View from the OUTER

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Policy shock absorber, but beware the cliff

COVID-19 and the 'Great Lockdown' generated an unprecedented shock to the global economy. It also triggered an equally unparalleled policy response. The monetary support has been more than matched by fiscal measures. At last count over US$9 trillion of fiscal spending has been committed globally. We estimate that the monetary and fiscal measures now equate to ~18% of world GDP.

With policymakers flying blind, the COVID-19 response was geared around severe scenarios put together during the crisis peak. Easing health concerns and economies reopening earlier than planned mean downside risks have lessened, yet stimulus based on worst-case outcomes continues to flow. Australia is an example. The economic contraction looks set to be shallower, but more stimulus is still in train.

On our figuring, the measures look to have plugged the income gap created by the labour market upheaval. The capacity to spend is there. And with confidence returning, we think households will draw down recent savings to fund pent up demand over coming months. This should be the case broadly, but we remain of the view Australia could relatively outperform given its health outcomes and near-term policy mismatch. We continue to look for opportunities to rotate into financials, consumer stocks, developers and building material firms. The A$ should also continue to garner support.

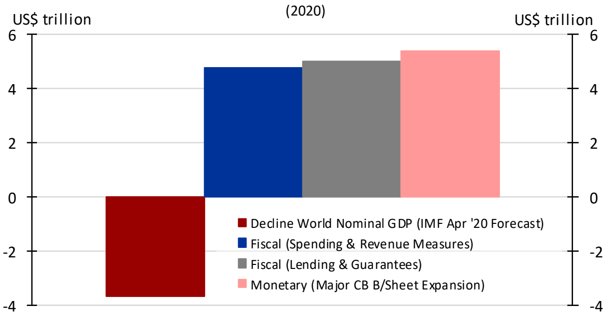
Things look better near-term, but further out sustained policy support will be needed to solidify the recovery. There is a danger, however, robust near-term growth gives policymakers a false sense of security, and measures are pared back. This is particularly relevant for H2 2020, with several initiatives set to end. Locally key dates are in September. But given the risks, we assume actions to avoid the 'cliff-edge' will be taken.

We think risks of a misstep, or of underwhelming expectations, are higher offshore.

- In Europe, 'furlough schemes' supporting ~40mn workers are set to expire by October. It is crucial support lives on, but the political will to do more may not be as great. High unemployment would stifle the recovery and add to solvency concerns.
- In the US, programs have either been exhausted or have upcoming expiration dates. The US' cliff is fast approaching, and the political backdrop is fractured. Some more fiscal spending is in discussion, but another large package could be challenging to get through Congress. The sense of crisis has faded, and the election is approaching.

The potential for renewed volatility, and surge in global money supply on the back of the extraordinary stimulus, supports our bias towards adding gold to portfolios.

ESTIMATED WORLD OUTPUT LOSS & POLICY SUPPORT
(2020)



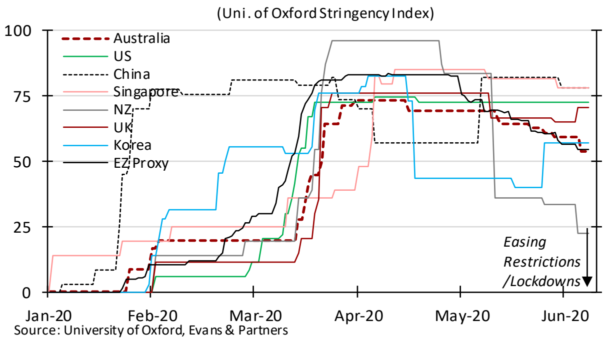
Source: IMF, Government & Central Bank Announcements, Evans & Partners

Policy shock absorber, but beware the cliff

COVID-19 and the 'Great Lockdown' generated an unprecedented shock to the global economy. It also triggered an equally unparalleled policy response. Unlike previous crises policymakers moved early to try and mitigate the adverse economic effects.

This reaction function was different, with decisions made without economic impacts having to crystallise. Recall, during the GFC, broad support only came through in the months after Lehman Brothers collapsed, not weeks as per COVID-19, and even then, in some instances, such as the US Troubled Asset Relief Program (TARP), it took a few attempts to pass.

COVID-19 GOVERNMENT RESPONSE TRACKER



Source: University of Oxford, Evans & Partners

With policymakers flying blind, the COVID-19 response was geared around severe outcomes put together during the crisis peak. However, with health risks now not as acute in some countries, restrictions are being eased and economies reopened earlier than planned. Hence, the economic damage, while still considerable, looks like it won't be as bad as the outcomes underpinning policy decisions (see "*View from the outer: The fiscal force*", 3 June).

