Stubborn Second Wave

72 – 14 December 2020

Key points

- The Brexit noises are deafening but the key news flow remains the pandemic. The current wave is relentless in the US. Most of Europe is past the peak, but restrictive measures in Germany and France are toughened or prolonged. More policy support is needed, and recently the Euro area has been making progress, finally clearing the Recovery and Resilience Fund and getting a more than decent additional package from the ECB.

The news flow continues to be dominated by the post-Brexit talks. Even in the face of amped up rhetoric we continue to think a deal is the most plausible outcome, focusing as always on what we think should be the rational calculation by the British Prime Minister in the political realm: in case of "no deal" he would trade a few months of popularity with the most extreme members of his parliamentary group against a mountain of hurdles to electoral victory in four years.

Still, even in Europe the fate of the post-Brexit negotiations will only have a marginal impact on the economic trajectory for 2021 when compared to the pandemic. In the US the current wave remains relentless, making it more likely that the bulk of the impact may be seen in Q1 2021. This makes the continuation of fiscal support necessary to avoid more significant economic scarring before collective immunity is reached. The news flow on this remains inconclusive, even if we still think a compromise will be found between the two main parties. Meanwhile, Europe has cleared a major institutional hurdle on fiscal policy thanks to the deal on "rule of law" implementation struck with Hungary and Poland. The second wave's damage continues to be concerning though. Most European countries seem to be past peak now, but it is taking more time than during the first wave to normalize sanitary conditions. Germany is about to implement a stricter lockdown from Wednesday onward. The economic impact – already significant in Q4 – is already spilling over Q1 2021.

In these conditions, the ECB had to offer more protection and we think the package announced last week will buy a lot of "peace and quiet" next year on the bond market. Market expectations had gone too far in the days ahead of the Governing Council meeting, but the central bank is still doing the maximum it can within its own constraints. The real question now is on the quantum of monetary support on offer once PEPP stops in March 2022 (at the earliest). Given the ECB's inflation forecasts, which remain significantly below its target at the end of 2023, the logical conclusion is that the "ordinary" quantitative easing programme will be stepped up. This will be the toughest test on Christine Lagarde in our view. Of course, this sequencing would be jeopardized if inflation surprises on the upside. We take a hard look at this. While fading exogenous shocks should mechanically lift headline inflation next year, we expect little will come from the endogenous sources of price pressure – in particular the state of the labour market.

No deal makes no sense

Call us stubborn, but even in the face of amped up rhetorics we continue to think a deal between the UK and the EU is the most plausible scenario. Economists are bound by the rules of their profession: ultimately, we need to think agents are rational. The very latest noises on Sunday night on the talks is that on "level playing field", the EU would be willing to make any retaliation against the UK in case of excessive divergence on standards conditional on an independent body determining whether divergence is significant enough to warrant corrective tariffs – instead of an unilateral decision by the Commission, as per its initial position. If this is confirmed, what would remain to discuss on this issue would be the scope and composition of said body. We find it hard to believe that the entire Free Trade Agreement would flounder on such an issue, given the significant consequences of "no deal" we discussed last week. Fishing is still a bone of contention, but also on this the latest noises are that some compromise on quotas per species, rather than over the overall catch, would be possible. Again, if discussions have reached this level of technicality, failure would appear quite reckless.

We always come back to the same political point: the "balance of pain" in case of no deal between the two parties is heavily skewed towards the UK, and Boris Johnson would trade a few months of popularity with the most extreme members of the Conservative parliamentary group against a mountain of hurdles towards an electoral victory in 4 years (the immediate cost of no deal on UK purchasing power, another independence push in Scotland, widespread distrust towards his administration in the business community, potential trouble in Northern Ireland, political isolation on the world stage). To take just one example, it's very fine to toy with the idea of sending warships to keep foreign trawlers out of British territorial waters in case of no deal, but then what? Would the UK accept the consequence for its international standing of repeated standoffs with key European powers over an industry worth 0.1% of the British GDP? There is no credible policy map for the UK post no deal. Another point we have made several times: there is something quite illusory in fighting for a "right to diverge" from the EU on social and environmental standards. The current political space for a supply-side, deregulation-heavy platform in the UK is exactly zero. Public opinion has moved decidedly to the left on economic issues. By going to "no deal", the UK would impose onto itself crippling tariffs immediately, without any meaningful capacity (or plan for that matter) to offset this competitiveness impairment with a regulatory revolution. That would be worse than the mere possibility of tariff should they – one day – decide to diverge.

