

## First thoughts on the shape of the recovery



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April 3, 2020

There are no historical precedents for the type of economic dislocations that we are experiencing. War time economies experience disruptions in some sectors, but they also benefit from the considerable mobilisation of economic resources towards the war effort. Today's shutdowns are of a different nature: they are a deliberate attempt to arrest the spread of the Covid-19 by minimising all economic activity that involves social interaction.

The economic costs of reducing social interactions are difficult to quantify. The first-instance consequences, such as the closure of all non-essential businesses are easy to identify. But the duration of the lock-downs remains unknown. These measures also have knock-on effects that are only just becoming apparent. Some businesses will not survive. Integrated supply chains mean that disruptions in one area will be amplified into disruptions in many other areas. The longer the duration of the lock-downs, the more complicated the resumption of economic activity will be.

Unlike 2008, when the crisis had a clear epicentre, today's crisis is endemic to the real economy of every country. A mandatory lock down effectively makes it illegal for many people to work. But government support, no matter how generous, cannot be sufficient to compensate for the drop in GDP.

While we still don't have clear signals as to when the current epidemic might peak, it is too early to come to clear conclusions regarding the depth of the recession. The sudden stop of activity in many sectors implies that we are in the midst of a drop in economic activity more typical of a depression than a recession. Whether or not this translates into an actual depression - meaning a prolonged period of depressed activity - depends largely on the success of the policies being put in place. These policies, however, are unprecedented and therefore untested.

Assessing the likely trajectory of the recovery, therefore, is subject to an unusually high degree of uncertainty. Nonetheless, several broad characteristics are becoming apparent.

First, absent the discovery of a cure or vaccine that can be available quickly on a wide scale, the removal of restrictions on economic activity will be gradual. Travel restrictions may take a particularly long time to be removed. A breakthrough is unlikely, given the time usually needed to verify the safety of a new treatment.

Second, discretionary consumer spending cannot recover rapidly. This is in part because it will take time for the unemployed to return to the labour market, and consumers will want to replenish depleted savings. We also think it is likely that consumers will trickle back at a slow rate to crowded venues, such as shopping malls, food courts, concerts and cinemas.

Third, economic nationalism, which was on the rise before the crisis, is likely to increase as governments think about what disruptions imply for key sectors such as healthcare, food and energy.

The three elements above all suggest that hopes for a V shaped recovery are likely to be disappointed. Economic recovery will be gradual and uneven across sectors and countries, and will entail permanent shifts in the geographic distribution of some supply chains.

The economic support measures introduced also have important implications for the post-crisis landscape. The size and nature of the support measures vary by country, but two elements are in common: exceptional direct income support to a very broad segment of the population, and substantial central bank intervention.

Direct income support to households may catapult the notion of Universal Basic Income to the top of the policy agenda. At a minimum, it has reset expectations for future recessions. The nature of central bank intervention has equally seismic implications for the future of monetary policy. The role of the central banks has evolved from focusing on inflation, and financial stability by lending to banks. Through quantitative easing, they have assumed a significant role in financing fiscal spending.

There is a compelling argument that the increasing role of central banks in financing fiscal packages will be inflationary, once demand recovers. It will be politically difficult for many governments to raise taxes sufficiently to fully finance the costs of the crisis. The degree to which inflationary pressures rise will depend on the size of the fiscal spending that is being financed, as well as the level of recovery in demand. In the US and the UK, pressure to fully finance the deficit will be high. In the Eurozone, it's likely that disputes over the role of the ECB will constrain meaningful monetary financing.

In emerging markets, the outlook is more varied and more extreme. The crisis has exposed the gap in the quality of government institutions across countries. China appears to have controlled the outbreak, even if it is highly likely that its data represent a gross underestimation of the number of cases. In countries like India, we may never see adequate data, but it is already clear that inadequate policies will lead to a grave humanitarian crisis.

Unlike past episodes of capital outflows, when emerging markets raised interest rates to stabilise their currencies, most emerging markets have loosened monetary policy in the past few weeks. This is understandable given that the epidemic is found in every country. But this has also meant that oversized currency depreciations increased foreign currency debt service ratios for sovereigns and corporates at a time of a sharp drop in economic activity. Unsurprisingly, a tsunami of credit rating downgrades has already started.

As in 2008, the market sell-off in global equities and bonds has exposed considerable dislocations. While the drop in equity prices to bear market levels has been the most rapid on record, the adjustment in fixed income markets has been slower but concerning. Liquidity evaporated. In part this because of the difficulty in assessing credit quality and recovery values under circumstances where cashflows suddenly evaporate, but governments are expected to provide support. In part, we believe, this is also because the nature of banking regulations introduced since 2009: banks can't make markets in many credits.

Navigating markets at times of such dislocations is very complex. We were fortunate to be underweight equities before the crisis, and further reduced risk exposure in the early stages of the sell-off. Given the uncertainties to the outlook, we are likely to maintain our higher than usual allocations to cash for some time. With central banks buying investment grade credit in addition to government bonds, we would expect greater stabilisation in fixed income markets, and some reduction in bid-ask spreads. Over the near term, we continue to expect fixed income to outperform equities. Over the medium term, if there is more evidence to support our view that inflationary pressures will see a structural upward shift, we would be preparing to make a significant shift out of fixed income assets.

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