BNY Mellon
Perspectives

The Shape of Economic Recovery to Come

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Shamik Dhar, Chief Economist, BNY Mellon Investment Management
Daniel Tenengauzer, Head of Markets Strategy, BNY Mellon Markets

Brenda Tsai:

Through times of calm and crisis, BNY Mellon's perspective has made us the trusted steward of the financial system. To help our clients make stronger decisions, our experts explore the many angles of the financial markets, investing and business. Welcome to BNY Mellon Perspectives. Hello, I'm Brenda Tsai, Chief Marketing Officer of BNY Mellon and just a quick note before we start. We're launching this podcast at an unprecedented time where working remotely has become our new normal, so we're recording this podcast from our homes. Thank you for joining us from yours.

Brenda Tsai:

Today we're going to focus on the financial outlook during the COVID-19 Pandemic. I'm happy to be joined by Shamik Dhar, Chief Economist for BNY Mellon Investment Management and Danny Tenengauzer, BNY Mellon's Head of Market Strategy. Shamik brings over three decades of experience as a leading economist. He has worked for the UK Treasury Department, the Bank of England, and has held a range of other posts within government and other major banking institutions. And Danny brings more than 20 years of buy-side and sell-side experience. He's a seasoned global macroeconomic strategist with extensive knowledge of the global markets. Shamik, Danny, welcome to Perspectives and thanks for joining us.

Daniel Tenengauzer:

Thank you for having us.

Shamik Dhar:

Thank you very much.

Brenda Tsai:

So there are three broad areas we want to cover with you today. First is around what we're seeing globally now in terms of the macroeconomic picture, vis-a-vis COVID-19. Then the second area is around the path to recovery, what form and shape will it take? Then lastly, we'd like to wrap with a sense of the longer term impacts; who will be the winners, the losers, what will be the longer term effects of this COVID-19 pandemic? Shamik, can you provide our listeners an overview of what you're seeing in the marketplace right now?

Shamik Dhar:

Well, let's start with markets, shall we? Because they're in quite an odd place, to be honest. If you think about stock markets, it's less than three weeks that we were at the depth of a bear market. We'd seen a massive sell off in stocks in a very short period of time. And since then, since the 23rd of March, we've seen stocks rally by over 20% now, both in the U.S. and worldwide. What that points to is that there's just a lot of volatility out there, so it's been absolutely bizarre. If you think about since the start of March, the average daily change in the S&P has been almost 5%. And if you think that we didn't have a 5% day up or down since the last financial crisis, that gives you a sense of the sort of turmoil that markets are finding themselves in at the moment. Sticking with stock markets, we are on a bit of a, well, not a tear exactly but we've seen a pretty strong rally. Why is that? Well, I would characterize it as the market being driven more by hopes and expectations. I think the stock market in particular has focused on the green shoots, if you like. The relatively good news, if we can use that term in these circumstances, surrounding the course of the disease in some of the major hotspot countries. So for instance, in Italy and Spain, we've seen both case and fatality rates starting to fall. We've seen hospital admissions starting to fall in the UK and the U.S. of course there are brighter signs coming out of New York. I think the markets grabbed onto that. Just very quickly, fixed income markets have stabilized, as have credit markets to some degree as well. I think in large part thanks to what the global central banks did, particularly with the Fed a couple of weeks ago. Things were looking very ropy then. I'm not saying that financial market turmoil in those asset classes has disappeared, but what the Fed and other central banks has done has helped to stabilize things enormously.

Brenda Tsai:

Danny, do you have anything to add to the current picture?

Daniel Tenengauzer:

I would say that I'm with Shamik in the sense of there has been an enormous amount of support thrown at the market by policymakers. The next step really is going to be to understand what damage has been done, what can be repaired and what must be recognized. So, I'd say that the recognition part of the process is critical and usually when that process begins, that's also when the healing starts. So understanding how many companies will go bankrupt, how many people will actually be fired, as negative and pessimistic that might be, it's also the beginning of the healing process that we'll have. So it's not surprising that actually the market took off and had quite a few very strong days since we had the negative news coming out from unemployment data, as well as the payroll data that came out last Thursday.

Brenda Tsai:

Speaking of data, BNY Mellon is at the center of servicing and managing a large number of financial assets around the world, and as a result, has a very unique perspective. You capture some of the world's liquidity trends in iFlow, a tool that helps clients understand capital flow movements across equities, fixed income and foreign exchange markets. Can you share a little bit about what you're seeing through iFlow? What is the data telling us?

