

LAZARD
FRÈRES GESTION

ECONOMIC AND MARKET OUTLOOK

September 2020



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While post-lockdown economic recovery has been brisk, the full impact of the crisis has yet to unfold. However, the massive monetary and fiscal policy response should enable business to return to pre-COVID levels by the end of 2021. Financial markets are facing extraordinary economic circumstances, but the equally extraordinary liquidity injections should reduce the risk of tight financial conditions and declines in risky assets. With the sharp fall in US long-term interest rates and the fall in the risk-free rate, the riskier alternatives, such as equities and credit, continue to offer attractive additional yield.

ECONOMIC OUTLOOK

AN UNPREDICTABLE EPIDEMIC BUT A RETURN TO FULL LOCKDOWN UNLIKELY

Nearly nine months after COVID-19 first appeared in China, the pandemic is still spreading. However, the global situation is masking disparities across continents. The emergence from lockdown is bringing with it a resurgence of the pandemic in Europe, and the pandemic is progressing in Asia, especially in India. Meanwhile, Europe is facing a second wave while Africa and Oceania remain relatively unscathed.

Although each continent's pandemic experience has been very different, lockdown measures have been relaxed almost everywhere. Some restrictions have been tightened in the United States and Europe, but the measures are now targeted and localised. As long as the disconnection between the number of new cases and deaths continues and the pressure on the hospital system is not too strong, a return to massive lockdown in Europe seems unlikely.

This approach is all the more likely given that progress on the vaccine front is faster than expected. Several candidates have already entered the final phase of pre-marketing clinical trials, and the US Food and Drug Administration (FDA) has paved the way for fast-track approval before the end of the trials. US and European pharmaceutical companies are gearing up for significant production volumes next year.

Figure 1
COVID-19: new cases per million of population (weekly average)
Source: European Centre for Disease Prevention and Control

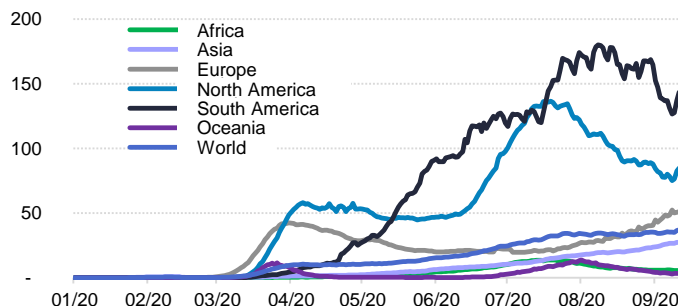
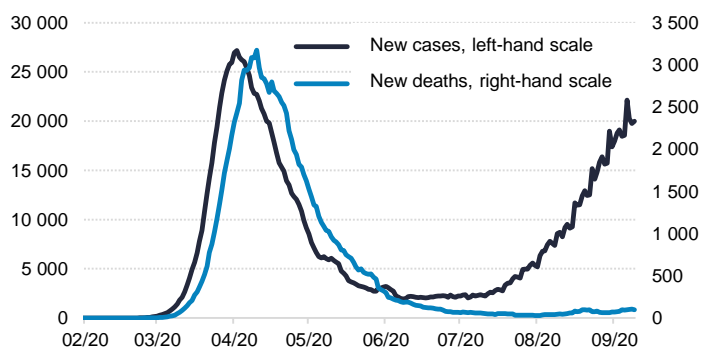


Figure 2
COVID-19: new cases and new deaths in the eurozone (weekly average)
Source: European Centre for Disease Prevention and Control



ECONOMIC OUTLOOK

BRISK POST-LOCKDOWN REBOUND

The post-lockdown rebound is occurring at a faster and stronger rate than consensus expectations. Surveys show a marked rebound over the last three months in both developed and emerging markets. However, following such an extraordinary period, it is difficult to equate this survey data to any precise growth rate.

