Demand Shock Gives Way to a Supply Shock

Search of the "V"

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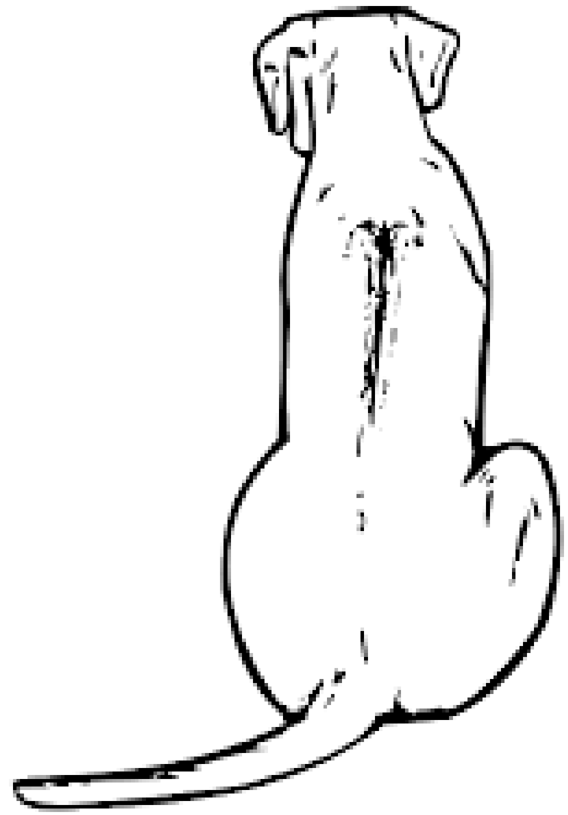
All Data sourced from CEIC unless noted otherwise. Data cut-off 22nd April.



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PARALLEL LINES

This Report will focus on the Four Strands of Analysis that are associated with the Current Pandemic

(i) The Progression of the Virus

(ii) The Policy Responses

(iii) The Impact on Demand Trends

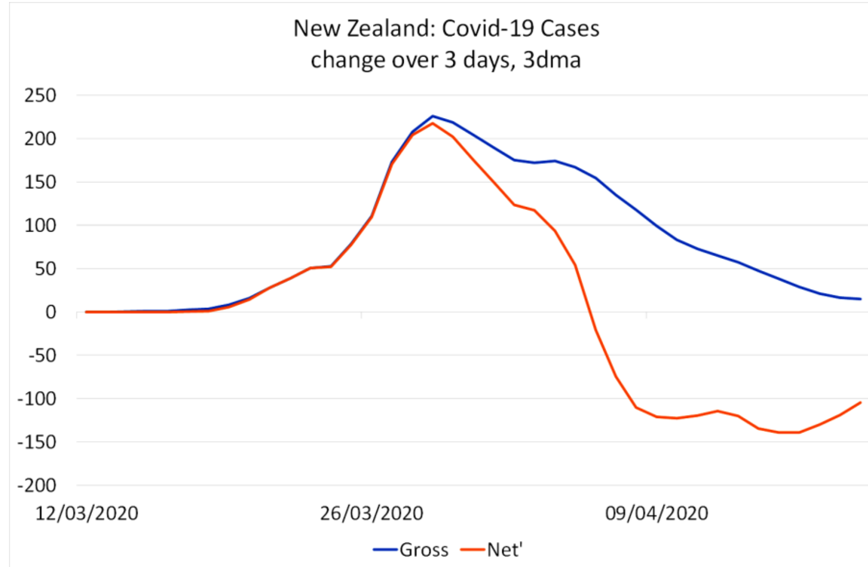
(iv) The Impact on Supply Trends and Inflation

THE VIRUS

- We do not expect an effective vaccine to be developed. The virus is mutating and is in any case a nasty mix of SARS, HIV and a Bat-derived Corona Virus.
- The more likely outcome is a better treatment of symptoms.
- Countries have in general adopted one of three responses.
- The first strategy involved an instant lock down before the absolute numbers of infected people rose. These countries stayed on ‘linear time’ before the infection rates went exponential, they enforced lock downs, heavy tracking & tracing and testing, although many tests deliver a lot of false negatives. Civil liberties were in effect suspended. Many closed their borders, or insisted on strict quarantines.
- These countries may succeed in eradicating the disease within their borders but they will have no ‘herd immunity’ and may have to wait for the rest of the World to ‘catch up’ before they can open their borders.

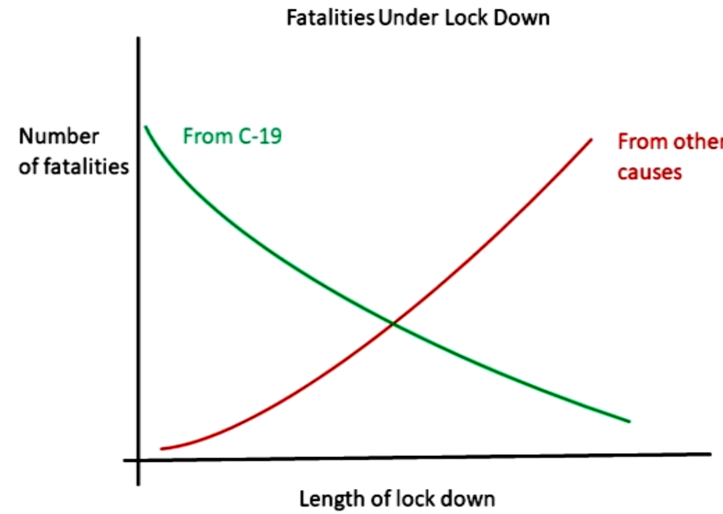
ISOLATION: WORKS IN NZ

- The go-early / go-hard isolation strategy has worked in Australasia, Taiwan and a modest number of other countries.
- However, these are special case economies that are either geographically isolated or 'scared' by their experiences with SARS.
- NZ estimates that it can soon re-open 90% of its economy but that any international travel / tourism is a year or more away.
- NZ is not a template for the USA or Europe.



