UNITED STATES

THE ECONOMY REBOUNDS, BUT SO DOES THE PANDEMIC

In spring 2020, partially paralysed by the Covid-19 pandemic, the US economy entered the worst recession since 1946. Global activity contracted by more than 10% in Q2 before picking up slightly since the month of May. The question is how much of the lost ground can be recovered. With the approach of summer, business surveys are improving and the equity markets are rebounding, signalling rather optimistic expectations, possibly excessively so. Bolstered by the Federal Reserve's liquidity injections, the markets could be underestimating the risk of corporate defaults, especially given their increasingly heavy debt loads. The latest statistics on the propagation of the virus are not good.

The American people and their economy have paid a heavy tribute to the Covid-19 pandemic. Arriving in North America a little later than in Europe, and long played down by President Trump, the coronavirus has already caused the death of some 130,000 Americans, which unfortunately is only a provisional figure. As we are writing these lines, there has been an alarming surge in the virus, particularly in the southern states of Florida, Texas and California (see chart). With nearly 50,000 new cases reported daily in early July, the first wave of the epidemic is still going strong, and healthcare authorities are warning that it may be "out of control".

Due to lockdown measures and social distancing, the US economy has entered the worst recession since 1946. According to Federal Reserve Bank of Atlanta estimates, US GDP plummeted 12% in Q2 2020 (an annualised rate of 40%), a dramatic slump comparable to what was seen in Europe. In the absence of job retention schemes, the impact on the job market was huge, with the destruction of 20 million jobs. In May, the number of companies filing for chapter 11 bankruptcy protection surged 50% compared to the previous year.

Fortunately, the stalled economy did not get any worse, thanks to combined support by the US Treasury and the Federal Reserve, which has prevented interruption in global funding, a predominant component of all major crises.

THE FED REVIVES THE MARKETS

In the first weeks of March, risk reassessments combined with the prospects of an economic downturn triggered a widespread flight to cash. Orders to liquidate assets (equities, bonds and mutual fund shares) put pressure on players vital for the financing of the economy, including Primary Dealers and Money Market Funds. To prevent the economy from freezing up, the Fed mobilised considerable resources, most of which were unconventional. After lifting the limits on its quantitative easing policy, the Fed purchased virtually the equivalent of a full year of French GDP in just four months' time[1]. A number of ad hoc refinancing programmes were launched and the Fed became less demanding about eligible collateral. By doing so, it positioned itself as the lender of last resort in absolutely all compartments of the debt market, including the primary and secondary markets as well as in the investment grade and high yield compartments.

Since the US dollar liquidity crisis was global, the Fed's interventions reached far beyond US borders. It concluded swap agreements with the main central banks around the globe. Altogether, the credit lines opened by the US Fed exceeded a trillion dollars, but since all of them have not been drawn on, the amount potentially available is actually much higher.

GROWTH AND INFLATION (%)

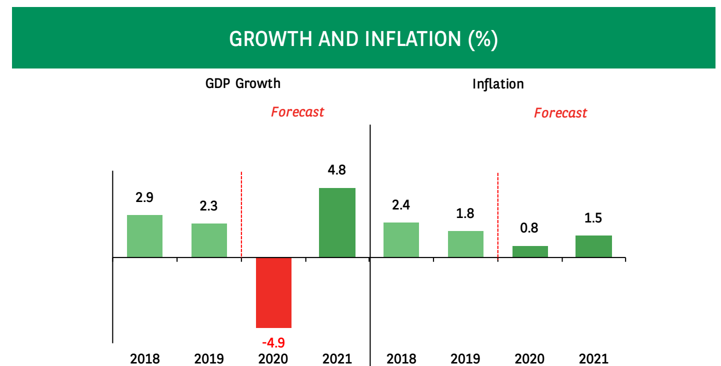

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

EPIDEMIC RECOVERY

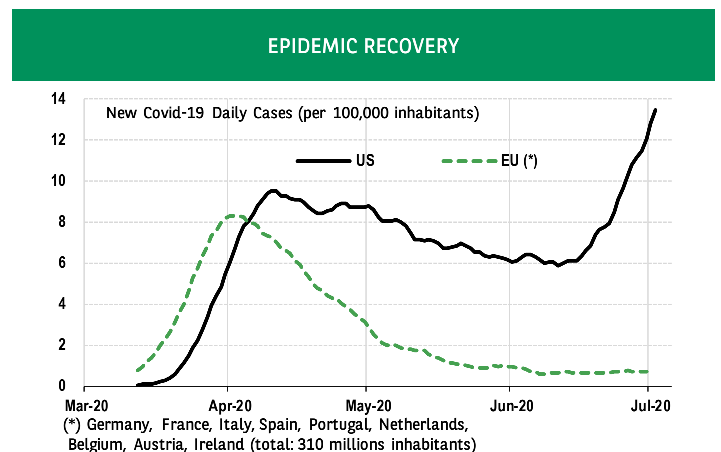

CHART 2 SOURCE: JOHNS-HOPKINS UNIVERSITY, BNP PARIBAS

Thanks to this virtually unlimited public reassurance, the markets were able to rebound rapidly and spectacularly. The most striking example is the cost of credit default swaps (CDS). After surging as high as a 1000bp in the high yield compartment, risk premiums began to ease as of 23 March, when the Fed activated its main support measures, including unlimited quantitative easing, and primary and secondary market corporate credit facilities (see box). Today CDS have returned to nearly normal levels, even though the number of credit events has surged in the United States and is showing signs of rising in Europe (FT, 24 June)[2]. The equity markets, which are highly correlated, recovered part or all of the losses engendered by the Covid-19 crisis, and some

