

1 April 2020

## The output gap, policy responses and consumers hold the key to the outlook

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As the world battles with the covid-19 pandemic, our assessment of the economic and investment implications depends upon three fundamental issues. These are the duration of the output gap, the policy responses to mitigate the output gap, and whether or not the crisis will result in fundamental and lasting changes in consumer behaviour. Let's take each issue in turn.

### Issue 1: The duration of the output gap

The output gap is the lost economic output a country will experience during a period in which the economy is effectively shut down. The longer the output gap, the deeper the economic damage. The duration of the output gap will largely depend on the effectiveness of the health response taken by governments.

There are two health responses that are being pursued. One is a hard suppression strategy, where authorities implement a total shutdown of the economy for, say, six to eight weeks. This is likely to be the most effective strategy to minimise the duration of the output gap. Following a period of total shutdown, growth in new cases should be near zero. Officials should be able to reopen the economy provided they have strong testing, contact tracing and monitoring to stop the spread of new cases. For many countries, this might prove to be hard to do comprehensively and effectively. External borders would have to remain closed to stop imported cases. China appears to be on this path.

The other strategy is a mitigation strategy where authorities implement a controlled social-distancing strategy and keep parts of the economy open as long as possible. This is likely to lengthen the duration of the output gap compared with a hard-suppression strategy.

Many countries are now pursuing courses in between these two bookends.

Our best guess is that the duration of the output gap ranges from two months to six months depending on the effectiveness of the various health responses. Based on the measures being pursued by various countries, we would put China at the low end of this range, the US and Australia in the middle and many emerging markets at the other end.

The one area that could shorten the output gap is an effective therapeutic being found that reduced the mortality rate in the most severe cases. This would enable countries to reopen with less fear. We would be surprised if an effective therapeutic could be found and scaled globally within six months. There is enormous work being undertaken on testing therapeutics with trials underway with little red tape. We note Johnson & Johnson has announced it will commence trialling a vaccine in September. At best, it would only be available for small-scale deployment in early 2021. This is unlikely to truncate the duration of the output gap.

### Issue 2: The policy response

The policy responses cover those by central banks and governments. Central banks appear to be taking two courses. The first is to reduce interest rates as far as practicable; that is, making money effectively free. The other is to ensure the financial system has sufficient liquidity to ensure it doesn't freeze. We are seeing

massive injections of liquidity by central banks via a scaling up of quantitative easing, providing liquidity-support facilities to businesses, liquidity support to other central banks (currency swaps) and liquidity to critical areas of the economy such as the repo markets and money-market funds.

We have been impressed with the actions taken by the major central banks to date; they are acting nimbly, and with scale and speed. They appear to be winning the fight to head off a liquidity crisis, and will tailor responses as issues emerge. At the same time, some difficult issues haven't yet been addressed that are likely to put further strains on the financial system. One unresolved issue is the support to be given to sub-investment-grade companies that have borrowed in the high-yield and leverage-loan markets. Another area to be resolved is what happens when many companies have their credit ratings downgraded from investment grade to sub-investment grade. Solving these issues is difficult and might require a co-ordinated response from governments and central banks.

With fiscal policy, we are seeing governments implement four possible packages of fiscal responses. One is to compensate all businesses for 100% of their lost revenue. This would keep balance sheets intact and enable businesses to pay all their employees and key suppliers; for example, landlords, lenders and so on. Businesses could furlough workers and restart when the economy reopens. In this instance, there would be a limited rise in unemployment, despite a hit to GDP, and activity would resume when the economy reopens. The output gap would be transferred to governments and to central-bank balance sheets via quantitative easing. This would be a V-shaped economic recovery. Singapore and Denmark come closest to adopting this strategy.

The second strategy is to compensate businesses for some of their revenue loss and allow them to meet permitted expenses such as wages, interest on loans, rent and utilities. Employees would be furloughed. The US has a program to lend up to US\$10 million to companies employing fewer than 500 people. Under this strategy, a large part of the output gap would be transferred to governments and central-bank balance sheets and the remainder would be shared by society. This would save many businesses and enable them to restart. This combined with an effective mitigation strategy would be the best chance of a U-shaped economic recovery. Germany is following this strategy.

The third strategy is to compensate workers for 70% to 100% of lost wages (typically capped at the median wage). This strategy preserves personal balance sheets, but not businesses that have to manage fixed costs. The issue here is that, outside of wages, the remainder of the output gap would fall on businesses, landlords, utilities and banks. This is also likely to hit property prices. Even if many businesses survive, they would emerge with additional debt or balance sheets that were damaged. This would impede their ability to invest and employ as many people as before. They would cut costs to survive even when the economy restarted. This strategy would head off the most dire of economic outcomes but it is unlikely to prevent a deep and prolonged recession and a significant jump in unemployment. Many western governments are pursuing this strategy. These governments might well provide additional fiscal support to preserve businesses' balance sheets that could be expected to support a stronger economic recovery.

The last strategy is zero compensation. A country loses 17% to 50% of annual output (depending on the duration of the blow to the economy). Many businesses would not survive, particularly small businesses. The property market would crash. Banks would face severe losses. This is the depression scenario. Fortunately, almost no developed country is following this strategy. We fear many emerging markets will not have effective mitigation strategies and be unable to fill a meaningful part of the output gap. We are particularly concerned about Africa, Latin America, India and emerging countries in Southeast Asia.

### **Issue 3: Changes in consumer behaviour**

In thinking about the economic and investment implications, investors need to assess the effect that the health and economic crisis is likely to have on consumer behaviour. This will determine the speed of any economic recovery and create winners and losers in a relative sense.

We know that significant events such as the Great Depression of the 1930s and the world wars had lasting effects on behaviour; so too will today's crisis. There are areas such as the cruise industry where there is

likely to be a lasting effect on consumer behaviour. It is possible that the travel industry will experience a fundamental and lasting reduction in demand. Retirees will probably not travel overseas like they did previously. Businesses might determine much business travel is inefficient and discretionary and that meetings can be held just as effectively via video conference.

Other questions investors must ask themselves include: Will there be a fundamental shift in consumption patterns? Will people dine out in restaurants less frequently? Will there be less conspicuous consumption? Will people change their hygiene habits enough to lead to higher demand for cleaning and hygiene products? Will there be a change to how people work? Will this lead to increased demand for software like video conferencing? What will happen to the savings rate? Will people delay renovations to their homes?

The extent of change in consumer behaviour will depend upon many factors. These include the duration of the output gap, the effectiveness of the policy response and the speed and shape of the economic recovery.

## **Conclusion**

The situation remains fluid. It is difficult to predict how the next two to 12 months will play out.

We think there is a range of outcomes for the economic recovery, from a V-shaped recovery (a fleeting recession) to a U-shaped recovery (a mild recession), a prolonged and deep recession and, at the pessimistic end, a depression. We believe that for many major economies a V-shaped recovery and a depression appear the least likely scenarios. Outside of a few countries, a recession (a U-shaped recovery) to a deep and prolonged recession appear the most likely outcomes at this point in time. The good news is that governments and central banks are calibrating their responses to attempt to mitigate the economic fallout.

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