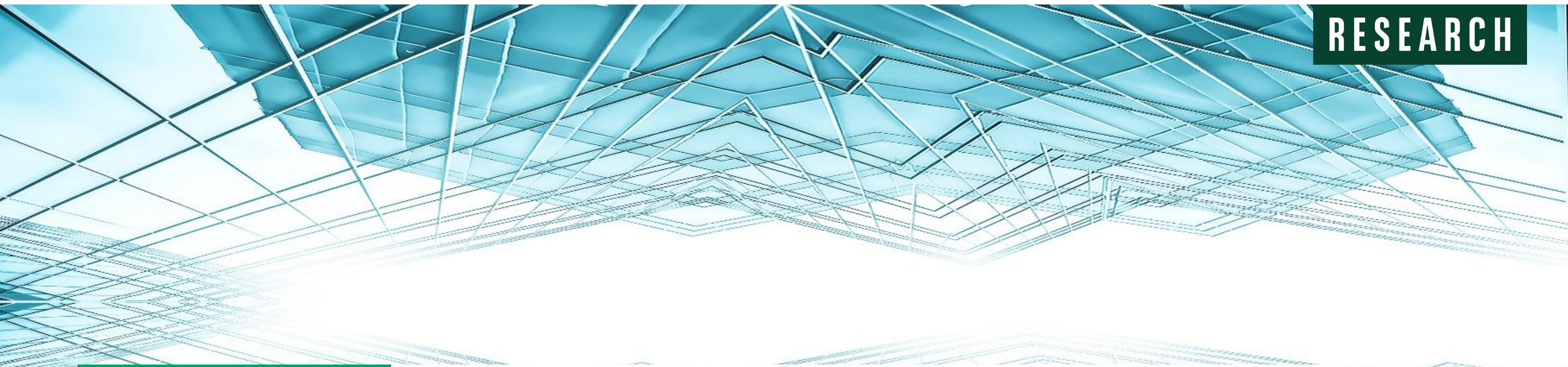


RESEARCH & INSIGHTS

COVID-19: THE VIRUS MAKING THE GLOBAL ECONOMY BRAKE

As of 25th March 2020

A different kind of systemic risk

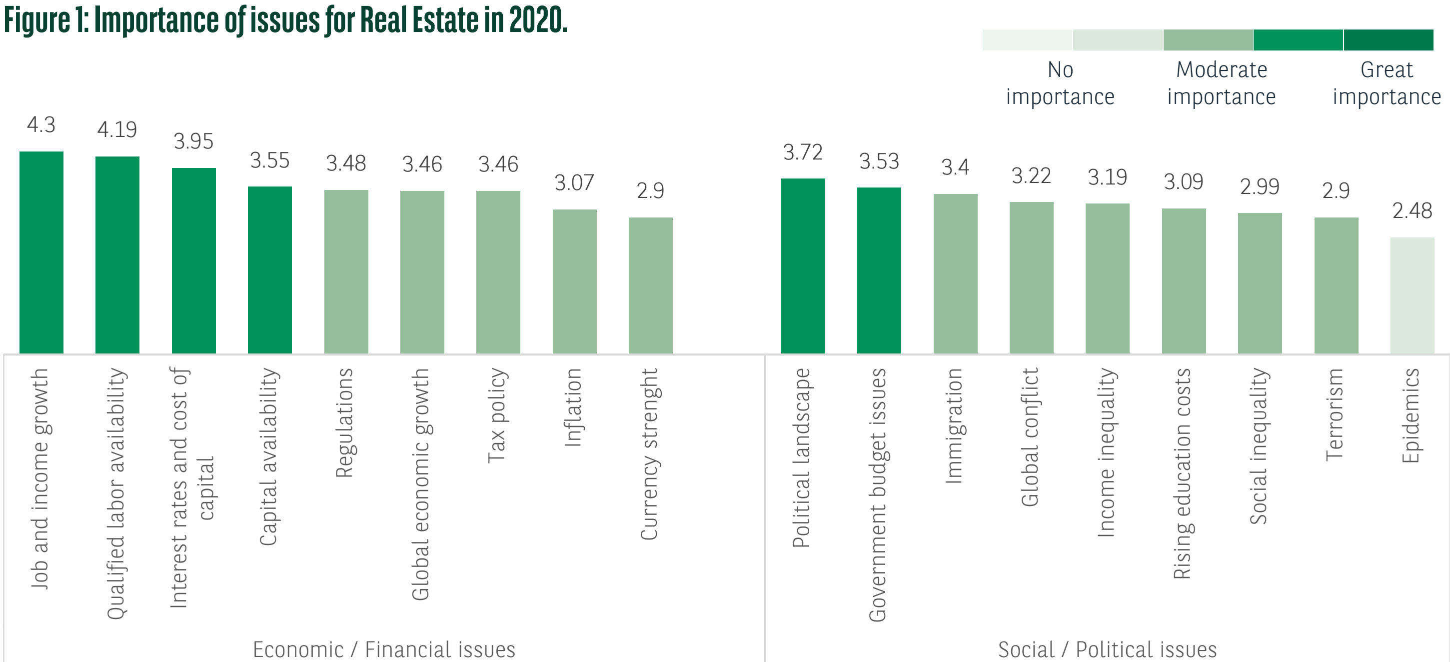
At the end of 2019, economists around the world were sure about one thing: 2020 should be a year of continuity, and even better than 2019 as economic systemic risk around us started to reduce (mainly Brexit and the trade war between the US and China). GDP and employment growth were expected to be slightly above their long-term average for the major economies, while investment would also continue to be strong for all asset classes (shares, bonds, real estate).

