BARINGS INVESTMENT INSTITUTE

October 2020

The “Not Quite” Recovery Meets the Second Wave

MONTHLY MACRO DASHBOARD

BARINGS

20-1384122

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November Outlook: "Not Quite Recovery Meets Second Wave"

The recovery this summer was vibrant. Cheap credit and accumulated savings were used to satisfy pent-up demand, resulting in strong activity in most of the world. **Last month, economic indicators showed a further normalization of retail sales, industrial production, and employment.** In the U.S., the consumer is showing up; in Europe, governments keep having the economy's back; and in Asia, firms are pulling the economy full steam ahead.

But the virus has not gone away. After the summer frolic, daily cases have increased back to, and often beyond, previous peaks. Everywhere, fortunately, the virus appears less fatal. This is understood to result from better contagion management and, importantly, newly acquired treatment expertise in hospitals. In the U.S., President Donald Trump managed to come out of the hospital in three days. In Europe, fatality rates remain a small fraction of what they were in April. In the rest of the world, Latin America is successfully coming out of its first wave. Stringent vigilance and efficient test, track and trace procedures have left most of Asia seemingly immune to a second wave, although a few countries are still combating the virus. Governments are taking preventive measures, particularly in Europe, where mobility restrictions have tightened significantly, including through war time-like curfews.

The dark cloud of the pandemic thus keeps hovering on the horizon. A nightmare feels worse the second time it intrudes your subconscious. This matters, as confidence remains key to the decision to consume and invest. Strong global demand is a necessary condition for a full recovery, as well as for the industrious Chinese manufacturers. **Governments have a large role to play in bridging the perilous gap until a vaccine is found.** In the U.S., the process of normalization is slowing and nearly 12 million persons remain out of work. A much-needed fiscal stimulus is suspended and faces political headwinds from electoral games. In Europe, the question is not about whether, when and how much the fiscal support will be, but how well it will be spent. There, governments are preparing investment plans for the next five years, focusing on the greening and digitisation of their economy.

Other risks linger on the horizon. The U.S. is engulfed in an election that has seen verbal sparring and polarization increase. The outcome will have a decisive impact on the global order, if the country's dominating economy goes deeper into populism, protectionism and nationalism. In Europe, Brexit looms, although it will only mark the end of the beginning of the U.K.'s web of negotiations needed for the country to find a new modus operandi with its trade partners.

For all these reasons, we keep our central scenario for the next 12-18 months as the "Not Quite Recovery," except in China, which is plowing ahead, though growth is slowing and the second wave presents risks to 2021 if restrictions are extended in geographic terms and duration. **The probability of a "Fiscal Cliff" has fallen (to 10%), as it is now likely that both U.S. political parties are converging on a significant amount of stimulus—if not now, soon enough in 2021.** Draft 2021 budget forecasts released in Europe indicate great care not to reduce the fiscal impulse too early. **This time, it is not profligacy but austerity that is considered a risk to the sovereign outlook. In this light, the "Kitchen Sink" scenario moves to slightly more likely (30%).** If the second wave thwarts the recovery, governments will likely invent new policies rather than disengage. The next months are likely to see further central bank accommodation and fiscal spending. Rates will turn more negative, in more asset classes, and for longer.

This is why risk assets, in particular **equities and high yield credit, present opportunities**. Chinese equities should perform well under our central scenario. To the extent that emerging markets tame the virus, **EM sovereign debt spreads become attractive in a world of low and falling interest rates**. For fixed income investors with a developed country mandate, duration is a friend—except in the U.S., where markets are pricing in further stimulus as inflationary. Central banks have reiterated they will keep rates low for years to come. They will have no choice but to extend their main policy tool (asset purchases) into the foreseeable future. Should the growth outlook deteriorate, equities and credit will suffer.

What Changed in October

WHAT'S NEW

- China is pulling the recovery in the rest of Asia (and also Germany)
- A European safe asset instrument has been issued
- The second wave has arrived in the U.S. and Europe

WHAT WE LEARNED

- Additional U.S. stimulus is not coming before the elections
- Effectiveness of therapeutics and treatments is improving, helping the fatality rate decline
- European governments may not be able to avoid restrictive lockdowns

WHAT WE ARE HEARING FROM OUR TEAMS

- China and the RMB look attractive
- Caution around the U.S. election and also COVID resurgence
- Duration is your friend, except in the U.S.
- Positive environment for EM Corporates

WHAT WE ARE WATCHING

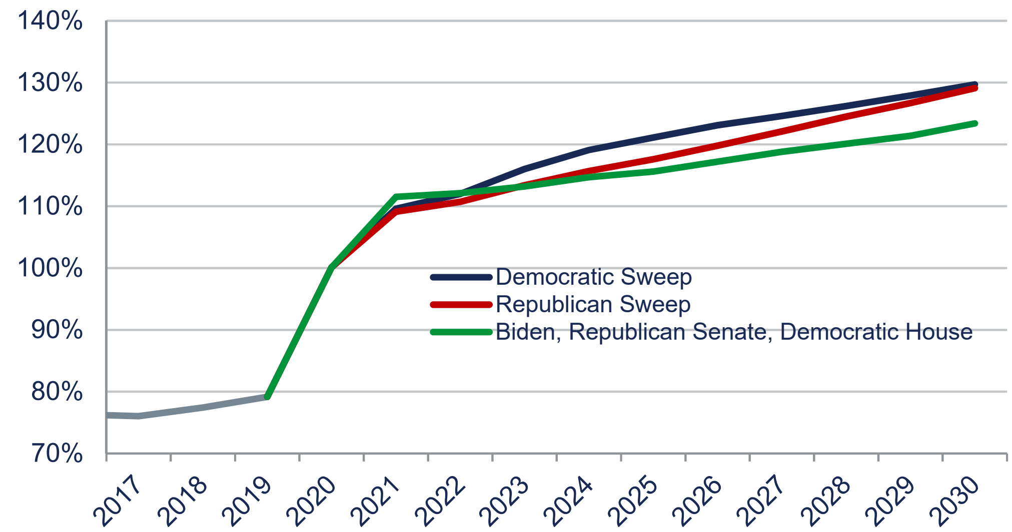
- COVID fatality rates
- Resistance to lockdowns, which can undermine containment efforts by governments globally
- Infrastructure and delivery of vaccines and therapeutics
- Smoothness of U.S. election results
- Light at the end of the Brexit tunnel

Regardless of the election result, further fiscal support is set to aid the economic recovery into 2021.