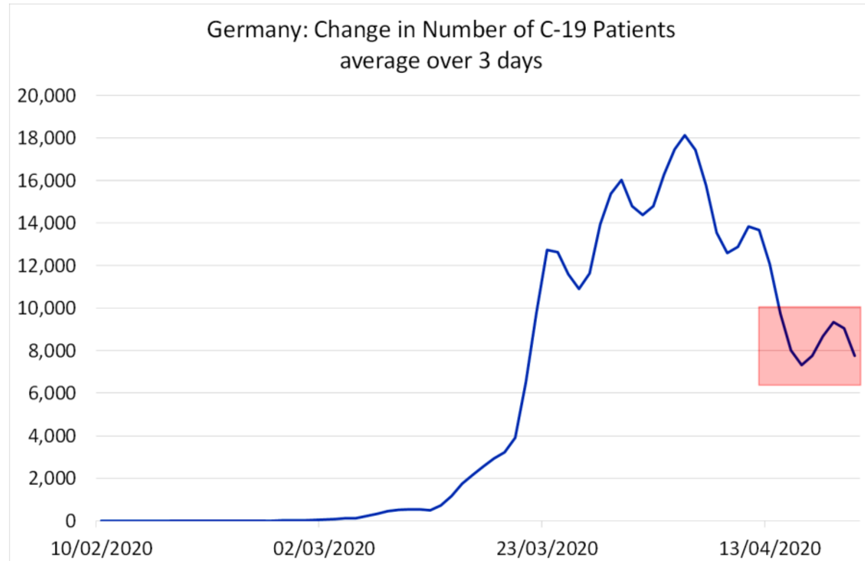
ANOTHER STRATEGY: MANAGE R0

- Much of the Northern Hemisphere was slow to react, under prepared, and as a result the infection curve was already exponential when they locked down in order to protect their health services.
- When they locked down, their R0's were between 3.5 and 5.0 – a frightening place on the exponential part of their curves.
- The lock downs are now bringing R0 back towards unity.
- They need to be below one to eradicate the disease but the potential loss of life from the lockdowns (caused by other diseases going untreated and the effects of the economic crises) are starting to match the C-19 casualties. Pressure to re-open is mounting



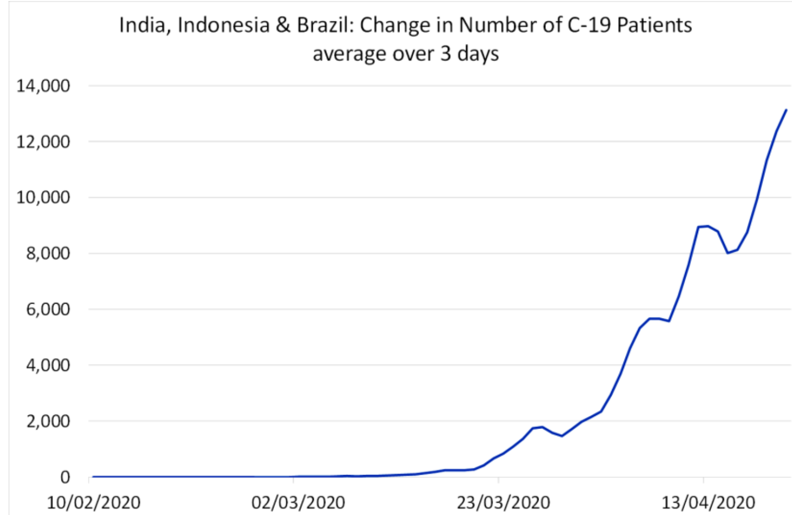
CAT AND MOUSE WITH R0

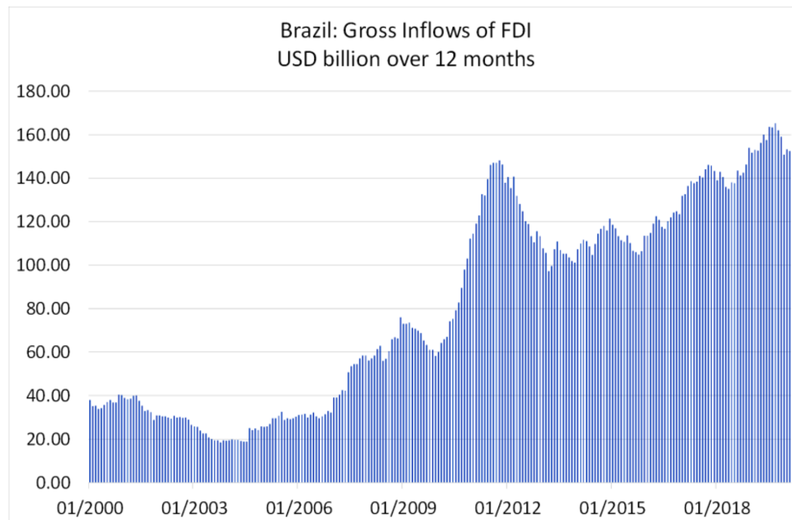
- Looking ahead, these countries will endeavour to keep R0 close to unity or below through continued social distancing, continuing restrictions on people's lives, and greater tracking / tracing and surveillance.
- There will be waves of good & bad news but for the economies to return to normal will take years, unless a vaccine is found…



OPTION III: LET FATE TAKE ITS COURSE

- Many of the more populous EM cannot lock down from a practical point of view.
- They may not have health services to protect and cannot afford to close their economies.
- They have to pursue Herd Immunity (default) strategies.
- This implies that the Human Race will have to live alongside Covid-19 for several years.
- Travel will not return to normal quickly and companies will need to adjust supply chains for the implied uncertainty.





THE STAGES OF POLICY RESPONSE

The initial ‘hit’ to the economies was a circa 10-15% of GDP drop in Aggregate Demand

- **Stage One:** Save the Banks, Guarantee Deposits.

- **Stage Two:** Intermediate Funds From the Banking System to Domestic Companies and Households in Difficulty.

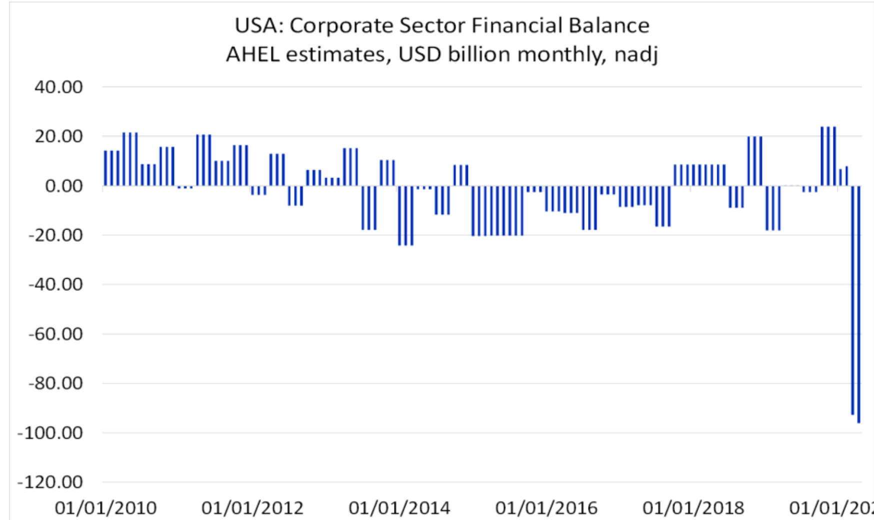
- **Stage Three:** Support Global Credit Markets, particularly for the EM

