies, including through further discretionary stimulus and coordinated action»."

1. source: G20 Leaders' Statement, Extraordinary G20 Leaders' Summit on COVID-19, March 26, 2020

INVESTMENT IMPLICATIONS

Impact on sovereign risk assessment and the challenge to risk-free investments and USD dominance in the long term

Over the short term, losing fiscal rules comes with unprecedented interventions from central banks (see rule #4). In Europe, the European Central Bank (ECB) has increased the firepower of its Quantitative Easing programme, making all countries including Greece eligible for its asset purchasing and with strong interventions in buying debt of the most vulnerable countries in this phase. Having said this, we consider much more likely a scenario whereby the ECB incorporates the role of Treasury, rather than seeing the mutualisation of debt issuances (again, given strong resistance from Germany and Northern European countries).

The old paradigm 'do not fight central banks' will guide financial markets in this phase, and consequently any market-driven assessment of fragility and solvency of sovereign debt will only be postponed. Once the crisis is over, some of the extraordinary measures will be relaxed, opening the door to the power of capital markets in the price discovery process. Debt sustainability will be back in focus, unless the debate moves to the cancellation of debt in central banks' balance sheets, the ultimate frontier. From an investor's perspective, this focus will require internal assessment and research of debt dynamics and sustainability, ahead of the rating agencies' job.

On the US front, the fiscal expansion legacy of the crisis is likely to put the US treasury debt under review by rating agencies, as the Debt-to-GDP ratio is set to hit new historical highs, even higher than the 106% Debt-to-GDP ratio touched after World War II. This may have a double effect. On the one hand, Treasuries status of safe-haven risk-free assets could be challenged, at least partly, as the US sovereign credit rating could be at risk moving forward. In addition, this may have implications on the role of the USD as leading reserve currency. The USD comes from an overvaluation position vs. main currencies. The lack of alternatives (with the euro being questioned at a time of weak coordinated global response to the crisis, and the Yuan not yet recognised as a leading global currency) could protect the greenback for some time. However, over the long term, the picture could change should Europe prove more coordinated and strong in its response than is currently, or China credible enough to continue to enlarge its area of influence.

Federal debt held by public (% of GDP)

Source: Amundi analysis based on Congressional Budget Office data, April 21, 2020

Rule #2

Public intervention in the economy should be as limited as possible

The 'Washington Consensus' theory and its adaptations has blunted the role of states in modern economies, based on principles of non-intervention, or at least 'the least possible non-intervention'. Since the 1980s, governments have seen their direct participation in economies decline progressively, through privatisation programmes, rules forbidding direct support to some companies or the private sector at large and -- more generally -- a belief in the efficiency of markets to allocate resources to produce public goods. Recently, a new *à la mode* corporate theory was even putting companies' participation in the production of global public goods at the heart of their mission. At least in the short term, the coronavirus crisis has called all these assumptions into question.

First, almost all governments have broken a 'taboo' by clearly deciding the nationalisation of private debts, through massive programmes of guarantees for private loans (with nationalisation occurring when defaults inevitably take place). A number of governments are also envisaging equity investments into strategic companies, which could become state-owned for a relatively prolonged period. It is therefore quite probable that a period of partial nationalisations will open, echoing similar events that followed most of the systemic crises of the 20th century. First on the list would be businesses under heavy stress, in the transportation sector for instance (airlines). Going forward, we should not exclude the possibility of banks themselves being nationalised.

Second, it seems obvious that the coronavirus crisis will lead to a government comeback in the production and management of public goods. For instance, the pandemic has highlighted the weakness of health systems across the world: underfunded, and with unequal access. Nowhere is this more salient than in the United States, where universal health insurance has been a hot topic, and which is facing a fallout most likely to be more severe than in Europe.

Third, given unprecedented state support for businesses, both big and small and across all sectors, some are calling for a new social pact after the coronavirus crisis abates: one in which businesses must enshrine the public good within their *raison d'être*. In a way, the coronavirus crisis may support an evolution that was already there. The Social Market Foundation, a UK-based NGO, released a report arguing in favour of such a reset[2]. Laurent Berger, the French union leader, is one of the many voices calling for businesses to be more responsible, in reciprocation for the lifeline that governments have thrown[3]. Where the crisis may lead to a new paradigm would be on the increased focus on the distribution of valued added by corporates.

> *"It is therefore quite probable that a period of partial nationalisations will open, echoing similar events that followed most of the systemic crises of the 20th century."*

2. Returning the Favour: A New social contract for business, Social Market Foundation, 2020
3. Union Boss calls for new social pact, Financial Times, 06/04/2020

INVESTMENT IMPLICATIONS

Impact on market structure with increase in State-Owned Enterprises in DMs vs. possible further opening up of Chinese financial and economic system (convergence West vs. East in capital markets). Changes in regulations to help sectors under pressure, with a likely rise of regulation pushing towards ESG best practice

Public interventions are likely to affect more western companies (in particular, European countries seem to move towards the idea of nationalisation of businesses in difficulty in the national interest) vs. Chinese ones, where the trend remains one of further market opening despite the crisis. In addition, state support is likely to come with some conditions attached to ensure that the rescue will benefit the entire population. At the sector level, some conditions could take the form of new regulations to push best practices in fighting, for example, climate change or in the field of social development goals more in general. Transparency and governance will also be in focus, as any state expenditure at this time of crisis and afterwards will have to demonstrate a direct positive impact on the wealth of the entire population and not only on the interest of the shareholder.