All these predictions were made before the outbreak of the SARS-CoV-2 virus in December 2019…

The emergence of SARS-CoV-2 virus (later called Covid-19) at the beginning of 2020 took the world by surprise with its virulence and delivered a shock, just as the global economy had begun to stabilise. To illustrate how unexpected this outbreak was for the global economy, we can quote the results of an investors' survey published at the end of 2019 by PWC (figure 1). The survey showed that the most concerning points were social and political issues, specifically the political landscape, government budget issues and immigration. Epidemic issues were last in terms of concerns.

However, despite confidence in Europe and in the United States that Covid-19 would be confined to Asia, the pandemic is now a reality and will definitely be the main issue of this year.

Figure 1: Importance of issues for Real Estate in 2020.



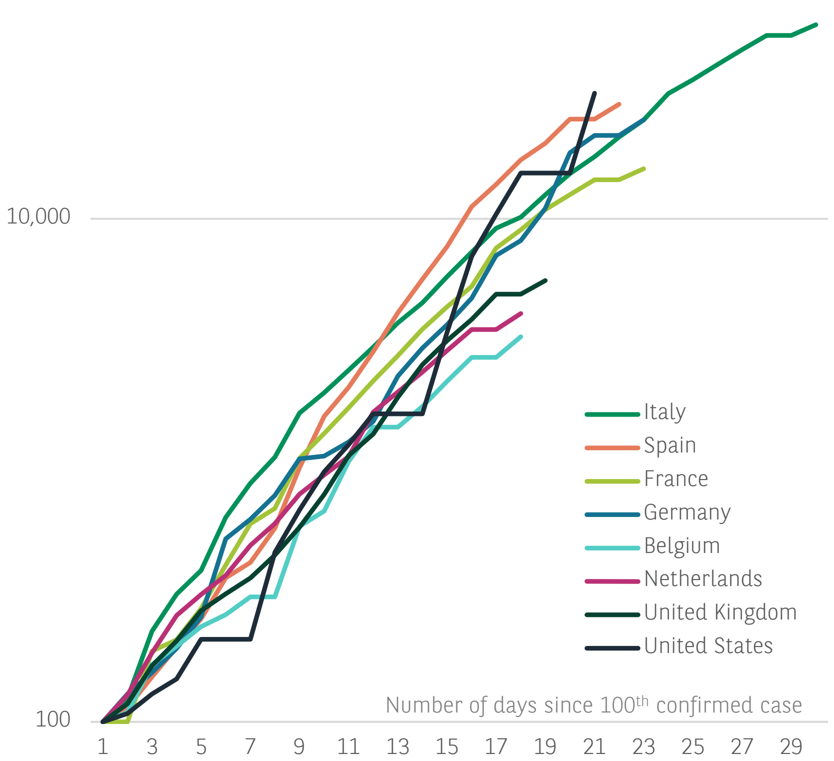
Emerging Trends in Real Estate, United States and Canada 2020, PWC, ULI

As of 24th March, we know that the virus is widely spread across countries (160 countries are infected). The hotspots are China (28% of cases), Iran, Italy, Spain, Germany and France.

