

V, U, W, L: Which shape will the recovery take?



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*“It’s a recession when your neighbour loses his job;
it’s a depression when you lose yours.”*

So said President Harry Truman after World War II – and it holds true in 2020, as the coronavirus triggers an economic crisis not seen since before his time.

The global economy is expected to contract by 3 per cent this calendar year¹, though some market economists expect it to be more. Unemployment is soaring. Businesses are closing. The only question is whether it’s a recession, a depression or something completely new to economics - a hiber-cession.

But what about the recovery? When will it come and what will it look like?

Emerging from a severe economic downturn isn’t a predictable event, particularly when the shock hits both the demand and supply sides of the economy. That’s what makes the 2020 economic crisis different from most others since World War II. It also makes predicting the path to recovery much tougher.

On the supply side, the shut-down of thousands of factories across China and the rest of Asia – and the closure of borders – stopped the production and distribution of goods. The supply of finished goods was halted, along with the parts that go into other manufactured products. For example, most of the glass used in Australian buildings is manufactured in China. With production and distribution halted, local builders can’t get glass.

On the demand side, it is self-evident that individuals and businesses are not spending money on a range of normal activities – from air travel and tourism to eating out, shopping in malls and buying new whitegoods and TVs. There are exceptions. Telecommunication companies, do-it-yourself retailers and supermarkets have all reported strong revenue growth.

The double shock has hit all economies hard.

Most recessions occur on the demand side. People and businesses cut back their spending. In these classical cases, the government uses fiscal or wages policy, and/or the central bank uses monetary policy, to boost demand.

But how do governments and regulators kick-start economies when both the supply and demand sides are hit? That's the US\$9 trillion question. (US\$9 trillion is what the International Monetary Fund expects to be wiped off the international economy over the next couple of years).

There are three, possibly four, trajectories that the economy could take, though admittedly there are variations within each.

V-shaped recovery

A V-shaped recovery is when economic growth plunges and then soars almost as soon as it hits the bottom. This is a possibility if you don't think there's much structural change in global economies as a result of COVID-19.

In this case the health crisis is more akin to a natural disaster – such as the recent bushfires in eastern Australia on a bigger scale. Once the health crisis is over people get back to work. There's pent-up demand among consumers and businesses, and everyone starts spending again. A V-shaped recovery can only occur if Australia's big trading partners – China, Japan, South Korea – power through and keep buying commodities.

This argument received a significant fillip from the IMF which said the Australian economy would shrink 6.7 per cent this calendar year and then rebound by almost as much next year. The United States, the Euro area and emerging and developing Asia will all follow similar trajectories, the IMF forecasts.

The IMF says COVID-19 will trigger a 3 per cent contraction across the globe in 2020 – much sharper than the 2008-09 financial crisis. Based on the pandemic fading and social distancing being unwound in the second half of this calendar year, the IMF expects the global economy to grow 5.8 per cent in 2021, led by China.

The argument for the V-shaped recovery is also aided by history. Recessions in the US in 2001, 1990 and after the oil crisis of 1973, all ended up in V-shaped recoveries. But those recessions were either demand side, or in the case of the oil shock, supply side-induced recessions – not both.

L-shaped recovery

It is a bit of a misnomer to suggest an L-shaped recovery is a recovery. It's more like a floor. Activity takes years to return to trend levels. This will occur if infection levels continue to climb, death tolls keeps rising, and there is a protracted period of rolling lockdowns.

An L-shaped recovery is not a likely scenario, given the trajectory of the disease in nations that got hit first. The province of Wuhan in China is re-opening. So are nations in Europe that were hit earliest and hardest.

It is possible some emerging markets will experience an L-shaped recovery – particularly those without adequate health resources to handle the virus, government finances to cushion the economic hit or exports to earn income from offshore.

U-shaped recovery

A U-shaped recovery is a more likely growth trajectory. As economies fall into recession they will take a couple of quarters to begin growing again after bottoming out. Governments will gradually relax social distancing rules – and economies will slowly begin to re-open – but businesses may still be reluctant to employ and train new people. Individuals and businesses may remain gun-shy and take longer to start spending and investing.