PHASE FOUR DEAL DILEMMA

Branch of Government	$ Amount	Major Sticking Points
House	$2.2 trillion	-State and local aid -Amount of UI benefit ($600) -Low-income family tax credit -Child tax credit
Senate	$0.5 trillion	-Liability protections -Amount of UI benefit ($300) -Childcare services
Executive	$1.8 trillion	-Liability protections -Amount of UI benefit ($400)

Federal Debt-to-GDP Ratio, Moody's Analytics' Scenarios



More U.S. fiscal stimulus and support for consumers are needed, and both sides of the aisle agree. However, major sticking points such as state and local aid, liability protections, and the amount of additional unemployment insurance benefits (and rising political pressures as we inch closer to Election Day) are preventing a bill from being signed.

While the dollar amount and details will vary depending on the election results, it is highly likely that additional stimulus will be passed into 2021, as both parties acknowledge more support is needed.

In the event of a sweep result, greater stimulus is likely to pass. Under a Democratic sweep, support will largely come via government spending, while a Republican sweep would lean more towards tax-based stimulus. However, if different parties control the White House and Senate, increased gridlock will likely limit the amount of stimulus that is passed.

While different industries will benefit under different administrations, growth is set to be supported in any case. Moody's Analytics' projects higher federal debt-to-GDP ratios under both sweep scenarios and lower in the case of split leadership. Low-interest rates over the medium-term will mitigate the macroeconomic consequences of the larger debt load.

Source: Barings, CBO, and Moody's Analytics. As of October 23, 2020.

CONSENSUS OUTLOOK

Economic Activity	2017	2018	2019	2020 (E)	2021 (E)	2022 (E)
Real GDP (Y/Y %)	3.8	3.5	2.8	-3.9 --	5.2 --	3.6 --
CPI (Y/Y %)	3.2	3.6	3.5	2.3 --	2.6 --	2.8 --
Trade Volume (Y/Y%)	5.6	3.9	1.0	-10.4 ▲	8.3 ▲	8.3 ▲
Inter-Bank Rates						
3-Month USD Libor	1.69	2.81	1.91	0.30 ▼	0.39 ▼	0.58 ▼
3-Month Euribor	-0.33	-0.31	-0.39	-0.47 ▼	-0.42 ▼	-0.38 ▼
3-Month GBP Libor	0.52	0.91	0.79	0.10 ▼	0.13 ▼	0.22 ▼
3-Month JPY Libor	-0.02	-0.07	-0.05	-0.09 ▲	-0.07 --	-0.07 ▼

Arrows indicate consensus estimate change compared to one month ago

CENTRAL BANKS remain on the sidelines as the burden of the recovery shifts firmly toward fiscal policy.

Economy	Policy Rate (%)	Next CB Meeting	Implied Policy Rate (%)		
			3M	6M	1Y
U.S.	0.13	11/05/2020	0.11	0.10	0.08
Eurozone	-0.50	10/29/2020	-0.53	-0.55	-0.58
U.K.	0.10	11/05/2020	0.08	0.04	-0.03
Japan	-0.01	10/29/2020	-0.04	-0.06	-0.05
China	2.20	—	2.11	2.24	2.32

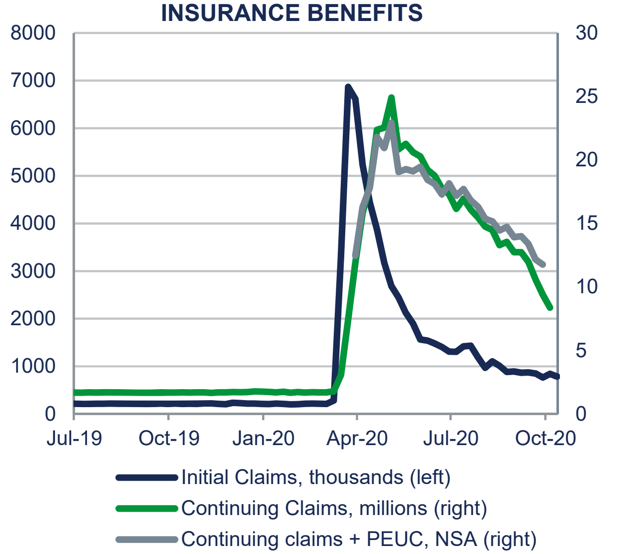
Source: Bloomberg and IMF as of October 26, 2020. (E)—Bloomberg private market consensus estimates for GDP, CPI and rates. Trade volume data is a projected figure from the IMF.

The **LABOR MARKET RECOVERY** is slowing, following much of the easy job gains.

High-income consumers, savings and fiscal stimulus will continue to support **RETAIL SALES** despite slowing job gains.

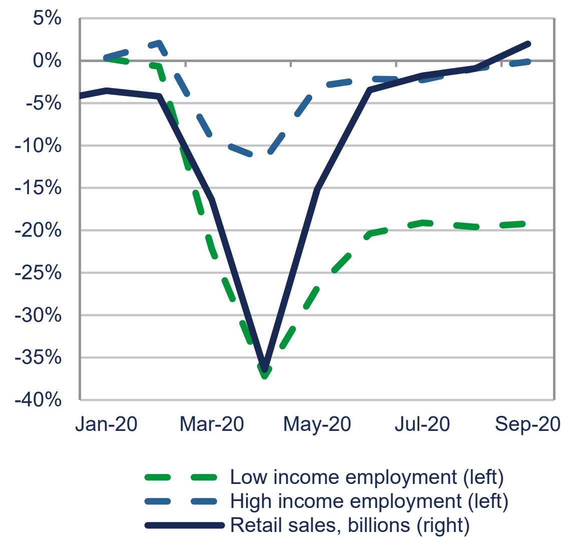
HOUSE PRICES AND RENTS have begun to diverge as a result of the pandemic.