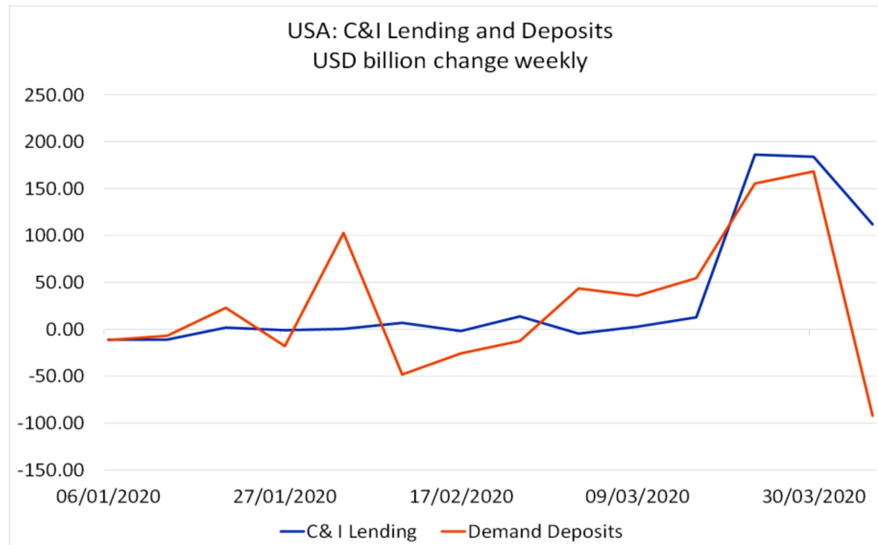
- **Stage Four:** Provide support for Aggregate Demand once conditions allow people to return to work.

TBC

STAGE TWO FAILURES

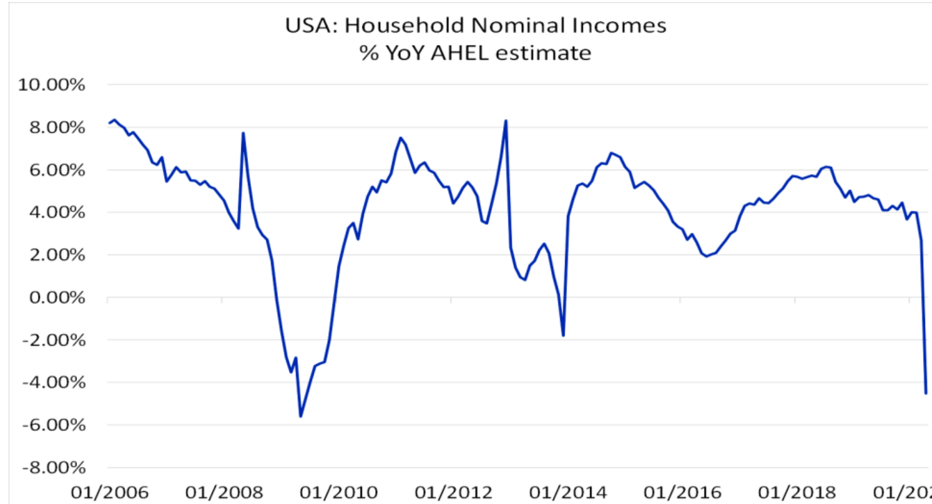
- Many companies entered the Covid Crisis with existing cash flow deficits.
- These have deteriorated significantly as demand has fallen away.
- If companies cannot finance these enlarged deficits, they have to reduce their costs by closing capacity and cutting employment.
- We estimated that the US 'with ample credit' would see unemployment rise to 9%, but if there was insufficient credit we estimated 17%.