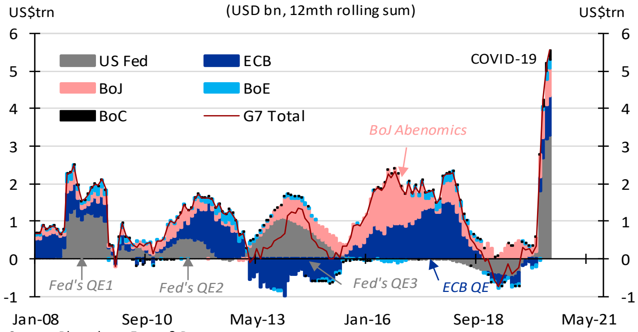
Given policy works with a lag, in places such as Australia, NZ and Japan, some of the impulse will be hitting the real economy as things are naturally springing back to life. This points to a burst of activity over late-Q2/Q3 as pent up demand and stimulus combine. But further ahead 'cliff edge' risks are looming, both here and abroad, with several initiatives set to end at different times during H2.

Unprecedented monetary support…

Throwing caution to the wind, global central banks moved at warp speed at the onset of the crisis. Borrowing costs were lowered quickly, and unconventional measures were put in place to support business and consumer cashflows, the flow of credit in the real economy and financial market conditions.

Indeed, with conventional interest rates now at their effective lower bounds, central bank balance sheets are being used more heavily. Indicative of the perceived risks, the expansion of the major central bank balance sheets since March has swamped anything that has occurred before.

G7* CENTRAL BANK BALANCE SHEET GROWTH

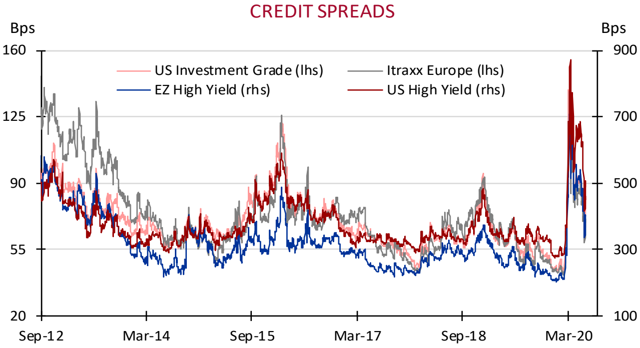


Source: Bloomberg, Evans & Partners
* US Fed, BoE, BoJ, ECB, BoC

Accepting the long shadow COVID-19 will cast over the global outlook central banks continue to stress their commitment to try and safeguard the recovery as best they can. While liquidity cannot solve solvency issues, enough liquidity can hold risks at bay while things recover. As such, accommodative monetary policy should continue for the foreseeable future, particularly with fiscal policy expansionary and central banks helping to keep financing costs low (see "*View from the outer: Rising deficits & debt*", 27 April and "*View from the outer: The fiscal force*", 3 June).

On this point, in recent weeks, the US Fed, Bank of Japan and RBA have reiterated they will maintain the level of bond purchases needed to ensure smooth market functioning and accommodative conditions. Given some of the structural headwinds plaguing their economies, and the ramp up in sovereign bond issuance stemming from expansionary fiscal packages, the ECB and Bank of England also upped their bond buying targets. At the same time the ECB has provided a substantial amount of favourable funding to banks to meet credit demand from Eurozone corporates.

CREDIT SPREADS



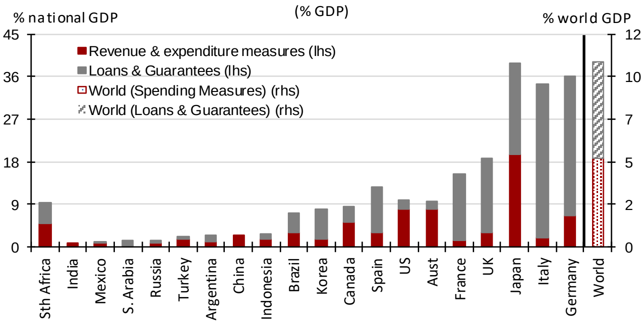
Source: Bloomberg, Evans & Partners

Indicative of the '*whatever it takes*' mentality, central banks also continue to wade further into unchartered waters. To complement its credit ETF purchases, the Fed announced it will begin buying corporate bonds to facilitate "*the availability of credit for large employers*". To date the Fed has only utilised a fraction of its credit facility (~US$5bn of US$250bn). But the mere ability to step in has tightened credit spreads in the face of worsening macro conditions.

