Quarterly Macro Report

2nd Quarter 2020

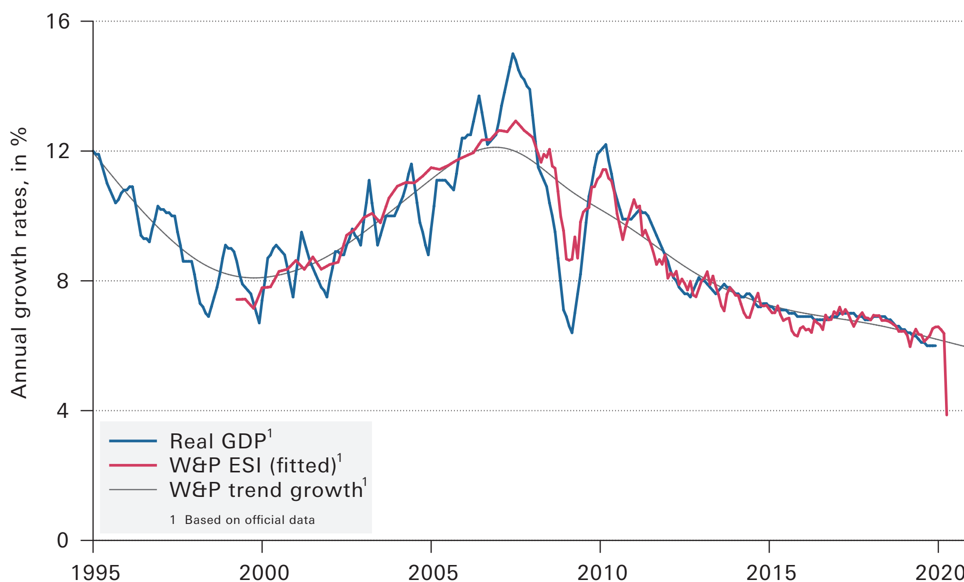
The coronavirus outbreak hit China after its economy had regained positive momentum in the second half of 2019. Economic indicators in the US and Europe also showed signs of recovery in the new year, until the virus emerged. What happens next depends largely on the path the virus takes.

In terms of purchasing power parity, China's economy is the world's largest. The chart below shows where China's economy was heading in terms of growth just before the virus struck. Data for December showed that economic growth, which had been recovering since last summer, continued to revive. And in the rest of the world, sentiment indicators at the start of this year had also improved significantly.

At the same time, our global sentiment indicator, which summarizes data from various countries and sectors, pointed to a return to above-trend growth after six months in the doldrums. And our recession indicator for the US also showed signs of recovery. Thanks to a dynamic US construction sector, our model suggested that the relevant indicators for the US economy were pulling away from indications of a looming recession. Thus, had it not been for the outbreak of the coronavirus, the overall economic outlook clearly seemed to be improving.

At present, the coronavirus epidemic has jammed the gears of the USD 87 trillion global economy. As people cut back on travelling, attending large events and bricks-and-mortar shopping in order to reduce exposure to the virus, this behaviour will obviously lead to a sharp slump in global GDP. Based on the latest data available as we prepared this report, economic scenarios are currently wide open. They range from a brief, sharp dip to a longer period of weakness – and even to a global recession.

Fig. 1: Coronavirus entered the scene just as China's economy had started accelerating



The Coronavirus outbreak started just as China's economy had begun to accelerate again above its trend growth rate. Whether we now enter a V-, U- or a W-shaped period depends on factors that cannot be forecast with any degree of certainty at this point.

Source: Refinitiv, Wellershoff & Partners

Waiting for the facts

Given the multiple unknowns unleashed by the coronavirus outbreak, we cannot forecast the depth of any potential economic slump; nor can we sketch its likely recovery profile. The possibilities range from what markets might initially have anticipated taking the SARS outbreak as a reference: that is, a V-shaped development lasting a quarter or two. Or the path ahead could become longer, more protracted and U-shaped or W-shaped as the virus comes back next winter. Moreover, the slump could be shallow or far deeper. What we know from previous economic slumps, however, is that they ripple through an economy, leaving palpable damages in their wake. Thus, if creditors cannot service their debts, say, there are knock-on effects far beyond the initial source of the problem. The previous US recession, which was triggered by American sub-prime debt defaults, ended up hurting economies far from the States and with no sub-prime lending at all. The collateral damage being done to integrated global supply chains will reveal itself the longer a crisis continues and it will do so in ways that the markets might not currently be pricing in.

