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# LIVING ON WITH A COVID-19 HUM

**24 September 2020**

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- Stop-and-go containment measures confirm a return to normal in 2022.** After strong post-lockdown catch-up effects, we expect the recovery to slow in Q4 2020 and Q1 2021 as distancing measures tighten again and ongoing job shedding keeps spending and investment in check. Therefore we lower our GDP growth forecasts for 2021 to +4.6% (vs. +4.8% expected in June), following a contraction of -4.7% in 2020. Q2 data has already confirmed diverging recovery paths, with China and its Asian trade partners, Germany and Brazil outpacing the rest of Western Europe and the U.S. The sharpest trend reversals in activity should be visible starting in Q4 2020 in Europe (mainly Spain, France and the UK), the U.S. and in Emerging Markets such as Brazil and Mexico. In this context, the gradual phasing out of temporary policy measures designed to support companies will lead to a major trend reversal in business insolvencies, with a +31% increase expected by the end of 2021.
- A dual recovery for trade, consumers and investors.** First, despite a stronger-than-expected recovery in goods trade worldwide, the U.S. and Western Europe are trailing China, Emerging Asia and Eastern Europe's export recovery. In 2020, we forecast a fall in global trade in goods and services by -13% (vs.-11% in 2009) in volume terms, leading to USD4tn of trade losses. In 2021, we forecast a +7% technical rebound but expect a return to pre-crisis levels only in 2022 as services continue to struggle and calls for de-globalization emerge. Meanwhile, a loss of purchasing power for the most fragile households will be hard to recover. The asymmetric exposure to job losses meant young, less qualified and part-time workers were hit the hardest, implying a K-shaped or "dual" recovery in consumer spending ahead.
- Political risk could be back like a boomerang.** Odds for a no-deal Brexit have risen to 45%, while the U.S. elections are paving the way for a new fiscal cliff and a judiciary dispute at the end of the year. In 2021, the tech war between the U.S. and China, tensions in the Mediterranean Sea and the U.S.-Russia dispute will remain top of mind. The risk of policy mistakes for Emerging Markets that loosened their fiscal discipline to fight the crisis will rise in 2022: anticipations of higher U.S. rates should materialize then and debt sustainability worries could trigger pressures on EM currencies.
- Not the time to take risks.** In the current market environment, it is important to consider that there is greater economic uncertainty now than at the beginning of the year, despite the current monetary and fiscal policy mix, as well as more geopolitical risks and tighter valuations. In this context, equity markets show a persistent detachment from fundamental determinants, making the recent rally hardly justifiable. Because of that we still expect the equity market to underperform in 2020 and to start a muted rally in 2021. When it comes to corporate credit, both investment grade and high-yield corporate spreads look too tight. As in equities, corporate credit markets remain detached from fundamentals on the back of the central banks' perpetual put option. Hence, we expect corporate spreads to converge towards higher values due to higher than expected market volatility and increasing default rates. Lastly, with the short-end of most developed countries' sovereign yield curves anchored by their respective central banks, we expect a timid curve steepening towards the end of 2020 and 2021. This gradual increase in term premium will occur on the back of higher inflation expectations and a halt in the recent decline of real yields. On the other hand, long-term Emerging Market sovereign spreads look overbought. The combination of this extreme bullish positioning and the current market fragility is a perfect combination for EM assets to become a victim of a second "risk-off" rotation in the wake of a second risky-assets market correction.
- Fiscal and monetary policy: The devil is in the details.** EU member states agreed on issuing common debt to boost the recovery in a historical move. Yet the different natures and spending calendars of fiscal policies will matter: countries focusing on (short-term) demand (Germany, U.S., China etc.) could see a faster recovery than those betting on supply (France). Some countries still need to do more (Spain, Italy, the UK). In the immediate crisis aftermath, inflation is likely to remain muted despite these policy impulses; we see it moderately and temporarily overshooting in the US starting in 2022. On the monetary policy side, we expect an acceleration of the U.S. Fed's securities purchases in H1 2021, with a tapering of its QE program to only start from mid-2022 and a first rate hike in Q3 2023. The ECB should announce an additional EUR500bn in Quantitative Easing in December 2020.

- **Scarring effects? Covid-19 has changed the rules of the game for economic growth and capital markets.** First, the fight for regional primacy will lead to a regular “weaponization” of technology, trade, currencies and payment systems. Second, the balance between the state and markets will change, to the disadvantage of the latter. And as the state gets more and more entangled in the private sector, market dynamics for innovation will get weaker while the number of zombie companies rises. Private players in social security – such as life insurers – might be pushed against the wall. The growing role of the state also has ramifications for monetary policy. High (unsustainable) debt levels will force central banks to backstop sovereign and corporate bond markets to ensure favorable refinancing conditions. In the end, these ultra-expansionary monetary policies may strip markets of their ability to price and allocate resources appropriately and encourage excessive risk-taking by both debtors and investors. However, every cloud has a silver lining: Covid-19 has showed how quickly change is possible; it is a welcome break-up of encrusted structures and a boost to digitalization. The way we work has changed for good. Future work will see more remote working and flexible team structures but less business trips. Finally, it has also raised society’s risk awareness, including for low-probability, high impact tail risks. The upshot: More demand for and better pricing of risk cover. This should be a boon for insurers – if they are able to offer comprehensive and simple solutions.

