Insight

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Addicted to stimulus?

It has been clear for some time that risk assets, and equity markets in particular, were "addicted" to monetary stimulus. Ever since the taper tantrum, markets have demonstrated that they almost require abundant liquidity and low rates from the Federal Reserve.

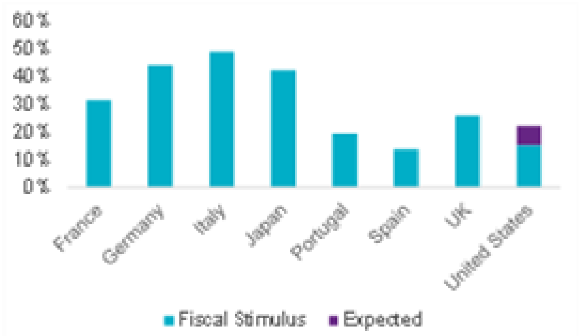
Confronted with a global pandemic, governments took a page out of central bankers' playbooks and also delivered above and beyond stimulus measures on the fiscal side. They were meant to be temporary, but many have already been extended, and all eyes are on now the US Congress to deliver the CARES Act 2.

Today, this support is necessary – and not just for markets – but there are also plenty of long-term consequences investors are choosing to ignore. In this context, have we all (economies and markets) become addicted to stimulus?

So far so good, mostly

The first wave of fiscal support was already massive, delivering the equivalent of about 14% of GDP in the US, 33% in Germany and a whopping 48% in Italy. Estimates are that globally, the 2020 fiscal boost is ~USD20 trillion. The measures included loans, guarantees, subsidies, unemployment benefits, deferrals, tax discounts and investments. Coupled with massive monetary stimulus, they managed to avoid the worst case scenario and restore confidence.

Stimulus measures have been massive

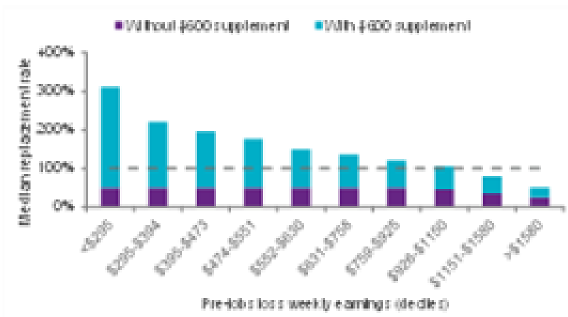


Source Bruegel, Natixis IM Solutions, 21 September 2020

The second wave of support has begun, with Germany adding another ~4% of GDP and EUR10 billion to support the labour market. France has added another 4% of GDP and EUR35 billion for job protection. Others in Europe are expected to follow suit. In addition, the upcoming European Recovery Fund is expected to start in 2021 and last for two years, disbursing EUR750bn in loans and grants according to the most in-need countries. In Asia, Japan announced a second package worth about 21% of GDP (after an initial one also around 21%). And while China has not had massive stimulus plans, policymakers have focused on getting manufacturing back to 2019 levels, though consumption has been slower to recover.

In the US, the first three phases are done, and totalled USD3 trillion. Phase 4 is still in negotiation, but when unemployment benefits expired at the end of July, President Trump issued executive orders to provide temporary funding (for a maximum of 6 weeks) for unemployment benefits of USD300 per week. However, federal budget laws restrict how much funding can be redirected without congressional approval so the CARES Act 2 is needed.

The CARES Act 1 made a big difference on income



Source Becker Friedman Institute, Natixis IM Solutions, 21 September 2020

More is needed

While support has been massive and on a scale beyond 2008-2009, plenty of challeges remain for global growth and we are not out of this crisis yet. Indeed, we have not yet vanquished the virus, suggesting it is going to take a

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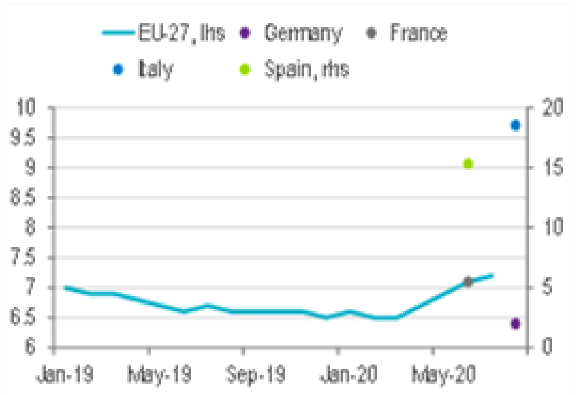
long time to get back to normal, even if a vaccine becomes available later this year or early in 2021. As such, a number of sectors will not recover fully for many more quarters, and unemployment is therefore set to remain high for some time. Businesses might not survive. And governments need to ensure they avoid waves of bankruptcies and joblessness. These could lead to much sharper financial crisis like the Global Financial Crisis.