According to scientists, the virus is highly contagious, cross-infecting three people per person compared to 1.5 for flu. Consequently it is spreading quickly, particularly since people who contract the virus are contagious from the onset of infection and symptoms can take up to two weeks to manifest. All the main European economies currently have a growth rate of confirmed cases of around 30% per day, and around 20 000 new cases are reported daily in Europe. The centre of the pandemic is Italy, with around 60 000 confirmed cases in cumulative terms (35% of the total in Europe). At the same time, the number of cases in Spain is also escalating and may be a point of vigilance.

Severe cases are rare (5%) and the majority of infected individuals will have mild symptoms (80%). The fatality rate is around 3.4% on average (estimated by the World Health Organisation), heavily weighted towards the elderly or those with pre-existing medical conditions (such as cardiovascular disease, diabetes or chronic respiratory disease). However, the fatality rate should be revised downwards as it is computed only on people that have been reported to be sick (and people may have been sick without reporting it).

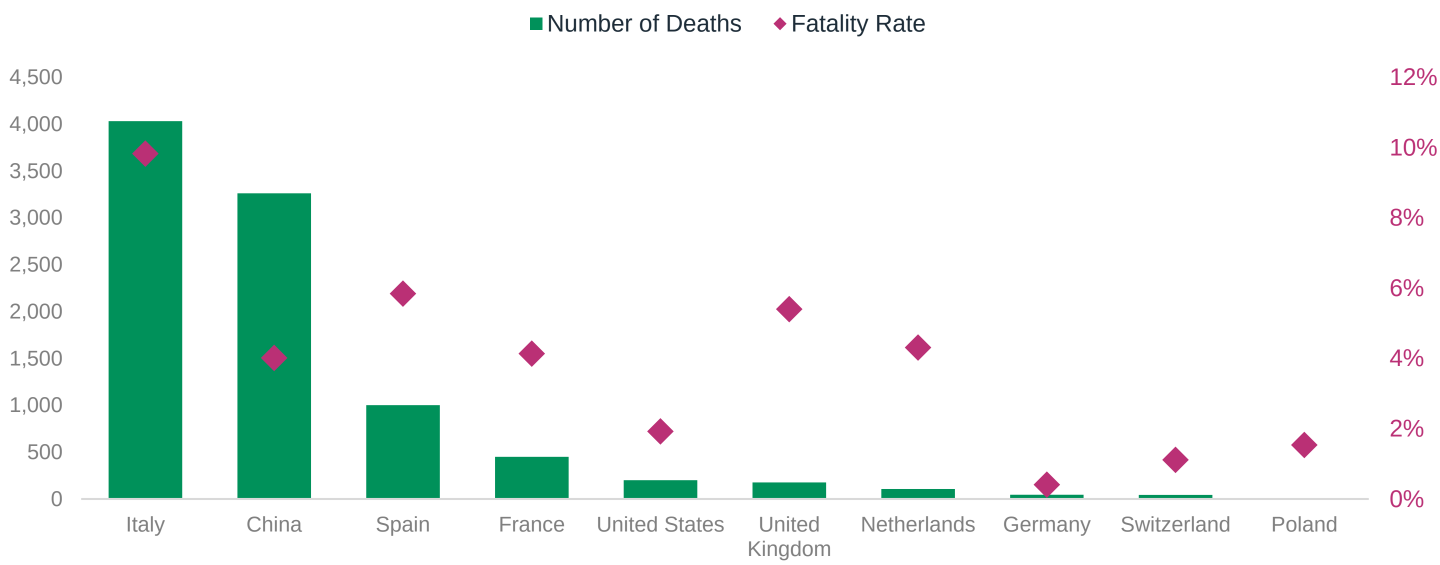
Figure 2: Infection trajectories: growth of outbreaks.



World Health Organisation, BNP Paribas Real Estate - Research - March 2020

Therefore, the fatality rate differs greatly for every country. In China, the rate has reached around 4.0% since the beginning of the outbreak, whereas Italy is experiencing the highest rate (around 10%), as 23% of the Italian population is older than 65 and nearly 60% is aged 40 or over. For countries with more robustly resourced healthcare systems (Germany, Switzerland, etc.), the fatality rate can drop to less than 2%. Indeed, the number of beds per inhabitant in the intensive care units in hospitals is high in these countries.

Figure 3: Number of deaths and fatality rate of Covid-19 (as of 24/03/2020).



World Health Organisation, BNP Paribas Real Estate - Research - March 2020

In order to mitigate the spread of the virus, some governments have announced sanitary measures, such as the closure of schools, partial closure of public transport and the lockdown of the population. The European Union has also closed its borders to slow the spread as the continent surpasses China in the number of cases and deaths. These necessary measures adopted in many countries are likely to have great implications for the global economy.