# -4.7%

**Forecast for global  
GDP contraction in 2020.**

# A STOP-AND-GO APPROACH UNTIL THE RETURN TO NORMAL IN 2022

Q2 data confirmed an unprecedented contraction in global GDP (-6.1% q/q vs. -7.0% q/q expected by us) after the Covid-19 shock, close to four times worse than the 2009 trough and double the Q1 contraction. However, some countries were hit much harder than others due to differences in lockdown intensity and in the structure of their economies (share of services vs. manufacturing): France (81% of pre-crisis GDP level), Italy (83%), the UK (78%) and Spain (77%) were much more impacted than the U.S. (90%), Germany (88%) and the Netherlands (90%).

During the summer, de-confinement strategies gained traction, allowing several positive surprises in the economic data, notably for order books, the residential market and retail sales, thanks to pent-up demand post-lockdown. On the industrial side, global production stood at -8% y/y in June (after a trough at -16% y/y in April) and confidence in the manufacturing sector reached pre-crisis levels. This confirmed our call of a faster return to pre-crisis levels for activity in the manufacturing sector (vs. services).

However, we think the recovery will lose steam in Q4 on the back of tighter sanitary restrictions and the ongoing job shedding, which will keep spending and investment plants in check.

**We remain in Phase 2 of the Covid-19 crisis, which means re-opening will remain divergent and dependent on the**

**evolution of the sanitary crisis.** Back in April we identified four different phases of the Covid-19 crisis. During phase 1, characterized by the urgency of monetary, fiscal and sanitary measures, real activity suffered heavily from the lockdowns, as mirrored by the sharp contraction of GDP across countries. Now, we are in phase 2, characterized by more targeted and progressive sanitary restrictions in response to rising infections, with persisting threats of a lockdown in countries where the second wave materializes. Hence, the recovery is expected to soften in Q4 and in some cases transform into a W-shaped one. We expect the highest trend reversal activity in Q4 in Europe (France, Spain, UK) and in the U.S.

**Phase 3 of the Covid-19 crisis: Transitioning towards normalization, with a stop-and-go approach until the end of 2021.** During phase 3 (from Q4 2020 until end-2021), we expect a succession of tighter and targeted sanitary restrictions, followed by periods of easing. This stop-and-go trend in stringency will continue until end 2021, assuming a vaccine would be widely available from September 2021 and that at least 6 months would be needed for vaccination campaigns. While it will not freeze the new investment cycle, it will hamper it, causing asymmetries across countries due to heterogeneous initial conditions, different sized stimuli, variable re-confinement strategies and unequal

potential access to potential vaccines. Phase 3 will also see the implementation of new fiscal stimulus packages but a slightly lower degree of central bank activity, keeping the global economy below pre-crisis levels until end-2021.

**Still some way to go until we reach the fourth and final phase of the Covid-19 crisis: What would it take for a full normalization by 2022?** We assume a finalization of vaccination campaigns in mid-2022. From the beginning of 2022 onwards, vaccines should be available at a large scale for the most advanced countries in this race (Russia, China, UK and the U.S.) and be progressively distributed to the rest of the world. In line with the World Health Organization's (WHO) own assessment, the full distribution of a vaccine at a global level could be completed by the end of 2022. In this context, stringency indices should return to their minimum levels and 80% of global GDP will be back to pre-crisis levels. However, we should not underestimate the risk of a possible temporary disruption in the transportation sector during the global vaccination campaign. In fact, vaccine delivery could mobilize half of the global transportation capacity for several months.

