INSIGHT

QUARTERLY MARKET REVIEW

Q2 2020

HIGHLIGHTED IN THIS PUBLICATION:

- GLOBAL STRATEGIC ASSET ALLOCATION
- GLOBAL SECURITY SELECTION
- REGIONAL ASSET ALLOCATION
- REGIONAL PORTFOLIO CONSTRUCTION

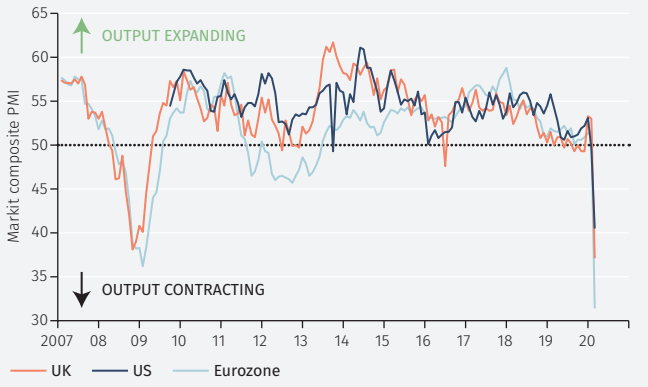
OVERVIEW

The coronavirus pandemic is a major shock to the world economy and financial markets. Its impact will be felt for some time, mitigated by the huge amount of fiscal and monetary support that has been implemented.

A sudden stop

Economic activity dropped off a cliff in March (see Figure 1). The phrase, normally overused, is appropriate in this case. Many shops, factories and offices suddenly closed down, mainly temporarily but some (possibly) permanently; the world stopped travelling and holidaying; and business meetings and offsites were replaced with Zoom rooms and video conferences.

1. Off a cliff

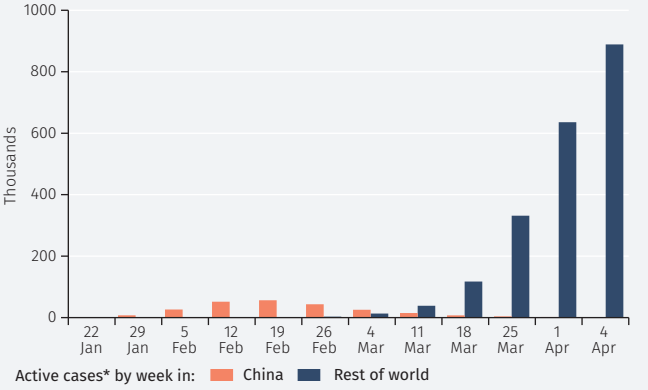


Source: Refinitiv. Data as at 1 April 2020.

By 1 April, almost a third of the world's population, 2.5 billion people, were in full or partial lockdown.[1] The intention of that lockdown is to slow and eventually stop the spread of the coronavirus. WFH (Working From Home), 'self-isolation' and 'social-distancing' have become the new normal. A disease, which many hoped would be contained in China, is now truly global (see Figure 2).

Normally, economists talk about the *growth* rate of global activity, real GDP. This was humming along steadily at around 3% per year before the shutdown. Many, ourselves included, expected this steady growth to continue in 2020. The disruption from the coronavirus, however, looks set to cut the *level* of GDP by as much as one third for as long as it lasts.[2] Arithmetically, that will cut global growth by 2.8% for each month it continues. So, in the first quarter of 2020, with lockdowns (outside China) starting quite late in the quarter, the immediate effect may be limited.

2. Coronavirus cases: China and the rest of the world

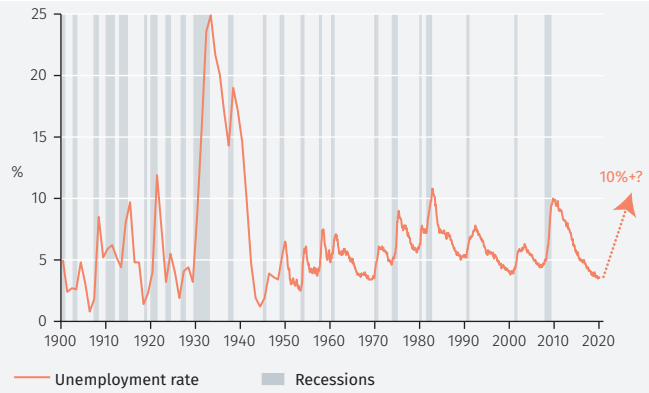


*Confirmed cases minus recovered and dead. Source: www. ecdc.europa.eu. Data as at 4 April 2020.

However, if such a hit to the level of GDP lasted for a full three months (say, the second quarter of 2020), it would cut GDP growth by 8.5%. Bearing in mind that the US reports economic growth as the change on the previous quarter at an annualised rate, that would be reported as a 30%+ drop. Indeed, several forecasts for the US economy in the second quarter of 2020 are along those lines.

If the recovery after that is subdued, it could, potentially, lead to a surge in the unemployment rate to levels beyond those experienced in the 2008/9 global financial crisis (see Figure 3).

3. US unemployment rate



Sources: NBER; Refinitiv. Data as at 1 April 2020.

V, U or L?

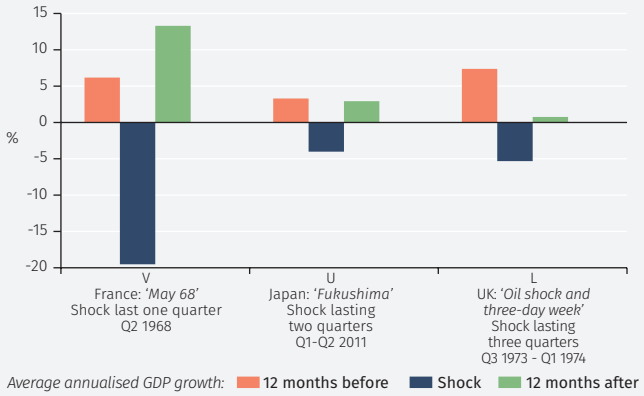
The key question, looking ahead, is when, and how soon, economies will recover from this shock. Will there be a 'V-shaped recovery' as economic activity quickly rebounds? Or a longer period of subdued activity – a 'U shape'? Or might there be a permanent effect, with potential economic output hit on a longer-lasting basis – an 'L shape'.