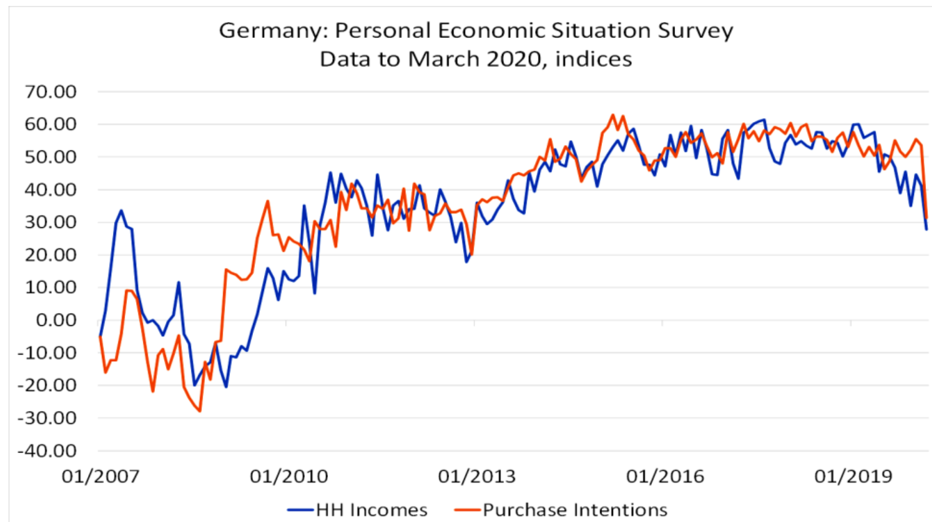




MARKET DOESN'T WORK DURING NON ECONOMIC SHOCK

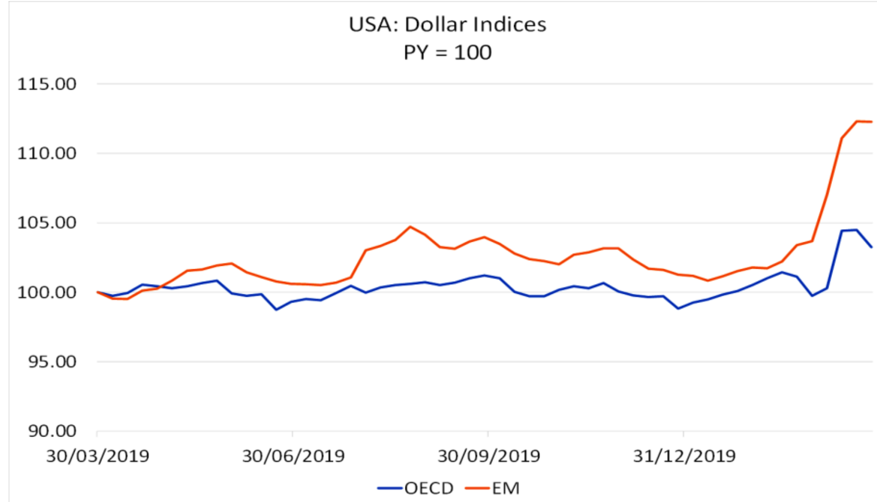
- The US has relied on its market system to fund the corporate sector, but the funds that were advanced were often hoarded where they were not needed, the banks became gummed up and austerity has been forced on companies.
- Other countries have attempted more mixed strategies and have generally witnessed less pressure, but the corporate funding issues have resulted in a compromised supply side and 'second round effect' falls in incomes.

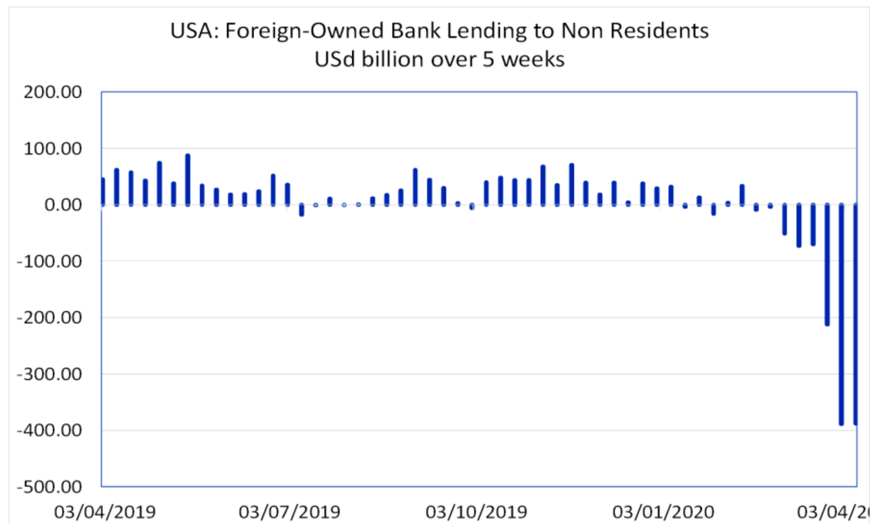




STAGE III: CRISIS AVOIDED, MAYBE

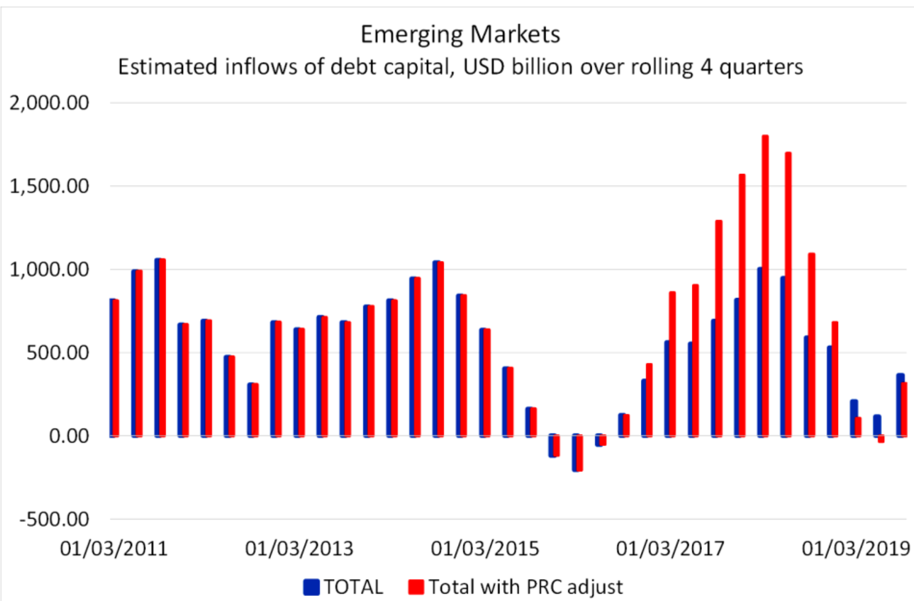
- The Fed's Swap Lines and Repo arrangements prevented a Global Financial Crisis in late March.
- But, the credit markets are not re-opening to new business and many EM need both new financing and the ability to roll-over existing debts.