Daniel Tenengauzer:

That's really interesting because the starting point should really be mid-January when the news actually hit us. If I was to look into what iFlow was telling us heading into phase one agreement signed by the U.S. and China, markets were in actually quite good footing. There was appetite to buy primarily Asian equities. The market was also selling European equities, there was appetite to buy carry, buy high interest rates currencies and sell low interest rate currencies and the flows were very clearly signaling to a fairly benign and healthy behavior in markets. Following that signing in the news, the first piece of news coming out of COVID-19, the first reaction from the market was to unwind those popular trades. And this is I would say the phase one of the process is deleveraging. So you just exit trades that you just entered. So we saw unwinding of long Asian inequities. We saw actually European equities buying, because they were unwinding the shorts. We saw also unwinding of carry currencies, so people getting out of high interest rate currencies and buying low interest rate currencies. That transition took about a couple of weeks. And then heading towards the latter part of February, we entered into what we would call the liquidation stage. And liquidation stage is essentially a stage where investors were clearly selling all assets. They were selling equities across the board. They were selling bonds across the board and accumulating cash. Over the past say week, week and a half, we started seeing actually some catch up to the benchmarks. And this is when you actually start seeing some reversals. We've seen some demand for U.S. equities, we've seen some demand for U.S. Treasury, which again is part of that process of catching up back with your benchmarks. Having said that, all that buying is extraordinarily cautious, because there is quite a bit of cash on the sidelines.

Brenda Tsai:

Given these different phases and the amount of cash on the sidelines, should governments and central banks be playing a greater role, in terms of helping manage this recovery?

Daniel Tenengauzer:

It's interesting because most likely we will be facing some sort of regulatory easing, right? So there will be a process where investors will be receiving more leeway to take this decision. And the backdrop for this is, again, if this is an environment where the healing process is companies and individuals that will go through a transition period, the support will also require agents that understand those that are in better footing and those that are in worse footing. So the role that regulators and supervisors will have in this process would basically allow for that transition to be quite smooth and rapid. So we do believe that, yes, you need liquidity. That liquidity will be there for quite some time. But also, will require different agents in different spaces in the market to make the decisions and pick the good assets.

Brenda Tsai:

What's the role that governments should play in this recovery?

Shamik Dhar:

So I think governments broadly speaking around the world have done the right thing. They've thrown the kitchen sink at this and they've had to, really. What we're seeing is an economy coming to a sudden stop, if you like, a sudden halt, economies all around the world. And that's more or less unprecedented. The first stage of the stabilization process actually came from central banks. It's important to realize what they did and why they did it. So, two or three weeks ago, the market was in entire panic. Essentially people were selling assets indiscriminately to move into dollars and cash. So what the Fed did and what other central banks did was they came out and said, “Look, we are going to supply as many dollars and as much cash as you'd like through various different mechanisms of which QE is one." And they did that as I say, to stabilize markets and to prevent them at least for now, from going into some kind of meltdown. I think that they did that very successfully. That was stage one. In stage two governments came along and they've now done a lot as well. I mean, just to put it into context, most economists are talking about the U.S. economy suffering something like a 10% GDP loss or something like two trillion dollars all because of this sudden halt it's come to. But if you think about it that the package that Congress has put together, together with the president is around $2.2 trillion. So in a way it kind of compensates and maybe even slightly more than compensates the actual hit to output that we've seen. Now there are all sorts of secondary issues about how that help gets to the people that need it, how long that will take, whether the timing is optimal or not, and whether in particular small businesses and the self-employed are getting enough help. But my initial judgment is that both governments and central banks have done pretty much the right thing. That's not to say they won't have more to do if things get worse from here, but I'd say they've made a pretty good start.

Brenda Tsai:

Shamik, you recently wrote a commentary in which you laid out four scenarios for global recovery, including V, U and L-shape recoveries, all of which have very distinctive economic and market outcomes. Can you walk us through some of these scenarios?