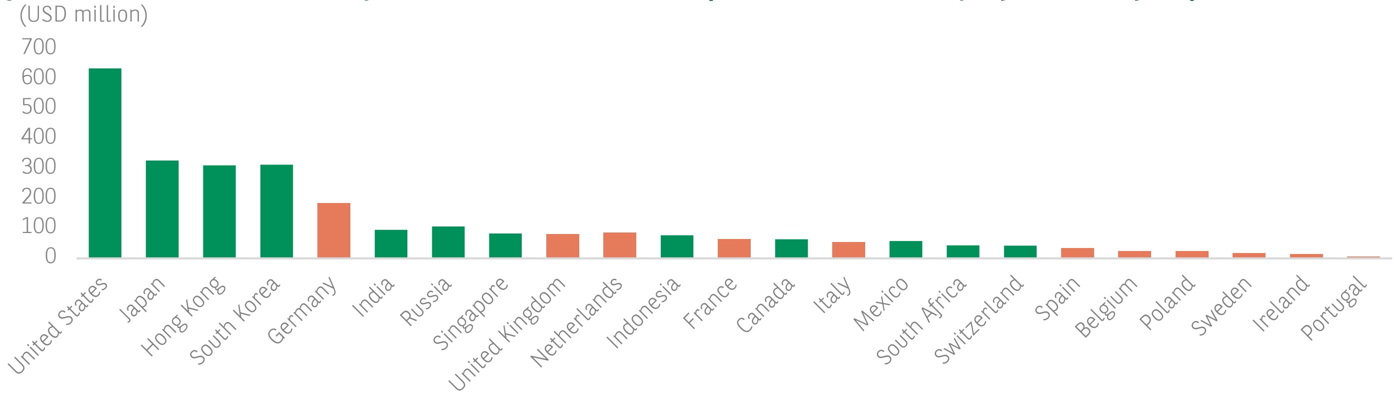
Covid-19: what are the economic implications?

The economic impact of Covid-19 remains uncertain, but it is clear that the effects are likely to be significant for both the supply and demand components of the economy.

A disruption to the supply chain

As most factories were shut during the peak of the crisis in China, the global supply chain has been disrupted. The direct implications for other countries varies, depending on the extent to which each does trade with China (Figure 4). Some countries fear a possible shortage of goods (such as pharmaceutical products or raw materials for production) and are now questioning their dependency on China and the organisation of their global supply chains. Companies may eventually want to re-shore some of their production sites closer to their main markets to reduce vulnerability.

Figure 4: Trade relations with China for some countries in the world (measured as the sum of exports and imports).

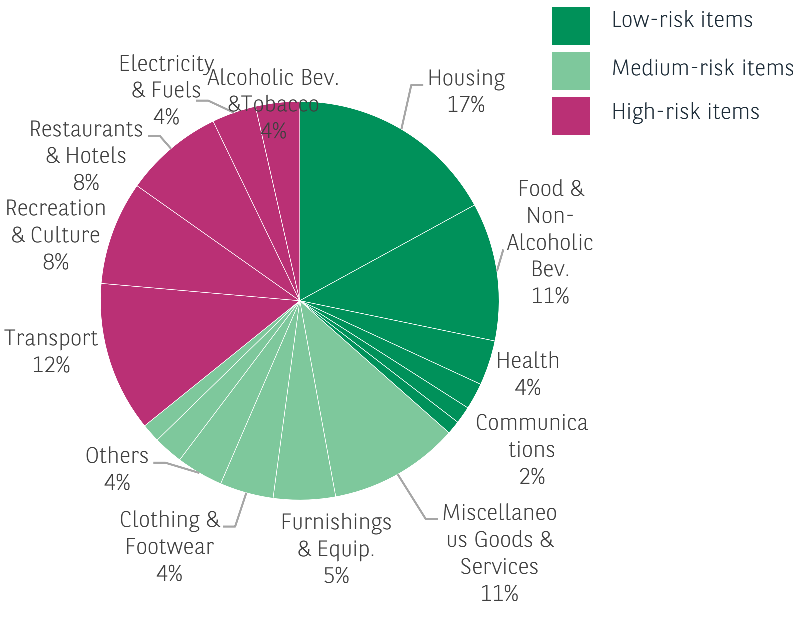


World Integrated Trade Solution (2018), BNP Paribas Real Estate - Research - March 2020

However, China is not the only production hub hit by the virus. For example, the global luxury and fashion sector is now facing a lack of supply following the lockdown of the main manufacturing regions in Italy (located mainly in the north of the country). Likewise, in Germany, one of Europe's main exporters, the partial lockdown has led to the shutdown of some major production sites. For example, Volkswagen has announced the temporary closure of all its factories, including the historic factory in Wolfsburg.