As strong believers in the ultimate rationality of political leaders we think a compromise is still possible. At this stage, **failure would probably stem from one of the two parties pushing the envelope a bit too far, too late to get an agreement done in time. From this point of view, the fact that no new deadline has been tagged on the latest round of talks is positive in our view**. We hear however that the European Parliament is getting concerned with the little time that would be left for them to exert proper scrutiny on a deal. There is a bit of time left, but not much.

Stubborn second wave

We are now dealing with two horizons: within the next 6 to 9 months, the world should be "Covid-free" and the debate is starting again on the speed of the rebound in these circumstances; within the next 3 months however, the advanced economies still need to deal with a nasty "second wave" which has not yet reached its peak in the US and which is proving harder than expected to tame in large swathes of Europe, even if the trend there remains broadly favourable. The equity market constantly oscillates between these two horizons, driven by the news-flow on the vaccines and their logistics, or any sense that the immediate activity contraction could be even worse than expected. The bond market is steadier, at least in Europe, largely because the ECB has provided visibility on its "implicit yield control" until March 2022 "at least". In the US, lingering questions on the fiscal stance can be a source of volatility, but the Fed would probably cap any rise in yield it would deem inconsistent with supporting the recovery (we expect US 10 year yields to reach 1.2% by the end of 2021 in our baseline assuming a fiscal push of USD 1trn).

The pandemic continues to accelerate in the US seemingly unabashed: for a month now, the 7-day growth rate in the number of new cases has been hovering around 10%. It is possible that the restrictive measures taken by a rising number of states (we have by now spotted such measures in states exceeding 60% of US GDP) are too new to curb the pandemic yet so that the last weeks of December would start to show an improvement, but the sanitary situation is getting dire in some of the US hotspots where healthcare capacity is nearly saturated. Our baseline is that the bulk of the second wave's impact on economic activity will materialise in Q1 2021 rather than in Q4 2020 as in Europe, and the latest dataflow is supporting our call.

This makes the continuation of emergency fiscal support even more necessary, but on this front the positive mood music still hasn't morphed into actual decisions. On Friday last week President Trump signed a 7-day spending extension bill which will avert a shutdown next week, but progress on a stimulus remains elusive. The bi-partisan 900bn bill has been backed by President-elect Biden and the Democratic leaders in congress, but the Republican majority leader Mitch McConnell wants to tag legislation granting immunity to businesses against future Covid-related litigation from their employees, which is opposed by the Democrats. To confuse matters further, Treasury Secretary Mnuchin backed a version of the stimulus package which does not include the continuation of the federal emergency unemployment benefits – a red line for Democrats. We remain convinced a deal will be found as the impact of the second pandemic wave on the economy is becoming more manifest – jobless claims last week came out again worse than expected. We may have to wait for the beginning of next year though.

Exhibit 1 – stubborn second wave, even for best-performers

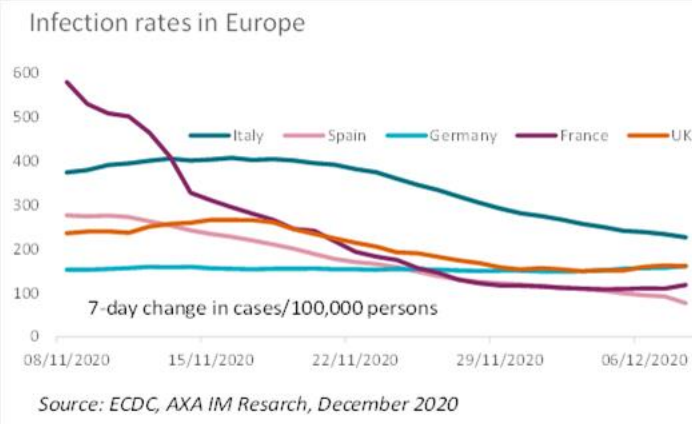
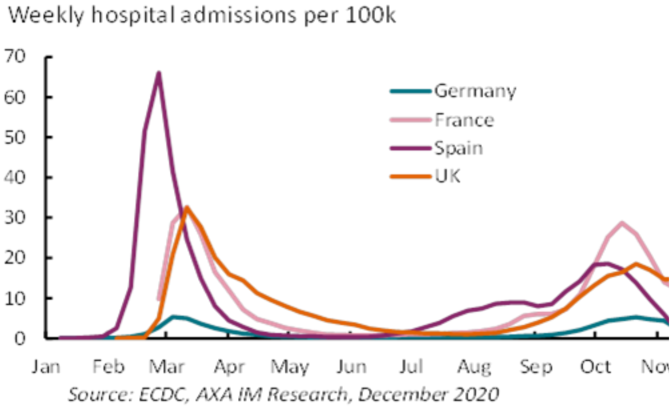