…and uber expansionary fiscal policy

The global fiscal support has also grown considerably as governments scrambled to protect lives and livelihoods. At last count, over US$9 trillion of fiscal spending has been committed. This has risen by over US$1 trillion since April. Approximately half of the total is allocated to direct spending, while the other half is for loans and guarantees to try and quell solvency risks.

G20 FISCAL MEASURES



Sources: IMF, Country Announcements, Evans & Partners

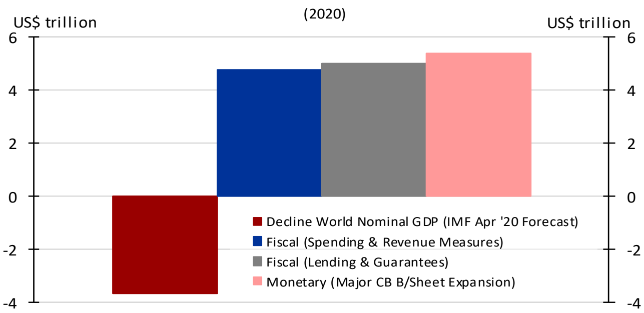
In some cases, such as Australia, the US, Canada, and Japan, there has been a greater tilt towards direct fiscal spending over lending assistance. This is a relative positive for the near-term growth impulse in these nations. Due to its limited monetary policy firepower Japan has been particularly aggressive on the fiscal front, announcing packages that exceed 40% of GDP.

The unprecedented shock also broke down barriers, with the political will to do what is needed winning out during the depths of the crisis. The adage of '*don't waste a good crisis*' has been on show. In the US, there was a flurry of bipartisanship, helping to get things done. In Europe, the EU is moving towards a EUR750bn Recovery Fund, with a disproportionate amount for fiscally compromised countries.

The scale of the policy shock absorber…

The global policy shock absorber is enormous. It needed to be to try and alleviate the steep contraction in activity, negative labour market impacts, and spillovers into business revenues and household incomes. We estimate that the size of the direct global fiscal response largely fills the void created by the forecasted loss of output. On top of that are the lending guarantees and monetary support being injected.

ESTIMATED WORLD OUTPUT LOSS & POLICY SUPPORT



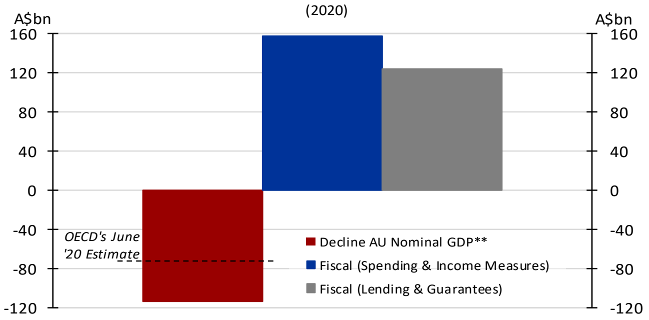
Source: IMF, Government & Central Bank Announcements, Evans & Partners

All together the measures equate to ~18% of world GDP. This provides some comfort that there is a road back to pre-COVID days, and policymakers are '*building a bridge to the other side*'. However aggregate calculations also mask things.

On the negative, there are timing issues and country specifics to consider. The effect on growth and labour markets has been front-loaded, but policy stimulus, even if announced quickly, takes time to be fully effective, and it may not be well targeted. And while the global response has been immense, there is regional divergence. Advanced economies are providing the lions share (and as mentioned, there is a gulf even within this subset), with emerging markets generally not being as assertive (see "*View from the outer: Emerging Problems*", 8 May). Though there are signs some, like China, are inching in this direction.

On the positive, the various initiatives were largely put together when COVID-19 anxiety was at its highest and there was incredible uncertainty about the scale of the economic damage that would be inflicted. But as health risks have eased, and economies have started to reopen earlier than planned, the downside risks have lessened. Yet stimulus predicated on worst-case scenarios continues to flow.