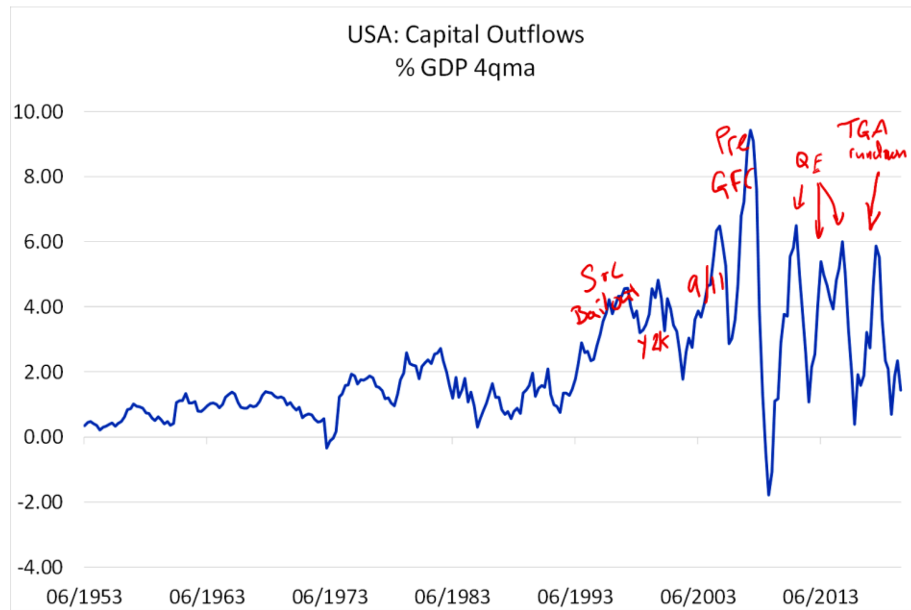




STAGE III: THE DOLLAR STANDARD UNDER STRESS

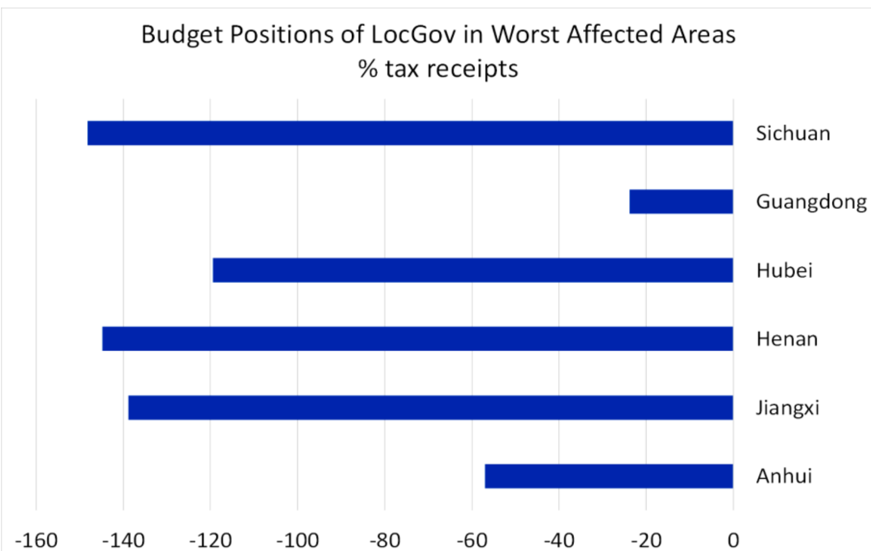
- The EM Countries became addicted to borrowing dollars as the US exported capital, often via EZ and Japanese intermediaries.
- The EM are now addicted to these flows but will they be forthcoming?
- If they are not, then the countries' economic response to the crisis will be limited by their BoP.





STAGE III IN PRACTICE: THE CHINA PROBLEM

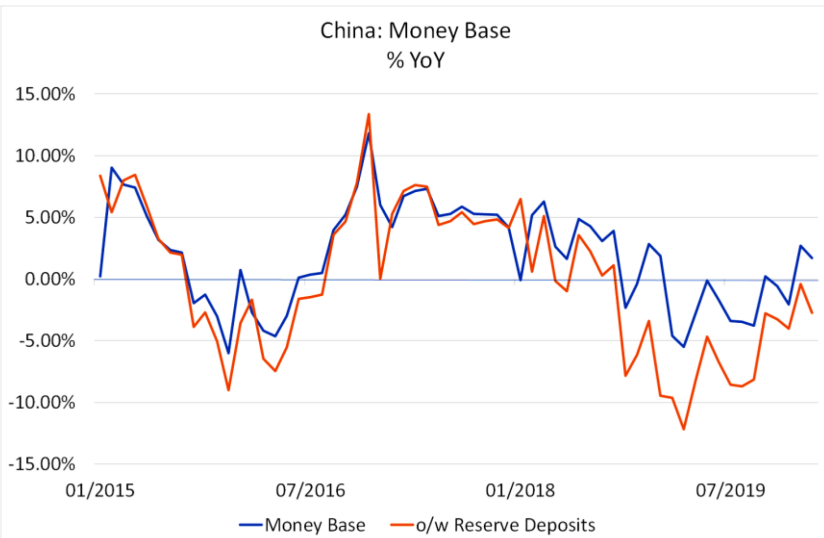
- We estimate – conservatively – that China's banks need to mobilize $2.5 trillion of new credit this year in order to fund the country's various deficits.
- Unfortunately, China's banks cannot fund the required credit growth from their deposit bases.
- In fact, they are already 'short' $2.5 trillion dollars that they used to fund 2017's excesses.
- China needs a massive injection of dollars.



NB: data used in these charts is very conservative

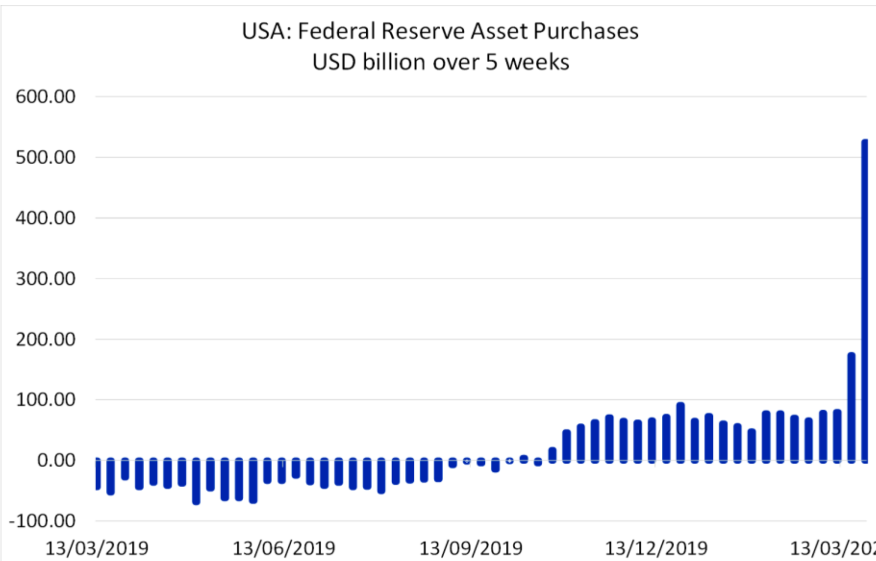
CHINA: A MULTIYEAR WORK OUT

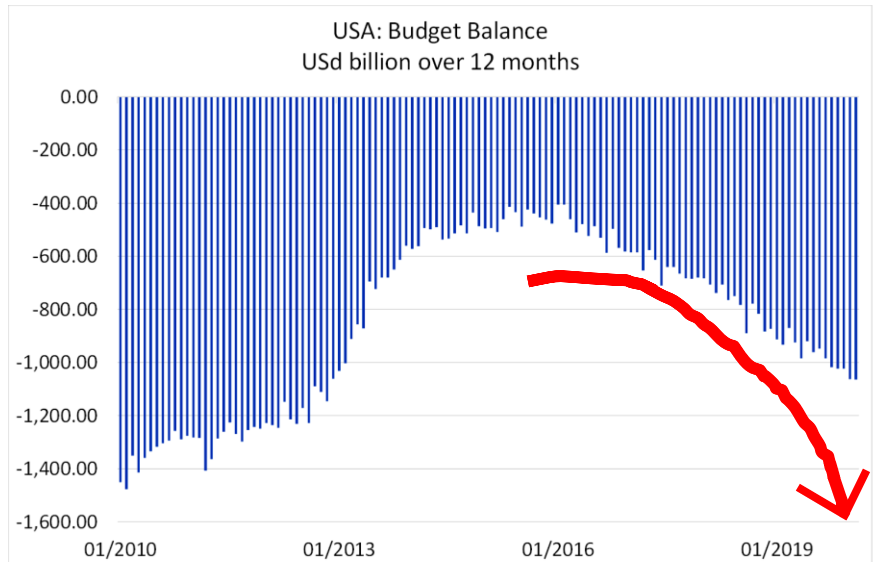
- If China does not succeed in borrowing dollars, and protects the RMB (as we think it must), then we can expect a multiyear slump as the country attempts to crunch its imports in order to produce the trade surpluses that will be necessary in order to repay its dollar debts.
- This Euro-like scenario will depress global growth for several years (China is almost 20% of Global Import Demand).



