CIO Memo

October 28, 2020

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Europe: more volatility as COVID-19 restrictions deepen

Key take aways

- COVID-19 infection numbers continue to rise. European governments are starting to impose stricter restrictions.
- Risk-off sentiment has dominated European equity markets today. German Bund yields have however declined only slightly. EUR/USD weaker at 1.175 (-0.4%).
- From here on, the road to recovery may become more bumpy and further volatility should be expected.

1. What happened?

COVID-19 infections continue to rise in Europe. After last week's record numbers, further growth has been experienced across Europe. Germany is now reporting new daily infections of nearly 15,000, France more than 30,000, Italy more than 20,000, Spain more than 18,000 and the Netherlands more than 10,000. Reported daily infections in the Eurozone's five most populous countries are now higher than during the first wave in March and April (with much higher testing rates, of course). Hospital intensive care units are now running at high capacity in some parts of Belgium, the Netherlands, Spain and France. During the summer months, the virus had seemed to be generally under control in Europe, with hotspots elsewhere (e.g. India, Brazil and the United States). But since September, new infection rates nearly everywhere in Europe have been growing.

Markets are therefore worried about the economic disruption from further lockdowns. While at first governments in Europe ruled out imposing broad and strict restrictions nationwide again, the specific restrictions have been increasing across Europe.

The German government has today announced new restrictions (e.g. bars and restaurants closed in November, but retail to remain open) as well as partial coverage of revenue losses with details to be unveiled soon. The French government is expected to implement new national measures too. Local restrictions have already increased: France has imposed already a night-time curfew on major cities while Germany has put some smaller, heavily affected regions under a strict lockdown. Italy put in place a few days ago curfews for bars and restaurants, forcing them to close by 6 p.m. nationwide – in addition to local restrictions.

Economic data suggest that the service sector in particular is suffering under the new restrictions and the uncertainties related to the spread of COVID-19 (note for example the recently-released October PMI data and the German Ifo).

2. How did markets react?

In the face of new restrictions and worries about related economic consequences, European equity markets have showed weak trading performance during the last few weeks – with the latest falls taking them back down to May levels. The EuroStoxx 50 closed today 3.5% down, with the cyclical sectors suffering the most. 10y German Bunds benefitted only slightly – yields fell by -1 bp. EUR/USD declined to 1.175 (-0.4%).

3. What does it mean for investors?

Before the latest increase in infection numbers, European economies and equity markets had recovered swiftly from their lows earlier this year. But rising coronavirus infection numbers and worsening sentiment will most probably lead to a substantial moderation in growth in Q4. This is in line with our long-established view that after an initial sharp recovery, European growth would be much slower – but recent developments do increase risks to the downside. In Europe, a return to pre-crisis levels of GDP is expected by 2022 only.

Comparing the current situation with the initial downturn towards the end of Q1 2020, it is worth noting that the knowledge about the virus has improved and medical treatment and vaccine research have progressed. The latter is only a topic for later on in 2021, however, as vaccination programmes may not be fully rolled out across entire populations until H2 2021. Monetary and fiscal support mechanisms are also now in place and today's measures are still far from a total lockdown: we are not expecting very sharp falls in GDP or other output measures, as experienced in Q2 2020. China's economy also now appears strong. There is also greater confidence that such lockdowns will work than there was in the early stages of the pandemic. But the expansion of regional or local containment measures to broad-based national lockdowns does still pose an additional risk to sentiment, even if it has a lesser impact on service and manufacturing sectors than earlier this year.

The U.S. election next week (and its possible aftermath) also adds to uncertainty. All this is likely to outweigh some reasonably good news on corporate earnings (in terms of Q3 earnings "beats" so far). Moreover, while likely further fiscal measures to offset the impact of new restrictive measures will eventually reassure markets, these may take time to materialise.

In summary, possible new European coronavirus restrictions along with weakening economic indicators remind us that after a sharp initial upturn, the road to recovery could be a bumpy one. It may take two to three weeks for evidence that the new restrictions are working. While we wait for such evidence, equity markets will likely experience additional volatility.

Glossary

Bunds are longer-term bonds issued by the German government.

EUR is the currency code for the euro, the currency of the Eurozone.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

The EuroStoxx50 Index tracks the performance of blue-chip stocks in the Eurozone.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Ifo Indices measure business confidence and expectations in Germany and other economies.

Purchasing manager indices (PMI) provide an indicator of the economic health of the manufacturing sector and are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The compositePMI includes both manufacturing and services sectors. They can be published by public sector or private agencies (e.g. Caixin, Nikkei).

USD is the currency code for the U.S. Dollar..

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