1 USD 2,295 bn in net purchases between 26 February and 24 June 2020. Source: Federal Reserve.
2 Financial Times, *Financial gravity will force credit default across Europe*, 24 June 2020

sector indexes, for technology and healthcare stocks, for example, rose above their pre-crisis levels.

LOOKING BEYOND A Q3 REBOUND

Since the economic recovery depends on keeping financing channels open, the Federal Reserve has done a lot to pull economic indicators out of depression territory. The fiscal deficit has also helped: roughly USD 1 trillion allocated to the Paycheck Protection Program (state-backed loans) and the extension of unemployment benefits helped maintain household income during the worst of the recession[3]. In May, as shelter in place and other protective measures were gradually lifted, private consumption resumed and employment picked up again[4]. The business climate perked up and the rally extended into June, with the Institute for Supply Management's purchasing managers index rising above the 50 threshold in manufacturing. After plummeting last spring, activity is bound to strengthen in Q3, partially making up some of the lost ground.

But what then? Looking beyond the fact that the epidemic has not disappeared, a number of imbalances that were already present before the crisis have worsened, making the recovery even harder. Corporate debt was already at a record high[5] and has continued to swell, raising questions about debt sustainability in the sectors where declining sales will not be transitory (such as air transport, retailing, natural gas and shale oil). Equity and bond market investors have convinced themselves that the worst is over and that monetary policy will remain permanently accommodating, but the rallies of recent weeks are hardly grounded in economic fundamentals.

Would the markets continue to rebound strongly in H2 2020, the current PE multiples of the corporate listed on the S&P 500 would still be in the area of 30, e.g. close to historical peaks. According to the valuation model of the International Monetary Fund (IMF), risky assets, whether equities or corporate bonds, are historically overvalued[6]. From a strictly business perspective, the economic situation in the United States seems to have improved, but it also seems to be very vulnerable to any snags in the recovery or shifts in expectations.

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MONETARY SUPPORT MEASURES

• **Conventional measures**		
Fed funds target rate	Cut by 100bp to 0%-0.25%	
Discount rate	Cut by 150bp to 0.25%	
Reserve ratio	Lowered to 0%	
• **Quantitative easing (USD bn)**	**Limit**	**Outstanding***
Securities purchases (Treasuries, MBS, Agency MBS)	Unlimited	6,090.4
• **Co-ordinated measures (USD bn)**	**Limit**	**Outstanding***
Swaps ECB, BoE, BoJ, BNS, BoC	Unlimited	402.7
Swaps RBA, BCB, BoK, BdM, MAS, Riskbank	360	36.6
Swaps DanNB, Norges B., RBNZ	90	10.7
• **Financing programmes (USD bn)**	**Limit**	**Outstanding***
Repo operations		
Repurchase agreements (Treasuries, MBS, etc.)	5000	441.9
CPFF : Commercial Paper Funding Facility		
Purchases of commercial paper on the primary market	Ad hoc	4.3
PDCF : Primary Dealer Credit Facility		
State-backed loans to primary dealers	Unlimited	33.4
MMLFF : Money Market Fund Liquidity Facility		
Loans for eligible collateral: money market funds	Unlimited	53.2
PMCCF : Primary Market Corp. Credit Facility		
Corporate bond purchases in the primary market	500	0.0
SMCCF : Secondary Market Corp. Credit Facility		
Corporate bond purchases in the secondary market	250	6.6
TASLF : Term Asset-backed Sec. Loan Facility		
Loans for eligible collateral: asset-backed securities	100	0.0
PPPLF : Paycheck Protect. Progr. Lending Facility		
Loans for eligible collateral: state-backed loans to SME	Unlimited	57.6
MSLP : Main Street Lending Program		
Purchase and extension of new loans to SME	600	0.0
MLF : Municipal Liquidity Facility		
Municipal bond purchases (state, county, etc.)	500	1.2

* Maximum amount observed as of 18 June 2020

SOURCE: FED, BNP PARIBAS (C. CHOULET)

3 Committee for a Responsible Federal Budget, Covid Money Tracker, www.crfb.org
4 Of the 22 million job losses reported in March and April, 7.5 million jobs were created in May and June, leaving a net gap of 14.7 million jobs.
5 BNP Paribas Eco-Perspectives, United States: *"2020: a year of living dangerously"*, January 2020
6 International Monetary Fund (FMI), Global Financial Stability Update, June 2020