Exhibit 2 – Generally lower peak – but slower improvement



Europe is in the downward slope of the second wave, but the improvement is slower than governments were probably expected when they opted for softer restrictions than in March-April. In Germany, which had dealt so well with the first wave, the infection rate (new cases / 100k) has been flat for a month and is now higher than in France, Italy and Spain, on par with the UK. Mortality – although it is a lagged indicator – is also getting problematic in Germany (6.6 deaths/100k in the 14 days to December 12th, slightly higher than in Spain during the same period). It seems in general the second wave is less acute but also more resilient than the first. It is difficult to ascertain this with the infection rates given the rise in testing capacity over the last 9 months, but this is the message from hospitalizations: the peak is lower in most countries (except for Germany) but the post-peak decline is slower (see Exhibit 2). It is probably not surprising that with less stringent lockdowns, it is taking more time to get the pandemic back in control.

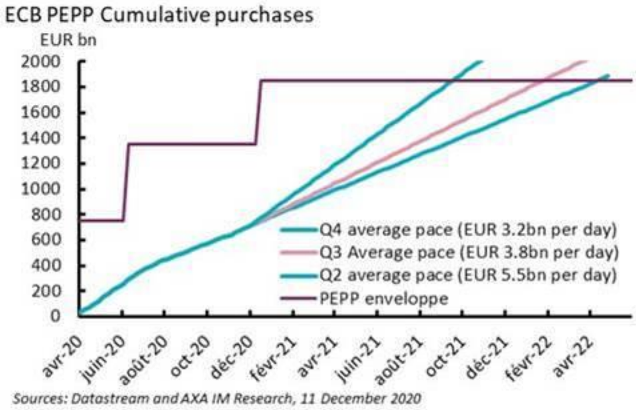
Our forecasts for Q4 GDP in the Euro area may have been too pessimistic – the drop in mobility so far has been lower than what we expected – but there is now a higher chance that the weakness persists into Q1 2021. France has pushed until January 21st the reopening of restaurants and cultural venues. Germany is readying a much stricter national lockdown from next Wednesday onward.

Another difference with the US is that at least the EU has managed to deal with its institutional hurdles on the fiscal front and finally deliver the Recovery and Resilience Fund thanks to a compromise with Hungary and Poland. The impact on effective fiscal action in the first half of 2021 is likely to be very small, but from a political and financial stability point of view, this is definitely a success, making European mutualised support material, contributing to the sustainability of public debt in the most fragile member states. Still, the main source of "peace and quiet" on the sovereign bond market comes from the ECB.

ECB: how not to be greedy

Last week in Macrocast we expressed our discomfort with some expectations for ECB action which we found "greedy". With some sell-side shops calling for very large amounts of purchases – above EUR600bn –in the last few days before the Governing Council meeting, what the central bank did felt almost disappointing. We consider this as an optical illusion. As we discussed last week, the ECB is doing wonders given its political and legal hurdles, but its constraints have not disappeared. We were expecting a top-up of EUR400bn until the end of 2021 to the Pandemic Emergency, with " *a strong risk the Governing Council will opt for a straightforward extension to June 2022, but we don't think the quantum of purchases can significantly exceed EUR500bn*". The ECB chose a 500bn top-up until March 2022, which is going to leave them with some dry powder. In our view this is better than what could have been expected just a few weeks ago.

Exhibit 3 – Steady it goes…only for longer



Several news outlets have suggested that the discussion at the Governing Council was not an easy one and the final announcements the result of a painful compromise. This does not surprise us much. Now that it is plausible that the Euro area economy will have escaped the toxic "lockdown/reopening" cycle around the middle of 2021, we were expecting the hawks to resist extending PEPP into 2022. Apparently, what unlocked the discussion was the notion that the envelope would not necessarily be entirely spent if financial conditions are "preserved".