Previous experiences

What can we learn from previous experience about the likelihood of the different patterns? The first point to note is that economic shocks in the last forty years or so have mainly started in the financial sector. But this experience is different. Searching for recent examples of economic shutdowns not

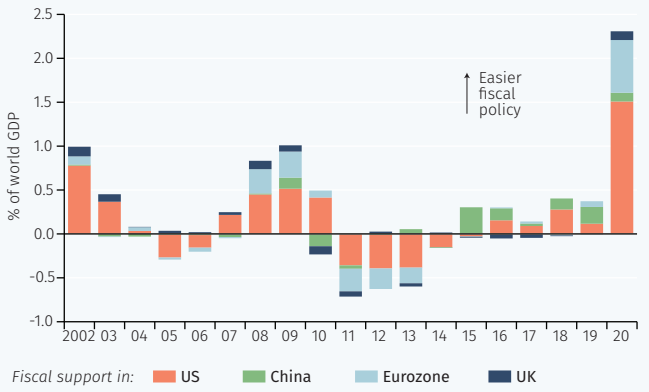
[1] *The Economist*, 28 March 2020.
[2] http://www.oecd.org/newsroom/oecd-updates-g20-summit-on-outlook-for-global-economy.htm

4. V, U or L?



Sources: Refinitiv and EFGAM calculations. Data as at 1 April 2020.

5. Fiscal support



Source: IMF Fiscal Monitor and EFGAM estimates. Data as at 1 April 2020.

due to financial crises (see Figure 4), there are fewer examples. The May 1968 student riots in Paris shut down the French economy for one quarter but it quickly rebounded: that was a 'V'. The 2011 Fukushima nuclear power plant disaster in Japan hit economic output for two quarters but the economy then recovered to its previous growth rate: a 'U'. The UK three-day week in the first quarter of 1974, which followed the embargo on Arab oil exports in the previous year lasted three quarters but the UK economy then remained mired in difficulties: that was an "L".

In Asia, of course, we have the experience of SARS in 2002/03 (see page 9) as a guide. That was a V-shaped hit to the economy, with a short contraction and a swift rebound. Asian governments have learnt much from that experience. Yet, it is clear that the type of measures taken in economies such as Singapore (where there have been just three deaths from the coronavirus) were either unpalatable (because of their impact on personal freedom) or technically not feasible (because of the lack of testing capabilities) to many western governments, at least in the early stages of the virus's spread.

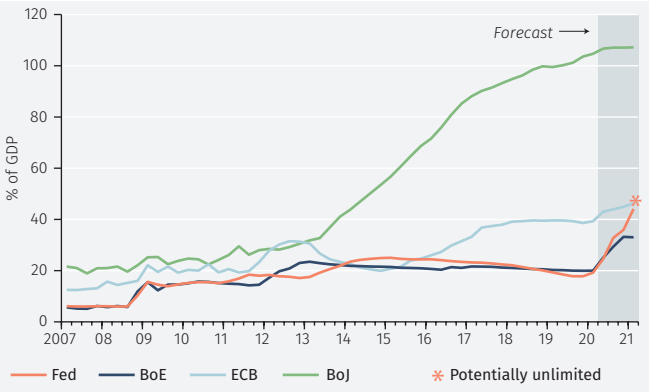
The other example many have turned to, the only pandemic of the twentieth century, is the Spanish flu of 1918/19. Despite its name,[3] it started in the US in Spring 1918 and spread around the world in 1918-1919. Around one-third of the world's population became infected with an estimated 50 million deaths worldwide.[4] US activity was hit for two quarters but quickly rebounded: by the end of 1919 it was back at the same level as early 1918. There was a massive recession in 1920, but thereafter rapid expansion and exuberance in the 1920s.

Moreover, that was achieved without economic policy support. Hampered by the debt accumulated in World War 1, governments were unwilling to support the economy through extra spending; and interest rates were not cut at all. US and UK interest rates remained at 5-6% throughout the pandemic, for example.

Policy response has been swift

This time around, we have already seen a strong fiscal response, not least the US$2 trillion package in the US (see Figure 5). The US Fed and the Bank of England have cut policy interest rates to near-zero; central banks have announced expanded asset purchase schemes (see Figure 6) and vigorous policies geared to support bank lending have been introduced. Some question whether this response is too aggressive; we see it as more likely just a partial offset for the demand shock. For the rest of 2020, the key issues will be the incoming evidence of the hit to economies from the shutdown; how quickly the disease comes under control; the speed of the recovery; and the impact of policy.

6. Central bank assets



Source: Refinitiv and EFGAM calculations. Data as at 1 April 2020.

On balance, we see the economic trajectory of the global economy being a U shape: a reasonably large contraction of real GDP in the second quarter of the year, a levelling off in the third quarter before a bounce back in the final quarter of the year. Broadly, demand is set to fall faster than output, so inflationary pressures will remain weak (a relationship seen, in microcosm, in the oil market). Financial markets are, of course, always forward looking. But the clarity of their vision is unlikely to be high in the coming months.

[3] According to Robert Gordon in *The Rise and Fall of American Growth* (Princeton, 2016), as Spain was neutral in World War 1 the geographic designation of the flu was chosen so as not to blame any of the belligerent countries.
[4] *Emerging Infectious Diseases*, Vol. 12, No. 1, January 2006 www.cdc.gov/eid

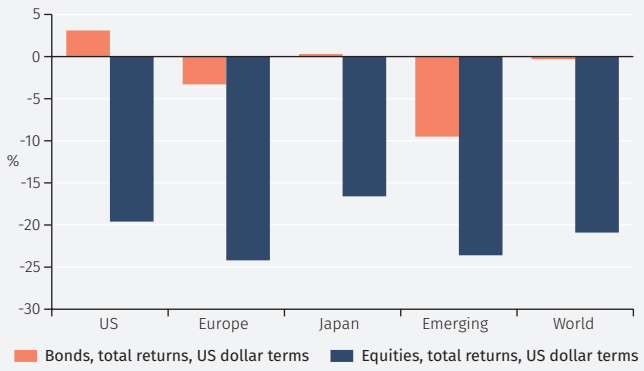
ASSET MARKET PERFORMANCE

The reaction to the coronavirus pandemic saw global equity markets lose almost all the gains made in 2019 during the first quarter of 2020. Government bond markets and the US dollar, Swiss franc and yen were relatively safe havens.

Asset market performance

World equity markets saw losses of 20.9% in the first quarter of 2020 (see Figure 7) on the basis of the MSCI World Index in US dollar terms. That weak performance came, however, after very strong returns during 2019: total returns since the end of 2018 are marginally positive. Global bond market returns were marginally negative on the basis of the Bloomberg Barclays Global Aggregate Index during the first quarter of the year.[5] However, returns from US bonds in US dollar terms were positive, by 3.1%.

7. Asset market performance



Sources: Barclays Bloomberg (bonds); MSCI (equities). Data for three months to 31 March 2020.
Past performance is not necessarily a guide to the future.