ESTIMATED AUSTRALIA OUTPUT LOSS & FISCAL SUPPORT



Source: RBA, OECD, Government Announcements, E&P ***inferred from RBA May '20 Forecasts*

Australia is an example of a potential near-term mismatch. The recent estimate from the OECD on the size of the 2020 economic contraction under the '*single hit scenario*' is less than the RBA's and Treasury's earlier thinking, and is more than offset by the fiscal spending. Indeed, the RBA has also noted that developments mean the downturn could be "*shallower than earlier expected*". The policy and health response underpin our view that Australia should come out of this shock better placed than others. The relative economic strength should continue to support the A$ (see "*View from the outer: A$ - crouch, touch, pause, engage*", 15 May, "*View from the outer: Australian dawn*", 28 May, and "*View from the outer: Rotation Stations*", 11 June).

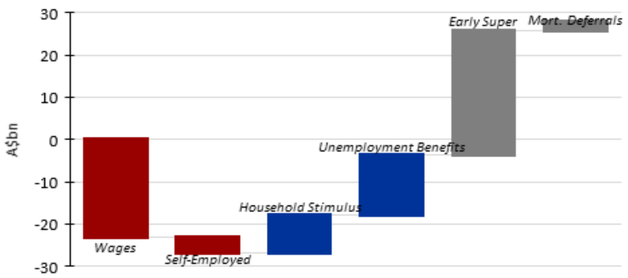
…is helping plug the income gap

Importantly, the support measures delivered, particularly in Australia, look to have effectively plugged the income gap created by the economic upheaval.

On our figuring, the household stimulus payments that have flowed (with another round to come in July) and lift in unemployment benefits, as well as schemes such as early super withdrawals and mortgage deferrals, are countering the drag on wages from job losses and reduced hours. While individual circumstances differ, on aggregate, household incomes are projected to have *grown* over Q2/Q3.

ESTIMATED IMPACT ON AGGREGATE HOUSEHOLD INCOME

(cumulative Q2 & Q3 2020)

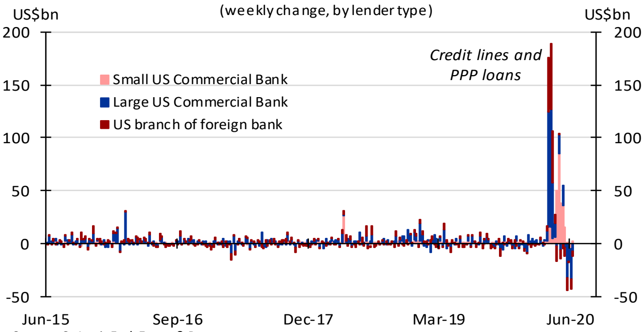


Source: APRA, ABS, AU Treasury, ABA, RBA, Evans & Partners

Similarly, in the US, government payments have bolstered incomes. Policies such as the [Paycheck Protection Program] (PPP) which provides businesses forgivable loans to help cover up to eight weeks of payroll costs, [tax rebates] for low-to-middle income households, and [enhanced unemployment benefits] have seen aggregate household incomes rise. For many low-paid workers in services industries such as retail, and leisure and hospitality, the cumulative support is greater than their typical wage.

US COMMERCIAL & INDUSTRIAL LOANS

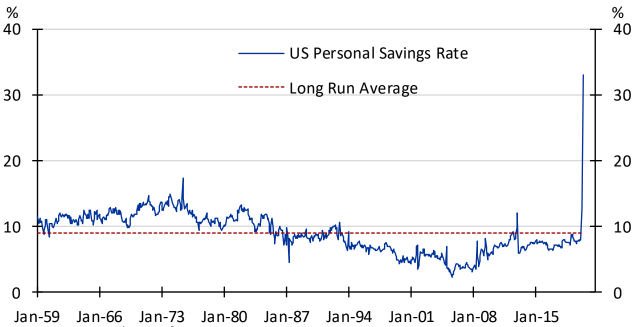
(weekly change, by lender type)



Source: St.Louis Fed, Evans & Partners

And with society locked down, the avenues to spend have been limited. As a result, the US personal savings rate spiked to 33% in April. Similar trends are likely elsewhere.

US PERSONAL SAVINGS RATE



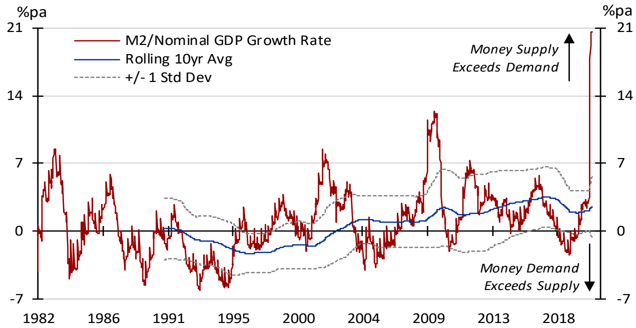
Source: St.Louis Fed, Evans & Partners

Liquidity surge flowing into markets…

Notably, in response to the extraordinary central bank balance sheet expansion, and the ramp up in savings following the injection of cash into the economy by governments, money supply growth has surged. This illustrates how abundant liquidity in the financial system now is. And it helps explain the wide gulf between equity markets over the past few months and trends in the real economy. As shown, in the US, money supply growth is now running at multiples of nominal GDP growth.