Shamik Dhar:

I think the outcome for the economy from here fundamentally just depends on the course of the disease from here. And that's massive, a huge unknown. But broadly speaking, one way you can differentiate the V, if you think about a V being a sharp fall and then an equally sharp bounce back maybe towards the end of this year. What would drive that? Well, I think the thing that would most definitely drive it is if there are signs, particularly in the sort of latest hotspots like Italy, Spain, UK, U.S., if we're getting on top of the disease and importantly that we don't see some kind of second wave in the second half of the year. Now given those conditions, if we do get on top of the disease in the way that, for instance, China seems to have, then given the amount of stimulus there is in the system, there's plenty of scope, it seems to me, for the economy to bounce back very strongly. Maybe not immediately, it might take until the end of the third quarter to really get going, but you could see a very strong fourth quarter in that environment. That's our V scenario. The U scenario, hopefully it's self-explanatory. It means that there is a recovery, but it's a bit more attenuated or elongated than in the V. It takes until maybe mid 2021 before the economy really gets going again. What causes that? Well, arguably that's if we don't get on top of the disease quite as quickly as in the V scenario, and/or there is some kind of echo or second wave in the second half of the year, and/or that it just takes a lot longer to open up the economy regardless of whether or not we have got over the disease simply because people will be nervous and fearful, et cetera, et cetera. The U, it seems to me, follows from that. There's another feature to the U that I think is quite important. The U, I think, becomes more likely if we see another bout of financial market turmoil or volatility. That's by no means impossible. If that were to happen, then I think credit conditions tighten again quite significantly. Financial conditions overall tighten significantly. Then you get some of that stimulus effect being offset or reduced. Finally, the L, or as my colleague, Kurt Custard, who's the CIO at Newton describes it, the reverse Nike swoosh, is what he calls it. That's hopefully, again, self-explanatory. You get a very sharp down. You get a pickup, but you don't get back to where you would've been if the disease hadn't happened. That happens, I think, frankly, if the shutdown continues for a significantly longer period of time, I'm talking about sort of at least two to three months from here, and because of that you get a wave of bankruptcies. You get these huge spikes of unemployment. We're going to see that anyway. We are going to see unemployment pickup really significantly as we're pointing out with the numbers in the next month will be awful. But the key to the L is to understand that it's possible that if you make too many companies bankrupt, if you put too many people out of work, that has permanent effects or near permanent effects on the ability of economies to supply the goods and services that we need. The L is really a situation where that supply capacity of the economy is impaired significantly. If you really, really pushed me as opposed to members of my team, so I won't speak for them, but if you pushed me, I'm slightly more in the V camp maybe than they are. I'm hoping that the market's right from here.

Brenda Tsai:

We all do hope for a quick recovery. Danny, are you a betting man? Did you have a view on these probabilistic scenarios and our paths for economic recovery?

Daniel Tenengauzer:

Well, first of all, that where there is more risk, there is more reward. We're going to have many, many, many more opportunities of very significant rewards, but also around an environment where volatility will be significantly higher. When it comes to sharp ratio, you actually might end up in an even lower sharp ratio because even though you might have higher returns, the volatility will be substantially higher as well. This is a very interesting market, very intriguing going forward. It's going to be a market that requires a lot more R&D. Just the same as we need the R&D to investigate the sickness, we need R&D to understand market behavior going forward. The profile of the agents and portfolio managers will change over time, and it will definitely become a lot more interesting going forward.

Brenda Tsai:

Very interesting indeed. This recovery may take a number of forms. Let's talk about what this could look like on the other side of recovery. What long-term impacts do you see this crisis having on the future of globalization and financial markets? Shamik, what do you think?

Shamik Dhar:

That’s a great question. I think the first thing to say is it's pretty clear that this has changed the world. The world was changing anyway, but I suspect this event has caused us all to sit back and reassess to some degree. What does it mean for globalization? I mean, globalization, it was not in retreat. It was sort of in decline, partly because of the nature of the new geopolitics defining the world really since about 2015. I think the virus might accelerate that in a couple of ways, both politically and economically. Economically, I think what we're going to see is supply chains shorten around the world. The extraordinary and incredibly efficient just in time manufacturing model that depends on rapid transfers along very long supply chains involving manufacturers in lots and lots of different countries. My guess is that for all sorts of reasons, both political and security related, those might end up shortening over time. Now, whether that has an impact on costs and productivity is yet to be seen. I'm still quite hopeful that tech in particular can help us in that situation, but it seems to me pretty clear that longer term that process accelerates. The geopolitics of this are also hugely up for grabs, it seems to me. I think you've got lots and lots of things going on. You had already, if you like, an emerging sort of more fractious relationship between the two largest economies in the world, the U.S. and China. I think it's hard to see how this does anything other than exacerbate. My guess is that politicians are so busy at the moment dealing with the fallout of the crisis and then they haven't really got time to think about those sorts of things, but my guess is that it will make the U.S.-China relationship much more tricky in years to come. It will go through ups and downs just like it always does, but my guess is that that sort of slightly adversarial relationship will only intensify from here because of that. You've got other sort of long-term geopolitical issues to think about as well. I mean, alongside what's going on with COVID- 19, we've had extraordinary changes in the oil market, lots of volatility in oil prices. I think that's another potential area, the relationship between the U.S., the Middle East, Russia, and China. All of that, I think, is up for grabs in the longer term as well. All we can say with some certainty is that things will be very different coming out with this.

