EDITORIAL

BOOMERANG ECONOMICS

Corporate sentiment has jumped following the easing of Covid-19 related restrictions. There is a risk of excessive enthusiasm because better business expectations do not tell us where we are in terms of the level of activity and demand. The current phase of the rebound is mechanical. It shows that the supply side starts to function again. The real question however is what happens to the demand side in the coming quarters. Companies and households are confronted with limited visibility, so caution will prevail.

It could be called a boomerang cycle. Earlier on in the year, as lockdowns became ever more stringent, the business climate as reflected in the composite purchasing manager indices deteriorated significantly. As shown in chart 1, there is some relationship between the strictness of lockdown measures –the stringency index- and the collapse of the PMIs. Starting in May, this movement has gone into reverse. Restrictions have been eased and corporate sentiment has jumped. The swing back has been most pronounced in France, which had one of the most stringent lockdowns, but in the UK and Germany as well, the gap between the June reading of the flash PMI and its level in January has narrowed a lot.

Looking at these data, there is a risk of excessive enthusiasm. After all, what the PMI series tell us is that in May, survey respondents felt better about the outlook than in April[1]. This feeling was even more pronounced in June. The survey does not convey information on the activity level. When somebody who has been standing in the cold for a long time enters a room without a fire, he will feel better, but not exactly warm. During recessions and recoveries, nowcasts[2] of quarterly real GDP growth based on the PMIs tend to show bigger errors than in normal times. Given the plunge in the activity level in the second quarter, this will become a real issue in the recovery which is now starting. Optimists will find a reason to be even more confident. As shown in chart 2 for the eurozone, the PMI tends to overestimate growth during a downturn and underestimate it during a recovery. This last point could actually mean that growth would surprise to the upside in the second quarter.

However, this tells us very little about the underlying strength, or rather, weakness of the economy. INSEE emphasised this week that although its business climate indicator in June showed the biggest improvement since the start of the series in 1980, its level is still well below the long term average.

1. "Respondents are asked to state whether business conditions across a number of variables have improved, deteriorated or stayed the same compared with the previous month." (Source: IHS Markit brochure).
2. A nowcast of GDP growth is a real-time, model-based estimate based on the latest available information

A similar observation can be made in Germany where the ifo business climate has also improved significantly. The key question is what happens after the current mechanical rebound. It is mechanical because it is very much driven by the ending of the lockdown, which means "we're open for business": the supply side starts to function again. This has led to a quick narrowing of the gap between current and normal operating conditions. In France, according to INSEE, this difference has shrunk to 12% in June coming from 29% in April and 22% in May[3]. The real question however is what happens to the demand side in the coming quarters. Companies, confronted with limited visibility about what the future may bring –the prime concern being whether there will be a second wave and, if so, how it would be addressed- will be reluctant to invest. Households face a worsening labour market which should weigh on their spending.

3. Source : INSEE, Point de conjoncture, 17 June 2020

COVID-19 STRINGENCY INDEX AND COMPOSITE PMI (PERIOD COVERED: JANUARY-JUNE 2020)

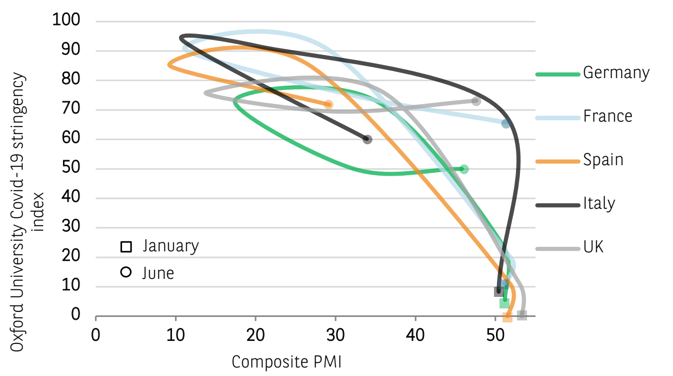

CHART 1
SOURCE: UNIVERSITY OF OXFORD, MARKIT, BNP PARIBAS

> The economic rebound is in the mechanical phase, reflecting that shops are open for business again. The real question however is what happens to the demand side in the coming quarters. Companies and households are confronted with limited visibility, so caution will prevail.

The IMF in the June update of its World Economic Outlook provides sobering reading: *"the recovery is projected to be more gradual than previously forecast… The steep decline in activity comes with a catastrophic hit to the global labor market."*[4] In this respect it quotes research from the International Labour Organization, that the global decline in work hours in the second quarter of this year versus the final quarter of last year is likely to be the equivalent of more than 300 million full-time jobs. Add to this that in a number of countries and in several US states, the pandemic is not yet under control, the risk of a second wave this fall and pervasive economic uncertainty and one comes to the conclusion that caution is warranted when making forecasts. Against this background, the Fund notes that *"The extent of the recent rebound in financial market sentiment appears disconnected from shifts in underlying economic prospects… raising the possibility that financial conditions may tighten more than assumed in the baseline"*. Were this to happen, it would be another boomerang, but a most unwelcome one.

William De Vijlder

NOWCAST ERROR FOR QUARTERLY REAL GDP GROWTH IN THE EUROZONE BASED ON THE MANUFACTURING PMI FOR THE FINAL MONTH OF A QUARTER

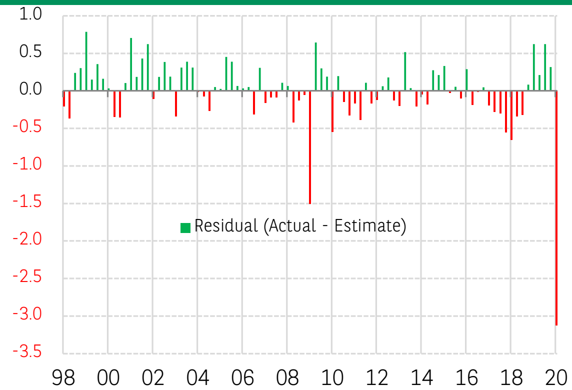

CHART 2

SOURCE: MARKIT, BNP PARIBAS

4. Source : IMF, June update of the World Economic Outlook.