In addition, with the closure of EU and national borders, countries now have restrictions on the export and import of some goods. Poland, one of Europe's main logistics centres, is decreasing flows at its border which is negatively impacting the delivery pipeline.

Figure 5: Household consumption in Europe by main purposes in 2018.



Eurostat, BNP Paribas Real Estate - Research - March 2020

A decrease in domestic demand

Uncertainties are not only coming from the supply side, with the European economy also suffering from a demand shock.

Analysing the individual consumption across Europe may help to understand how domestic demand will be impacted by Covid-19, or more precisely by the closure of all social venues (cafés, restaurants, cinemas, etc.) and other restrictions.

We have identified that 35% of household expenditure is at risk, meaning that it will be greatly reduced and maybe almost non-existent if the lockdown lasts for months. Moreover, when restrictions are lifted, there may not be a steep recovery as previously assumed, but only a gradual recovery as the shock fades. The psychological effects of a lockdown may endure and we cannot anticipate a catch-up effect as the virus will still be a big part of our lives. For a large proportion of products that have not been consumed in H1, a sharp increase in H2 should not be expected.

The low-risk items is the expenditure that households will have to make, even during the lockdown periods (food, housing, communication, etc.). For other spending, we may assume a catch-up once the restriction measures are lifted. Indeed, once supply chains are fully operational, this expenditure may rise sharply. This should be the case with clothing & footwear and house furnishings.

Lastly, a long-term effect from the demand shock is an ensuing increase in the unemployment rate across Europe, as it is directly linked to consumption. With the loss of economic output, we are anticipating a rise in unemployment and, in turn, an erosion of consumer purchasing power. Once again, an expected steep recovery is questionable as it may depend on the magnitude of the economic loss caused by the lockdown.

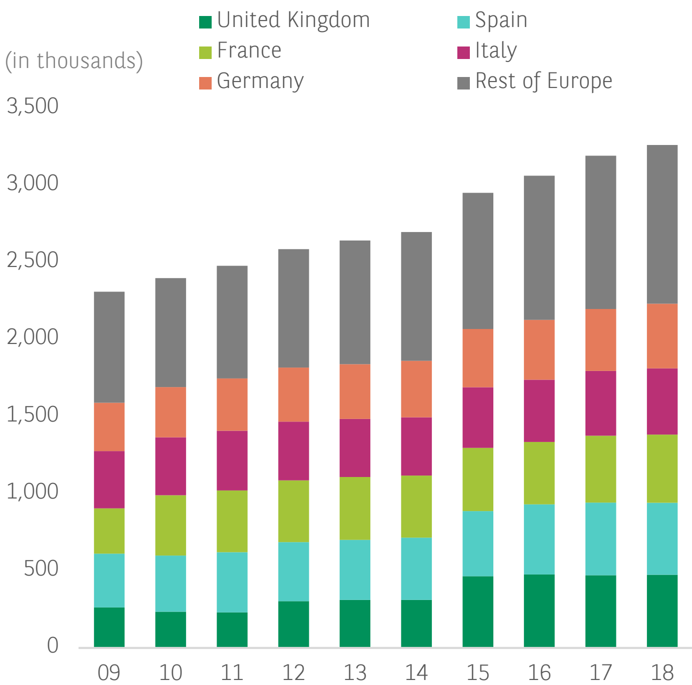
Foreign demand is also damaged

Domestic demand is not the only loss for European countries as there are two external dampeners. Firstly, exports should logically decrease, as the outbreak is worldwide and all countries will be hit. Secondly, with border closures, tourism revenues will fall abruptly.

With the ease of travel, tourism has become an important source of income for all European countries. In 2018, Europe registered 3.2 billion overnight stays and they have been growing at an average annual rate of 4% for the last 10 years. The main visited countries are the UK, Spain, France, Italy and Germany. As expected, the most attractive countries in Europe are also the ones that are suffering the greatest impact from the virus outbreak.