Brenda Tsai:

It sounds like some interesting roads to navigate even after COVID-19. Danny, what are your thoughts on longer-term systemic changes?

Daniel Tenengauzer:

So the easy part to it is to just look around us and see what are the sectors that you are using exponentially more compared to those that you are using exponentially less. So when it comes to communication, when it comes to cloud computing, when it comes to healthcare, you're definitely moving in a much higher usage than you were prior to this event. But on the other hand, entertainment as we know will change forever going forward. There will be a very different way of thinking about sharing and social interaction going forward. So all those things will have very clear gainers and very clear losers. It’s quite difficult to actually come across and say this is going to be necessarily a negative outcome or a positive outcome, it will be just a different outcome. The second part that I wanted to actually mention, which is very, very important when it comes to the trade war, is the world was really divided into, I'll say, two groups of countries, one group that essentially had almost full free trade amongst themselves. So let's say that's, roughly speaking, Europe, Japan, the U.S. Tariffs between all those blocks were close to zero or something very, very low. Then the emerging market space where basically tariffs were hovering around 10%. There is a silver lining to all of this because the crisis might actually expose many, many sectors that the emerging markets need to open up to avoid shortages that they might face as a result of the crisis. So there is a scenario, I would say a positive scenario, where emerging markets actually significantly lower tariffs against the charters, in particular against China that will result in a much more free trade environment for the global economy going forward. Let's not forget that emerging markets are more than half of the global economy, and those countries are very, very protectionist. They have very high tariffs. So if only they improve that marginally, that would be already a big boom for the global economy.

Brenda Tsai:

Terrific. So as we wrap up, I'm sure our listeners are looking for guidance on how and when to participate in the capital markets.

Shamik Dhar:

I think clearly, like I said, some risk assets, particularly equities, appear to be on a bit of an upscale, and people might be wondering have I missed it. I honestly don't think that's the case. I agree that I think we're going to see quite a lot of volatility from here now on. When we do our modeling of the V, the U, the L. When we do that modeling, what we end up with is a world in which actually risk assets perform okay over the course of this year as a central expectation, but there's huge downside risks. One other thing to say is, just quickly, there'll be a lot of interest in multi-asset portfolios on the role that sovereign fixed income plays here. My own bet is that we will probably see the reestablishment of the relationship between equities and bonds that we've seen for much of the past 10 years, basically since the financial crisis, in which bonds have essentially acted as a natural hedge towards equities in multi-asset portfolios. When equities fall, bonds tend to revive, et cetera, et cetera. Now, I think that will continue to be the case, but I have to say there are a couple of reasons for thinking bonds may be less effective than they have been in the past. The first is that yields, real yields in particular on bonds have just fallen so much. Of course, central banks have done a lot more since, so the scope for them for further is in a tick. Secondly, I have mentioned this before, but the one way in which it seems to me bonds really struggle is if we get inflation at some point down the line. Now, let me absolutely emphasize here I don't think inflation is likely to come around. But if it were to, and that's the kind of thing that would send the bond-equity correlation positive and not negative as we've had in the past 10 years. So that's something just to keep an eye out for when you're looking at multi-asset investments.

Brenda Tsai:

Excellent advice, very insightful and informative conversation on the many scenarios at play. It was great to gain your perspective. Shamik, Danny, thanks so much for joining us today.

Daniel Tenengauzer:

Thank you for having us.

Shamik Dhar:

Thank you very much.

Brenda Tsai:

And thanks for listening to Perspectives, where we will continue to look at critical topics from every angle.

Brenda Tsai:

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