But at the same time, the velocity of money (i.e. the speed and number of times money circulates in the real economy) has remained in its post-GFC downtrend. As we have written before, the '*Quantity Theory of Money*' highlights how it is the velocity of money that is important for inflation, not simply money supply (see "*[View from the outer: Rising deficits & debt]*", 27 April).

US MONEY SUPPLY



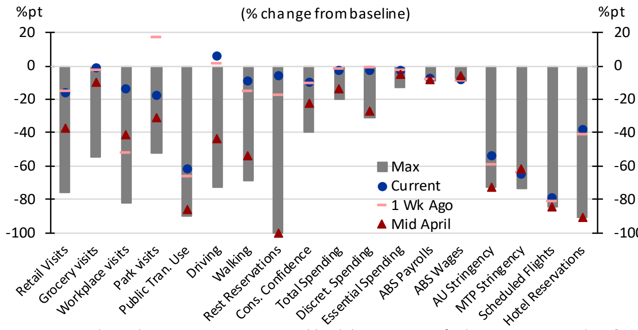
Source: St Louis Fed, Evans & Partners

…and pent up demand points to a burst of activity

As flagged, with society opening up, pent up demand should generate sequential improvement in the economic data over late-Q2/Q3, with some indicators looking particularly strong (see "*[View from the outer: The fiscal force]*", 3 June).

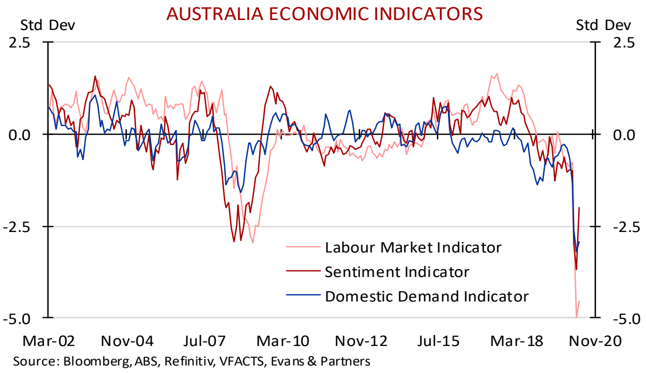
ACTIVITY & MOBILITY TRACKERS: AUSTRALIA

(% change from baseline)

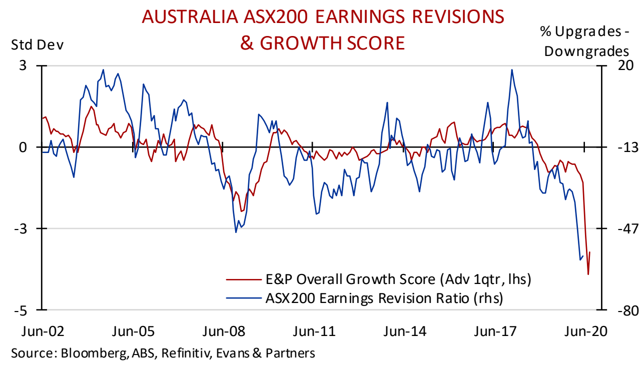


Source: Google, Apple, CityMapper, ANZ, OpenTable, AlphaBeta, ABS, Oxford Uni., OAG, SiteMinder, E&P

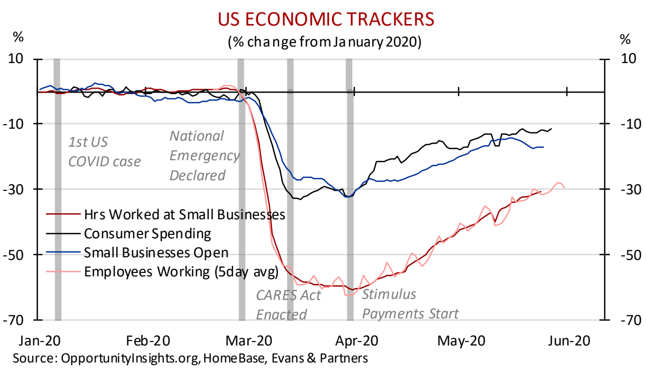
Our further analysis shows that with the income gap closed, the capacity to spend is there. With confidence returning, we think households will draw down accumulated savings to fund pent up demand over coming months. This in turn should feed into employment, at least in the short-term. The snap back in US (+17.7%), UK (+11.8%) and Australian (+16.3%) retail sales in May shows this is starting to occur. Following large contractions in Q2, Q3 GDP growth outturns should be historically strong.