CLAIMS FOR UNEMPLOYMENT INSURANCE BENEFITS



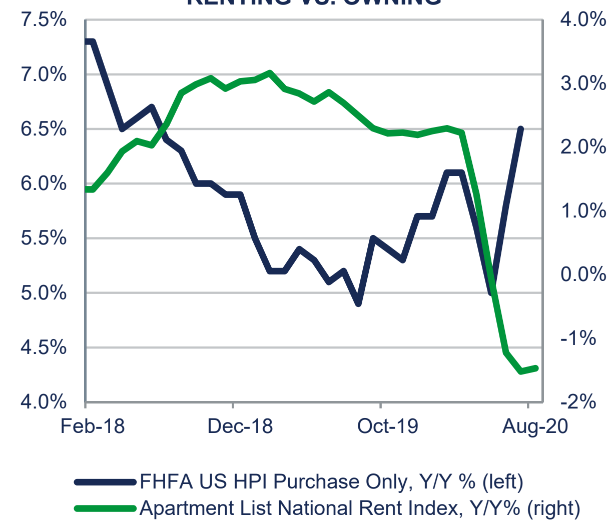
- Initial claims data point to a slowing labor market recovery. Claims remain elevated historically, and the improvement between the Employment Report payroll reference weeks slowed dramatically in October, suggesting a weaker October jobs report.
- While continuing claims are showing a sharper decline, this is overstating the improvement, as much of the decline is due to the expiration of regular benefits as recipients shift to the 13-week extension PEUC program from the CARES Act.

EMPLOYMENT VS. RETAIL SALES



- A patchwork of fiscal stimulus, such as Trump's executive order expanding UI benefits, and pent-up savings are aiding spending despite a slowing pace of job gains.
- While the pace of spending will likely slow as fiscal support fades, high-income consumers will drive retail sales. The top quintile of income accounts for almost 40% of consumer expenditures, while the bottom quintile accounts for just 9%. While low-income employment is still reeling from the pandemic, high-income employment has held up much better—back to pre-crisis levels.

RENTING VS. OWNING



- The impact of rising inequality is also seen in the divergence in prices for renting vs. owning a home. Record-low mortgage rates, millennials entering the market, high-income employment holding up, and shifting housing preferences (i.e. suburbs and single-family) are supporting demand, and, combined with limited supply, boosting prices.
- Conversely, lower-income workers most impacted by the downturn are more likely to rent than own. Combined with shifting preferences, this is pushing down rent costs and leading the price-to-rent ratio higher in the near-term.

Source: Bloomberg, Apartment List, and tracktherecovery.com. As of October 23, 2020.

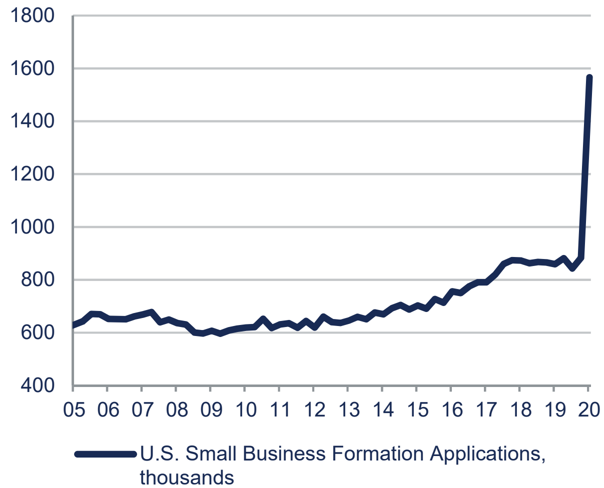
U.S.

Despite an uneven recovery, policy responses have created a more favorable environment for BUSINESS FORMATION.

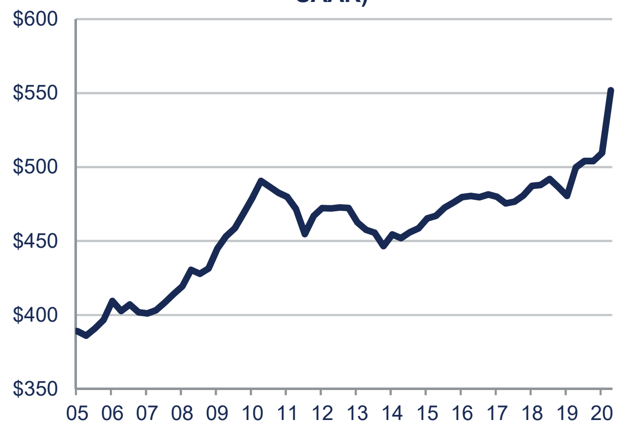
The massive amount of FISCAL SUPPORT is set to ease while stimulus negotiations drag on.

While STATE AND LOCAL budgets are being squeezed, the impact is not as bad as initially feared.

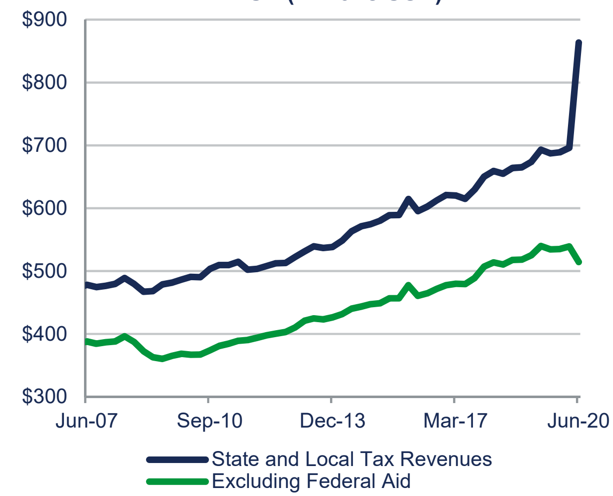
U.S. SMALL BUSINESS FORMATION APPLICATIONS



FEDERAL GOVERNMENT NONDEFENSE PURCHASES & INVESTMENT (Billions USD, SAAR)



STATE AND LOCAL GOVERNMENT TAX REVENUE (Billions USD)



- The dynamic nature of the U.S. recovery, low interest rates, supportive monetary and fiscal policies, solid consumer spending, and a likely backlog have contributed to a record rise in small business formation applications.
- Small businesses are the engine of job growth in the U.S. and are highly correlated with GDP growth. The unprecedented jump in applications provides upside for both the employment and growth outlooks.

- While fiscal stimulus has been key to propping up consumer spending, support is set to ease in the near-term due to prolonged negotiations, which will likely lead to a slower pace of spending in the near-term.
- However, more fiscal support is likely into 2021, following the election. While the dollar amount and details are not yet clear, additional stimulus is set to support the recovery next year.

