



The optimist sees the light at the end of the tunnel and the realist plots the journey there. Today we observe a tunnel in three global dimensions: an immediate public health challenge, a continuing trade war challenge, and a rising environmental challenge. Economics, politics, and markets will interact during this journey and the following themes start to emerge:

1. Public Health Challenge

COVID-19 is developing into a pandemic influenza that we have not seen since the 1918 Spanish flu that lasted for 18 months through three waves resulting in over 50 million deaths (chart 1). A recent simulation called Event201 by Johns Hopkins' Center for Health Security projected a worst-case scenario with 65 million deaths over 18 months with global GDP declining by 11% and lamented massive gaps in preparedness for their simulated generic pandemic.

Reality may turn out more favorably but clearly COVID-19 won't be history by April as some politicians had suggested. German chancellor Merkel is quoting experts who predict that 60% to 70% of Germans could become infected, although the WHO is rating Germany as among the best-prepared nations. That is unless a treatment or vaccine can be developed while the spread is contained. ECB head Lagarde is warning that the impact could be as severe as the 2008 financial crisis, unless smart fiscal measures are taken promptly.

2. Trade War Challenge

World trade contracted in 2019 and is now estimated to decline by 3% in 2020 after its continuous expansion since the 2009 financial crisis. Most pain has been experienced by China, where experts now predict negative GDP growth for the first half of 2020. Supply chains have been diversified beyond China, large parts of the technology sector are de-coupling, and tariffs are hurting China's exports. Before COVID-19 started, the IMF predicted global growth to slow from 3.6% in 2018 to 2.9% in 2019, the lowest global growth since 2009.

The IMF estimates that trade wars left global output 0.8% lower in 2019, even after monetary stimulus had added the equivalent of 0.5% to global output, and is now issuing warnings about a likely global recession for 2020. Market analysts project a 0.5% decline in global GDP for 2020 (chart 2) as result of ongoing trade conflicts and declining global equity markets, but are now revising their estimates downwards as the COVID-19 pandemic is spreading.

3. Carbon Challenge

US shale oil exports have doubled over the past decade and now exceed those of both Saudi Arabia and Russia (chart 3) which both have given up market share after production cuts negotiated by OPEC. US producers are heavily leveraged and their bonds represent 11% of the US high-yield market. They are targeted by the recent oil price war between Russia and Saudi Arabia, which led to crude oil prices drops of 50% from \$62 in January to \$31 pb in early March.

Lower growth from trade and health challenges implies lower demand for oil. While most US shale producers were profitable at earlier prices of \$60, the majority is no longer profitable at current prices and substantial defaults can be expected which would then adjust global market shares. The massive expansion of US energy production could reverse and would negatively affect US growth. However, a decline in global energy production would help in catching up with the climate goals in the Paris Agreement.

4. US Recession and Election

Populist US policies look likely to be reversed with the presidential election in November 2020. Historical election models predict a change in administration when the economy enters a recession and/or stocks enter a bear-market prior to the election. The probability for a US recession already had been elevated at 2008-levels in the NY FED model (chart 4) based on the inverted yield-curve before the health pandemic was declared. When the Dow Jones index declined into bear-market territory on March 11, former FED vice-chair Alan Blinder said that the US is likely already in recession, putting recession odds at 90%.

The US policy response has been inadequate. Public health infrastructure had been curtailed, information flows are still defective, testing has been delayed for weeks, and containment cannot work while mega-events are continuing. Monetary policy tools have been almost depleted at the onset of the crisis and prior credit stimulus has contributed to unsustainable leverage of zombie firms, incl. in the shale industry. Fiscal headroom has been constrained by earlier ill-timed tax cuts and targeted fiscal measures have not been agreed. Nationalist trade policies and lack of international collaboration are adding to the damage.

5. European Fiscal Union

Angela Merkel has stated that Germany would contribute “whatever is necessary” to address this unprecedented crisis and uncertainty across Europe. Mario Draghi stated in July 2012 that the ECB would contribute “whatever it takes” to preserve the Euro. Monetary policy has indeed contributed almost everything in its toolkit, whereas German fiscal policy still has headroom and the European neighbors have long been advocating for a “fiscal union”.