The restrictive measures put in place (border closures, lockdowns) will severely reduce tourism-generated revenues for a considerable time. Again, as the restrictions are lifted, tourism may not soar. The psychological effects and protective measures should dominate in the early stages of a recovery and we should see an increase of domestic holidays. International tourism will resume but later in the year, and only gradually. For low-income households, lockdowns should drain savings for the purchase of necessities and we can expect big-ticket spending (such as holidays) to be out of the window. Moreover, the economic losses resulting from the decrease of overnight stays cannot be fully recovered, as most of the holidays or business trips have been cancelled.

Figure 6: Overnight stays across Europe.



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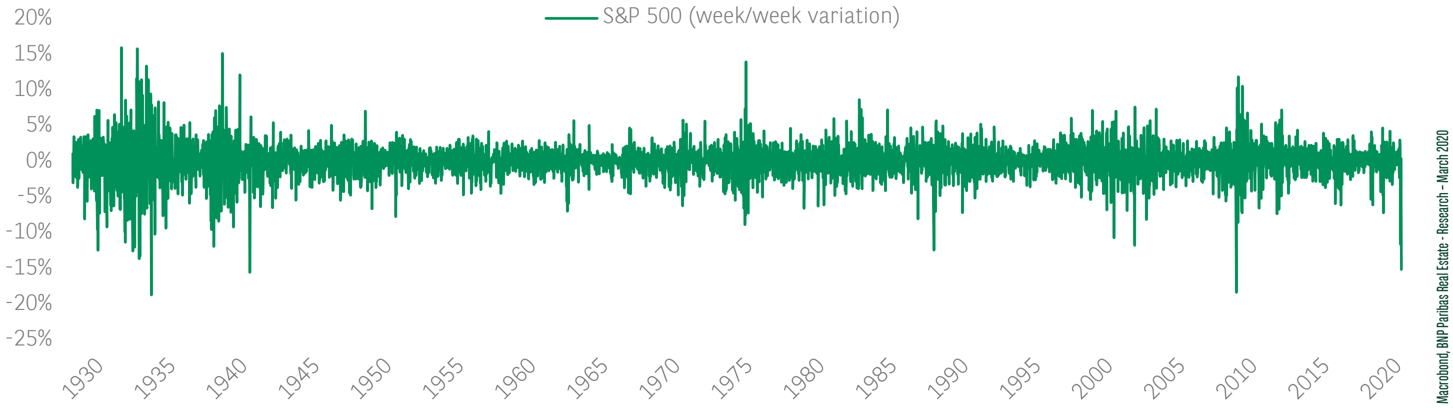
Covid-19: what are the financial implications?

As the virus outbreak pushes governments to take extreme measures, investors have quickly reacted. The impact on financial markets is still ongoing, but we may have already seen the main repricing. However, some further adjustments could occur.

Since 2008, financial markets have experienced one of the best decades for growth, being widely bullish, but not without uncertainties. The trade war, tension on oil prices, declining corporate profits and even Brexit may have made the market shiver, but it is Covid-19 that has been the trigger for a major repricing. Following the outbreak, it seems that investors are being more cautious, as they measure the direct impact of country lockdowns on companies' profits. A first crash occurred in the final week of February and a second one in the week finishing Friday 20th March, when the main stock markets faced their worst week since 2008.
Comparing this crash to historic market falls may be instructive. The coronavirus crash appears less severe than other shocks. As a benchmark, the fall of the Great Depression (July 1933) and the financial crisis (October 2008) were much more significant in terms of magnitude. Both crises registered a peak at -18% in a week, compared to -15% for Covid-19.

The financial crisis in 2008 lasted 25 weeks and the market lost 45% of its value. Currently, the shock has lasted 4 weeks with a loss of 30%. The decrease should not go much further down at the moment as most of the repricing has been driven by assumptions on companies' cash flows. The uncertainty may come back in April and July, when companies publish their quarterly results.

Figure 7: S&P 500 historic movements (1928-2020).