- While state and local budgets continue to be squeezed as a result of the pandemic, leading many state and local governments to cut programs and employment, fiscal support both directly to governments and to consumers has cushioned the blow.
- In 2Q20, state and local governments had a surplus, largely due to federal grant aid. Excluding the federal aid, tax revenues fell 4.6%, less than expected. While more aid will be needed, they likely won't need as much as initially feared, and needs differ by region.

Source: Bloomberg and BEA. As of October 23, 2020.

CONSENSUS FORECAST

- Our view is in line with consensus for growth, inflation and unemployment for 2020
- For 2021, though, we see a slightly stronger labor market recovery and growth rate than consensus due to the strong initial policy response

Economic Growth	10/26/2020	12/31/2018	12/31/2019	2020 (E)	2021 (E)	2022 (E)
Real GDP (Y/Y %)	-9.0	3.0	2.2	-4.0 ▲	3.8 ▲	2.8 ▼
Inflation						
CPI (Y/Y %)	1.4	2.5	1.8	1.2 ▲	1.9 --	2.0 --
Core PCE (Y/Y %)	1.6	2.0	1.7	1.4 ▲	1.7 ▲	1.7 --
Labor Market						
Unemployment (%)	7.9	3.9	3.7	8.3 ▼	6.7 ▼	5.5 ▼
Rates						
Fed Funds	0.13	2.38	1.63	0.25 --	0.30 --	0.35 ▼
2Y Treasury	0.15	2.52	1.57	0.20 ▼	0.38 ▼	0.63 ▼
10Y Treasury	0.80	2.72	1.92	0.76 --	1.14 ▼	1.53 --

Arrows indicate consensus estimate change compared to one month ago

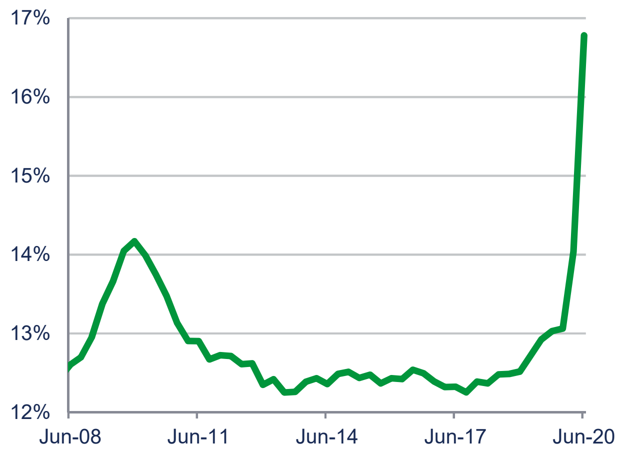
Source: Bloomberg. As of October 26, 2020. (E)—Bloomberg private market consensus estimates.

Cheap CREDIT AND SAVINGS accumulated in Q2 supported spending in Q3.

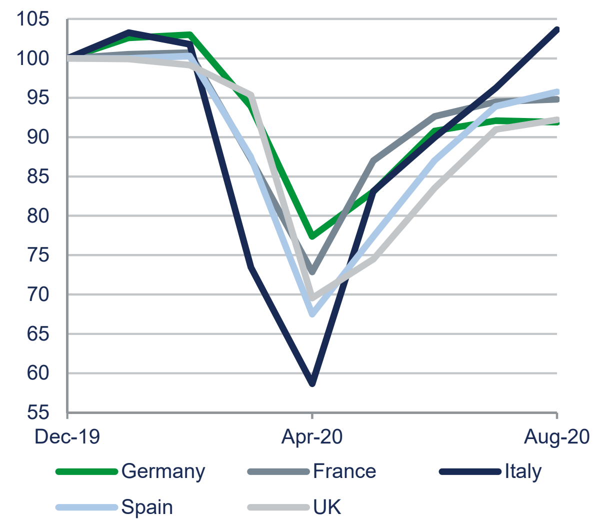
Most economies are 5-10% BELOW pre-COVID levels but face the threat from a second wave.

The SECOND WAVE has arrived but appears less fatal than the first.

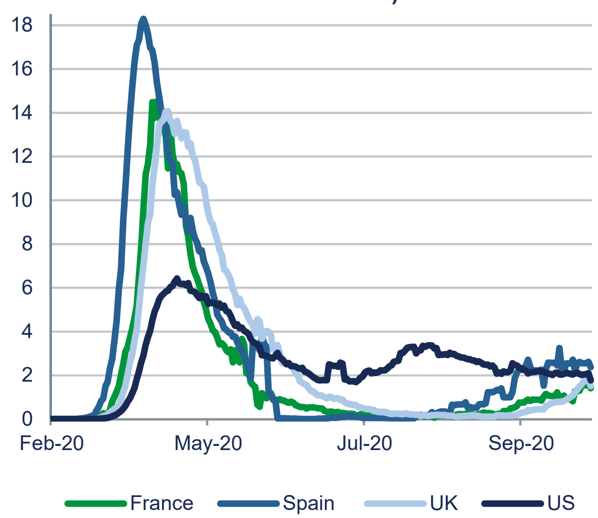
HOUSEHOLD SAVINGS RATE



INDUSTRIAL PRODUCTION



DAILY FATALITIES (PER MILLION INHABITANTS)



- The recovery this summer was vibrant In Europe. Cheap credit and the unprecedented amount of savings accumulated in the second quarter were used to satisfy pent-up demand, resulting in strong activity.
- The joint fiscal and monetary support was evidently effective in shielding households' income and liquidity.

- Most economies have stabilized around 85-90% of pre-COVID levels of activity. Italy is the surprising front runner, with industrial production almost 5% above its end-2019 level. While part of this outperformance may be explained by temporary factors, other incoming data (e.g. retail sales) have been upbeat.
- September PMIs indicate that the second wave threatens this recovery.