Italy already had negative growth, banking sector problems, and fiscal pressure prior to the health pandemic. Now Italy is facing a financial collapse after all businesses have been ordered to close and mortgage payments are suspended. Banking stocks have plummeted and credit default swaps are indicating stress. Analysts say that a massive bailout is needed rather than more ECB patches. This may well become the litmus test for solidarity in the European Union with wide-ranging political and financial consequences.

6. Chinese Stimulus and Debt

Moody’s characterized Chinese corporate debt as the “biggest threat” to the global economy in December 2019, before the latest stimulus measures. Earlier, S&P stated that China faces a “debt iceberg with titanic credit risks”. China started a massive stimulus after the 2008 financial crisis to create jobs and build infrastructure, with its financial sector size quadrupling to \$40 trillion. The IMF estimates overall fiscal deficits exceeded 10% annually and corporate debt increased by 150% of GDP over the past decade, to a level of 270% of GDP. After the current crisis, an even larger stimulus is envisaged to reboot the Chinese economy.

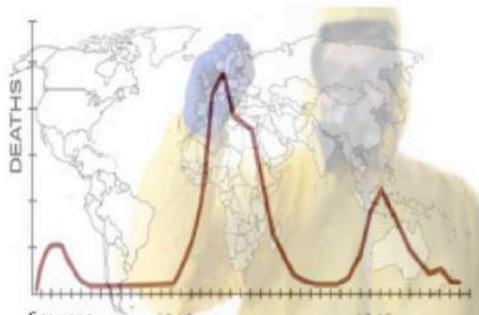
The Japanese model may become a last resort, where Central Bank borrowing is used to stimulate the economy and to prop up insolvent banks and local vehicles. Pensions and insurance companies may be forced to hold that debt. Eventually, a debt restructuring will be required, likely on a new monetary basis, possibly by introducing a regional RMB-based crypto-currency as means to transform and redenominate outstanding debts. Chinese policymakers are keen to use financial engineering rather than lose two decades with stagnation.

7. Market Implications

The evolving pandemic could lead to major financial changes. Collaboration may overcome nationalism after transformative US elections. Commodities may crater in a bear-market. Airlines and tourism may face tough downsides. Healthcare and remote technologies may become the main beneficiaries. Smaller companies with domestic focus may outperform multinationals as supply chains are further curtailed. Fiscal and structural policies may take the baton from exhausted monetary toolkits. Debt restructurings may follow down the road as bond yields normalize and credit bubbles implode. Solidarity may become more pronounced, both within communities, within the European Union, and globally, as public health challenges are jointly tackled. Investors may be wise to anticipate regime changes and emphasize quality rather than rely on technical or momentum indicators.

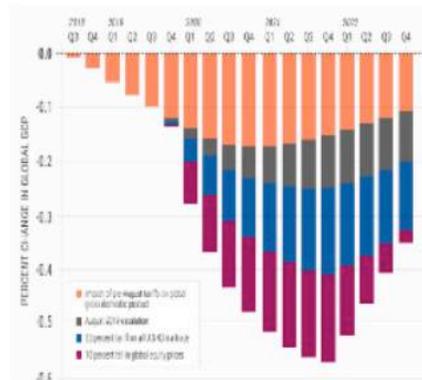
<http://emleaders.com/pdf/EML-Beyond-2020.pdf>

Pandemic Duration up to 18m Chart 1



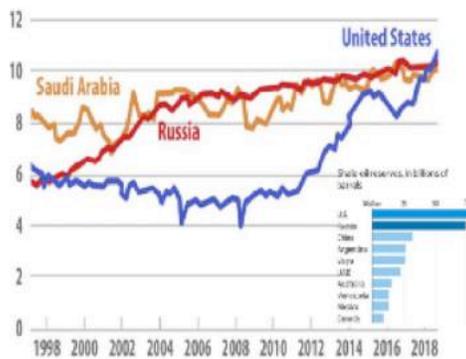
Sources:
 1> World Economic Forum: www.weforum.org/projects/managing-the-risk-and-impact-of-future-epidemics
 2> Johns Hopkins Event 201: www.centerforhealthsecurity.org/event201/event201-resources/200117-PublicPrivatePandemicCalltoAction.pdf
 3> CDC Resources: www.cdc.gov/flu/pandemic-resources/1918-commemoration/three-waves.htm