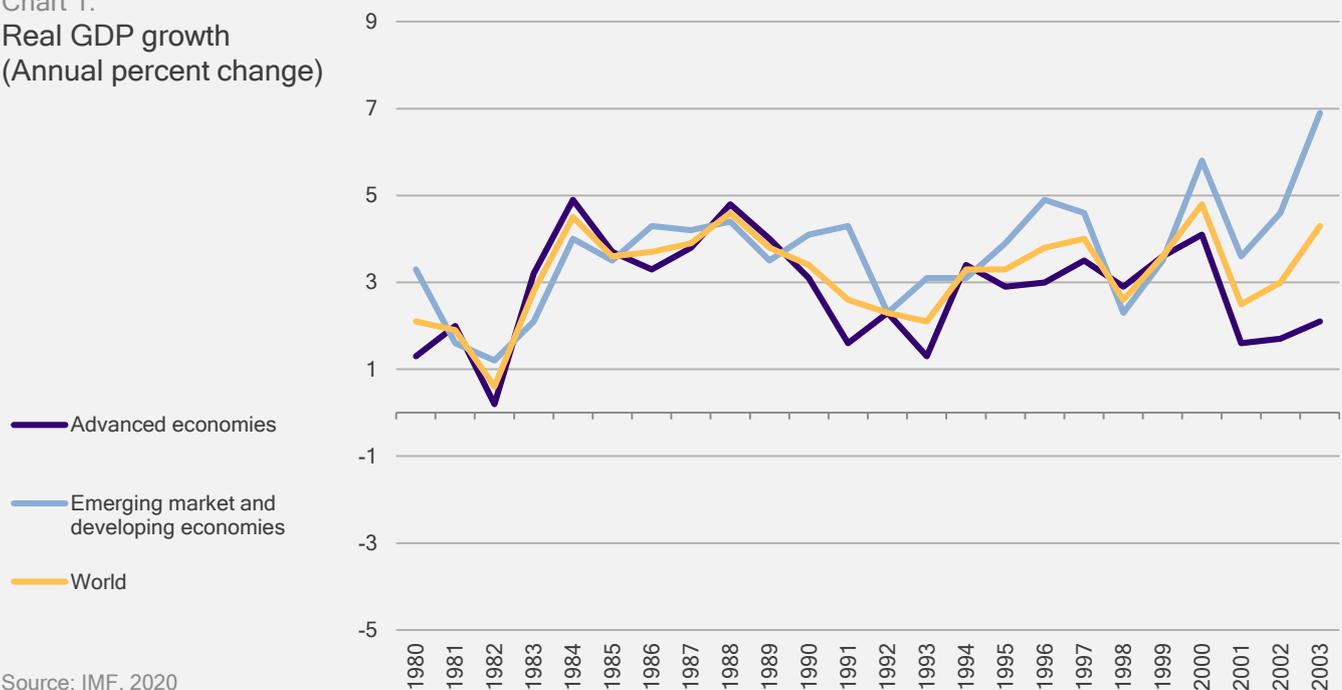
Re-opening of the economy is likely to occur in stages. School may be first to open, while overseas travel will likely be last. The full economy won't be firing on all cylinders for many quarters – it will stutter forward before picking up consistent momentum.

Unemployment is likely to be a prime concern for a long period because many companies will use the COVID-19 to restructure operations and in some cases reduce workforces. There will still be jobs available, but they may be different, or take longer to re-emerge.

Key to whether the economy experiences a V or U-shaped recovery is the damage inflicted on corporate balance sheets. The more damaged, the longer it will take to see a rise in corporate profits and employment. Investors will try to anticipate the eventual recovery but the slow pace will likely lead to ongoing volatility in financial markets.

Australia's relatively high household debt also augurs against a quick rebound. In a market where a person's home is his castle, and house prices are high, there isn't much left in the bank for tough times.

Chart 1.
Real GDP growth
(Annual percent change)



Source: IMF, 2020

W-shaped recovery

This style of recovery is sometimes called a double-dip recession. As lockdowns are eased, activity picks up – but the effects of high unemployment and corporate bankruptcies kick in and the economy slides back into recession. In the worst case – as has happened in some Asian economies – the coronavirus gets a new life, infections start to rise again, lockdowns are put back in place and the economy goes backwards.

The risk of a W-shaped recovery is why lockdowns are likely to last longer than many individuals and businesses think necessary. They are very damaging to confidence and ultimately exact the highest economic cost.

The 1980 US recession, bought on by sharply higher oil prices, is an example of a W-shaped recovery. The world's biggest economy recovered and then went back into recession in 1981.

Why the RBA and federal government will determine the recovery

The shape of the recovery will depend primarily on how and when governments remove restrictions; interest rates and other monetary policy measures; and assistance packages. Certainly, no-one has been shy about using monetary and fiscal policy (with the possible exception of the Euro zone).

The Reserve Bank of Australia's response was swift, and seemingly long term. By targeting yields on three-year government bonds, the RBA has extended its direct control further out along the yield curve than ever before and better anchored yields across semi-government and corporate debt.

Strictly speaking, targeting yields on three-year government bonds is not quantitative easing because a price, not a quantity, is being targeted. But the mechanics are the same. By operating in the secondary market to purchase government bonds, the Reserve Bank is pushing money into the system.

The central bank has also made clear it will keep capping the three-year yield until it begins achieving its legislated charter of heading towards full employment and its stated inflation target. The Reserve Bank has said it will wind back non-conventional policies first, so the official cash rate won't change until after the central bank removes its yield target.