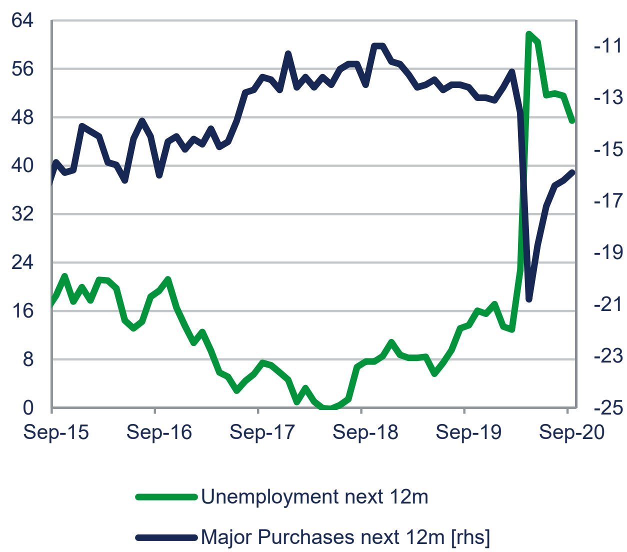
- Fatalities are on the rise again, albeit still very far from their April peak. Medical progress with avoiding ICU keeps people in regular hospital beds longer, risking to overwhelm capacity. This could motivate governments to tighten further confinement restrictions.
- Reintroducing lockdowns that helped EU countries keep fatalities well below levels in the U.S. could hurt the ongoing recovery.

Source: Bloomberg and Haver. As of June 30, 2020.

Europe

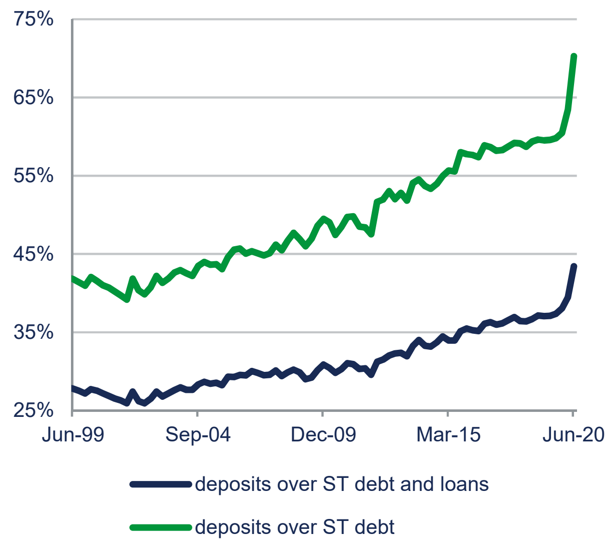
The **IMPACT ON CONFIDENCE** cannot be avoided.	The good news is that **FIRMS' BALANCE SHEETS** are solid…	…and **POLICY** will continue to support the economy fully.

EXPECTATIONS



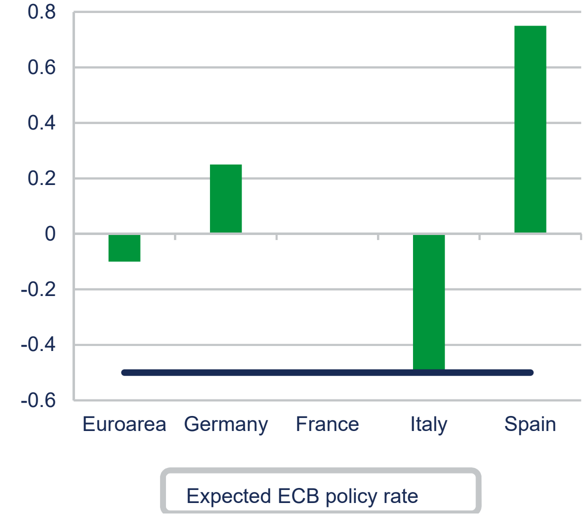
- With confidence levels still depressed, a resurgence of the virus could represent a shock to consumer spending.
- A slowdown in the process of normalization in economies would likely increase fears of unemployment.

FIRMS' CASH ACCOUNTS



- Firms appear to be in a strong position to withstand the second wave, having stacked up on cash for the rainy days.
- They did so for at least a decade, and then took advantage of the central bank largesse in the first half of 2020 to bring their cash deposits to record highs. Corporate deposits currently cover 70% of their short-term debt and 45% of their short-term debt and loans.

CHANGE IN FISCAL ACCOMODATION 2020-21



- Draft 2021 budgets show virtually no fiscal tightening planned across Europe.
- In Italy, the small 0.5% of GDP cut in accommodation hides a decision to keep fiscal spending high, with the 2021 deficit to reach 11% of GDP.
- The ECB commitment to low rates for longer is inflexible.

Source: Bloomberg and Haver. As of June 30, 2020.

CONSENSUS FORECASTS

- We share the consensus view for what remains of 2020
- Faster than expected resurgence of COVID-19 tilts the risks slightly to the downside for 2021

Economic Growth	10/26/2020	12/31/2018	12/31/2019	2020 (E)	2021 (E)	2022 (E)
EZ Real GDP (Y/Y %)	-14.8	1.9	1.3	-7.9 ▲	5.5 ▼	2.5 --
U.K. Real GDP (Y/Y %)	-21.5	1.2	1.3	-10.0 --	6.0 ▼	2.7 ▲
Inflation						
EZ CPI (Y/Y %)	-0.3	1.8	1.2	0.3 ▼	1.0 --	1.3 --
U.K. CPI (Y/Y %)	0.5	2.5	1.8	0.9 --	1.5 --	1.8 ▲
Labor Market						
EZ Unemployment (%)	8.1	8.2	7.6	8.2 ▲	9.3 --	8.8 ▲
U.K. Unemployment (%)	4.5	4.1	3.8	5.3 ▼	6.9 ▲	5.5 ▼
Rates						
EZ Central Bank	0.00	0.00	0.00	0.00 --	0.00 --	0.00 --
EZ 2Y Note	-0.74	-0.62	-0.61	-0.67 ▼	-0.56 ▼	-0.47 ▲
EZ 10Y Bond	-0.58	0.24	-0.19	-0.47 ▼	-0.25 ▼	-0.07 ▼
U.K. Central Bank	0.10	0.75	0.75	0.10 --	0.05 ▼	0.10 ▼
U.K. 2Y Gilts	-0.04	0.74	0.53	-0.04 ▼	0.07 ▼	0.16 --
U.K. 10Y Gilts	0.27	1.27	0.82	0.23 ▼	0.44 ▼	0.51 ▼
Currencies						
EUR/USD	1.18	1.14	1.12	1.18 ▼	1.22 ▼	1.22 ▼
GBP/USD	1.30	1.27	1.33	1.30 --	1.35 --	1.38 ▼

Arrows indicate consensus estimate change compared to one month ago

Source: Bloomberg. As of October 26, 2020. (E)—Bloomberg private market consensus estimates.