Many of the European measures targeted the protection of jobs first, keeping people furloughed or employed in short term work schemes. Indeed, over 30% of the workforce in France, Germany, Italy and the UK (45 million jobs) is covered by employment subsidy programme. A number of countries have already extended these benefits, but unemployment is likely to rise in the coming months, suggesting unemployment support will continue to be needed. As such, many of the new plans are set to work well into 2021, sometimes 2022. In addition, while the EU Recovery Fund was a significant step towards further integration and cooperation within the EU, the scale might still not be enough.

Persistent high unemployment is a concern

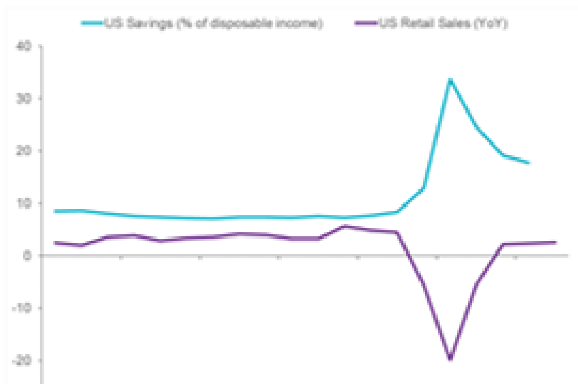


Source Bloomberg, Natixis IM Solutions, 21 September 2020

In the US, more than 20 million people lost their jobs, and less than half have been recovered (unemployment still sits at 8.4%), highlighting the need for ongoing support. The snag is that the USD600 of unemployment benefits previously provided were larger than what many people made working, so negotiations are ongoing to reduce the headline figure. So far, consumption has held up relatively well since the end of July as enough savings were accumulated during lockdowns, but this can only last so long. Indeed, retail sales for August were below expectations, rising only 0.6% from July (compared to 1% expected).

If there is no CARES Act 2, we expect consumption to drop off sharply over the coming months and quarters, stalling the economic recovery. Indeed, the CARES Act, via the USD1200 check and the USD600 in unemployment benefits, helped disposable income rise more than 7% since March, compared to pre-crisis levels. If these are not renewed to some extent, the drop in spending will eventually come through.

US consumption holding up, for now



Source Bloomberg, Natixis IM Solutions, 21 September 2020

That said, we expect the CARES Act 2 to arrive, but it might not happen before the election. With filling the Supreme Court seat likely to take the spotlight into the election, the next fiscal package is probably still some months away. As such, it is a risk for the US recovery – though we believe consumption will hold up – and for markets, where the short-term risk is bigger in our view.

When will it be enough?

The big question is: when will stimulus be deemed enough. In our view, it is not just about scale and scope – though they do matter. The question is what measures will help assess success.

Unemployment measures are traditionally used, but the diverging structures of the labour markets in Europe and the US suggest very different paths. In Europe, furlough schemes have managed to keep large portions of the population employed, whereas in the US the idea was to encourage business to re-hire employees as they reopened. The concern, especially in Europe, is that a number of sectors will take so long to recover, particularly in the services industry, that unemployment is set to rise, or short-term employment schemes will need to be continually extended. In the US, the unemployment may not fall back to the Fed's estimate of full employment (~4%), for a long time.

If we take the US economy as an example, consumer spending is likely one of the key indicators for success.

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Coupled with consumer and business confidence, so far it has been a success. Lower for longer interest rates have also helped, providing a boost to the housing market. Despite the end of the CARES Act 1, confidence remains strong, but for how long? With the virus situation still unresolved, growth constraints are going to persist.

Short-term necessity, long-term consequences

A number of risks derive from this fiscal expansion. The first is inflation, but, as discussed in previous pieces, we do not see inflation as a risk for the time being. Yes, stimulus is massive, but on the fiscal side it is income replacement, not enhancement, and on the monetary side, the velocity of money remain low even if the stock of money has grown significantly. Moreover, the Federal Reserve, with its new symmetrical inflation target, has indicated it will remain on hold even if inflation rises above 2%, so the fear of rate hikes is nowhere on the horizon.

Further out, the question of debt and deficit levels is likely to preoccupy markets. For now though, given this is a global trend and absolutely necessary, individual countries are not likely to be punished. At some point, bringing down these numbers will be important, but it might be years until that point. Nonetheless, we highlight that Europe cannot afford the same deficit as the US, given the US dollar’s role as a reserve currency, and given that a number of peripheral European countries entered this crisis with too high debt levels already.

Ultimately, we believe the big risk is that economies become so dependent on support measures to prop up employment and consumption that they will need to be continually extended – or that recession will loom. From a market perspective, the need for monetary stimulus is clear. Today, and while the COVID crisis lasts, markets will also require ongoing fiscal support to fill the gaps, starting with the US CARES Act 2. Thinking further out, this need can last until we see self-sustaining growth after the pandemic.

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