While there is real momentum driving the recovery, the pace of upturn is uneven. Generally speaking, and as can be seen in the United States, while total consumption is in decline, the same cannot be said for all its components. The consumption of goods has in fact rebounded, and that of consumer durables in particular. In contrast, spending on services, a major component of total consumption, still falls short of previous highs.

In France, certain sectors are recovering rapidly, with consumer durables even benefitting from a catch-up effect. Latest INSEE estimates show activity for July reaching 95% of normal levels.

In Europe, as things stand, it looks very likely that the economy will return to 97% of pre-shutdown levels by the end of the year.

Figure 3
COVID-19: new hospitalisations in France (weekly average)

Source : data.gouv.fr

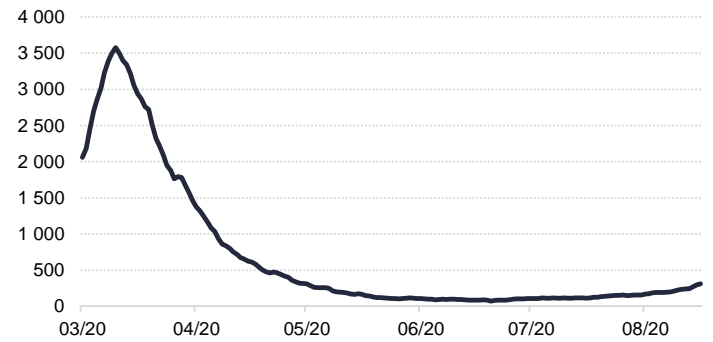
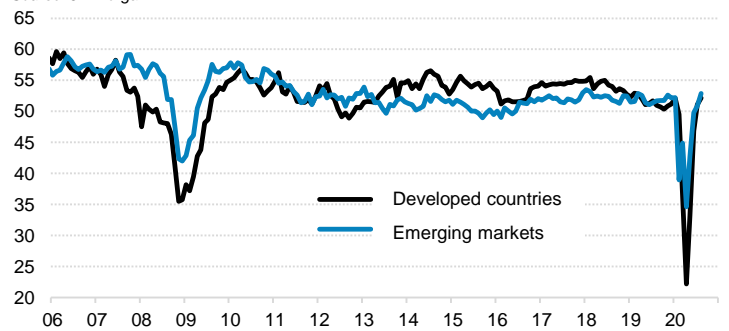


Figure 4
Composite PMI: production component

Source: JP Morgan



LONG-LASTING CRISIS EFFECTS VERSUS CONTINUED MASSIVE ECONOMIC SUPPORT

Even if, by year-end, the economy is running much closer to near-normal levels than to the extraordinary lows experienced in the spring, the year-on-year decline will still be the equivalent of a major recession.

The full impact of the crisis has yet to unfold. Bankruptcy suspensions in many countries are concealing the effect of the crisis on the whole productive apparatus and on the employment situation. In Europe, although short-time working schemes have helped limit the rise in unemployment, the picture continues to worsen despite the economic rebound. In the United States, of the 13.5 million unemployed in August, 6.2 million were classified as temporary layoffs, but they could become permanent.

While the full effect of the crisis remains uncertain, the massive fiscal and monetary response should continue to fuel the recovery. The announcements made by Jerome Powell in Jackson Hole suggest that the FED's supportive monetary stance is here to stay. In addition, the developed world's low interest rate policies are easing the financial burden attached to the ever-higher levels of public debt that are the flipside of implementing fiscal measures on a totally unprecedented scale.

Fiscal tightening remains unlikely in the short term. Instead, support measures are being stepped up, including the extension of short-time working provisions and the introduction of fresh recovery packages. Negotiations for a new support package in the United States are however in stalemate. Although all these support provisions are an unprecedented response to an unprecedented crisis, we could also be shifting towards a paradigm of sustained higher government spending.

All these measures should enable the developed markets to return to their pre-COVID levels by the end of 2021.

