Video Transcript: Global Macro Webcast – 1Q 2020
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Can You Summarize the Current Macro Outlook?

It's been about six weeks since our last macro webcast on March 13. Events continue to move quickly and dramatically with the macro outlook—pretty much marching to the drum beat of the pandemic, how policymakers are choosing to fight the disease and how they are fighting the economic consequences from the social-distancing measures.

The known unknowns are still the same.

When will the lockdowns end? And what will the recovery look like?

In our webcast from March, there were a few takeaways worth revisiting and updating.

We said that lockdowns as a method for battling the pandemic would be very destructive economically—and that the world was lurching into a very sharp and deep recession.

In the last six weeks, the traditional economic data reports in North America and Europe are beginning to catch up to events, and they confirm a scale of contraction in the global economy not seen since the Second World War. There are lots of comparisons being made with the Great Depression, which we can come back to. But for comparison purposes, the U.S. unemployment rate reached 25% in the mid-1930s. James Bullard, president of the Federal Reserve Bank of St. Louis, openly speculated as early as late March that nearly 50 million Americans might lose their jobs as a result of the lockdowns, which would be an unemployment rate closer to 30%. Based on unemployment insurance claims as of April 23, we are halfway there. There is widespread speculation on the scale of the contractions in GDP likely to hit North America, Europe, and the developing world during the second quarter. But China's performance during the first quarter is a realistic guide of what is coming.

There is going to be a lot of hyper-ventilating about the data—they are dramatic but should not be too surprising given the nature of the lockdowns. This is not an economic or financial crisis in the economy in the conventional sense; it's what happens when you tell people to stay home and essentially try to turn the economy off for a while. This chart from EvercoreISI offers some perspective on this point. It is its proprietary survey of wine and spirit wholesalers in the U.S. Yes, we are still drinking, not more but not less either. What is interesting is that the current flat profile suggests something very different about the attitude of U.S. households than was the case during the Great Financial Crisis. Twelve years ago, the story was an economy brought to its knees by a real estate bust and financial collapse. For most people, real estate is the biggest asset in the portfolio, the collapse crushed confidence, and we came out of the recession with the savings rate soaring. This time around, it seems different, for now. And it could be easier/faster to normalize if people feel confident about managing the disease. Hence the

intense focus on finding a treatment, vaccine, and testing to see who has the illness. But the sooner people go back to work the better.

Six weeks ago, we said policymakers were mobilizing to a war-time basis in terms of efforts that would be made to keep companies afloat and people with income for the duration of the crisis.

In the last six weeks, the policy initiatives have been breathtaking in scope, speed, and scale—policymakers, central banks, as well as fiscal authorities have focused on keeping credit pipelines open to companies starving for liquidity in order to keep them afloat and employing people as well as providing incomes to people who have not been able to keep their job. Chart 3 shows the consolidated balance sheet of the world's major central banks is soaring, and we have listed the battery of actions taken by the Fed to support the economy and financial system. For central banks, in general, the playbook has fast tracked to Modern Monetary Theory—financing at virtually zero rates, at least in the developed world a flood of debt issuance as fiscal authorities around the world blow out their budget deficits in order to shore up employment and keep companies alive. Central bank balance sheets have expanded by trillions and government fiscal stimulus is currently around 5%-6% of global GDP and increasing. While all this is aggressive stimulus, it should be looked on as counter-cyclical policy It is not going to fill the hole in demand created by the stay-at-home measures.

Six weeks ago we opined that by the end of April/early May, if the models were accurate, we should be coming down the other side of the viral curve, which would mark the beginning of the end to the extreme lockdown and potentially the early phase of a re-start.

We still seem to be on that path. Chart 4 shows some familiar distribution curves for the viral infection. It is hard to believe that this virus is going to go away in six months. The goal of the lockdowns has not been to overcome the disease so much as to reduce and stretch out the level of infections to a pace that can be managed by the healthcare system. In theory, the strategy allows authorities to gradually switch the economy back on, so to speak, and also buys more time for scientists and drug companies racing to find a treatment/cure for this new disease. Importantly, the U.S. is approaching the point on the more flattened curve where the number of cases should begin to retreat. In some of the more infected areas in North America, medical authorities have stated that they are not receiving the surge in ICU cases anticipated earlier. Emergency medical support provided by the U.S. military is being withdrawn. Temporary hospital shelters are being closed. Correspondingly, several European economies have already moved to re-open their economies in phases. Similar discussions are underway now in the U.S.

What Are the Key Uncertainties in the Macro Outlook and How Should We Think about Them?

The two crucial questions for investors on the macro outlook still remain: when do the lockdowns end or how will they be phased out? And, what will the recovery look like? The simple answer is we don't know.

But what we can do is try to understand what kind of macro view is priced into asset markets at the moment and what the biases are in that view relative to the distribution of possible macro outcomes. That perspective may lend some insight into which direction the macro surprises might come from.