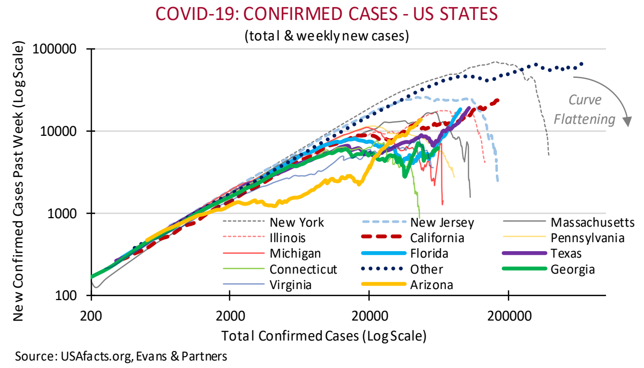
More specifically, our aggregate Australian confidence measure (consumer and business) has lifted from its lows. Historically this has led a turn up in activity data and relative improvement in the labour market over subsequent months (see "*View From The Outer: Navigating Through The Recession*", 26 March). The uptick in our '*growth score*' also points to net earnings downgrades nearing their end. With overall valuations elevated, we would continue to look for opportunities to selectively rotate into areas that will benefit from the cyclical improvement such as financials, consumer stocks, developers and contractors, and building materials (see "*View from the outer: Rotation Stations*", 12 June).



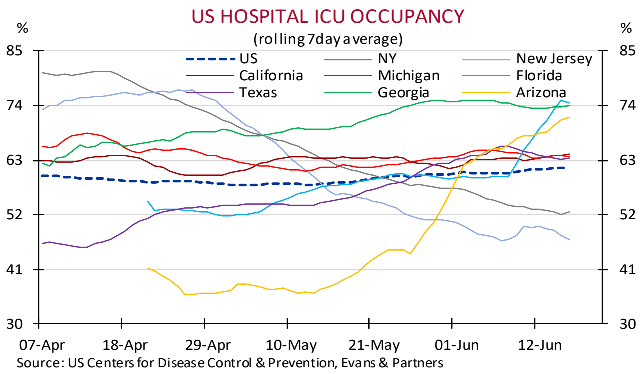
There are similar signals across US economic trackers. As the US has reopened things like restaurant and hotel reservations, and visits to retail sites have bounced back, and this has supported a steady turnaround in consumer spending and employment indicators.



However, with COVID-19 infection and ICU occupancy rates rising across the US states that pushed to reopen early (i.e. Arizona, Texas, Georgia, Florida), the US economic recovery is at more risk of stalling. Despite their resistance, some state governments may have to consider localised lockdowns if pressure on the health sector gets too high. This could dampen the markets optimism; hence these trends remain on the radar, particularly ICU occupancy rates.



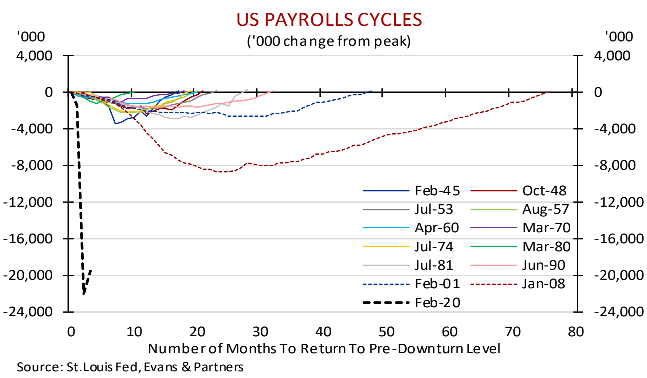
Even if localised restrictions/social distancing measures aren't restored, the renewed health risks could stifle confidence and consumer behaviours, holding back the US recovery (see "*View from the outer: Rotation Stations*", 12 June).



Will decisionmakers fall into the growth trap?

The rebound in activity and leading labour market indicators are positive first steps. This will create an interesting backdrop. Although *growth rates* will look very strong near-term, the *level* of activity/employment will remain a long way below pre-COVID heights for a while.

