Connecting the dots – time to prepare for trouble

A bungled response in the USA to the pandemic now threatens to derail the global economic recovery. The US economy will likely shrink by 3-4% in 2020-22. A Federal Reserve Governor says a "thick fog" of uncertainty is surrounding the US economy. Despite extraordinary uncertainty about earnings, the stock markets continue their upwards momentum.

Our proprietary economic indicators suggest that after the initial rebound US economic activity is already levelling off. On 13 July, US Fed Governor Lael Brainard warned there is a "*thick fog surrounds us and downside risks predominate*"(2 min. read).

This is not exactly the impression one gets looking at the stock markets, where most of the losses from March have now been recovered. The explanation being that, "market participants realise the uncertainty, but try to look through to the other side".

By our measures, risk in the financial markets is growing rapidly and we believe that it is time to prepare for the possible fall-out. Quite a number of elements are now moving the wrong way.

Risk from the US CoVid-19 response

Right from beginning of the pandemic in the US it was clear there was a risk that the Trump administration would politicise the response, side-lining sound medical advice.

It happened as expected and the Coronavirus has flared up again with the new infections per day setting new records and the infection numbers growing.

It becomes likelier by the day that new measures will be introduced to curb the spread of the virus. A vaccine will not be ready until 2021 and it will take time to produce and distribute it.

At the same time, the virus is spreading quickly in the rest of the world with the exception of Europe and China.

Which in turn creates regional divergences, in financial market performance to be explored.

Risk from a protracted and slow economic recovery

Initially, policymakers expected that the effects of the virus would last a quarter. Significant assistance packages were introduced to carry the economies over that quarter without structural damage.

But the loss of economic activity was much deeper than expected. The explanation is simple: people saved far more than expected during the lockdown and are hesitant to open their wallets again as the countries are opened.

The economic recovery thus already appears to be losing steam.

Federal Reserve does not expect the US economy to have fully recovered even by end 2022. IMF has recently downgraded global growth estimates (again) and now expect GDP growth of -8% in the US and -10.2 per cent in the EU.

Emerging markets economies are expected to shrink by -3.1% and the global growth is set to be -4.9% - the worst since IMF was established after WW2.

In Geneva, BIS hold similar concerns and recently lowered its global growth outlook for 2020 from flat to -5%.

Policy risk

Most countries threw caution to the wind in February and added fiscal spending, loan packages and "payroll guarantees". Many countries announced that the assistance would be temporary, 3-4 months. They expire around now. (Paul Krugman, 20 min. audio).

The recovery now seems to be slower than expected and a new situation occurs: many countries are close to dangerous levels of government debt. Politicians are now far more hesitant to just continuing forking money out in the months to come.

In the US, the Republicans have suddenly realised that the 2017 tax cuts led to a huge increase the federal deficit. With critical general elections coming in November, it seems unlikely that additional stimulus will be forthcoming.

In Europe, Germany has made a 180-degree turn and now supports EU-wide support to the economies as a way of preventing the Union from breaking up. But of course, not every member country is ready for such a paradigm shift. However, it seems certain though that a new package will be forthcoming, but far less ambitious than the packages of March.

Central Bank risk

Across the globe, central banks have inflated their balances strongly and offered credit lines to banks. As a part of their programmes, the banks can sell everything from AAA government bonds down to CLO's to the central banks.

It all increases the available liquidity for the banks to lend, and we have not seen a credit squeeze so far.

Central banks continue to promise that they can do more - if needed.

Again, we emphasize that the central banks are aiding banks, not private investors. And we are not talking about a bailout for corporate loans, only a pause.

A credit crisis risk

A couple of months before the coronavirus struck, IMF published a study on corporate debt. It warned that if for some reason the global economy would enter a recession, we would be facing a major credit event.

They were of course talking about the high-yield segment – which formerly was referred to as "junk bonds". They also mentioned that the BBB segment, the lowest investment grade segment, would be in danger of downgrades if a recession were to happen.

They did not mention CLOs, packaged corporate loans, which are fundamentally CDO's 2.0. Except that the estimated volume is only 1/3 of the CDO market in 2007.

Taken together, the corporate loan structure and volume pointed to a major credit event in case of a recession.

It is no coincidence that the central banks specifically opened new facilities to purchase junk bonds, BBB bonds and even CLOs. It was done to protect the investors. The banks were granted more lenient terms for corporate lending – which of course would postpone the credit event.

Importantly, the central banks have **not** suspended a safety net under the corporate loan/bond market. They have nationalised part of the losses in case of defaults and they have postponed some defaults by supporting additional credit lines (more on that).

Obviously, just as massive stimulus has postponed credit events, any delay in the economic recovery will keep increasing the default risk.

Market Risk

With both stock markets and bond markets gaining, the normal correlation pattern is (again) absent. In our experience, it is a bad sign. It implies that the normal portfolio diversification does not work and that portfolio risks are growing.

Add that the stock markets increasingly are decoupled from planet earth, where growth is slowing and uncertainty about the future reigns.

Finally, in the immortal words of Yogi Berra: "*It's déjà vu all over again*". Or so it seems. Just like in 1999, the markets are pulled upwards mainly by leading tech firms, while most other companies are languishing. Some of the main drivers are far away from healthy points.

The overall risk scenario

The current situation is one of convergence of several factors which, taken one by one, each have the potential to wreak stock market havoc. This convergence of threats does not necessarily resolve itself in a stock market breakdown. Markets could remain stable. But it would require that one or more of the threats begin to subside.

We do not see any signs this is happening. Instead the risk is increasing steadily. Such risk scenarios have a tendency to stretch and suddenly snap – by then, it's too late to start the process of planning.

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