This gets us back from our discussion of the calibration last week. A top up of EUR500bn would allow for a continuation until March 2022 of the purchasing pace so far observed in Q4 2020 (see Exhibit 3), when financial conditions were benign. This explains Christine Lagarde's insistence during the press conference on the notion that the quantum was flexible in both directions, i.e. that it could also be further increased if need be, even if in our understanding this would take another formal decision by the Governing Council.

Ultimately, the strength of PEPP lies in its flexibility. We maintain our view from last week: **faced with uncertainty as to which thresholds on market interest rates would trigger a sudden acceleration in ECB spending, investors' appetite to "test" the central bank's resolve to engage in implicit yield control is likely to be limited.** It is only towards the end of the programme, when it will get obvious that any additional top-up would quickly hit the "50% limit", that the ECB's handle on market conditions may diminish. In the meantime, it gives much power to the ECB board in fine-tuning every week's quantum of purchases and defining what "preserving market conditions" precisely means. Isabel Schnabel, credited by Bloomberg as the broker of the compromise last week, is in charge of the ECB's market operations and this will make her crucial throughout this new "PEPP wave". Investors will dissect every single word she utters within the next 15 months for implementation clues.

A possible "market backlash" then would depend on the interplay between three forces: i) the strength of the economic recovery once "collective immunity" is reached, mechanically improving the cyclical component of member states' public finances; ii) the quality and credibility of the future discretionary fiscal stance – as we expressed often government don't need to tighten fiscal policy in 2022 already but they need to provide the market and the central bank with some visibility on their fiscal trajectory as their economies normalize; iii) the quantum of support the ECB once PEPP is over.

The latter will be essentially determined by the state of inflationary pressure by the time PEPP is drawing to a close. **At the end of the horizon of the ECB's new forecasts (Q4 2023) inflation would remain quite subdued (1.4% year-on-year),** still far away from target and presumably lower than what the ECB was expecting before the pandemic, even if its forecasts did not extend that far at the time. There are two ways to read this. We have noticed the emergence of a "grumpy lot" of ECB watchers – that is often where we stand, but not this time – who lament the inconsistency of the central bank. In a nutshell, if the Governing Council believes that in 3 years from now inflation will still be that weak, then they should step up monetary easing now, even more than what they did last week. Another interpretation of the forecasts is that – true to Philip Lane's sequencing principle – the central bank is waiting for the "dust to settle" on the current emergency but will very likely step up APP from its current pace of EUR20bn a month when PEPP ends. It would make little sense to calibrate the necessary quantum now given the uncertainty on the strength of the post-pandemic rebound and the fiscal stance post 2021. We have maintained for some time now that the real test for Christine Lagarde's ECB would come with this post-pandemic policy calibration, which is likely to be much thornier than the current response to the pandemic emergency. But in the meantime, **we consider that last week's move from the central bank has bought a lot of "peace and quiet" on the Euro area bond market in 2021.**

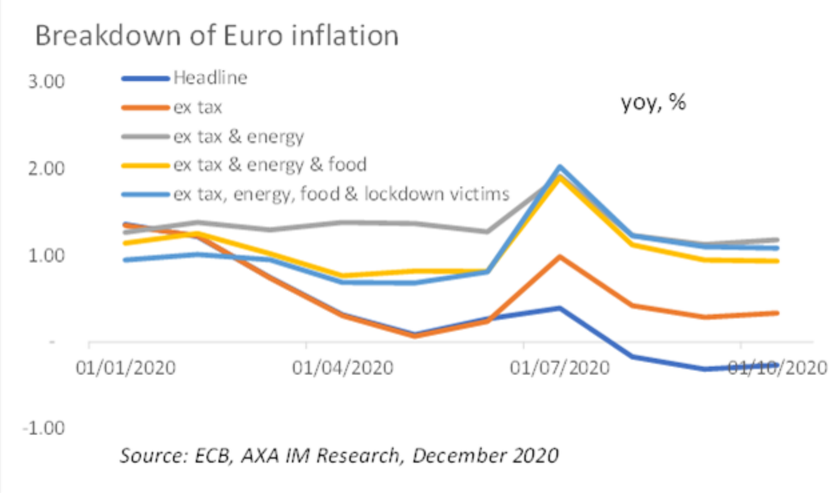
It seems the debate withing the Governing Council was also a bit tense on the other key aspect of last week's announcements: the generosity of the next batch of Targeted Long Term Repurchase Operations (TLTROs). The Governing Council added three new operations between June 2021 and December 2021, with similar modalities including a 3-year maturity. The discount period has been extended by one year, until June 2022, during which the minimum interest rate applies for banks meeting their lending criteria (50 basis points below the deposit rate). Moreover, the amount of maximum TLTRO allowances has been raised to 55% (from 50% of their stock of eligible loans). Still, again according to Bloomberg, the original plan submitted to the Council pushed the allowances to 60%, which would have freed some space for banks which are already close to their ceiling, most of them located in peripheral countries. In the same vein, the "tiering" mechanism – which allows a substantial part of banks' excess reserves to escape the negative deposit rate "tax" – was not altered. It seems a majority of the Governing council is getting concerned with providing too much support to the banking sector. This is a slightly odd concern at this stage of the crisis in our opinion. As much as we are convinced that in the current configuration the most efficient transmission channel is through creating financial space for fiscal policy, making PEPP the essential tool, there is some logic in clearing more hurdles on the "banking channel", especially in the most fragile countries. This is however the price the European banking sector probably needs to pay for some substantial protection and the obvious reluctance by the ECB to engage further on the negative deposit rate route.