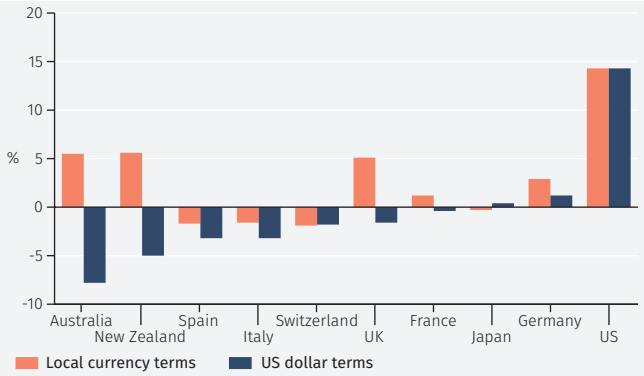
Bond markets

That aggregate performance data masks, however, important differences between different segments of the bond market. US 10-year Treasury bonds produced total returns of 14.3% in the quarter (se Figure 8). This primarily reflected the sharp rise in price of such bonds as yields dropped to all-time lows. Shorter-maturity government bonds produced lower returns, as did investment grade and high yield bonds.

Local currency returns across the eurozone government bond markets were much lower and were further undermined in US dollar terms by the euro's weakness. Within the eurozone, however, the weak performance of Italian and Spanish bond markets during the quarter was largely reversed by the end of the period as the European Central Bank eased its former restrictions on purchases of such bonds.

The fall in Australian, UK and New Zealand 10-year bond yields and consequent strong returns from their markets reflected policy interest rate cuts and the weak economic outlook. That translated into total returns of around 5% in local currency terms in those three markets, but in all cases

8. Bond market returns



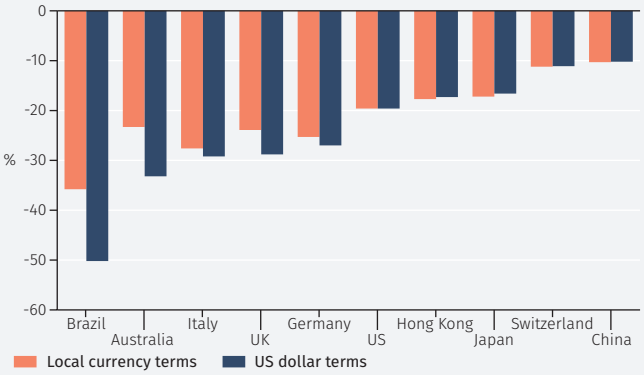
Source: Refinitiv. 10-year benchmark bond total returns. Data for three months to 31 March 2020.
Past performance is not necessarily a guide to the future.

this was undermined in US$-terms by currency depreciation. Indeed, all major currencies, except the Swiss franc and Japanese yen, depreciated against the US dollar during the quarter.

Equity markets

The US equity market (see Figure 9) lost around 20% in total return terms during the first quarter. All developed and emerging equity markets produced negative returns in both local currency and US dollar terms. Commodity-reliant markets such as Brazil and Australia were amongst the worst hit. At the other extreme, China (for which the index used in Figure 9 consists largely of Hong Kong-listed stocks) recovered, after a period of marked weakness during the quarter, to record losses of only 10% for the quarter. The Swiss equity market also performed relatively well against the backdrop of the weak global performance of equities.

9. Equity market returns



Source: MSCI. Data for three months to 31 March 2020.
Past performance is not necessarily a guide to the future.

[5] The Bloomberg Barclays Global Aggregate Bond Index is a benchmark of government and investment grade corporate debt from developed and emerging markets issuers in 24 countries.

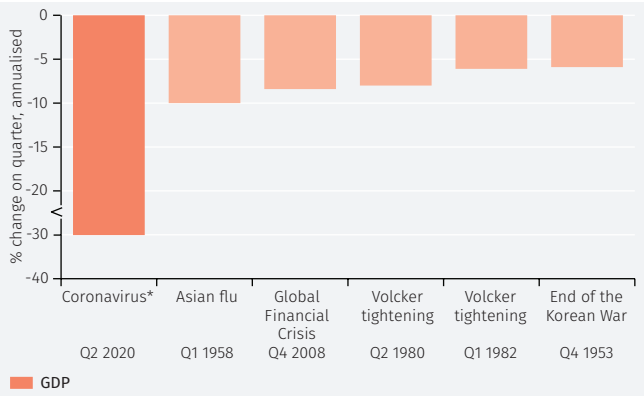
With three-quarters of Americans under some form of lockdown, prospects for the economy in the second quarter of 2020 are poor. Suddenly, the US is in recession. How soon, however, will the economy bounceback?

Suddenly, a recession

Suddenly, the US is in recession. It has not yet been confirmed but seems a near-certainty. The prospect has been much discussed in the last two years or so. In the end, it seems that the inverted yield curve did prove to be, as it has in the past, a reliable indicator of such a downturn, even for an unusual reason.

As a result of the widespread lockdowns which occurred from March onwards, it seems likely that US GDP growth will be negative in the first quarter of the year; followed by a larger decline in the second quarter. That quarter may well see a record decline in GDP at an annualised rate, surpassing the previous largest post-World War 2 declines: in the Global Financial Crisis and (a parallel which has not been widely made) the Asian flu epidemic of 1958 (see Figure 10).

10. US: setting a new record



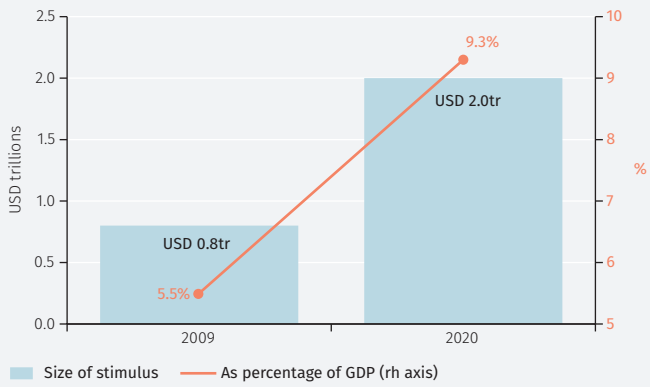
*Estimate. Source: Refinitiv and EFGAM calculations. Data as at 1 April 2020.

Even so, as economic prospects depend almost entirely on the spread of, and reaction to, the coronavirus, the outlook at this stage is particularly uncertain. Hard evidence of two quarters of negative GDP growth (one definition of recession) will not be available until late July. The NBER may take a while to declare the onset of recession.[6] But a new indicator (the Sahm indicator, named after its inventor) is very likely to identify the start of recession much sooner: it is based on the unemployment rate compared to its recent low point.