For now, downward pressure on inflation is likely

Economic slumps also take the steam out of inflationary pressure – at least initially. We can already note this diminished inflationary potential in the recent declines in oil prices. And the decline in yields on the US Treasury 30-year bonds to levels below those recorded during the previous recession is yet another indicator of lower inflation pressure ahead. From the losses investors in long-term US government bonds sustained in the 1970s, we know that the market back then failed to accurately price in the longer-term inflation risks. Similarly, we cannot now assume that 30-year US Treasury bonds are accurately pricing in the inflation risks over the next three decades. Nevertheless, with long-term US government bond yields falling to new lows amid the coronavirus epidemic, we are not looking at the most bullish signals for growth at this juncture. This perception is also likely fed by the markets pricing in lower near-term inflation.

Just before the coronavirus outbreak, US inflation – both the headline and the core numbers – had comfortably broken through the 2% barrier, which, in the past, had been the Federal Reserve's long-held target. In the

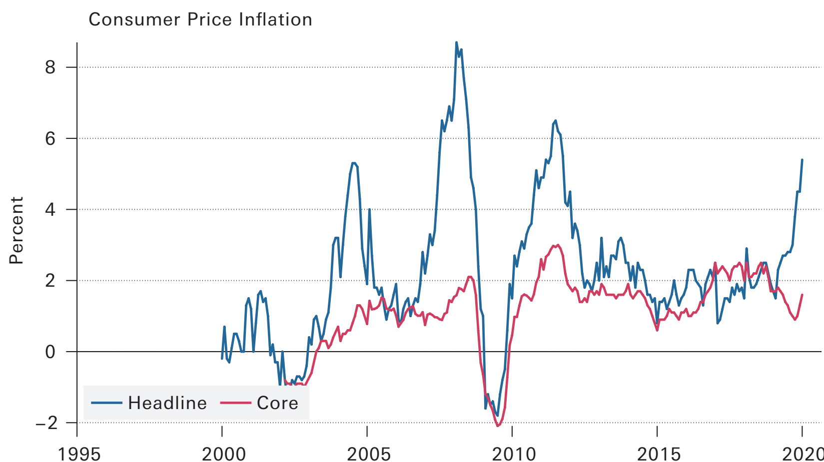
Table 1: Macroeconomic estimates

	Real GDP growth in %						Inflation in %					
	2018	2019	2020P	2021P	2020Δ	2021Δ	2017	2018	2020P	2021P	2020Δ	2021Δ
USA	2.9	2.3	1.4	1.5	-0.5	-0.5	2.4	1.8	1.7	2.2	-0.3	0.1
Euro area	1.9	1.2	0.6	1.1	-0.3	-0.1	1.8	1.2	1.1	1.3	-0.1	-0.1
Germany	1.5	0.6	0.2	0.7	-0.7	-0.4	1.7	1.4	1.2	1.5	-0.2	0.0
France	1.7	1.3	0.7	1.1	-0.4	-0.1	1.9	1.1	1.0	1.5	-0.3	0.2
Italy	0.7	0.3	-0.5	0.3	-0.8	-0.3	1.1	0.6	0.5	0.9	-0.3	-0.2
Spain	2.4	2.0	2.1	1.6	0.5	0.0	1.7	0.7	0.9	1.4	-0.1	0.0
United Kingdom	1.3	1.4	0.6	0.8	-0.5	-0.7	2.5	1.8	1.5	1.8	-0.1	-0.1
Switzerland	2.7	0.9	0.8	0.8	-0.5	-0.5	0.9	0.4	0.3	0.5	0.0	-0.2
Japan	0.3	0.8	-0.4	0.9	-0.7	0.1	1.0	0.5	0.5	0.5	-0.1	-0.1
Brazil	6.7	6.1	1.5	1.8	-0.7	-0.5	0.6	0.8	3.5	3.8	0.0	0.3
China	1.3	1.1	3.9	5.5	-2.1	-0.3	3.7	3.7	3.2	2.8	0.8	0.4
India	6.8	-	4.5	6.1	-1.3	-0.4	3.9	3.7	4.8	4.5	0.7	0.4
Russia	2.3	-	1.8	1.8	-0.1	-0.2	2.9	4.5	3.3	3.7	-0.2	0.2
World (PPP)	3.6	2.9	2.8	3.2	-0.5	-0.2	3.6	3.4	3.1	3.3	-0.4	-0.2

E Estimates Wellershoff & Partners   Δ Deviation from consensus economic forecasts