Figure 5
United States: household consumption volumes (basis 100 in Dec. 2019)

Source: Bloomberg

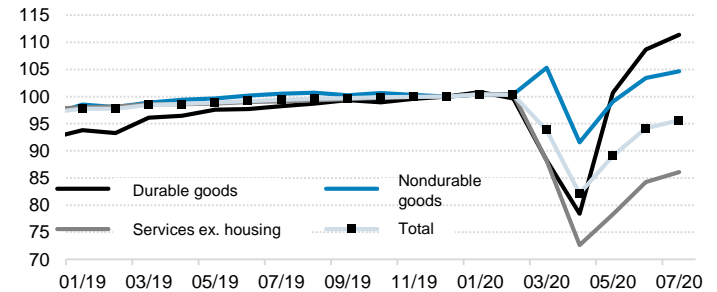


Figure 6
United States: quarterly bankruptcies (thousands)

Source: Bloomberg

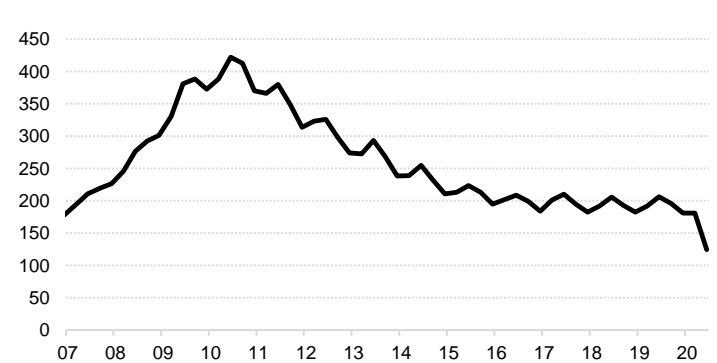


Figure 7
Eurozone: unemployment rate

Source: Bloomberg

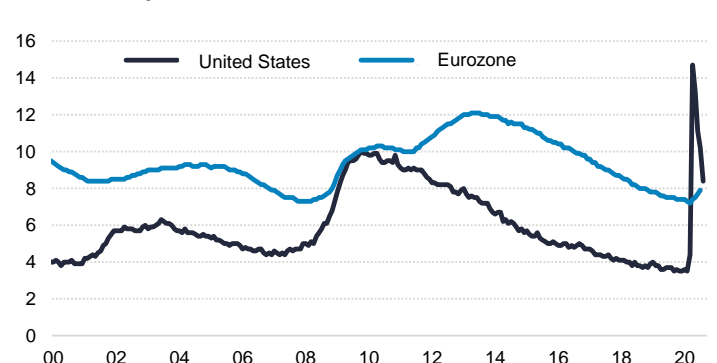
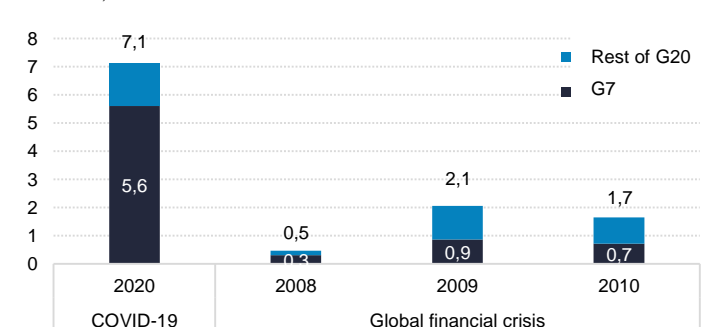


Figure 8
Fiscal provision excluding guarantees and liquidity (% G20 GDP)

Source: IMF, data as of 12 June 2020



MARKET OUTLOOK

HYPERACTIVE BOND BUYING BY CENTRAL BANKS

Monetary policy can be expected to remain accommodative for some time to come. Fed Chair Jerome Powell's statements have pushed expectations of higher interest rates out by over four years. In Europe, the ECB has, via its PEPP, undertaken to continue its sustained pace of asset purchases until the end of June 2021. In the United States, the Fed has not set a limit on its asset purchases.