This has the dual effect of putting money into the economy while anchoring yields for corporate debt at lower levels than otherwise. While spreads between government bonds and corporate debt can blow out, the starting point is still lower. So corporate borrowers will continue enjoying lower interest payments than they otherwise would have faced.

The Reserve Bank has also set up a term funding facility (TFF). Its objective is to lower funding costs for the entire banking system, which will flow through to the costs of credit to households and business. This facility provides an incentive for banks to lend to business – especially small and medium businesses – at discounted rates.

The funding from the TFF is at a fixed interest rate of 0.25 per cent for three years. That's much cheaper money for the banks than available else.

The Reserve Bank has made clear it doesn't expect rates to rise anytime soon and inflation is not part of its central case scenario in the foreseeable future. As a result, while it has lowered the starting point for the yield curve, the risk of any near-term back-up in yields appears remote. Japan and Europe have never emerged from their zero rates and the US took almost seven years – so it may be mid-decade before we see a rate hike.

Investors agree. Measures of inflationary expectations in Australia, the US and Europe are near record lows. These certainly are extraordinary times when so much government spending doesn't trigger inflationary fears. Modern Monetary Theory appears to be accurate when it says inflation is not a money supply issue but an excess of real demand over real supply in the economy.

The effect is that during the next few quarters government bonds – which always provide ballast in a portfolio – may not underperform as much as expected when economic recovery gains traction. We continue to believe massive excess savings will keep real yields very low, providing support for nominal bonds even at these historically low levels.

On the fiscal side, the Morrison government will spend beyond \$200 billion paying wages and providing pay-as-you-go tax refunds to businesses as part of its support packages. The goal is simple: keep people in jobs and keep businesses operating. If the government is successful, households will spend, businesses will invest and the eventual recovery will be somewhere between a U and V-shaped.

Public debt in Australia is low compared to governments around the world. Ahead of COVID-19 spending net debt was forecast this financial year to be \$361 billion, or 18 per cent of GDP. This is low and a dividend from nearly 30 years of growth and fiscally conservative budget policy.

The banks, which ANZ chief executive Shayne Elliott called the intensive care unit of the economy, were in good financial shape entering the COVID-19 crisis. Tightened lending standards over the past five years improved the quality of bank assets. The banks' liquidity position was stronger than previously. Slower credit growth meant they didn't need to issue much debt immediately ahead of the COVID-19 outbreak.

Also, much of the corporate sector had relatively low levels of gearing and most have significant liquid assets which will help them manage the downturn.

The signs to look out for

Keep an eye on the real economy, not just financial markets. Look out for when businesses start to re-open – and probably more importantly – which ones re-open first.

This doesn't refer to government rules. It's about management decisions. Many travel agents, for example, will simply never open their doors again. Some franchisees, regional newspapers, cafes and restaurants won't be seen again. Management in professional services and education will take this opportunity to rethink their business models, with an eye on efficiency.

Perhaps the most unpredictable industry is the airline sector. Cruelled by travel bans offshore and internally, all major airlines are suffering. The Australian government says it wants a duopoly in the air. Why? Because a lack of competition in that sector, in a country the size of Australia, would lead to much higher prices. But how do you ensure sustainability? Which routes will airlines start flying again and which will they abandon?

Some sectors of the economy – notably mining, parts of agriculture and manufacturing, supermarkets and healthcare – have withstood the crisis well. It would be a concern if any of these sectors felt second-round effects and started to stand down staff and reduce production.

Are people still building homes? Are the malls around the country filling up again once the government restrictions start being lifted? Is small business re-opening?

This latter question is important. The sector employs almost five million people, or two out of every five working Australians. It is why the federal government is ploughing so much money into its JobKeeper package and other support measures for the sector.

Unemployment is critical. People without jobs don't spend money. If the unemployment rate hits 10 per cent, which is probable, then how fast does it drop again? Are people finding full-time work or part-time work? This economic crisis will have a lasting legacy for the employment market. Many over 50-year old workers made redundant may never work again. The career path of school leavers and university graduates will change.

Conclusion

Unemployment holds the key to the shape and speed of any recovery. If people can find jobs again relatively easily, they will spend again. If the JobKeeper package in Australia saves people from losing their employment, then it's done its job of averting the greatest ongoing cost of the crisis.

Employment is also critical to fixed income markets. The Reserve Bank charter says its goal is full employment and keeping prices in check. Only when the central bank sees that happening is it likely to pull back from capping three-year bond rates and eventually lifting the cash rate. There are no indications the central bank is in any hurry to do that.

The search for yield will soon resume as Australians – like so many citizens of developed economies – get used to a world with rates stuck at the lower bound.

It is a world where there are still good reasons to own bonds.



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