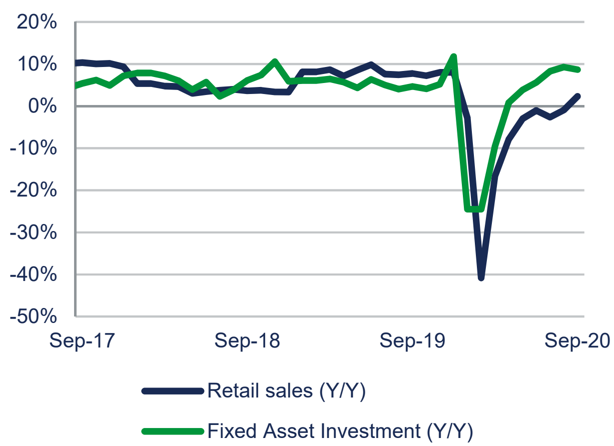
Asia Pacific

INTERNAL DEMAND in China appears to be returning and is catching up to the recovery in investment…

…as a result, a rising China is lifting all boats through INCREASED TRADE, and could be signaling a bottom in capex.

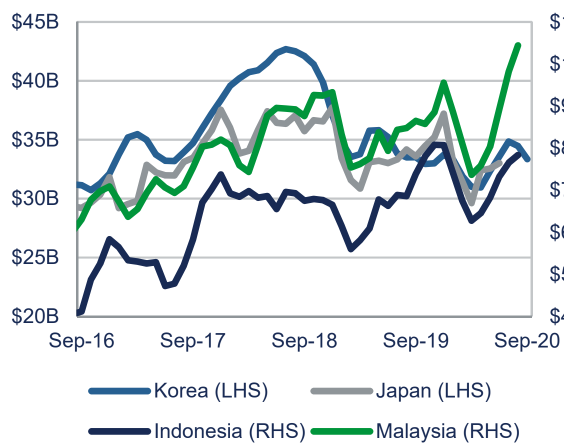
REGIONAL EMPLOYMENT LEVELS, while still broadly below where they were in 2019, have recovered significantly.

CHINA RETAIL SALES AND INVESTMENT GROWTH



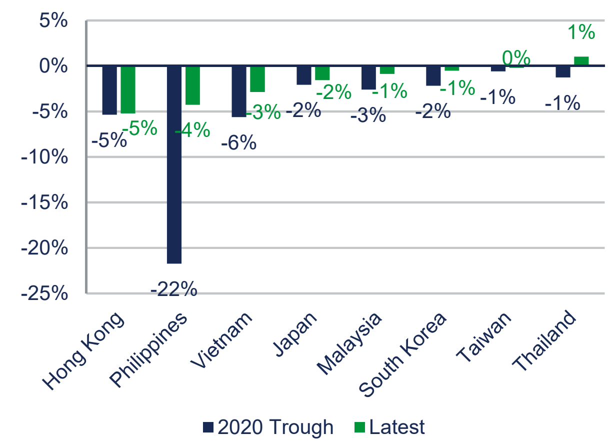
- A contained pandemic risk is allowing consumer spending to return.
- China's new economic model, called "dual circulation," will attempt to rely on these two sources of domestic demand, consumption and investment, to drive growth while maintaining openness to international trade.

THREE-MONTH ROLLING EXPORTS TO CHINA



- Robust exports to China could mark a bottom in Asia ex-China real investment, which has declined 29% on a Y/Y basis.
- The perspective of having China as the main engine of global growth may be limited, however. The model is different, its initial conditions are vastly different compared to the GFC and sustained double-digit growth is an unlikely scenario.

EMPLOYMENT RELATIVE TO YEAR-END 2019



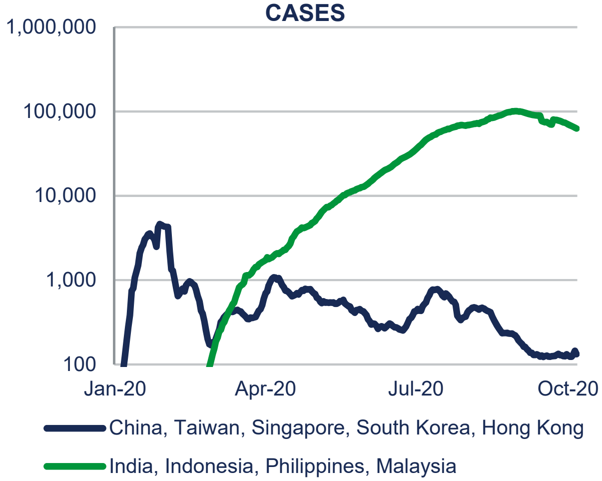
- The bounce-back in trade has been a boon to export-driven economies, which have seen employment gradually revert back to 2019-levels.
- While capacity utilization is still below where it was pre-crisis, the strongest recoveries are those seen in Malaysia and Thailand.

Source: Bloomberg and Haver. As of October 23, 2020.

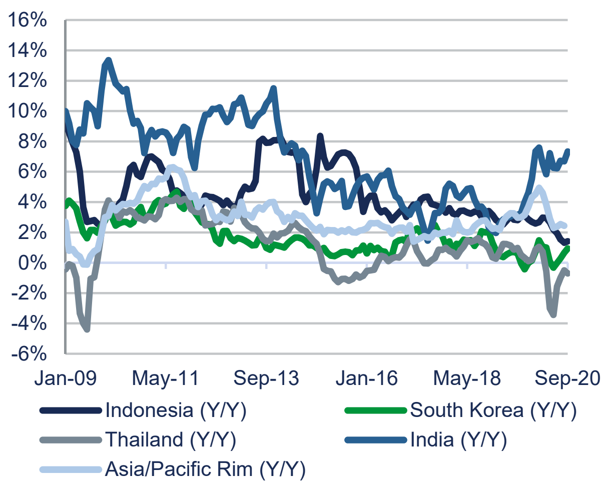
Asia Pacific

While the contagion rate for the region as a whole is improving, VIRAL CONTAINMENT is not an even story across the region.	**Fiscal policy is the preferred tool of action at the moment amid BENIGN INFLATION.**	**IMF FORECASTS are pointing to a better-than-originally expected rebound, but prospects continue to remain precarious.**