An example of this recently came through in the US May payrolls report. Although the monthly rise was a record (+2.5mn), it followed far larger falls, and on net employment is still ~19.5mn below the February 2020 peak. History shows labour markets take longer to heal than they deteriorate.



Growth rates grab the headlines, but activity levels are what influence business revenues and profits over the medium-term, and these in turn drive CAPEX and employment intentions. Given pent up demand is a finite resource that can quickly peter out, sustained policy stimulus will clearly be needed over the next few years to solidify the recovery and absorb the excess capacity that has been created (see "*View from the outer: The fiscal force*", 3 June). The crisis effects will outlive the current suite of support measures.

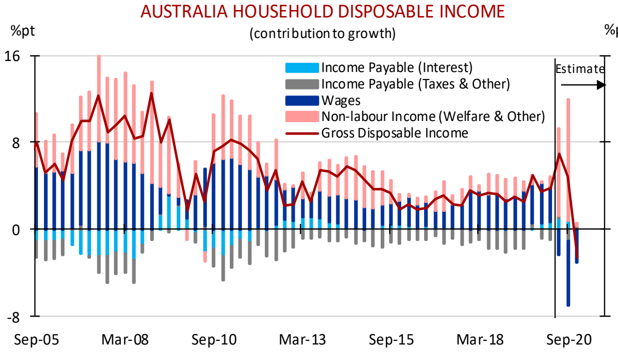
There is a danger, however, that robust near-term growth gives decisionmakers a false sense of security economies have normalised, and as a result policy is withdrawn too soon or not continued. This is particularly relevant for H2 2020, with several key fiscal initiatives set to end. As these dates come closer into view, markets could start to fret that the policy bridge that has been created may really be a cliff.

The policy cliff is looming

In Australia, the JobKeeper wage subsidy, additional JobSeeker welfare payments, mortgage deferrals, ability to access super early, SME loan guarantees, and moratorium on evictions come to an end in September. As things stand, ~3.5mn people are on JobKeeper (~30% of private sector employees), ~1.65mn people are receiving JobSeeker, 485,000 mortgages have been deferred (~780,000 when including business loans), 2.1mn people have tapped their super, and over 5mn people are getting cash handouts.

On our estimates, even if you assume a sizeable recovery in employment over the next few months, household disposable income is set to fall back sharply in Q4 as the significant safety net rolls off. The removal of support will pose an enormous economic challenge, and all else equal, points to a pull-back in activity towards year-end.

AUSTRALIA HOUSEHOLD DISPOSABLE INCOME

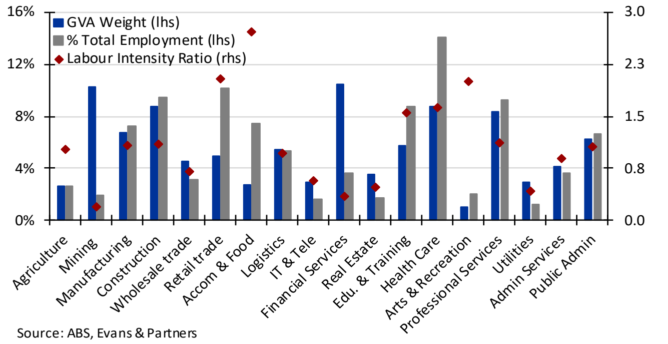


Source: ABS, Federal Treasury, ABA, APRA, RBA, Evans & Partners

Given the risks, we assume measures to avoid, or at least taper, the impending Australian 'cliff-edge' will come through. Australian policymakers have worked collectively during this crisis, and influential policymakers such as Treasury Secretary Kennedy and RBA Governor Lowe have already emphasised the importance of maintaining support.

In our opinion, targeted ongoing support in the areas that are labour intensive (i.e. retail, hospitality), have positive multipliers (i.e. construction, infrastructure) and/or will be impacted by health policies (i.e. tourism) are on the agenda. The recent *HomeBuilder* and shovel-ready infrastructure announcements are examples of the targeted approach. Bringing forward legislated tax cuts, and/or lifting unemployment benefits are other options that would boost incomes (see "*View from the outer: The fiscal force*", 3 June).