Support measures

The US has swiftly put in place a package of support measures. Fiscal support comes from the aptly titled CARES (Coronavirus Aid, Relief and Economic Security) Act, a US$2 trillion set of measures. This is larger than that at the time of the global financial crisis (see Figure 11) and includes direct payments to households, support for businesses via bailouts

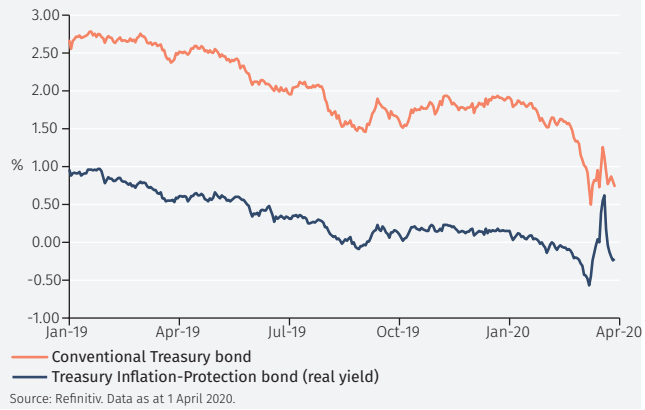
11. US fiscal stimulus



Source: Refinitiv. Data as at 1 April 2020.

and loans, additional unemployment insurance, increased funding for healthcare and small business aid. The US Fed has cut interest rates to 0-0.25%, announced potentially unlimited purchases of Treasury and investment-grade corporate bonds, eased bank capital requirements and provided support for companies via the commercial paper market. In the bond markets, Treasury yields have fallen sharply (see Figure 12). They are likely to remain low, given the Fed's purchases and continued low inflation (as a result of the weaker economy and the recent fall in oil prices).

12. US Treasury yields



Source: Refinitiv. Data as at 1 April 2020.

Whether these measures will be enough to offset the hit to the economy from the pandemic cannot easily be judged at this stage. We see the recovery as likely to be relatively quick – starting in the third quarter of the year – although at this stage that has to be a tentative forecast.[7]

[6] The NBER identified the start of the 2008/9 recession 12 months after it began; and the start of the 2001 recession only after it had finished. See: http://www.nber.org/cycles/cyclesmain.html

[7] For a more detailed analysis of US and global recovery prospects see our *Macro Flash Note*, 'The duration of the Covid-19 epidemic and the size of the real GDP loss', 1 April 2020.

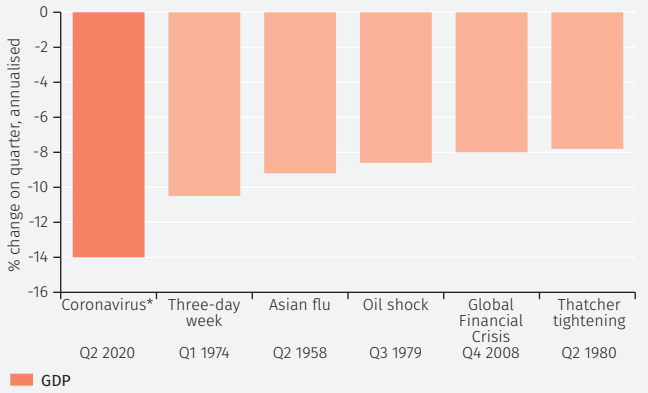
In the UK, as in the US, the shock to the economy from the coronavirus looks set to be substantial. Support measures and the shock to the economy will raise government borrowing substantially.

Setting a new record (in a bad way)

Before the coronavirus and the measures to contain it started to have their effect on the economy, UK economic growth had ground to a halt. GDP in the final quarter of 2019 showed no growth, with retail spending particularly weak. The widespread lockdown in response to the coronavirus started only late in March and it is reasonable to expect it will have its biggest effect on the economy in the second quarter. That quarter may well set a new record for the weakest GDP ever recorded in the post-war period (see Figure 13). The UK has experienced somewhat similar disruptions to its economy in the past – although not on the current scale. In 1974, UK industry was put on a three-day week, needed in order to ration power as a result of the Arab oil embargo following the Yom Kippur War. That particularly weak quarter was sandwiched between two other quarters in which GDP fell. Afterwards, the UK economy remained mired in difficulties, culminating in the 1976 IMF crisis, engagingly depicted in the book, *Goodbye Great Britain*.[8]

Excessive government borrowing, rapid monetary growth fuelled by the freeing of restrictions on the banking sector and high inflation meant the UK was particularly vulnerable in the mid-1970s. Now, the UK faces the crisis in a better condition: inflation has been well contained, government borrowing has been reduced to low levels and government debt is not particularly high.

13. UK: setting a new record

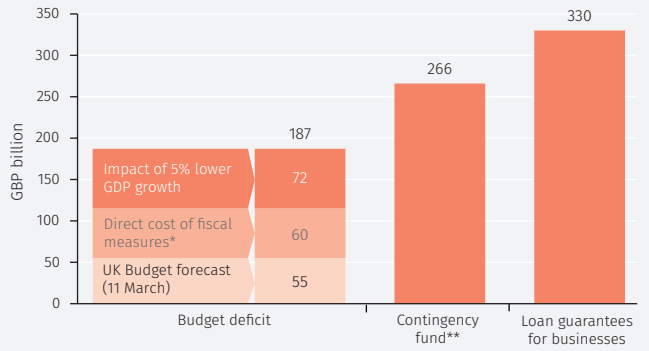


*Estimate. Source: Refinitiv and EFGAM calculations. Data as at 1 April 2020.

Government borrowing surge

However, the cost of fiscal support for the coronavirus pandemic will be large. Government borrowing in the 2020/21 financial year, estimated in the 11 March budget at £55bn (2% of GDP) could well be nearly four times larger as a result of weaker economic growth and the direct fiscal measures which have been taken (see Figure 14). Further action may well be needed. The Bank of England has introduced a set of policies – reducing interest rates to 0.1% and additional asset purchases, in particular – which provide further support.

14. UK fiscal support



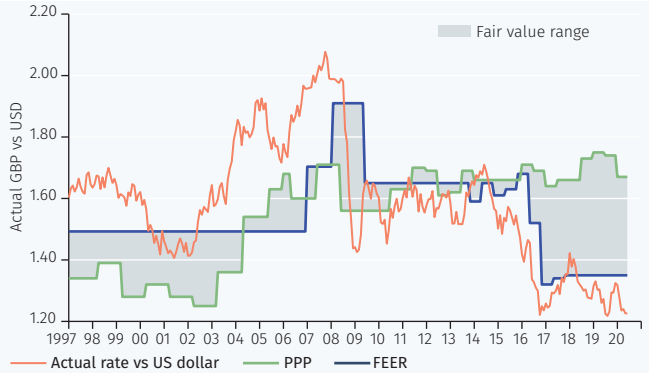
*Including paying 80% of wages kept on by employers; support for the self-employed; additional NHS spending; and cut in business rates.
**Increased from £11bn to £266bn. Source: Institute for Fiscal Studies; 1 April 2020. Data as at 1 April 2020.