STAGE IV RESPONSE: MMT

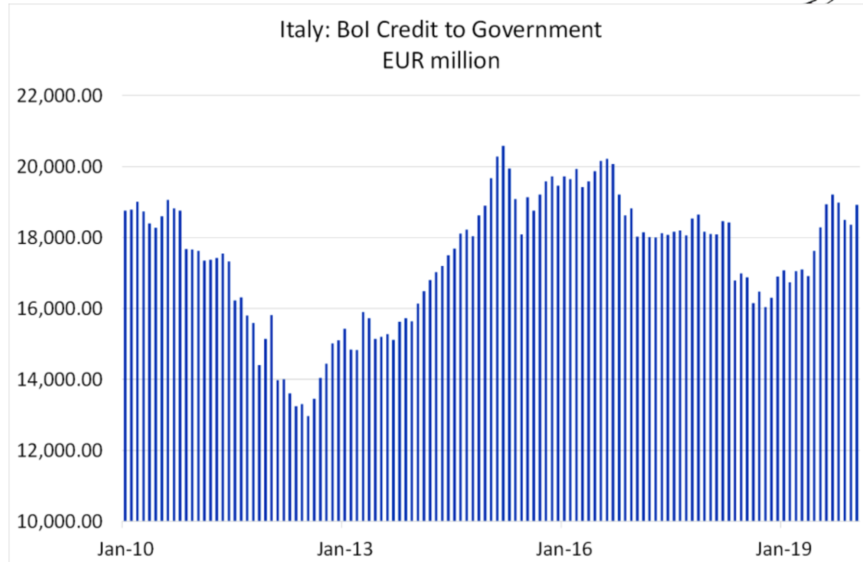
- The final stage of the policy response, which may not 'kick in' until after the lockdowns are eased, will be fully monetized fiscal expansions.
- With no debate or discussion, MMT has arrived.

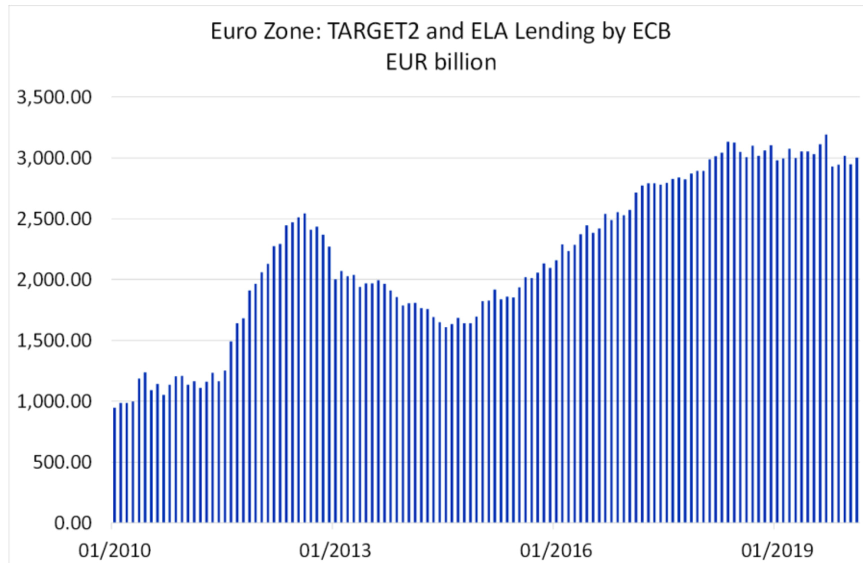




STAGE IV: CAN THE EZ DO MMT?

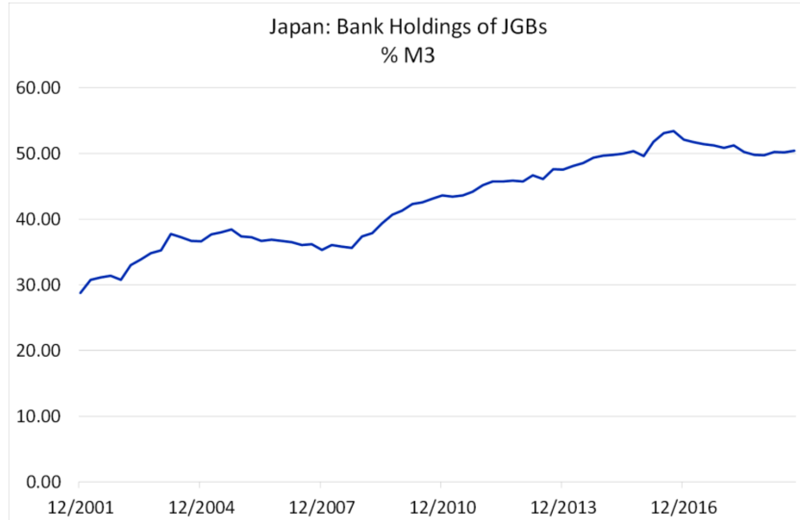
- Legally, the answer is no.
- To do so would require a referendum in Germany.
- Italy and Spain may however be obliged to monetize their own deficits.
- At this point, either the countries introduce capital controls or ‘fall’ on to TARGET2 to finance them off-balance sheet.
- The second route will impose a massive “negative rate tax” on the German banking system.
- The EZ faces an existential crisis and capital controls are possible – wither the EUR?