Trade War Impact on GDP Chart 2



Sources:
 4> Bloomberg Economics: geopoliticalfutures.com/china-and-the-us-are-dealing-with-the-easy-stuff/
 5> Oxford economics: www.marketwatch.com/story/heres-the-hit-us-chinese-and-global-economies-could-face-as-trade-battle-heats-up-2019-05-09
 6> IMF: www.imf.com/content/078e2ca2-cf2a-11e9-bfa4-b25f11f42901 and www.imf.org/en/Publications/WEO/Issues/2020/01/20/weo-update-january2020

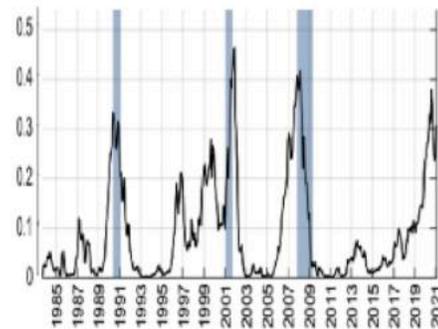
US Crude Oil Exports Chart 3



Source: US Energy Information Administration

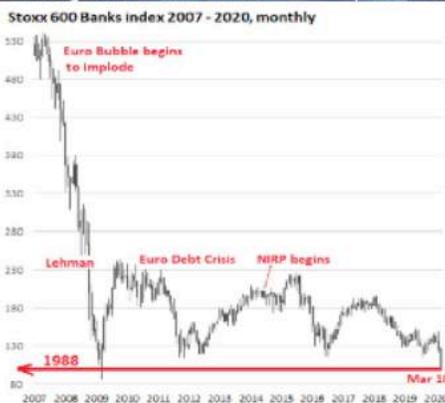
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US Recession Probability Chart 4



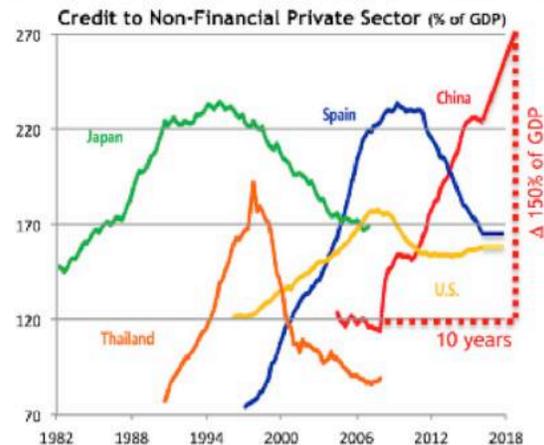
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 10> NY FED: www.newyorkfed.org/medialibrary/media/research/capital_markets/Prob_rec.pdf
 11> Moody's: www.cbsnews.com/news/coronavirus-mark-zandi-nouriel-roubini-kenneth-rogoff-recession-forecast/
 12> Alan Blinder: www.cnn.com/2020/03/11/economist-alan-blinder-says-the-us-is-probably-already-in-recession.html

Italy on the brink Chart 5



Sources:
 13> Italian financial crisis: www.theguardian.com/world/2020/mar/10/italian-financial-crisis-is-certain-the-big-question-is-how-contagious-it-is
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 15> German fiscal support: www.bloomberg.com/news/articles/2020-03-11/merkel-says-eu-must-work-in-concert-to-fight-spread-of-virus

China's Corporate Debt Chart 6



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 16> IMF Article IV with China: www.imf.org/~en/media/Files/Publications/CR/2019/1CHNEA2019003.aspx