As elsewhere, however, the economic outlook and policy measures are almost entirely dependent on the progress of the coronavirus and measures to contain it.

Sterling

In this environment sterling has been volatile reflecting, in particular, the relative prospects for the US and UK economies and policies. It still appears undervalued to us (see Figure 15) , but until the prospects for the economy, let alone Brexit, are clearer few will be willing to enthusiastically embrace the currency.

15. Sterling against the US dollar



Purchasing Power Parity rate (The Economist) **Fundamental Equilibrium Exchange Rate (Peterson Institute for International Economics). Source: Refinitiv; 3 April 2020.

[8] Kathleen Burk and Alec Cairncross, Yale University Press (1992).

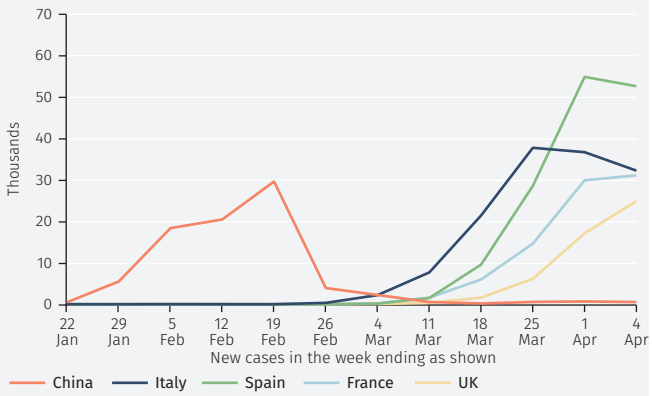
EUROZONE

The spread of the coronavirus in Italy and Spain has shocked the world. Germany has not been as badly affected, but the economic effects across the eurozone will be extensive. Crisis, however, may bring some welcome changes.

Sudden shock

The rapid spread of the coronavirus in the eurozone has come as a major shock. The sharp weekly rise in reported cases in Italy and Spain (see Figure 16) looks like an echo, unfortunately an exaggerated one, of the trajectory in China. However, that provides some hope that, in Italy in particular, the recent drop in new cases may be the start of a continuing trend.

16. Coronavirus cases: China and Europe

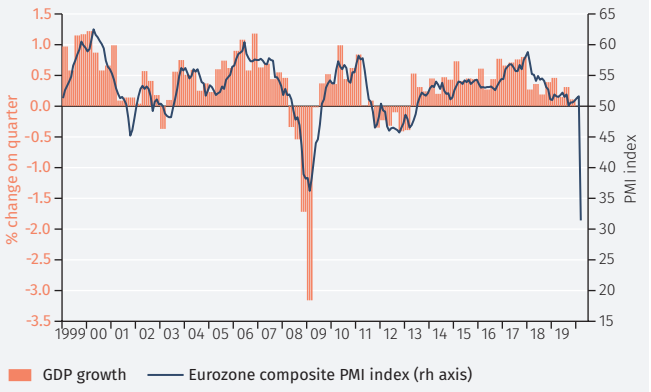


Source: www.ecdc.europa.eu. Data as at 4 April 2020.

Economic shock

In common with the UK and the US, indicators of business confidence in the eurozone have weakened sharply. They indicate a contraction in GDP at least of the size seen in the global financial crisis (see Figure 17). Although Germany has fewer coronavirus cases than many other eurozone economies, it may be more vulnerable to an economic shock, particularly because of the importance of its auto industry.[9] Much of this has been shutdown since late March.

17. Eurozone GDP and PMI



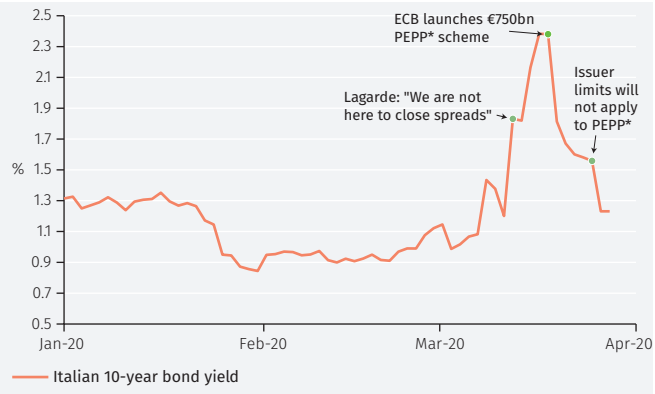
Source: Refinitiv. Data as at 1 April 2020.

The fiscal response across the eurozone has been largest in Germany (around 2% of GDP, around twice the stimulus in Spain, France and Italy). But even there it is small in comparison to the US (7% of GDP) and the UK (4% of GDP).[10] Nevertheless, Germany has a well-established Kurzarbeit (shorter working time) system in which companies hit by the downturn can send workers home, with the state replacing a large part of lost income. The scheme worked well in the global financial crisis and has been credited with a relatively rapid rebound in the economy at that time. Three countries outside the eurozone – Denmark, Sweden and Norway – have similar systems; and the UK's recently launched scheme works along similar lines.

ECB bond purchases

Perhaps the most significant change in the ECB's operations in response to the crisis has been to remove the limit on the proportion of a sovereign's bonds which can be purchased under its asset purchase scheme (which itself, has been expanded by €750bn). Although ECB President Christine Lagarde commented that the ECB's job was not to 'close the spread' (that is the difference in government bond yields between different members of the eurozone), a comment for which she later apologised, the change of policy has had that effect. Notably, Italian government bond yields have fallen (see Figure 18). The removal of the limit helps to reduce perceived country risk and may ease the path to common eurozone debt issuance. Whether such "coronabonds" are issued remains to be seen.

18. Italy: 10-year government bond yield



*PEPP: Pandemic Emergency Purchase Programme. Sources: ECB, Refinitiv. Data as at 1 April 2020.

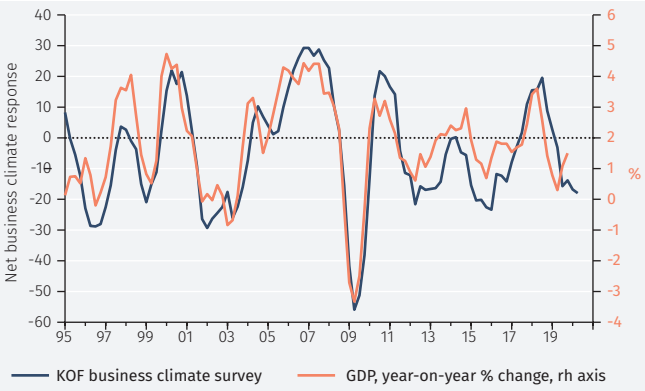
[9] Source: http://www.oecd.org/newsroom/oecd-updates-g20-summit-on-outlook-for-global-economy.htm
[10] Source: Gavyn Davies, *Can the world afford fiscal and monetary stimulus on this scale?*, https://www.ft.com/content/0f289d20-6e97-11ea-89df-41bea055720b

There is a high risk of recession in 2020 as a result of the coronavirus pandemic. However, the underlying strength of the Swiss economy and the scale of resources deployed will mitigate the shock and speed the subsequent recovery.