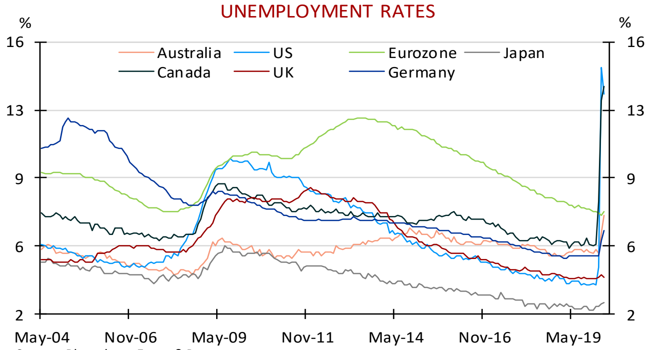
AUSTRALIAN ECONOMY



Source: ABS, Evans & Partners

We think risks of a misstep, or of underwhelming expectations, are higher offshore. In Europe, 'furlough schemes' which have helped limit the rise in unemployment are set to expire between end-June and end-October. It is estimated that more than 40mn workers are registered on these schemes in the four largest Eurozone countries plus the UK. Without a continuation or alternate policy, unemployment rates would spike across Europe, given economies aren't strong enough to sustain all these jobs.

UNEMPLOYMENT RATES



Source: Bloomberg, Evans & Partners

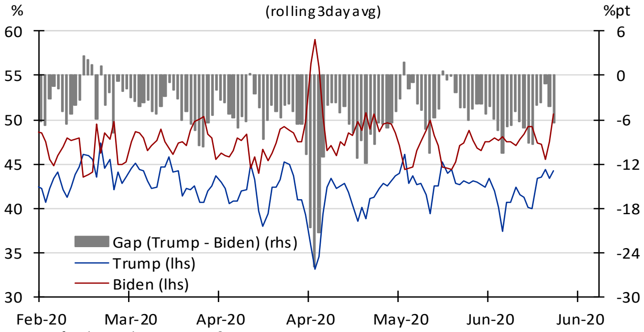
Higher unemployment would weigh on consumption and business investment, and in turn prolong the recovery and add to solvency concerns. Unless they are brought to the brink, history shows European political leaders tend to move slowly. Indeed, even the EU Recovery Fund mentioned is only due to distribute funds from 2021, and underlying divisions across the region remain.

In the US, many programs have either been exhausted or have upcoming expiration dates. For example, enhanced unemployment benefits end in July, PPP loans largely disbursed in late-April/May only cover two months of costs, and tax rebates have been paid. This contrasts Australia where some direct stimulus has yet to flow.

The US' policy cliff is coming up sooner than Australia's and Europe's, and the US political backdrop is far more fractured. Failure to extend support would weigh significantly on US activity in Q3 across consumer spending and the labour market. It is clear that ongoing help is needed, and President Trump has flagged his desire to do more. But another large package could be challenging to get through Congress, especially as the sense of crisis has faded.

US PRESIDENTIAL ELECTION POLLS

(rolling 3 day avg)



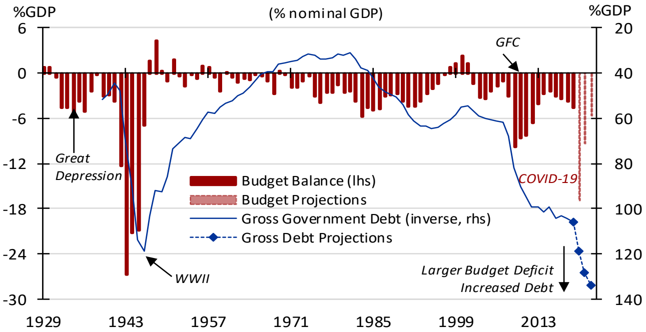
Source: fivethirtyeight.com, Evans & Partners

Bipartisanship has quickly reverted to partisanship, with a growing divide between the Republicans and Democrats on the type and size of additional aid that is required. With the November Presidential Election fast approaching, and the polls shifting, the Democrats may want to capitalise on momentum and play politics. Stalling or watering down further stimulus could avoid giving President Trump an economic free kick heading into the election, thereby improving former Vice-President Biden's odds of winning.

Moreover, some Republicans have also raised concerns about the US' fiscal position and stated another batch of support should be guided by the data. This suggests less underlying appetite for another substantial fiscal injection in an environment where *growth rates* are improving.

US BUDGET & GROSS FEDERAL DEBT

(% nominal GDP)



Source: St Louis Fed, CBO, CRFB, Evans & Partners

The potential for renewed market volatility as policy cliffs are navigated, and surge in global money supply on the back of the extraordinary stimulus, supports our bias towards adding gold to portfolios (see "*View from the outer: Gold - the safe haven solution*", 4 May).

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