Debates on dividends or levels of compensation have already started and are likely to pave the way to a new organisation of profit sharing, including through public intervention (progressivity of tax systems, rise in corporate taxes, etc.) This is already affecting the structure of the markets.

Overall, we could see an acceleration towards incorporation of higher ESG standards by companies. On the investor side there will be a rising need to consider materiality of ESG factors into the assessment of each investment ideas.

Rule #3

Free trade and the optimisation of value chains are the best way to allocate global resources

The third phase of globalisation since the 1980s has lived on the general hypothesis that the global optimisation of value chains is central to any modern economy. Unfettered exchanges in goods, technology and people was considered as sound public policy, enabling millions to escape poverty.

The current crisis has the potential to strike a deadly blow to this line of thinking. Indeed, globalisation was already under fire before the coronavirus. Donald Trump was partly elected in 2016 because of his "America First" platform and since 2018, his administration has launched 'trade wars' against several partners, mostly China. Moreover, certain sectors had already begun "relocalising" supply chains, notably in the textile industry, to bring production closer to demand. The volume of global trade has contracted slightly since then.

The coronavirus crisis has exposed the over-reliance of numerous sectors, including strategic ones such as healthcare, on international supply chains. For instance, many drugs or their key raw materials are produced almost exclusively in China and India. This has become increasingly unacceptable for citizens in Western countries. The French president Emmanuel Macron stated that "the paradigm of atomised supply chains at the global level, in particular in China, without safety net" has to change. Some of the sectors having benefited the most from low production costs in Asia will come under mounting public pressure and will have to relocate, possibly under duress. We will probably shift towards relocations and shorter supply chains, at least for some parts of the economy. It is likely that some governments will pursue energetic policies to facilitate, accelerate or trigger the repatriation of production on home soil. The main question here is not whether the relocation process will occur or not, but its extent and its speed. This will surely prompt debates on the fair price of goods and on the fair level of wages in developed countries just after the coronavirus crisis and this could affect inflation.

"We will probably shift towards relocations and shorter supply chains, at least for some parts of the economy. It is likely that some governments will pursue energetic policies to facilitate, accelerate or trigger the repatriation of production on home soil."

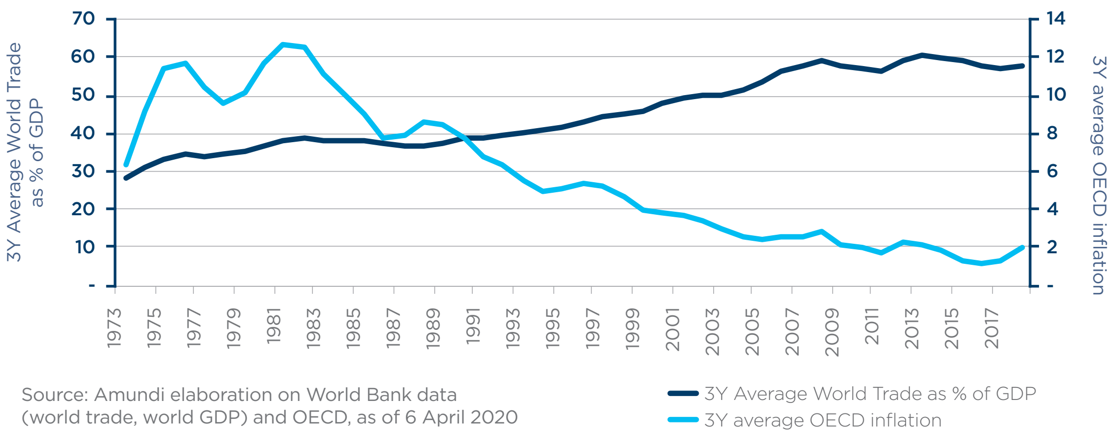
INVESTMENT IMPLICATIONS

Impact on the appeal of regional/local vs. global players (at least in some industries) and long-term implications on inflation

The end of global growth driven by global trade will have relevant implications for investors. In particular, global players in some industries will likely be challenged by the rise of new regional or local champions, as supply chains readjust to the new reality. This is the case of Asia, where the appeal of the One-Belt-One-Road initiative could be reinforced by the regional proximity and by the key role that China will play to finance local businesses. Renewed nationalist forces could result in renewed protectionism, especially against those to blame for the crisis (i.e. US vs. China, should Trump win a second mandate).

