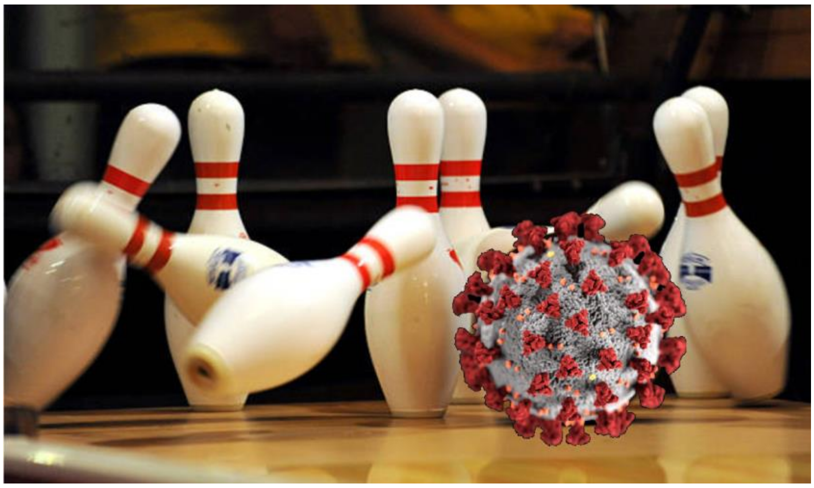
Covid-19: it's not a recession, it's a tsunami



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*The **incredible fall in PMI** indices in China in February is telling what will occur in the rest of the World. **The recession** is coming, and it's going to be **a tsunami**.*

*Just as the tsunami waves **sooner or later recede**, so will the SARS-Cov2, but not before it has **devastated the world economy** with a shock that is affecting both supply and demand. In any scenario, the IMF says, world GDP growth will be lower than before, which does not rule out that it could be zero or worse: at least **three points of GDP** are at stake at the level of the planet.*

***Monetary policies** are going to be loosened everywhere, but more liquidity and lower rates can't do much to fix the **broken links** of global supply chains and cannot help if **people are afraid to die**.*

*Inflation is not a problem. Deflation, on the other hand, is, and there are many reasons to think that the economic consequences of the **virus will aggravate deflationary trends**.*

*The **Wall Street crash** and lower interest rates in the US weaken the **greenback**, despite its role as a safe haven. Meanwhile, **long-term yields** have preceded the short-term rate cuts, with new record lows for T-Bond and Bund.*

The epidemic hits services more than industry. *The **fall in activity is very steep** – more in the **service sector** than in **manufacturing** – and is caused by a **simultaneous double shock** of supply and demand. The double shock is caused by **abstention from all social activities**, both work and play. **Three points of global GDP are at risk**. **The recovery will be slower and longer** than commonly believed.*

It's a **recession**. The **most abnormal** that has ever been seen and therefore unimaginable.

The **anomaly is of two types**, with the **same root cause**: the **rarefaction of social activities**, both professional and playful. Thus we have the **first type of anomaly**: minimizing social interactions has caused a **double and simultaneous shock**, of supply and demand. **People abstain as both workers and consumers**, and as a consequence we have a **collapse of production and purchases**. As if the **Jewish precept** of quitting work on Saturdays, the Sabbath (when even switching on the light is one of the 39 banned melachots), had **become universal** practice. Respect for Islamic Friday and Catholic Sunday is limited to prayers in mosques and churches.

The **second anomaly** is the result of that abstinence: this recession has hit hard, first and foremost, social activities and travel provided by the **service sector**. Normally, the latter suffers little from the ups and downs of the economy. Manufacturing instead is cyclical par excellence, because it manufactures those goods (durable consumption and investment) whose demand fluctuates a lot depending on the economic weather.

This second anomaly has an **important implication**: **lost GDP is not recovered**, if not to a small extent. In fact, those who give up taking a trip, going to the restaurant or the cinema, having a haircut or going to the gym, after the crisis do not intensify these activities to recover what has been given up – for a simple reason: **lack of time and limits to catching-up** (eating twice as much is not possible). A Proustian search for lost time becomes impossible.

The tertiary sector is **highly labour intensive**. This means that the decrease in its activity **lowers employment and wages** and therefore the income of households, if it is not offset by the intervention of automatic stabilizers (unemployment benefits, salary integration, paid absences).

Now there are no longer just anecdotal clues of the **recession**, but **statistical evidence**. For example, in the **collapse of the service PMI indices**, especially, and manufacturing in **China** and the closest **neighbours** (geography-wise, trade-wise and production-wise): from Taiwan to Singapore, from South Korea to Japan, from Vietnam to Australia. **Elsewhere** the epidemic has spread later and the effects will also be evident later, in the March and April numbers**.**

How steep is this recession? **A lot**, because the activities **stop abruptly**: for lack of demand, for lack of work, for lack of transporters (who refuse to go to the most infected areas). So, in some sectors, activity drops by 100% (hotels close, flights and events are cancelled, and so on and so forth).

More than a recession, it's a tsunami.

Early estimates say that in **China GDP** fell by 1.5% in the first quarter, rather than increasing by 1.5%. That is, a difference of three percentage points. But it could turn out to be even worse, because it is not yet known how much is recovering in March. If the same happens elsewhere, taking **three points of GDP out of the world economy** would mean zero growth in 2020. This would be is a very rare occurrence and no one has yet faced to it.