Chart 5 is a stylized way of describing the distribution of macro outcomes, complete with two tail risks:

The left tail risk everyone is worried about is a deflationary depression. The longer the economy stays closed, the harder it is to restart, the more difficult it will be for employment to recover. So far deflation has been localized to specific sectors like energy and some services. But the longer the duration of a sizeable output gap, the greater the tail risk.

The right-side tail risk is an inflationary boom, which might come about from sequencing lags from all the macro stimulus. If a rapid V-shaped normalization in the economy gets turbo-charged by the tailwind of all this policy support, we conceivably could come flying out of this downturn with late-cycle pressures reemerging much more quickly than expected.

At the moment, asset pricing seems skewed toward the left side of the distribution. Markets generally have discounted a pretty severe recession, but the efforts of the authorities are keeping us away from left-side tail risk territory. I think the markets have stabilized around this recessionary view and anticipate an inevitable upturn, but I'm unsure of when and how much. So, the surprises seem most likely to come on the positive side, at least for now.

Based on our models, U.S. long bonds are trading in the 2+ and 3+ standard deviations below their fair value. This is an expression of acute macro pessimism, but it is only a little more severe than at other periods of recession or crises than in the past. Given the historic scale of the current contraction, there seems embedded in this pessimism some sense of looking across the valley.

Similarly, corporate bond spreads also have recession priced in. An even darker outlook seemed on its way in the second half of March as liquidity dried up and spreads widened even further, but the promise of Fed intervention to backstop the investment-grade credit pipeline has encouraged investors to provide liquidity to this sector. Spreads have since narrowed back to more normal levels associated with a recession.

The slope of the oil curve suggests markets are looking for a rapid but only partial recovery between May and the end of the year. The curve is not necessarily a forecast, but it is noteworthy that futures prices don't recover to pre-crisis levels for another 10 years.

The S&P 500 has rebounded relative to staples also suggesting that the market may be starting to look across the valley at a potential upturn, but a detailed breakdown of the equity market shows tremendous sector dislocation, and that pessimism runs heavily through the heart of the market. The cash-heavy popular growth stocks in the tech sector and the so-called COVID winners have driven the rally off the March lows, but the breadth of the rally is incredibly narrow. The relative valuation gap between these growth sector stocks and the more traditional value stocks is so extreme that only economic recovery will begin to reverse the anomaly. So, the overall tone in the market is still fairly

pessimistic—the downside contained by aggressive policy support, the upside awaiting information to demonstrate that there is upside.

The only other hard piece of information on the tendency for surprises comes from China—6 to 8 weeks ahead of the U.S. where 90% of the workers are back in the major cities, electricity usage is nearing pre-crisis levels, along with traffic activity and pollution levels. Still pretty mixed: year-on-year auto sales are down 50% in March from a year ago, which is better than -80% from a year ago in February. Commercial air traffic is back to about 50% of pre-crisis levels, but only because airlines offer massive discounting on air travel. All the signs point to a U-shaped recovery in China with the most recent data points out performing relative to what have been very low expectations.

Should We Worry about Inflation in the Long Run given the Amount of Central Bank Money Creation?

No, not for a long time anyway. If anything, we should worry about a premature end to unorthodox central bank stimulus around the world, especially by the Fed. People worried about the same thing back in 2008—it was a mistake then too.

The lockdowns have triggered a massive demand shock in the developed world and a massive output gap that is very deflationary. The collapse in the oil market is one manifestation of the potential deflation. People don’t need gasoline to drive their cars if they are told to stay at home. During the Great Depression, the 25% collapse in real GDP was matched by a 25% drop in the GDP deflator—a generalized deflation because the central banks did not react. Only after FDR revalued the dollar against gold—a 1930s style of QE—did the deflation stop, but it was too late. That was why it took so long for employment to recover despite rapid real economic growth for most of the remaining years of the 1930s.

So far, the Fed has behaved admirably by working pretty boldly and confidently to make sure there are no dollar shortages, that liquidity is ample and is effectively taking on the role of financial intermediary by backstopping various credit channels in the economy. These are lender of last resort functions, and it is doing it well, but at some point, the central bank will shift its focus back to the macro outlook. We don’t know how fast the economy will come back, how many firms won’t make it, or how quickly people will get back to work. Odds are that recovery in almost any form except for rapid renormalization means that there will be a residual deflationary output gap for some time. Central to that outlook is the dollar. In a dollar-centric world, bound by zero rates, there has been a strong negative correlation between the dollar and inflation expectations. The BIS has produced a growing body of research to show that dollar strength has been negative for global growth—the world needs an accommodative Fed and a softer dollar. Hopefully as we progress, the Fed will adjust from firefighting to positive forward guidance on the need for sustained reflationary policy.