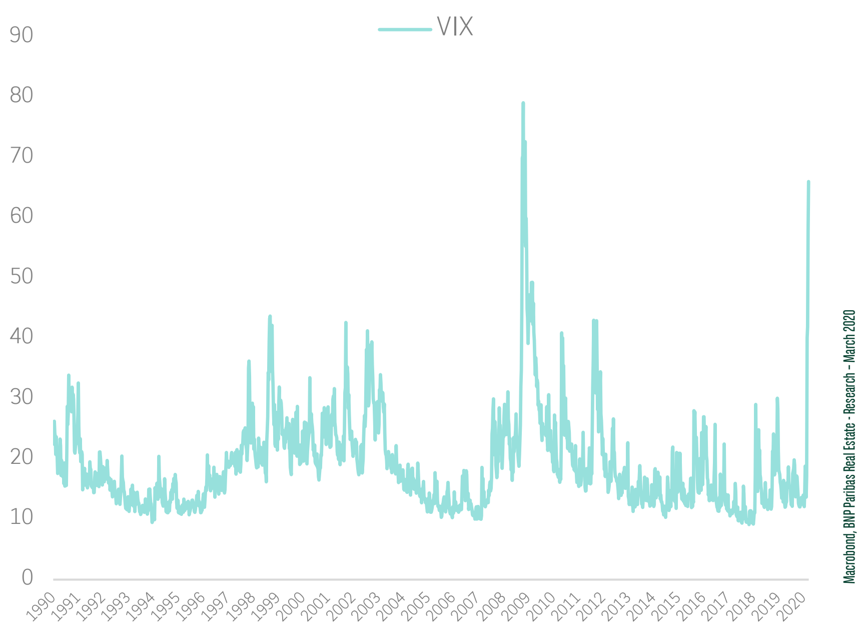


However, even though the historical events of the financial markets put the latest reactions into perspective, volatility remains high.

The VIX (a measure of the stock market's expectation of 30-day forward-looking volatility) provides an estimation of investor risk sentiment. The Volatility Index is at the second highest point in its history, near to the level of the 2008 financial crisis. This means that past events (such as the European debt crisis, the UK EU referendum and 9/11) brought fewer uncertainties and less fears than the Covid-19 outbreak.

If the market stays volatile for a couple of weeks, we are not expecting anything stronger than that for the financial crisis. The Volatility Index stayed high for 6 months during this period, while we can assume that uncertainties will fade quickly with this current crash. The market is mostly repricing following lower economic expectations and it may rebound when the strategies of countries is clearer. Successful vaccine results should also flatten out uncertainties, as investors will know the disease is containable and manageable without extreme measures.

Figure 8: S&P 500 Volatility Index (weekly basis).

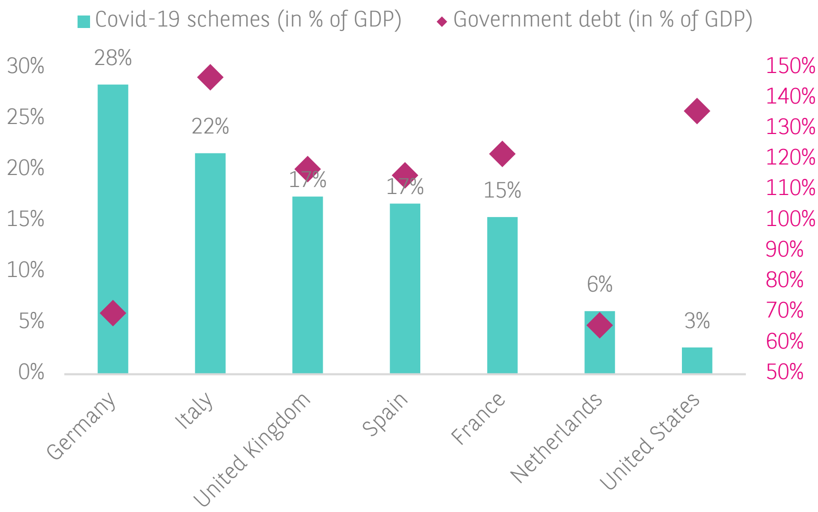


Amid such a great degree of unpredictability about the outlook for the pandemic and the measures taken by governments across Europe to try to contain it, we believe a recession is unavoidable in most (if not all) European economies. We cannot realistically forecast the depth and length of this recession, but with the shutdown of all countries and sections of the economy, the falls in output in Q1 and Q2 2020 are likely to be heavy. During the last crises, the economy continued to contract for an average period of six consecutive quarters in Europe, with policy support mainly targeted at the financial sector. Judging by the size of the current policy responses and the direct nature of it, into the real economy, we believe that the length of contraction in economic activity is likely to be shorter than during the last crises.

Covid-19: what are the policy responses?

The main central banks have been the first to announce economic measures in order to improve the global sentiment of investors. The Fed and the Bank of England have cut their rates and announced an expansion of their balance sheets. The European Central Bank will also inject liquidities into the market, up to €750bn (and potentially unlimited). The ECB has also announced a cut in its deposit rate to -0.75%. But while the cuts in rates and injections of liquidities are effective in comforting the financial market, they cannot solve many of the challenges triggered by the virus outbreak. The disruption to the supply chain and the fall in consumer spending will not be solved by central banks. However, national governments are now holding the keys to help the real economy, and major measures have already been implemented.