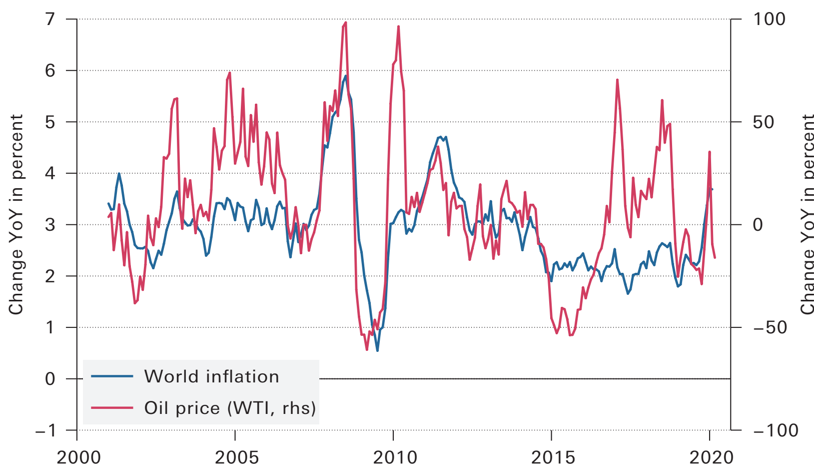
Source: Consensus Economics, Refinitiv, Wellershoff & Partners

Fig. 2: China's headline inflation driven higher by food prices, but core inflation is moderate



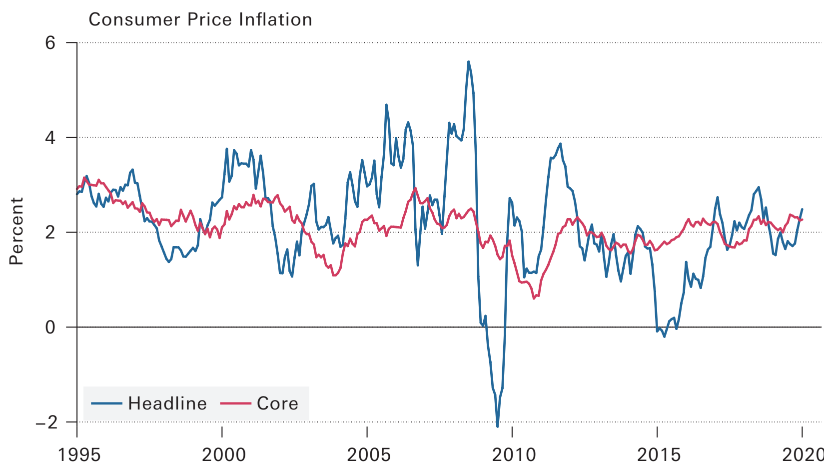
In the run-up to the coronavirus breakout, headline inflation had been rising due to rising food prices. The core inflation rate, which excludes food, remained moderate.

Fig. 3: Falling oil prices should result in downward pressure on global inflation



Oil prices declined following the coronavirus outbreak. The chart shows that global inflation tends to fall when oil prices decline.

Fig. 4: US core inflation had drifted higher before the Coronavirus outbreak



The US Fed changed its interest rate policy in 2019, shifting from a tightening bias to one that is more accommodating. Headline and core inflation were above 2% just prior to the outbreak of the coronavirus. In light of the economic consequenes of the coronavirus breakout, the Fed lowered interest rates further.

Source: Refinitiv, Wellershoff & Partners

meantime, the Fed has been talking about pursuing a new "asymmetric" inflation target, meaning that it would be willing to tolerate inflation above 2% to "make up" for inflation below 2% in the preceding period.

Regardless of the Fed's definition, one impact from the expected economic weakness triggered by the coronavirus is that US inflation should moderate in the near term. In the first week of March the US Fed decided in an emergency meeting to lower interest rates. There is still further leeway to do more, and for longer, if need be.