The Swiss shock and response

To limit the rapid spread of Covid-19, Switzerland imposed a lockdown on 16 March. It will last until at least 19 April. This restricts openings to grocery stores and pharmacies and to essential services, including banks. Inevitably, the economy will suffer a severe shock, the size of which is difficult to quantify. Our baseline scenario is that it will be temporary and that the economy will quickly return to normal starting from the summer. Even in this relatively benign scenario, GDP is expected to contract by about 0.5% this year, the weakest since 2010 (see Figure 19). The risk is mainly to the downside because the lockdown could last longer and the recovery could be slower than expected.

19. Switzerland: business confidence and GDP growth

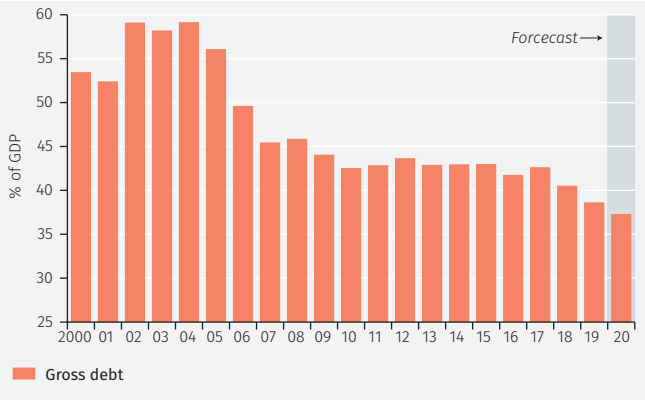


Sources: Refinitiv and EFGAM calculations. Data as at 1 April 2020.

Underlying strengths

However, the Swiss economic outlook benefits from the availability of ample resources to support businesses and households affected by the lockdown. Indeed, Switzerland's public debt, at just 40% of GDP (see Figure 20), is among the lowest in the world.

20. Switzerland: gross government debt



Sources: Refinitiv and EFGAM calculations. Data as at 1 April .

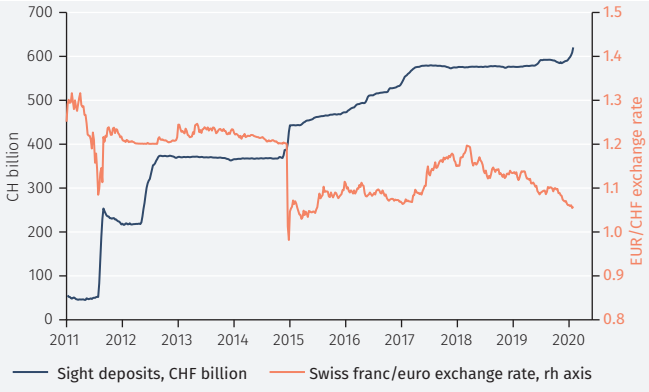
Measures taken

So far, the Federal Council has announced measures worth CHF 42 bn (6% of GDP). These will be used to: increase health spending; compensate companies that resort to temporary reduced work or partial unemployment; increase companies' liquidity by means of extensions to tax payment deadlines; guarantee loans to small and medium-sized firms; and to extend unemployment benefits to the self-employed and employees that stay at home to take care of their children after the closure of schools.

The Federal Council also committed to increase the fiscal package, as needed, to overcome the crisis. In addition, the cantons, within their fiscal autonomy, are taking further measures, such as extending the payment period on invoices they issue.

Although monetary policy is not suited to tackling health-related shocks, the Swiss National Bank (SNB) has also taken steps to sustain the economy. The SNB's main focus is preventing an excessive appreciation of the Swiss franc, and to this end it stepped up intervention in forex markets (see Figure 21).

21. SNB interventions and the EUR/CHF rate



Sources: Refinitiv and EFGAM calculations. Data as at 1 April 2020.

Moreover, to guarantee abundant liquidity and incentivise the flow of credit to small and medium sized firms, the SNB introduced the new COVID-19 refinancing facility (CRF). This allows banks to obtain unlimited liquidity from the SNB and is secured by federally guaranteed loans. In addition, the SNB raised the exemption threshold on banks' overnight deposits subject to negative rates.

Finally, the Federal Council approved the SNB proposal to reduce the countercyclical capital buffer to zero in order to increase banks' lending capacity and thereby cushion the economic impact of the coronavirus pandemic.

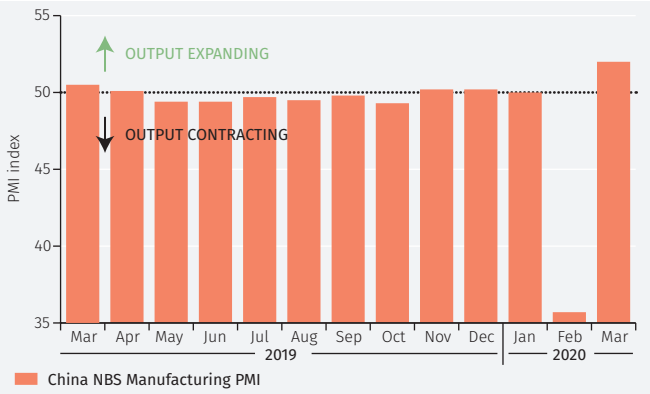
ASIA

China has already started to recover from the coronavirus shutdown, as evidenced by early survey data. For the Asian region, the SARS outbreak of 2002/03 has provided valuable lessons in how to deal effectively with an epidemic.

China's V-shaped bounce back

The lockdown in Wuhan and other cities in Hubei province in China, imposed on 23 January 2020, was lifted on 27 March. At least one business survey (see Figure 22) suggests a swift bounce back in economic activity after a sharp drop in February. It is supported by other evidence on, for example, the number of factories now operating again, air and road traffic and (less favourably) air pollution. Many other economies, at earlier stages of their containment of the coronavirus pandemic, may take some comfort from the ability of China to recover quickly.