Discussing inflation

Of course, all the nice "sequencing" we discussed in the previous section hinges on the materialization of very low inflation as the Euro area economy exits the pandemic crisis. If inflation were to rebound too quickly, the nice "mutually agreed fiscal and monetary normalization" which we think would be the optimal path for governments and the central bank from 2022 onward would be in jeopardy, especially since the ECB has not committed to allow inflation overshooting in the future as the Fed has – at least not as clearly. We are quite relaxed on this given our view that this crisis is more deflationary than inflation, but we want to take a hard look at the current state of affairs on this crucial issue.

The recent negative prints for inflation have put this debate to the back burner for some months now, **but while spending 3 months in a row in negative territory for the year-on-year change in consumer prices is of course quite spectacular, for now much of this deflation is exogenous**. In November, the temporary VAT cut in Germany, from July to December 2020, was still shaving 0.6 percentage points off headline inflation, while the drop in energy prices subtracted another 0.8 points. Maybe surprisingly, the price of the services which were worst hit by the pandemic (package holidays, railway and air transport, hotels, cafes and restaurants) did not fall that much when taking them together. All in all, not much has changed since the beginning of the year: inflation was weak then, it is weak now (see Exhibit 4).

Exhibit 4 – Beyond exogenous shocks, not much is happening



In 2021 some mechanical rebound is likely, if only because the VAT rate will normalize in Germany and the downward shock on energy prices will fade. This is reflected in the ECB's forecasts, which have headline inflation back to 1.5% at the end of next year. From then on, inflation would be mostly flat. This makes a lot of sense if one considers the endogenous sources of price pressure. **For the mechanical rebound in prices to trigger a permanent drift higher, wages would need to react.** Current data on wages and labour costs is affected by statistical glitches. Among other factors, productivity temporarily collapsed in advanced economies as workers are kept on their employers' payroll amid lower output, while the crisis is disproportionately affecting lower-skilled and younger workers, mechanically lifting the average wage in the samples. However, the ECB maintains a series on "negotiated wages" which is unaffected by those shocks and provide some forward-looking information, since the collective agreements on which it is based typically have a lifetime of a year or and beyond. Before the pandemic struck, an acceleration was clearly underway. This has been reversed over the last two quarters (see Exhibit 5).