While short-term rates are expected to remain low, a rise in long-term rates cannot be ruled out. The Fed's policy shift sets a medium-term inflationary bias that the current yield curve does not yet reflect. Nevertheless, if rates were to move off course, the Fed could always resort to yield curve control, not unlike Japan.

In the corporate bond segment, collapsing sovereign rates have resulted in stubbornly high credit spreads. Central banks are now set to target credit conditions via their corporate bond purchases, which will serve to curb the risk of runaway spreads.

Figure 9
Implied US short-term interest rates

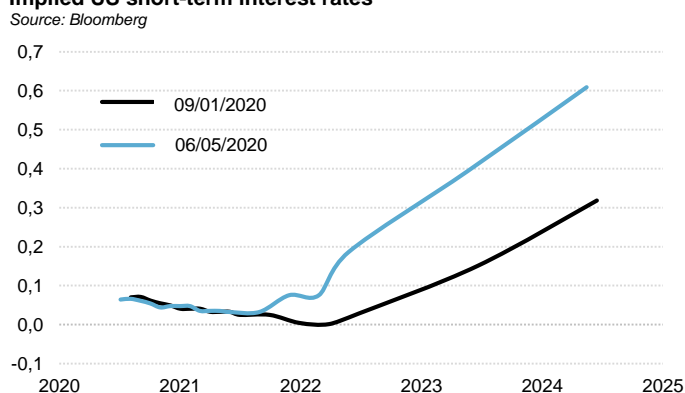


Figure 10
United States: 10-year term premium estimates



Figure 11
Eurozone: private issuer spreads

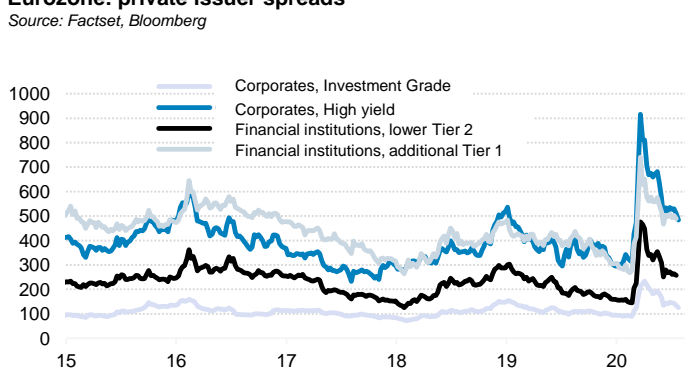
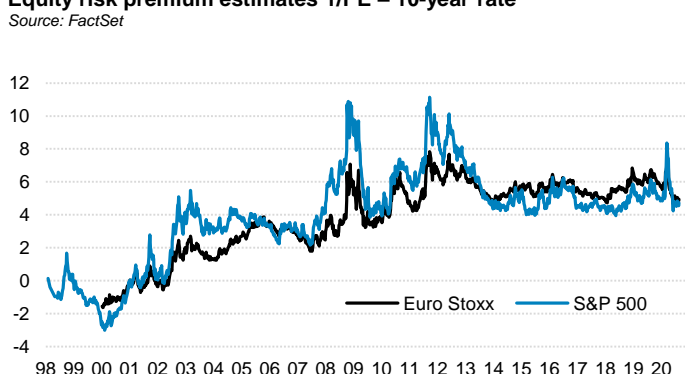


Figure 12
Equity risk premium estimates 1/PE - 10-year rate



UNREASONABLE EQUITY MARKETS?

We believe that the backdrop for equity markets remains favourable. Despite earnings outlooks being revised significantly downwards, falling interest rates mean that the return on equities remains high. Furthermore, the spate of downward revisions is now behind us.