22. Bounce back?

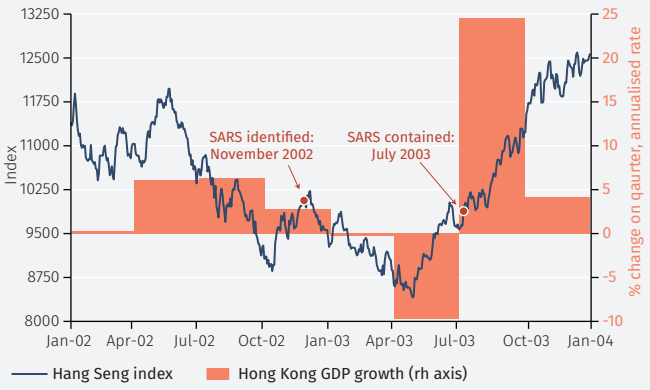


Source: Refinitiv. Data as at 1 April 2020.

SARS in 2003

Even so, China has been criticised for its slow initial recognition and reporting of coronavirus. A similar criticism was also levelled at the Chinese authorities during the Asian SARS epidemic in 2002/3. This started in the Guangdong Province in Mainland China, but particularly affected Hong Kong. Nevertheless, it was just nine months from identification of SARS to its containment.[11] The recovery in the economy and the equity market followed a V-shaped pattern (see Figure 23).

23. Hong Kong and SARS 2002-2004

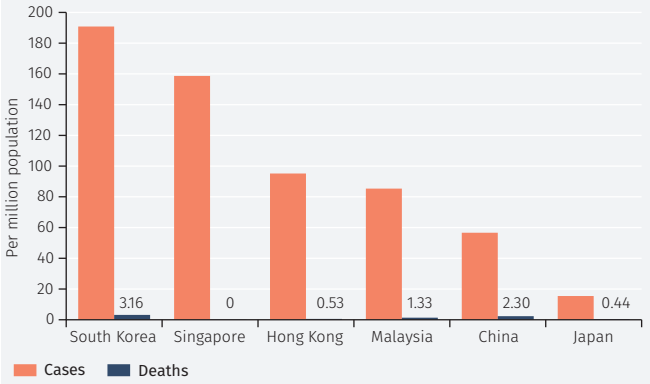


Sources: WHO, Refinitiv. Data as at 1 April 2020.

Asia has learnt from the SARS epidemic but even so there is a range of different approaches being taken to deal with it. Singapore is often cited as the most successful. It imposed border controls soon after the disease first erupted in China, it actively traces known carriers, has high levels of testing and a clear public communication strategy.

The Asian country with the highest prevalence of the disease, South Korea, with 190 cases per one million of the population has an infection rate around one-tenth of that of Italy (see Figure 24).

24. Asia: Coronavirus cases



Source: www.ecdc.europe.eu. Data as at 1 April 2020.

Looking ahead, however, concern now surrounds a second wave of infections – a phenomenon which is, sadly, often prevalent when initial restrictions are lifted.

Policy responses

Across Asia, we see countries responding to the economic shock with further cuts in interest rates and fiscal stimulus measures. South Korea stands out as having one of the largest fiscal responses to date, but at US$9.8 billion or 0.6% of GDP it is relatively modest by global standards. In Japan, fiscal support has so far been even smaller. Many Asian economies have room to cut short-term interest rates further, particularly India and Indonesia and it is safe to think that can be done without risking higher inflation.

[11] There were far fewer cases of SARS (7,000 across Asia and 8,000 worldwide, one thousandth of the number of coronavirus cases) although it had a much higher mortality rate (almost 10%). Source: 'The SARS epidemic in Hong Kong: what lessons have we learned?', *Journal of the Royal Society of Medicine*, August 2003.

Latin America will not escape disruption from the coronavirus. While the number of cases is so far limited, Latin America's trade is being adversely impacted and the scope to provide domestic support is limited.

At the start of April, Latin America had relatively few coronavirus cases, but experience elsewhere in the world suggests there are no grounds for complacency. So far, Brazil has 4,500 cases and Rio de Janeiro and Sao Paulo have already ordered residents to stay at home. Hopefully, learning from the experience of other countries, the effects can be contained.

Exchange rate weakness

Across the region, the exchange rate often provides the first sign of concern about prospects, not least because capital is typically quick to leave at times of uncertainty. This time has been no exception – inded, capital outflows have been larger than in previous periods of stress. The Brazilian real and the Mexican peso have depreciated by 30% and 25%, respectively, in the first months of 2020 (see Figure 25).

25. Currency weakness

Source: Refinitiv. Data as at 1 April 2020.

An important concern with regard to the region is its commodity dependence. Lower oil prices have hit the major oil exporters: Colombia, Mexico and Venezuela (compounding the latter country's own idiosyncratic problems). Weakness in demand for agricultural commodities and metals, initially stemming from the slowing of the Chinese economy, but now a feature of North America and Europe, is a particular problem for Argentina, Brazil, Chile and Peru. Tourism in the region is also set to be hit hard.

International support

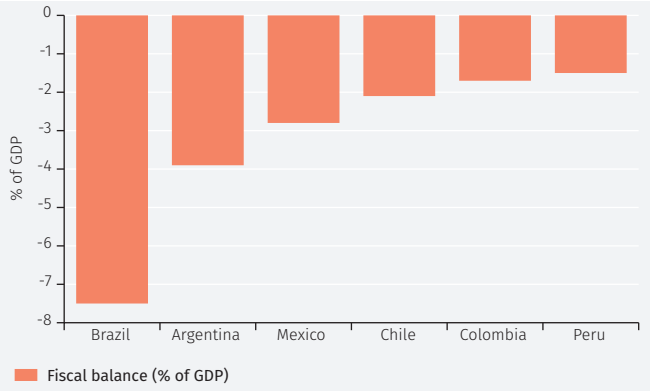
Some support for the region has already come from the Inter-American Development Bank (IADB), which has assigned USD2 billion, particularly to support countries with the weakest healthcare systems. IMF programmes look increasingly likely although a reticence on the part of both donor and receiver can be expected to be a characteristic of any negotiations. The IMF recently rejected Venezuela's request for an emergency loan, for example, given the political uncertainty in the economy. Also, Argentina's IMF bailout has been mired in difficulties.

Domestic support

Some countries have scope for self-help measures through fiscal and monetary support. Brazil, for example, has already announced a fiscal package of USD29 bn and the central bank has cut interest rates by 50bps. However, the situation of the largest economies does not leave much room for fiscal stimulus.