Exhibit 5 – Wage deals getting less generous

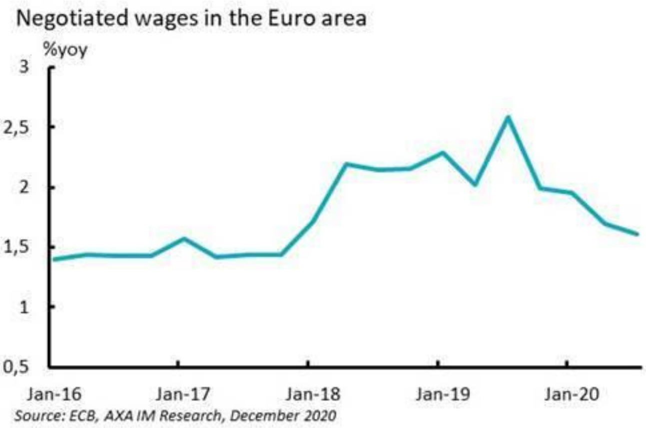
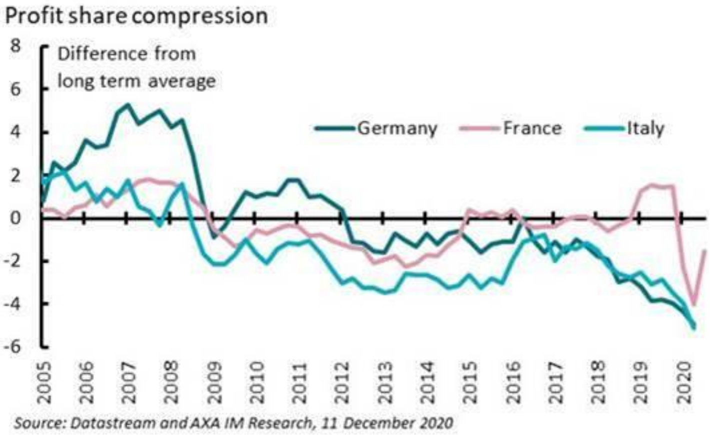
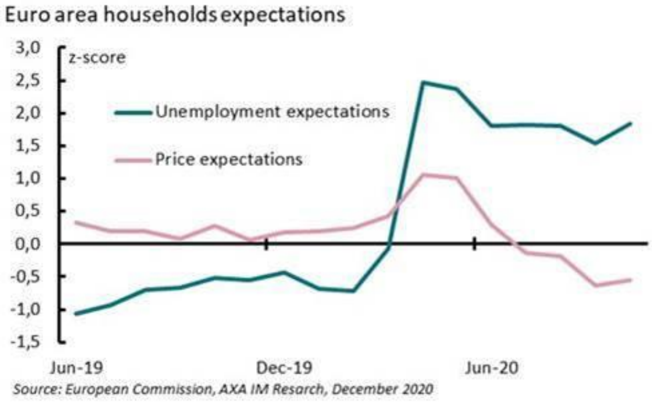


Exhibit 6 – The business sector does not have much space



In our view, **the current configuration is consistent with even more downward pressure on wage growth in the coming quarters.** With the exception of France, business margins have been under pressure on trend for the past 10 years (see Exhibit 6). Having to deal with the debt accumulated during the acute phase of the crisis, we think it is more plausible than not that firms will try to protect their financial position by exerting additional pressure on wages. This is all the likelier given the dispositions of households themselves. Consumer confidence surveys suggest that since the summer they have revised down their inflation expectations, while remaining quite concerned about their job prospects (see Exhibit 7). We find echoes of this in the recent "opening gambit" by IG Metall, the union which normally sets the tone for pay deals in Germany: they explicitly chose to focus on job security, putting their initial demand for a wage rise of 4% (they had started above 6% in the previous round).

Exhibit 7 – Households are unlikely to be very demanding on pay rises

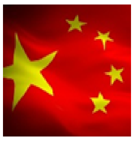


A bit of modelisation on a Monday morning cannot hurt, so we complement this approach by estimating equations over the last 15 years explaining inflation (corrected for the impact of indirect tax) by the lagged change in wages and cyclical conditions, the latter being proxied by the capacity utilization rate which we took from the European Commission quarterly survey, distinguishing the manufacturing and the services sector. The idea is that consumer prices follow with a lag the gyrations in labour costs, controlling for the margin behaviour which should be a function of the level of economic activity (when the economy is getting close to full capacity, it becomes easier for producers/retailers to pass any increase in their costs to the consumers). Unsurprisingly, this very simple model does not work well for the first component – possibly because manufactured prices entering the consumer basket are largely imported and reflect wage and cyclical conditions outside the Euro area - but it does a decent job at predicting the main inflexions in the more domestically-driven services prices, the biggest component of the consumer basket.

$$\text{P Services yoy} = \underset{(5.0)}{0.38} * \text{W services yoy}_{(t-3)} + \underset{(2.6)}{0.04} * \text{capacity utilization}_{t} - \underset{(-1.8)}{2.1}$$

$R2=0.30$
RMSE=0.4
P= Consumer price index at constant tax rate. W: average wages per head.