The way the system readjusts will also have significant implications on a new battle that is opening up inflationary vs. disinflationary forces. In fact, while in the short term the collapse in global demand is favouring the disinflationary front, the economic cure for the crisis (debt creation with monetisation of debt, regionalisation vs. globalisation in trade dynamics) could prove to be inflationary.

Global trade to GDP and OECD Inflation dynamics



Source: Amundi elaboration on World Bank data (world trade, world GDP) and OECD, as of 6 April 2020

Rule #4

Central banks have exhausted their room for manoeuvre and must work within narrowly defined mandates of supporting financial stability

Before the coronavirus pandemic, the idea that central bank leeway was very limited was prevalent in financial circles. The theory of the independence of central banks was also still alive, notably to avoid public debt monetisation, which would oppose the core objective given to central banks: inflation and inflation forecast management. This was a key feature of the classic corpus. The coronavirus pandemic has led central banks to enter into a new regime: unlimited support, with a new core objective, the preservation of economic capacities in the short to medium run.

In the case of the European Central Bank (ECB) – at the time this paper is being published - the capacity to buy sovereign debt securities was limited by the self-imposed rule stating that the Eurosystem cannot hold more than 33% of a country's bond debt, and because of the rule limiting the asset purchases to investment-grade securities. These two 'limits' have been broken with the PEPP (Pandemic Emergency Purchase Programme), a €750bn asset purchase programme, as

- The Eurosystem will buy Greek sovereign bonds (Greece is rated below investment grade), whereas this had never happened since the ECB started its Quantitative Easing operations in March 2015;
- The ECB will follow the capital key rule with a flexible approach to avoid dislocations in the sovereign debt markets (understand that it will not allow sovereign spreads to widen too much); and
- The 'issuer share limit' rule will not apply to purchases made under the PEPP.

When considering also the other programmes, the Eurosystem will purchase around €1,050bn of assets (almost 9% of GDP) from April to December, which is clearly unprecedented.

The same type of questions about the Fed's capabilities had been raised recently[4]. However, the measures announced by the Fed to deal with the coronavirus crisis are spectacular:

- It bought $1,195bn in Treasury securities in four weeks (from March 16 to April 10), an amount larger than the federal deficit over the past twelve months, and its purchases could go as far as necessary to ensure an effective transmission of monetary policy; and
- Jointly with the US Treasury, it has set up several investment vehicles/facilities capable of buying private securities for several trillion dollars. Through the CARES Act, the Treasury can release up to $454bn, which can be used as equity for joint Fed/Treasury investment vehicles (the 'facilities'). Through these facilities, the Fed will purchase corporate bonds and ETFs for the first time, including high-yield rated ones. The Fed will also purchase up to $949bn of loans to SMEs.

Whether central banks are practicing 'helicopter money' policies or not is becoming a semantic debate (central banks are purchasing sovereign bonds issued to lend directly to corporations or to send checks to households). We have entered a new world from a monetary theory perspective, where central banks' core objective is no longer inflation and where public debt monetisation is a new frontier. Two corollaries to increased Central Bank balance sheets must be noted. First, the role of markets in setting prices and allocating resources is under increasing pressure, as Central Bank actions have huge repercussions on the functioning of "free markets". Second, transmission mechanisms, the process by which monetary policy affects the economy and price levels, are most likely being distorted.

4. In January 2020, a Financial Times piece was titled Economists fear US is approaching limit of monetary policy https://www.ft.com/content/e82bfb10-3136-11ea-a329-0bcf87a328f2

INVESTMENT IMPLICATIONS

Impact on distortion in sovereign and credit markets under the purchasing programmes and the need to be selective

The increasingly relevant role of central banks in bond markets is inevitably weakening and altering capital markets structures. For example, some part of the high-yield space could benefit (even indirectly) from the Federal Reserve actions during the first wave of interventions, but be under pressure in a second wave of normalisation. Similarly, in the equity space, some overreaction in the short term could lead to compelling long-term opportunities. We are seeing this occurring in sectors currently under pressure, such as the airline sector, where companies have been almost indiscriminately affected, but where those with strong balance sheets will be able to navigate these stormy waters. Eligibility for central banks' programmes will make the difference, leaving the ineligible part of markets more exposed to default and more vulnerable. There can be opportunities also in this segment, for companies that will be able to withstand the crisis, but a deep credit research will be needed to spot them.

Overall, the large increase in Central Bank balance sheets, and their holdings across economic sectors, will have huge implications for the functioning of "pure free market forces", in terms of crowding out effects, mimetic attitudes, moral hazard and rational bubbles and distorted capital allocation, among others.

In conclusion, we have seen that after the Covid-19 many old rules have been challenged and have left room to new rules. In this new world, central bank policies will play a key role in designing the future regime.

How central banks role and actions are evolving in the aftermath of the crisis, and what are the implications for investors, will be the focus of our next paper of 'Day After' series.