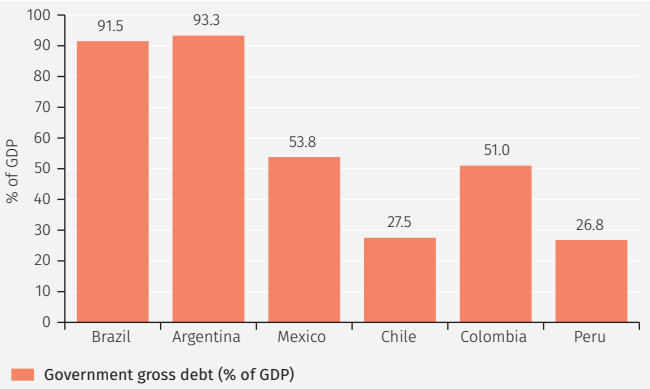
Peru, Chile and Colombia are in a better position given their lower deficits and debt-to-GDP ratios (see Figures 26 and 27) but all will be keen to avoid a large expansion, especially after hard-won progress over many years.

26. Latin America: government budget balances



Source: Refinitiv. Data as at 1 April 2020.

27. Latin America: government debt levels



Source: Refinitiv. Data as at 1 April 2020.

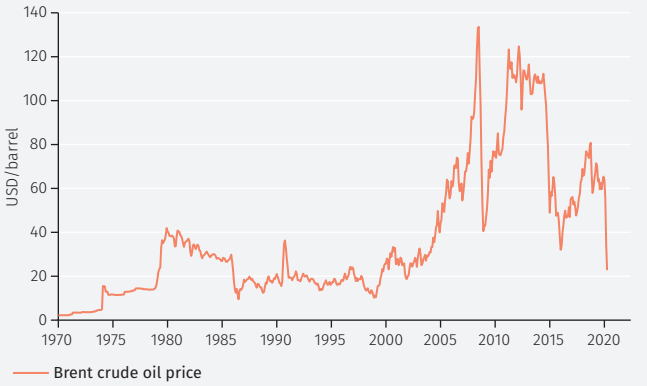
Latin America will undoubtedly weather this latest storm. But in all likelihood, brighter prospects may not be evident until the end of the year.

The failure of the OPEC+ meeting in March to cut oil production reflects a change in the strategy of Saudi Arabia and Russia. After three years of restricting output to support the oil price, priorities have been reversed.

Two key factors in the oil price collapse

The collapse in oil prices to around USD 20/barrel, the lowest level since 2002 (see Figure 28), is due to two factors: a large increase in supply; and sharply weakened demand as a result of the coronavirus pandemic.

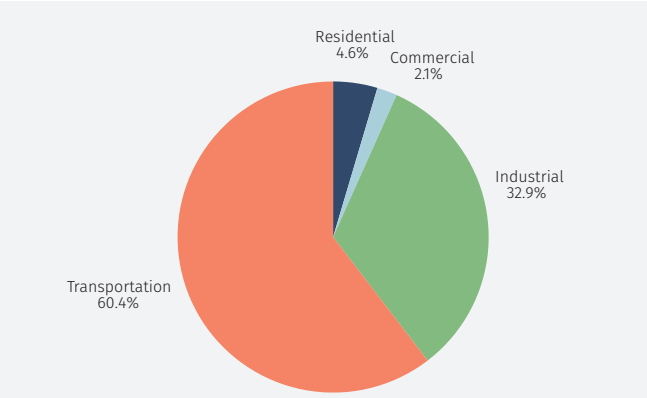
28. Oil price



Source: Refinitiv. Data as at 1 April 2020.

With transportation representing about 60% of oil demand (see Figure 29), many commentators forecast a demand shortfall of more than 20 million barrels per day at the peak of the crisis. In contrast to previous periods of falling demand, such as after Lehman's collapse in 2008, Saudi Arabia and Russia are increasing output. A record excess supply of oil will be recorded in the first half of 2020.

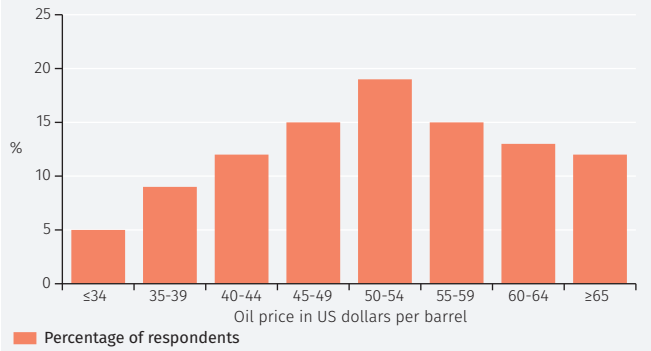
29. Global oil consumption by sector



Source: Energy Information Administration and EFGAM calculations. Data as at 1 April 2020.

In this scenario, prices will remain low. Although neither Saudi Arabia nor Russia can sustain such low prices for long, they are financially stronger than US shale oil producers. The latter will be the main victim of the new market environment. In fact, 75% of shale oil producers need prices above USD 45/barrel to generate sufficient cashflow to cover their capital expenditures (see Figure 30). They are also under pressure from shareholders to increase profitability and repay the investments undertaken over the past decade; and are heavily indebted so are at risk of insolvency.

30. Oil price needed to cover capital expenditure



Survey responses from 93 (E&P) Exploration and Production firms at oil and gas firms located or headquartered in the Eleventh District—Texas, southern New Mexico and northern Louisiana—which operate regionally, nationally or internationally. The survey was conducted between 11 and 19 December 2019.
Source: Federal Reserve Bank of Dallas.

Russia's needs

The Russian government needs oil prices around USD 50/barrel to balance its budget. Russia's financial position is, however, stronger than in the past. Revenues from oil sales above USD 42/barrel are transferred to the National Welfare Fund, which in December 2019 had net assets of USD 124bn (7% of GDP). Foreign exchange reserves are also high (25% of GDP) and public debt (mostly denominated in roubles) is low (12.5% of GDP). Furthermore, Russia's ability to withstand low prices benefits from a weaker currency as its cost base is denominated in roubles. The depreciation of the rouble means that the cost of production of a barrel of Russian oil is now less than USD 40/barrel.

Saudi Arabia's position

Saudi Arabia's oil production cost is one of the lowest in the world at less than USD 20/barrel, according to IHS Markit. It also has low public debt (24% of GDP), which means that running a budget deficit will not be a problem in the short term.

However, in the medium term both Saudi Arabia and Russia need higher oil prices. In Saudi Arabia, Prince Mohammed bin Salman has launched an ambitious Saudi Vision 2030, a project to modernise the country and diversify its economy from the oil industry. In Russia, higher oil revenues are needed to finance generous social spending plans and Putin's plan launched in 2018 to modernise the infrastructure.

In conclusion, oil at USD 20/barrel or below is unsustainable for US producers, so their production will likely fall soon. An agreement between Saudi Arabia and Russia is possible and OPEC+ could return to support prices. However, only when the global economy recovers from Covid-19 will oil prices rise again.

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