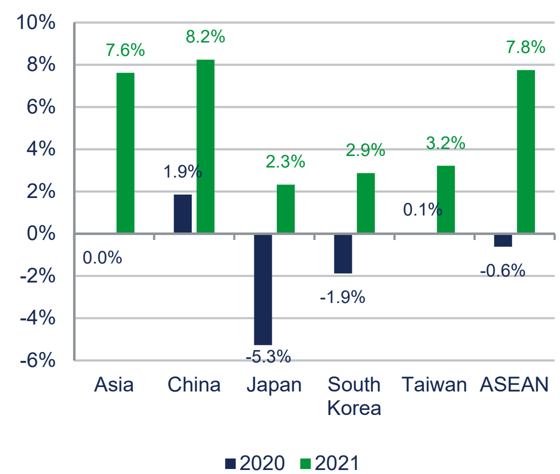
7-DAY ROLLING AVERAGE NEW COVID-19 CASES



CONSUMER PRICE INFLATION



REAL GDP Y/Y GROWTH IMF FORECAST



- While not worsening, pockets of high virus counts still exist, notably in Emerging Asia.
- As both the U.S. and Europe see additional waves of contagion, the risk exists that this bleed into Asia, which could derail the recovery momentum.

- Central Banks moved early and swiftly, pushing up against the limits of their traditional tools. Strong currencies may stymie a quick build up of external inflationary pressures, providing more room to ease if needed.
- But fiscal is the focus in the near-term. Most monetary easing is likely done, but space for additional marginal easing is possible in countries such as Thailand and Indonesia.

- Advanced Asian economies are projected to have a more moderate contraction compared to Europe amid a better-contained pandemic.
- However, Emerging Asia ex-China economies are still prone to setbacks amid continued spread of the pandemic and a high degree of reliance on tourism and external finance.

Source: Bloomberg, Haver and IMF. As of October 23, 2020.

CONSENSUS FORECAST

- Our view is in line with consensus for growth, inflation and unemployment for 2020
- We see inflation running slightly higher than consensus in Japan for 2021 on stronger demand

Economic Growth	10/26/2020	12/31/2018	12/31/2019	2020 (E)	2021 (E)	2022 (E)
Japan Real GDP (Y/Y %)	-9.9	0.3	0.7	-5.6 ▲	2.5 ▼	1.6 ▼
China Real GDP (Y/Y %)	4.9	6.7	6.1	2.1 --	8.0 --	5.4 ▼
Inflation						
Japan CPI (Y/Y %)	0.0	1.0	0.5	0.0 --	0.2 --	0.6 --
China CPI (Y/Y %)	1.7	2.1	2.9	2.8 --	2.2 --	2.3 --
Labor Market						
Japan Unemployment (%)	3.0	2.4	2.4	2.9 --	3.2 ▼	2.7 --
China Unemployment (%)	3.8	3.8	3.6	3.9 ▼	3.9 ▼	3.8 ▼
Rates						
Japan Central Bank	-0.10	-0.10	-0.10	-0.10 --	-0.10 --	-0.10 ▼
Japan 2Y Note	-0.14	-0.15	100.46	-0.12 ▲	-0.09 ▼	-0.10 ▲
Japan 10Y Bond	0.03	-0.01	100.69	-0.01 --	0.03 --	0.04 --
China Central Bank	4.35	4.35	4.35	4.30 --	4.30 --	4.20 --
China 2Y Note	2.86	2.75	99.63	2.52 --	2.44 --	2.23 --
China 10Y Bond	3.19	3.30	95.84	2.97 --	3.01 --	2.93 --
Currencies						
USD/JPY	104.87	110.27	104.87	105.00 ▼	105.00 --	103.50 ▼
USD/CNY	6.67	6.86	6.67	6.78 ▼	6.75 ▲	6.65 ▼

Arrows indicate consensus estimate change compared to one month ago

Source: Bloomberg. As of October 26, 2020. (E)—Bloomberg private market consensus estimates.

THE NOT QUITE RECOVERY (60% ODDS)

Fast and effective policy response from mostly key central banks and finance ministries have shielded the cash flows of households and firms. Unlike 2008, firms and households also entered this year with strong balance sheets.

The world economy will recover steadily, but slowly and unevenly. Some firms continue to tap credit markets and enjoy strong demand; others will suffer from permanent changes in consumer behavior or run out of liquidity before demand returns.

In this scenario, spending and investment are expected to rebound over the next 12 months but remain below 2019 levels because:

- Not all household and corporate income was (or will be) protected by policy support
- Lingering uncertainty on global demand
- Firms may cut labor costs to afford future investments, including in green and digital infrastructure

Conditions

- Continued policy support, especially in the form of direct government payments to households and businesses
- COVID containment succeeds so that consumer confidence steadily returns

Indicators to watch

- Personal income, spending and savings
- Non-performing loans, downgrades, bankruptcies
- Unemployment dynamics and labor force participation rates
- Consumer surveys and capex intentions

Analysis

Even in China, where the downturn was most shallow and the recovery is most advanced, the **picture is mixed**, as retail spending lags the recovery on the supply side. Also, income loss has been substantial for poorer urban and migrant workers. The government-driven investment boom needs to be accompanied by a recovery of world trade for a return to full capacity.

In Europe, furlough schemes protect 70-80% of **employees' income**, but independent workers are less protected and firms' revenues have declined considerably. In the U.S., the CARES Act raised private incomes, but that support has now expired and savings are being drawn down.

The COVID-19 shock hit a **global order** that was already in transition to address the challenges of climate change, rising inequality and tremors in geopolitical alliances. The shock may accelerate some long-term changes in behavior already underway: digitization has made a quantum leap, teleworking has become a credible alternative, and travel and leisure seem likely to find new patterns.

This points toward new **winners and losers** across sectors and countries. The job prospects of the millions in temporary layoffs are unclear. Out of precaution, households are cutting spending for now. If vaccines emerge over the next six months, as now seems likely, will consumers forget about all the uncertainty and jump back to spending and investing? Hope is not a plan. Government support remains essential even to achieve a "not quite recovery."