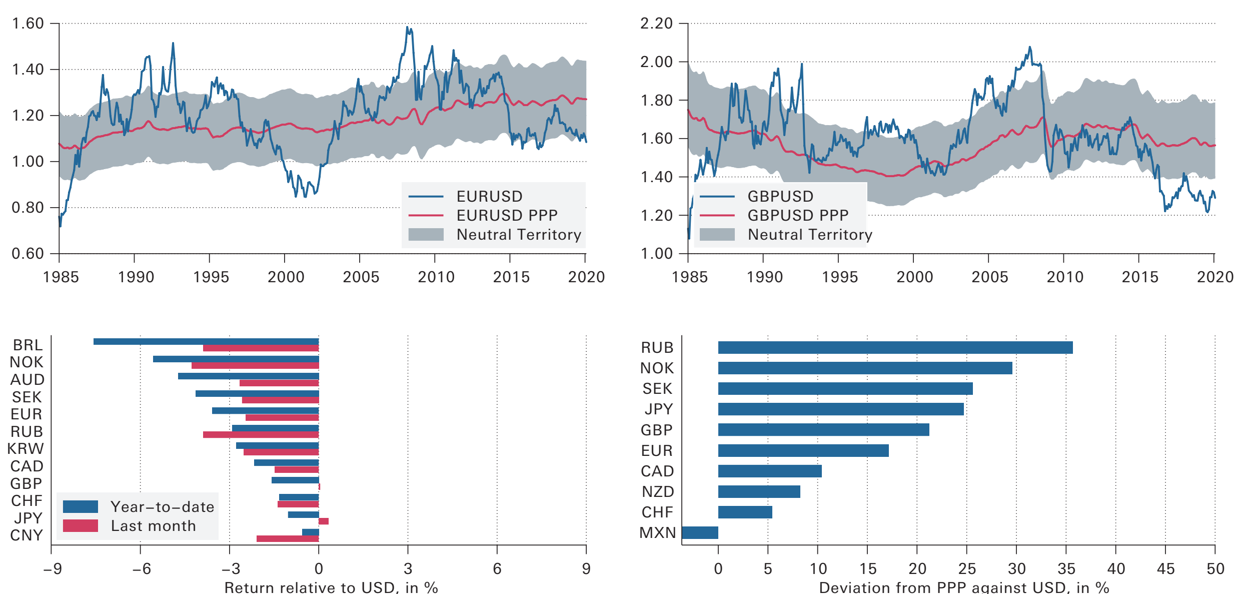
The US dollar is still too expensive

Concern about the potential fallout from the coronavirus initially helped to buoy the US dollar against a broad basket of currencies in the opening weeks of 2020. This kept the greenback strong – or "expensive" – in purchasing power parity (PPP) terms, as can be seen from the FX performance and valuation data in Fig. 5. Subsequently, the dollar weakened in response to the coronavirus impact also in the US.

Our purchasing power estimate for the US dollar against the euro (EURUSD) is 1.27, making the dollar around 15 per cent more expensive than implied by its PPP value – using end-January 2020 data. Against the Japanese yen, the US dollar was around 25 percent overvalued (a USDJPY PPP of 88). The dollar's strength relative to the Swiss franc was less pronounced (around 6 per cent using a USDCHF PPP estimate of 0.93).

Against the euro, the Swiss franc was around 10 per cent overvalued in PPP terms (a EURCHF PPP of 1.18). Many observers think that the Swiss National Bank has continued to intervene on the FX markets in recent weeks to prevent the Swiss franc from appreciating too rapidly. Overall, the outbreak if the coronavirus is a reminder that economies are always at risk of unexpected supply and demand shocks.

Fig. 5: FX performance and valuations



PPP estimates based on producer price indices
Positive deviations from PPP indicate an undervaluation against the respective currency and vice versa.

Source: Refinitiv, Wellershoff & Partners

Disclaimer

This report has been exclusively prepared and published by Wellershoff & Partners Ltd for Perpetual Wealth AG. This publication is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis. Although all information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, no representation or warranty, express or implied, is made as to its accuracy or completeness. All information and opinions indicated are subject to change without notice. Some investments may not be readily realizable if the market in certain securities is illiquid and therefore valuing such investments and identifying the risks associated therewith may be difficult or even impossible. Trading and owning futures, options, and all other derivatives is very risky and therefore requires an extremely high level of risk tolerance. Past performance of an investment is no guarantee for its future performance. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in foreign exchange rates may have an adverse effect on the price, value or income of an investment. We are of necessity unable to take into account the particular investment objectives, financial situation and needs of our individual clients and we recommend that you take financial and/or tax advice as to the implications (including tax liabilities) of investing in any of the products mentioned herein. This document may not be reproduced or circulated without the prior authorization of Perpetual Wealth AG or Wellershoff & Partners Ltd. Perpetual Wealth AG and Wellershoff & Partners Ltd. expressly prohibits the distribution and transfer of this document to third parties for any reason. Neither Perpetual Wealth nor Wellershoff & Partners Ltd. will not be liable for any claims or lawsuits from any third parties arising from the use or distribution of this document. This report is for distribution only under such circumstances as may be permitted by applicable law.

About us

Perpetual Wealth AG is a wealth management boutique offering financial and family office services to a sophisticated international clientele. Perpetual Wealth AG is a member of Aquila & Co., which is regulated by FINMA (Swiss Financial Market Supervisory Authority) as a security dealer and as a bank. Perpetual Wealth AG is a member of SAAM, Swiss Association of Asset Managers, and FINMA regulated with regards to Anti-Money-Laundering regulations.

Wellershoff & Partners Ltd is an independent consulting and research company that focuses on global economics, financial markets and comprehensive risk management. The internationally operating consultancy was founded in 2009 and is based in Zurich.

Imprint

Published by // Wellershoff & Partners Ltd., Zurich
Author // Costa Vayenas
Concept // Wellershoff & Partners Ltd., Zurich
Design // Feinmass Kommunikationsdesign, Lucerne

Editorial deadline: March 6, 2020