In the short term, attention should be paid to the following risks: weaker economic data (following an extraordinary recovery period); the lack of agreement over a new support package in the United States (the economy may stall); a no-deal Brexit; the US presidential elections (risk of a close election and disputed results); and Sino-US tensions.

However, in the medium term, we believe that equity markets have greater upward potential than other asset classes. Compared with bonds, where central bank action is putting pressure on yields, the return on equities seems more reasonable. Furthermore, the prospect of a vaccine could revitalise the economy and by extension the markets, amid strong fiscal stimulus.

While equity markets are currently trading at high levels, they are coherent with the backdrop of strong fiscal and monetary stimulus and persistently low interest rates. While rising prices would push central banks to raise interest rates, potentially upsetting the current equilibrium, such a scenario is distant. The scale of the measures currently being taken makes central bank rate rises a potential scenario only likely to unfold in the years to come.

Glossary:

INSEE: The National Institute of Statistics and Economic Studies is responsible for the production, analysis and publication of official statistics in France.

ECB: The European Central Bank.

PEPP: The Pandemic Emergency Purchasing Programme, a plan implemented to purchase debt on the markets as a means of lowering financing costs for governments, businesses and households.

FED: The Federal Reserve, the central bank of the United States.

PMI indices: The Purchasing Managers' Index (PMI) summarises confidence levels among business purchasing managers who are surveyed to establish if market conditions are expanding, staying the same or contracting.

Term premium: The additional amount that investors receive for duration risk, which in turn is linked to the average life of the instrument.

PE: The price-to-earnings ratio (PER, or P/E) is a stock market analysis indicator. It is used to value a stock relative to that of similar stocks within the same sector.

Earnings estimates revisions: Often reviewed when something new happens in the company and analysts believe that these changes could affect the company's future earnings. An increase in revised earnings estimates is generally considered an upward sign, while a decrease in revised earnings estimates is considered a downward sign.

Figure 13
Euro Stoxx: net earnings estimates revisions

Source: FactSet



Figure 14
Yield to maturity or equivalent for other asset classes

Source: Factset, Bloomberg

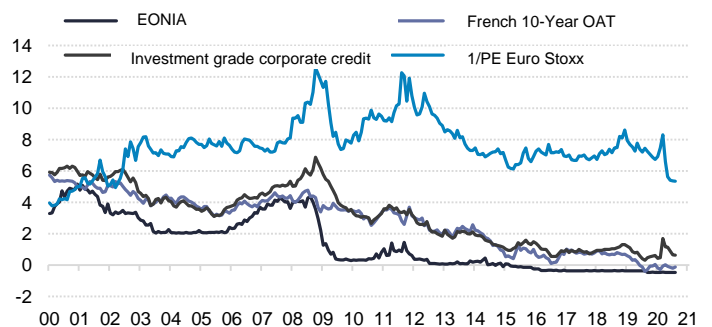
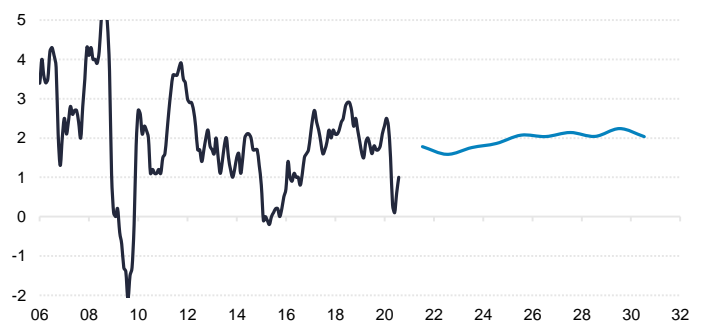


Figure 15
United States: inflation expectations as of 4 September (inflation swaps data)

Source: Bloomberg



The opinion expressed above is dated September 2020 and is liable to change. Latest available data is used.

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