FISCAL CLIFF SCENARIO (10% ODDS)

If public support is withdrawn prematurely, either in the U.S. amid rising partisan tensions or in Europe as public debt worries return, a central pillar to the recovery will disappear. With unemployment benefits and furlough schemes fading, the depletion of household savings and firms' liquidity buffers will lead to another recession in 2021.

A second wave, in this context, would be devastating.

Conditions

- Policymakers reduce fiscal support, notwithstanding persisting labor market fragility (lower employment, falling wages)

Indicators

- Cuts in furlough schemes and unemployment benefits
- Rising long-term unemployment
- COVID-19 hospitalization and fatality dynamics

Analysis

Initially in the crisis, politicians of all stripes stood united around large and lasting public support. There was talk of largely unchecked public spending supported by central banks in a world of low inflation and low growth.

But with the initial stages of recovery, the **traditional debate** returned. In the U.S., the extra unemployment benefits have been left to expire, while presidential executive orders provide a limited offset. In Italy and Spain, furlough schemes will expire by year-end. Surely governments will be forced to spend more as the final stages of recovery slow. But what if they don't and start trying to balance the budget the way they did in the wake of the Global Financial Crisis?

KITCHEN SINK SCENARIO (30% ODDS)

A recovery that disappoints significantly could force governments into even more aggressive action. This could arise from a resurgence of COVID-19, unexpected financial turmoil or unemployment rates that get stuck above acceptable levels. Fiscal authorities under such circumstances would be forced into much greater spending commitments, while central banks would be expanding their balance sheets even more. Ultimately, such a response seems likely to succeed in reflating the economy, but it would leave financial markets dominated and distorted by government intervention.

Conditions

- Broad, strong and protracted fiscal expansion that leads to slowly rising prices

Indicators

- Signs of permanent damage to labor markets
- Corporate bankruptcies
- Extreme financial market volatility

Analysis

Modern Monetary Theory (MMT) has moved from the fringes of academic thinking to polite policy circles, arguing in favor of running expansionary fiscal policies until the economy reaches full employment, and only then caring about inflation.

This scenario would likely come closest to what its supporters advocate. An efficient outcome with employment could still create the greatest risks for surging inflation that markets find difficult to envision today.

Scenario Matrix—Economy

		Scenarios						
		1. Not Quite Recovery		*2. Fiscal Cliff*		*3. Kitchen Sink*		
		2020	**2021**	**2020**	**2021**	**2020**	**2021**	**Comments**
U.S.	Growth	-4.5%	+4.0%	-6.5%	+1.0%	-3.5%	+2.0%	The U.S. economy continues to rally and the 2020 forecast could improve further if Congress passes another fiscal relief package.
	Inflation	+1.0%	+1.4%	+1.0%	+1.7%	+1.0%	+1.0%	
	Unemployment	9.0%	6.5%	11.0%	8.0%	7.0%	7.0%	
Euro Area	Growth	-8%	4-5%	-8%	0%	-8%	1–2%	Fast and effective monetary and fiscal responses are supporting household spending and firm viability, without any inflation pressure on the horizon.
	Inflation	<1%	<1%	<1%	<1%	<1%	<1%	
	Unemployment	10%	7%	10%	12%	10%	10%	
Japan	Growth	-6%	2–3%	-6%	0–1%	-6%	1–2%	The new PM will continue the reflationary policies of his predecessor and supports current monetary policy, which backs fiscal expansion efforts.
	Inflation	0%	.5%	0%	0%	0%	0%	
	Unemployment	3%	3%	3%	4%	3%	3%	
China	Growth	2–2.5%	8%	2–2.5%	3–4%	2–2.5%	6-7%	The recovery in key economic drivers remains uneven. Exports are surprising to the upside and real estate investment is rising at double digits, but retail sales lag.
	Inflation	2–3%	2%	2–3%	2%	2-3%	2-3%	
	Unemployment	4%	4%	4–4.5%	4–5%	4–4.5%	4%	

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Scenario Matrix—Central Bank Policy

	Scenarios			
Central Bank	*1. Not Quite Recovery*	*2. Fiscal Cliff*	*3. Kitchen Sink*	*Comments*
FED	Fed Funds Rate: 0% Balance Sheet: Accommodative	Fed Funds Rate: 0% Balance Sheet: Very accommodative	Fed Funds Rate: 0% Balance Sheet: Less accommodative	In the Fed's new framework, tightening only begins after balance sheet reduction, perhaps in 2023, when inflation rises above 2%.
ECB	Policy keeps rates negative; Asset purchase programs continue into 2021 and are renewed if needed.	Policy rate steady; Asset purchase programs are expanded.	No rate hike; Asset purchase programs enlarged	As inflation will remain subdued and far below its 2% policy target, the ECB remains under constant pressure to do more.
BOJ	Policy rate stays negative; Balance sheet: Accommodative	Policy rate stays negative; Balance sheet: Very accommodative	Policy rate stays negative; Asset purchase programs enlarged	Maintain easing to support economic growth and elusive inflation target.
PBOC	Cautiously accommodative stance for 2020 and 2021	Monetary easing	Close eye on financial stability	The PBOC keeps a watchful eye on the economy, ready to do more at any hint of weakening but mindful of financial stability implications.

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Scenario Matrix—Markets

	Scenarios			
Markets	***1. Not Quite Recovery***	***2. Fiscal Cliff***	***3. Kitchen Sink***	***Comments***
Rates	Policy rates unchanged; 10Y UST drifts higher	Policy rates unchanged; 10Y UST steady-to-lower	Policy rates unchanged; 10Y UST higher	Short rates anchored by central bank policy, watching the long end to gauge steepening.
Corporate Credit	Spreads grind tighter	Spreads widen some	Spreads move tighter	Liquidity environment supportive of credit conditions.
Equities	Modestly higher	Likely lower	Likely higher	We expect some moderating of valuations through year-end as current measures seem to price in an ideal cyclical recovery.
FX	USD weakness continues	USD steady	USD weakens more	U.S. election presents near term risks, but sustained USD downtrend is unlikely.
Commodities	Oil, copper and gold generally higher	Oil, copper and gold generally range-bound	Oil, copper and gold move higher	Supported by weaker USD and continued global economic recovery.

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