The sequence of Chinese events is being replicated in **Western economies** where the infections and the deaths from SARS-Cov2 are now counted. **Italy is worse** off than France, Germany, the United Kingdom and Spain. But it's only **a matter of time** before we see a similar spread elsewhere.

Tsunami waves lose strength as they move away from the epicentre. This is the case with the economic consequences of the epidemic. But if even **one point of GDP were to be cut in the US**, the effect would be considerable and would also extend to the outcome of the **November presidential election**. Trump's re-election suddenly has become much less certain.

And after the recession? There will definitely be **a bounce**, even a strong one. But it won't be exactly a V. In fact, the **recessive echo** will extend to the next quarters. Because some losses in supply and demand are, as mentioned, permanent; because they set in motion those mechanisms typical of a recession on the labour market and on finance (defaults on debts); because international tourism will suffer for a few quarters; because it will take some time before people resume their usual life; because some behavioural changes adopted during the epidemic will remain (more telework and online shopping).

In short, **the worst is in front of us**. So far we've painted the devil less ugly than it might turn out to be.

The **available data** still help little to understand what will happen, because they tell us how the economy was before contagion. But in this they provide a useful information: the **US was in good shape** (see excellent labour market data from February), the **Eurozone** was trying to break out of stagnation, and therefore more fragile and exposed to the economic consequences of the epidemic; especially **Italy**, but this is not, unfortunately, anything new.

The virus kills an inflation that was already dead. *Price drops take place* ***through four channels****: commodity prices, discounts to attract customers, lower wage pressure and greater use of online purchases. The latter is slated to remain even after the end of the epidemic*.

Inflationary or deflationary? What is the effect of SARS-Cov2 on price and wage dynamics? There are those who fear that the scarcity of certain goods, due to interruptions in value chains, will increase prices and therefore cause inflation. But the truth is the opposite: **there will be a resurgence of deflation**. For four reasons. First, the **fall in demand** is pushing down **commodity prices**, starting with the undisputed king: oil has fallen by 35% since the beginning of the year. Recovered a little from the lows on the expectation that OPEC&P would cut supply, but then fell when the agreement was not found.

Secondly, the dwindling of consumer expenditure forces **companies to lower their prices** in order to encourage purchases. Thirdly, lower production leaves **many workers unemployed**, which reduces wage pressure. Fourth, the **increase in competition** due to the spreading use of online purchases. Instead of going to shopping malls and crowded supermarkets, many people prefer to **shop online**, where transparency and price comparability are greater. This re-orientation of purchases to the net is unlikely to unwind when the epidemic has passed. In other words, the virus is accelerating the transition to new sales channels where competition is more radical.

To sum up: **the virus is killing** an inflation already dead.

Stocks down, rates down, dollar as well. ***Economic policy*** *is doing what it can in order to reassure people that something is being done against this infection. But the weapons of interest rate cuts and liquidity injections cannot do much when* ***the horse is afraid to drink*** *and when global supply chains are disrupted.* ***Stock prices*** *believe more in the wounds to profits from the coronavirus than in the benefits of easy money. The* ***dollar*** *was affected by the half-point reduction in the Fed rate. On the long part of the curve the descent was clear and rapid (apart from Italy). On the two banks of the Atlantic real rates are very negative, as appropriate to a World facing recession.*

In this anomalous turn of the world economy, **actions and reactions are also anomalous**. Let's take the **dollar**. Convention would want that when the horizon of the cycle gets dark, capital runs towards safe-haven assets, the dollar and the gold. And at first that's what happened.

But then the collapse of Wall Street redirected **capital to other shores** (or towards cash), and the Fed's quick reaction (half a point less for the Federal Funds) reduced **the short-term rate differential** between the **dollar** and the euro. The exchange rate with the single currency, which a few weeks ago had gone lower than 1.08, has risen, in favour of the euro, to levels higher than before the "virulent" crisis. However, the **yuan**, whose exchange rate is famously controlled, has not taken advantage of the virus crisis to depreciate and soften the blow to the economy. Indeed, price competitiveness is the least of the problems for the Chinese economy, and the exchange rate has nobly remained below 7, far from the highs reached in the worst days of the trade war with the US.

Short-term rates around the world have turned downwards. Not only in the US but also in Australia and a dozen other countries. But, of course, support to the economy is limited by the fact that the wounds to supply and demand cannot be cured by monetary policy. As usual, **long-term yields** did not wait for the central banks: it had never happened before that the 10-year T-Bond went below 1% (0.66% as we write), and, likewise, another negative record was recorded by the Bund (-0.80%): in these cases, the role of “safe haven” was vindicated.

For the **BTPs**, which, as we know, are not a safe haven asset, yields have risen by around 50 basis points from all-time lows (0.84% on 23 September 2019), but, at 1.30%, still allow the Treasury to save on interest expenses. The contrary trend in Italian bond yields is related to the **impact on budget deficit** (and debt) of measures to support the economy. These, however justified, will only damage the image of the Italian public finances (the "curse of high debt" still strikes).

In other financial markets, **gold** followed the ups and downs of the dollar. After initially strengthening, as is appropriate for a safe (?) haven in the turmoil of this complicated world, it then weakened for arcane reasons (perhaps related to the need, for those who needed urgent liquidity following the stock market crash, to sell the bullion). But afterwards, unlike the dollar, the yellow metal resumed the role, loved by gold bugs, of safe haven.

In the **stock markets**, the mistrust about the unshakeable hold of share prices, has been confirmed. For the moment we are within the perimeter of a “correction”, but **it may get worse** (this is not an advice to buy – or sell!).