We find that a lag of three quarters for wages are the best fit for consumer prices. Crucially, it would take a rise in capacity utilization by a staggering 10 points (3 standard deviations) to offset the impact of a 1 percentage point deceleration in wages in the services sector. That inflation fails to recover much once the impact of the exogenous shocks is absorbed thus looks like a very reasonable expectation. This makes the current European policy-mix sustainable for quite some time.

Country/Region	What we focused on last week	What we will focus on this week
	• US sets record weekly high of new virus cases, mobility falls back as restrictions rise • Stimulus talks resume around a $900bn deal, differences remain over liability waivers • Jobless claims post 853k – a 3m high - seasonals exaggerate, but a rising trend likely • CPI inflation firmer than expected at 1.2% headline and 1.6% core, despite weak rents	• Electoral college meets effectively ending any chances of overturning election result • Fed meets, expected bal sheet guidance. Some expect maturity extension, we do not. • Retail sales provide guide to Q4 GDP, we expect firm 6% annualised • Dec's Philly and Empire State Fed surveys • FDA likely to approve Pfizer vaccine
	• German and French industrial production surprised to the upside • ECB boosts PEPP by EUR 500bn until March 22 and opts for easier TLTROs with longer discount period, larger allowances and 3 additional tenders • The EU reached a deal on the EU budget and NGEU	• After France postponed part of the additional easing planned for 15 Dec, Germany could announce more stringent lockdown during Christmas break • Flash PMIs to show slight improvement • German IFO to point to continued strength in the manufacturing sector
	• Continued negotiations as optimism over UK-EU trade deal fades, Sunday next deadline • GDP +0.4% (Oct), better than our forecasts for dip, Q4 drop likely less than feared • Vaccinations begin; 70% public want shot • BoE Financial Stability Report warns of some disruption from Brexit, but sufficient capital	• UK-EU trade deal saga: we still expect deal, decision in balance, deadline could be 18th • BoE meeting to deliver no change in policy, but update of outlook in minutes • We except worse than consensus fall in Nov retail sales on lockdown (cons -2.1%) • Nov inflation and labour market data
	• Dec Reuters Tankan manufacturer index has been resilient, rising to -9 from -13 • November bank lending is stable at 6.3%yoy • Q4 business survey index breached a record high at 21.6 from 0.1 but doesn't take into account recent restrictions	• Q4 BoJ Tankan surveys should rise but they don't fully account for recent restrictions • Nov exports is expected to rise modestly • Dec manufacturing PMI flash shouldn't fall but is unlikely to recover, staying below 50 • Nov CPI is expected to decline to -0.7%
	• Exports surged by 21.1%yoy, led by a pick-up in global demand ahead of the holiday season • Headline CPI fell 0.5%yoy, the first negative reading in 11 years	•
	• Central banks of Brazil, Chile and Peru decided to keep policy rates unchanged • Mexico CPI inflation at 3.3%yoy in Nov (after 4.1% in Oct) thanks to strong sales period effect • South Africa Q3 GDP rebounded 13.8%qoq thanks to strong mining/manufacturing sectors rebound	• Central bank meetings: Philippines, Indonesia, Mexico, Russia, Colombia, Hungary, Czech • Industrial Production in Turkey (Oct.) and Russia (Nov.)

Upcoming events		
	US :	Mon: EC meeting; Tue: Empire State survey (Dec), IP (Nov); Wed: Retail sales (Nov), Mfg, serv PMI (prel., Dec), FOMC announcement; Thu: Pilly Fed Index (Dec); Fri: Current account balance (Q3)
	Euro Area:	Tue: EA IP (Oct); Wed: EA comp, mfg, surv PMI (prel., Dec), Ge, Fr mfg, serv PMI (prel., Dec); Thu: Ecofin meeting, HICP (final, Nov), Fr Insee mfg confidence (Dec); Fri: Ge IfO busi climate index
	UK:	Tue: Unemp (ILO, Oct); Wed: CPI (Nov), comp, mfg, surv PMI (prel., Dec); Thu: MPC decision – Bank rate; Fri: GfK consumer confidence (Dec)
	China:	Mon: IP (final, Oct); Tue: TB (Nov); Wed: Mfg PMI (Dec); Thu: CPI (Nov); Fri: BoJ announcement
	Japan:	Tue: Fixed asset investment (Nov), Industrial production (Nov), Retail sales (Nov)

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