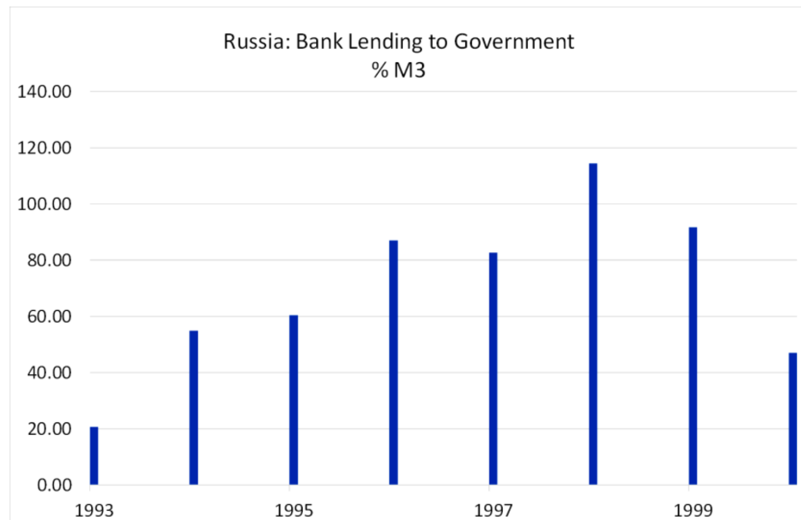




STAGE IV: CAN JAPAN DO MMT?

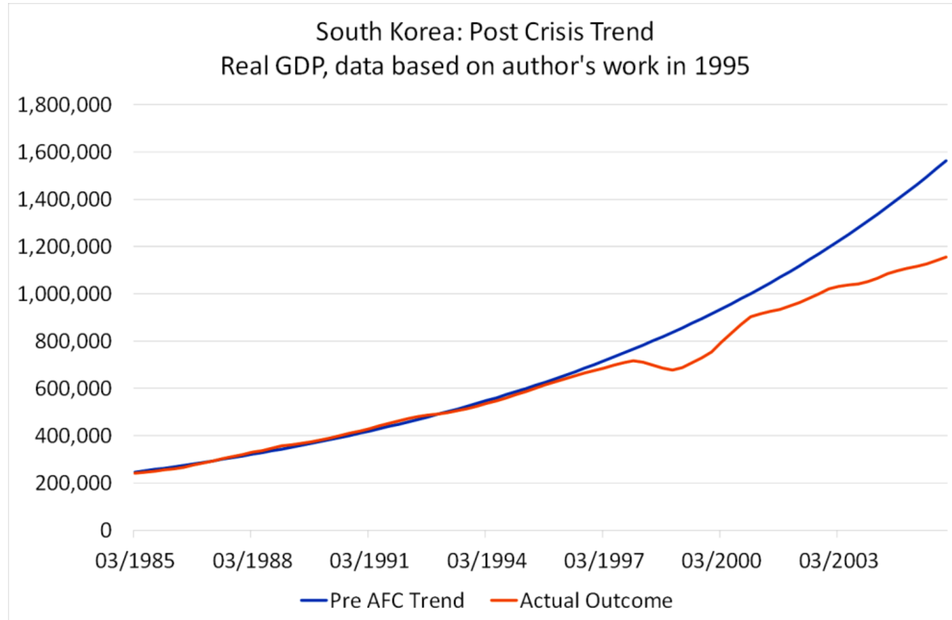
- Japan has been practising MMT for a decade.
- Japan's cash flow positive private sector has less need of assistance.
- But, Government Debt is High and already 50% of the Broad Money Supply is backed by unproductive public debt.
- Taking this ratio further would be a gamble with the Demand for Money & Financial Stability.
- We expect the BoJ to act sparingly; there may also be a shortage of JPY.





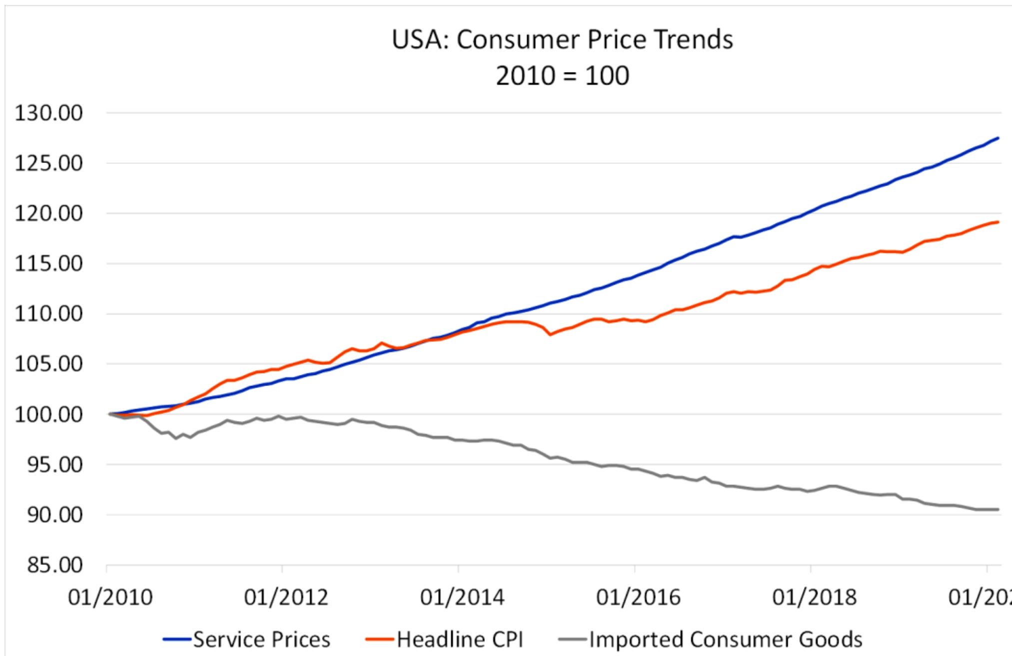
HAS SUPPLY BEEN COMPROMISED?

- Will re-shoring raise costs and reduce quantities of goods?
- Will people return to work or will they need a “virus wage premium”
- How much capacity has been destroyed
- Will restrictions on movement & work remain?
- Country’s trend GDP has been reduced, their output gaps have been re-set.
- We saw this first-hand after the GFC and certainly following the Asian Crisis.