Figure 9: Stimulus in response to Covid-19 and Gov. debt (as % of GDP).



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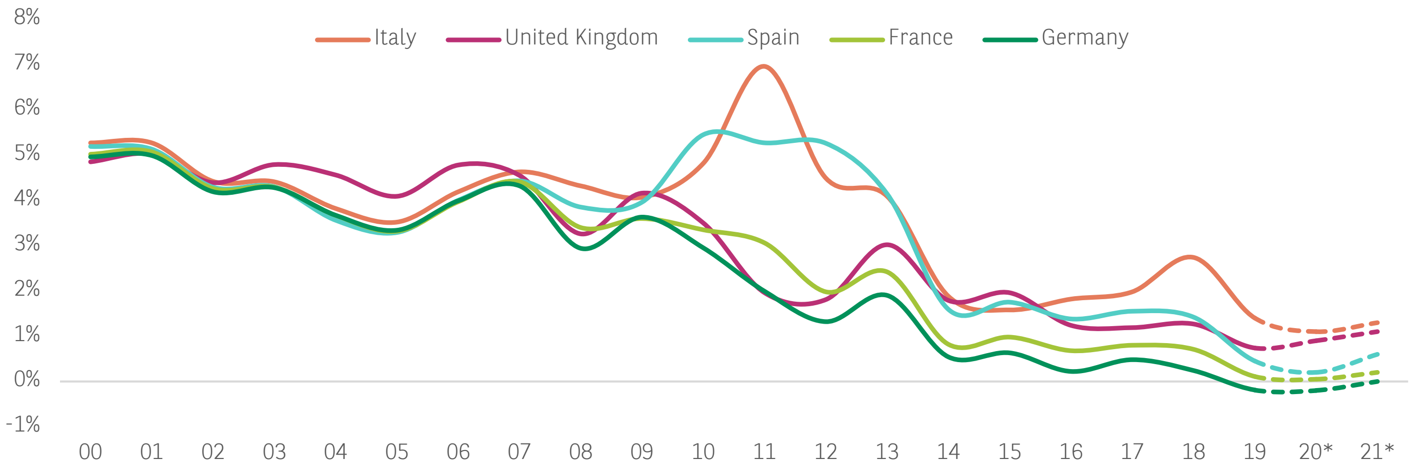
The emergency policies announced by most countries are extraordinary and are focused on supporting the real economy. The main one put in place by almost all countries in Europe is a loan guarantee to companies. The amount varies between countries, from €100bn for Spain to £330bn for the UK (circa €360bn). Another major scheme is the one focusing on tax. Companies will have, in almost all countries, a tax break and/or a deferring of VAT. Governments will also strongly support partial unemployment in order to protect their job markets from the pandemic. Moreover, France and Germany have also recently announced that an intervention in the capital of major groups is not excluded in order to protect their economies. "Whatever it takes" is now the main directive of countries hit by the virus outbreak.

Individuals are also benefiting from state interventions, as some of the measures are directly applied to them. In Italy, Spain and the UK for example, individuals may benefit from mortgage repayment breaks under certain conditions. Tenant evictions are also banned in most countries to relieve any personal financial difficulties that may be faced.

If fiscal policies are going to support the real economy and the job market, the high level of debt already experienced by European countries will not improve. As a result, we expect government bond yields to rise slightly when things get back to normal and the level of uncertainty decreases.

Figure 10: Government bond yields across Europe.



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Covid-19: the virus making the global economy brake

At the beginning of 2020, the world was focused on Middle East tensions and Brexit negotiations, but the pandemic is finally the event that has shattered the global economy. The impact, unmeasurable for the time being, will be heavy with both supply and demand sides impacted. But the responses of policymakers to support the economy are also significant and we are expecting the length of the crisis to be short. Even though we are not now forecasting a sharp increase in economic activity, global growth should bounce back in H2 2020, albeit only gradually as the shock fades.

Now, the important question to ask is when are things going to return to normal. According to specialists, the virus, like the common cold and flu, prefers cold weather. The coming summer in the Northern Hemisphere implies that we can expect less and less confirmed cases. Even so, the coronavirus is not going to disappear and countries need a management strategy. The current restrictions are not sustainable in the long term and the economic damage is already starting to be felt. The market psychology will also be negatively impacted and a V-shape recovery scenario may not be realistic.

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A 360°vision

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