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Research & Strategy Insights

Focus on the swoosh or the push?

Monthly Op-ed

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Key points

- Beyond a mechanical rebound, the world is not experiencing a V-shaped recovery.
- Policy support remains important: Fiscal stimulus in Europe is being extended as the virus re-emerges. Further support has been derailed in the US.
- Federal Reserve monetary support remains robust – though it has to do the work for two. We expect further European Central Bank stimulus in December.
- Credit should outperform government bonds. But the earnings cycle needs to strengthen

Dealing with the "swoosh"

The recent dataflow is consistent with our base case: the world's economy is not experiencing a "V-shape" recovery, but rather is following a "swoosh" trajectory in which after an initial spectacular rebound, growth slows. Focus is again on the supply-side of the economy as more and more regions are imposing "partial lockdowns" which are not as stringent as those experienced in March and April but which are still consistent with significant impairment for some sectors (e.g. hospitality). In turn, this makes the unavoidable demand-side backlash even more problematic. With the labour market outlook deteriorating further, precautionary savings will inevitably hold back consumption.

In such a configuration, a predictable accommodative policy stance is key to sustain confidence. In the US, politics is getting in the way. There, the initial fiscal push was initially very powerful, but this support is fading now as Republicans and Democrats in Congress still don't agree on another emergency package. With the elections coming closer and neither side willing to appear as responsible for the incapacity of the federal government to act at a decisive moment, a deal is always possible, but by construction any medium-term fiscal stimulus will have to wait for the outcome of the elections and next year in practice. We would add that the current political backdrop is made even more unpredictable in the US by the fact that the election result could be contested.

Fortunately, the electoral calendar is light in Europe in 2021. This puts governments in a better position to provide visibility to businesses and households. Germany and France have already unveiled significant stimulus plans for 2021-2022. Still, the sequence set in motion before the summer in Europe is jeopardised. Those medium-term programmes were intended to kick in while the emergency schemes would be gradually phased out. The lingering supply-side restrictions we are seeing now call for those very costly schemes to be prolonged. France announced two weeks ago that its main, part-time unemployment system, which was due to become less generous in October, would be kept unchanged until next summer.

Towards another monetary push

This means that in Europe, monetary policy will have to continue ensuring easy financial conditions for ever more fiscally active governments, while in the US it may have – at least for a while – to be "accommodative for two", i.e. to additionally offset a lack of support from the federal budget. At this stage, in developed economies where interest rates were already very low before the pandemic struck, the capacity of any additional monetary policy stimulus to move the dial is probably very limited. Making fiscal policy possible may well be the most powerful transmission channel for central banks now.

The Federal Reserve (Fed)'s conversion to average inflation targeting which pledges to allow some inflation overshooting in the future is another dovish move which is consistent with "lower for even longer" interest rates, even if the Federal Open Market Committee (FOMC) chose not to announce any "hard" policies (e.g. targeting longer maturities). The latest communication from the European Central Bank (ECB) has been encouraging from this point of view. It is quite clear that the "hawkish noises" perceived by the market in Christine Lagarde's latest press conference have been more than offset by a series of speeches and interviews from other board members who have highlighted the central bank's readiness to act. We continue to expect a time and quantum extension in the Pandemic Emergency Purchase Programme to be announced in December, which will allow a swift absorption of higher government funding needs next year.

So, the market, again, needs to decide what to focus on, either the mounting downward risk to the recovery, which is negative for earnings and pushes corporate default risks up, or the resulting policy push and the liquidity wave that it triggers. So far this year the latter has always won. We are concerned with diminishing returns though: the policy push substitutes public spending to private spending, but it does not necessarily protect business profits.

Earnings and inflation

With that in mind there are two fundamental factors key to the investment outlook: inflation and corporate earnings. While there may be some noise in the monthly inflation data in the months ahead, achieving a period of average inflation in line with central bank targets seems some way off. As suggested above this means central bank policies will remain geared towards higher inflationary expectations while at the same time ensuring interest rates remain low. Government bond yields will remain low for some time and any steepening of yield curves – a traditional signal of economic recovery – will be limited by what many call "financial repression".

Investment returns from government bonds have already flattened in response to the dampening of volatility and this is likely to remain the case for now. There may be limited further opportunities for inflation-linked bonds to perform better if markets start to price in levels of inflation consistent with the resolve of the central banks. Furthermore, we think credit returns will also outperform the risk-free rate, given prevailing credit spreads.

Historically equity market multiples have been in their higher ranges with inflation around current levels. Periods of lower inflation (e.g. below 1%) or higher (above 4%) in the US have been associated with lower price-earnings multiples. In the short-term the risks are probably towards lower inflation, which central banks will continue to address. Lower inflation means less pricing power and reduced earnings capacity. Hence the importance of the central banks' resolve.

What is important for the outlook for equity markets is the level of earnings that are being discounted by ongoing low rates. So far in this recovery, investors have valued the long-term earnings potential of defensive growth sectors like healthcare and technology over cyclical sectors more impacted by the disruption to global growth. Looking at current estimates for S&P500 sectors, forecasts show only a modest upturn in earnings from depressed, below trend levels for sectors such as basic materials, industrials and consumer cyclicals. Any second-wave related set-back to global growth could result in more disappointment on this front. Despite recent volatility and the threat of regulatory and tax hurdles ahead, the resilience of earnings growth and the strong secular story for sectors like technology suggest they could continue to perform relatively well.

Hopefully the earnings cycle picks up before inflation. As forecasts rise, earnings will be discounted at rates that aren't going to move for some time. There could be a sweet spot for cyclical equities in 2021 if the recovery remains on track. Through the noise of the US election and the winter path of the pandemic, the growth data and the trajectory of earnings relative to inflation is key to the investment outlook.

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