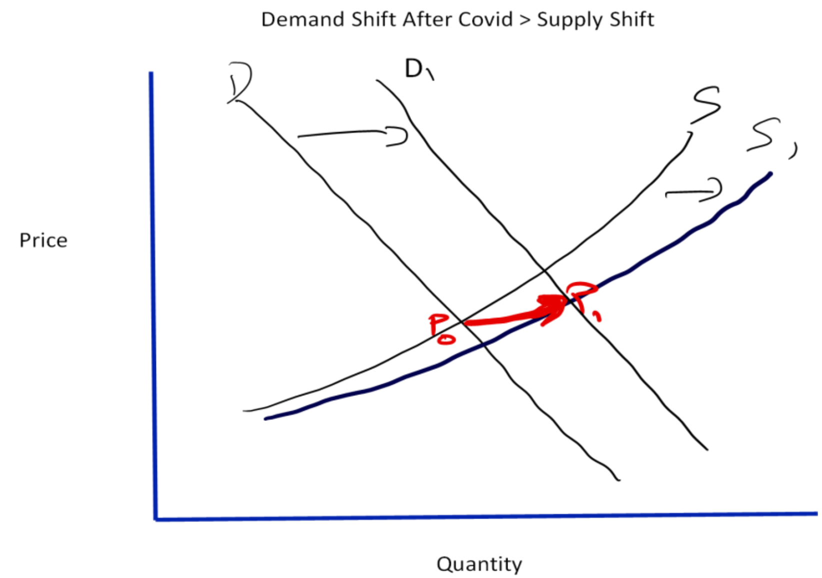
AFTER COVID INFLATION WILL BE RESULT OF TWO STORIES

- In order to forecast Inflation After Covid, we need to look separately at the Services & Goods Markets.
- ‘Goldilocks’ was Always Schizophrenic….



SERVICES: HIGHER UNEMPLOYMENT BUT INFLATION POSSIBLE?

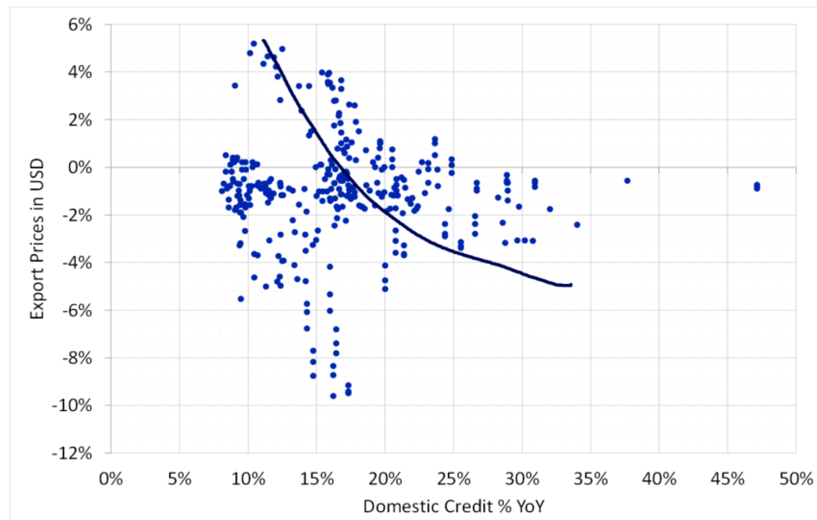
- Could Demand rise by more than Supply in the Post Covid World?
- Phillips Curves will have shifted and restrictions may remain in place.
- We may have fewer deflationary disruptors in a corporate credit crunch world.
- We may also have higher taxes….
- Ultimately we can expect service sector deflation (and property price deflation) but this may take some years to unfold.
- Even in Japan, deflation was not immediate



A WORLD WITHOUT CHINA

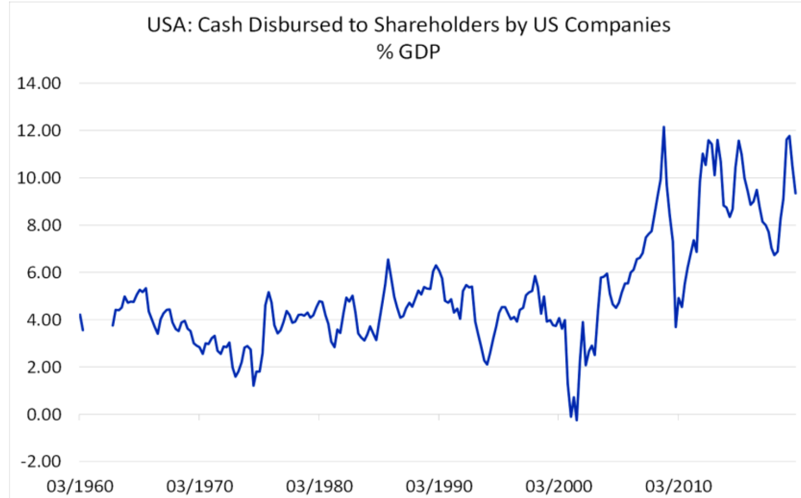
- Meanwhile, re-shoring, probable political friction, tariffs and credit problems in China all argue for higher goods prices….

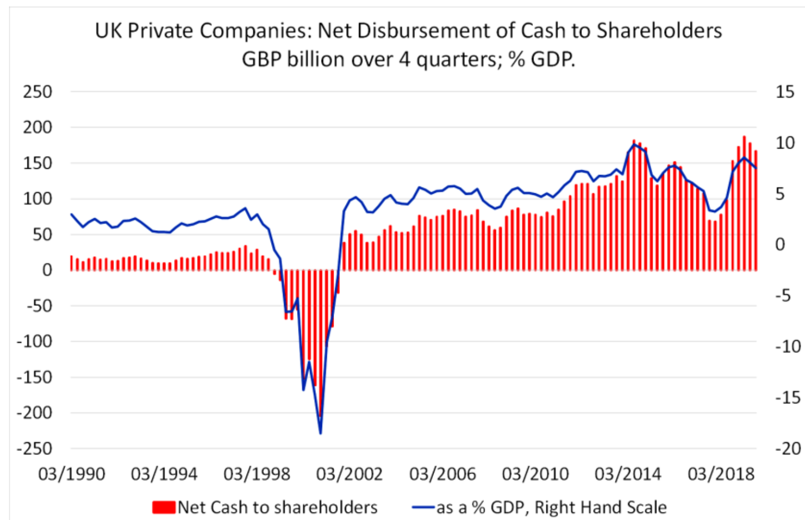
China Export Prices & Credit



FINALLY, AN AC WORLD WITHOUT ZAITECH?

- In the Post Covid-19 world, corporate debt will be higher and corporate credit supply likely constrained as a result.
- The ability of companies to issue debt in order to buy in their equity may be compromised?
- We estimate that the S&P without Zaitech would have a likely level of 1700. (The Price / Cash Disbursement Ratio is remarkably stable.)
- Other markets would also feel the effects of a change in the 'shareholder culture' back to more typical historical norms.





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