**Figure 1: Real GDP forecasts, %**

	2017	2018	2019	2020	2021
<b>World GDP growth</b>	<b>3.3</b>	<b>3.1</b>	<b>2.5</b>	<b>-4.7</b>	<b>4.6</b>
United States	2.4	2.9	2.3	-5.3	3.7
<b>Latin America</b>	<b>1.0</b>	<b>1.0</b>	<b>0.1</b>	<b>-7.9</b>	<b>3.3</b>
Brazil	1.3	1.3	1.1	-6.5	2.5
United Kingdom	1.8	1.3	1.5	-11.8	2.5
<b>Eurozone members</b>	<b>2.7</b>	<b>1.9</b>	<b>1.3</b>	<b>-7.9</b>	<b>4.8</b>
Germany	2.8	1.5	0.6	-6.0	3.5
France	2.4	1.8	1.5	-9.8	6.9
Italy	1.7	0.7	0.3	-10.1	4.2
Spain	2.9	2.4	2.0	-11.8	6.4
Russia	1.8	2.5	1.3	-5.1	2.9
Turkey	7.5	3.0	0.9	-4.7	4.0
<b>Asia-Pacific</b>	<b>5.2</b>	<b>4.7</b>	<b>4.2</b>	<b>-1.5</b>	<b>6.2</b>
China	6.9	6.7	6.1	2.0	8.4
Japan	2.2	0.3	0.7	-5.5	2.5
India	7.0	6.1	4.2	-7.2	6.5
<b>Middle East</b>	<b>1.4</b>	<b>0.9</b>	<b>0.3</b>	<b>-7.1</b>	<b>2.3</b>
Saudi Arabia	-0.7	2.4	0.3	-5.1	2.0
<b>Africa</b>	<b>3.1</b>	<b>2.7</b>	<b>1.9</b>	<b>-4.3</b>	<b>3.4</b>
South Africa	1.4	0.8	0.3	-8.2	2.7

\*Weights in global GDP at market price, 2019

NB: fiscal year for India

Sources: national sources, Allianz Research

**Watch out for the massive trend reversal in business insolvencies.** Up to September 2020, the temporary adjustments made to insolvency frameworks across countries - designed to give time and flexibility to companies before they resort to filing for bankruptcy – as well as the temporary business support measures (such tax deferrals, social security charges and loan repayments; guaranteed loans, etc.) designed to prevent liquidity crisis, have resulted in significant decreases in business fail-

ures. Our EH Global Insolvency Index posted a -13% y/y decline in Q2 and -7% y/y for H1. This decline continued in most countries during the summer. Yet, the overall outlook remains that of a sharp increase in insolvencies by 2021 (+31% by 2021 compared to 2019). This trend reversal will begin in Q4 2020 in most countries and accelerate in H1 2021 amid the gradual withdrawal of various support measures and the zombification of many companies. This would lead our Global Insolvency Index

to increase by +10% y/y in 2020 and by +19% in 2021. We expect all regions to post a double-digit increase in insolvencies by 2021 but with an uneven tempo between 2020 and 2021, ranging from +21% in Asia to +64% in North America. In 2020, the larger increases are expected in North America, Latin America and Central Europe, while Western Europe and Asia will post larger annual increases in 2021.

**Figure 2: Insolvency figures and forecasts (selected countries)**

	2020			Forecasts				
	Last point	3m y/y	Ytd y/y	2020	2021	2020 y/y	2021 y/y	2021/2019
U.S.	June	-11%	-3%	31500	37500	39%	19%	65%
Canada	July	-26%	-30%	2850	3450	4%	21%	26%
Brazil	June	-26%	-16%	3450	3800	20%	10%	32%
Germany	June	-9%	-6%	19350	20850	3%	8%	11%
France	August	-37%	-36%	46800	62000	-9%	32%	21%
United Kingdom	June	-31%	-20%	22929	30072	4%	31%	36%
Italy				11660	14039	6%	20%	28%
Spain	August	13%	-1%	4600	5600	11%	22%	35%
The Netherlands	August	-23%	-7%	4000	5000	5%	25%	32%
Russia	June	-25%	-4%	13800	14500	18%	5%	23%
Turkey	July	8%	4%	17200	18400	22%	7%	31%
Poland	July	32%	3%	1100	1210	13%	10%	24%
South Africa	July	-7%	-20%	2280	2450	12%	7%	20%
Morocco	June	-87%	-38%	8861	10456	5%	18%	24%
China	August	1%	7%	13500	14700	14%	9%	24%
Japan	August	1%	0%	8600	9400	3%	9%	12%
India	June	-75%	-25%	750	2100	-60%	180%	11%
Australia	July	-51%	-34%	6150	7150	-4%	16%	12%
South Korea	August	-34%	-41%	400	470	-3%	18%	14%
<b>GLOBAL INDEX</b>						<b>10%</b>	<b>19%</b>	<b>31%</b>

Sources: national sources, Allianz Research

# AN INITIAL UNEVEN OR “DUAL” RECOVERY FOR TRADE, CONSUMERS AND INVESTMENT

## Recovery for trade in goods, but remember it's a services crisis

Global merchandise trade suffered a historic blow in Q2 2020 compared to Q2 2019, contracting by close to -15% in volume terms y/y and -21% in value (USD) terms. Overall, in H1 2020, merchandise trade was -9% lower than in H1 2019 in volume and -13% in value terms. Yet June figures and the latest real-time maritime data show that in August, maritime trade (80% of total trade) was back at only -3% below the levels of a year earlier. The recovery in merchandise trade was thus faster than we previously expected, outpacing the 2009 recovery. However, the U.S. and Western Europe are trailing China, emerging Asia, and Eastern Europe's export recovery. On the services side, we estimate the collapse in the value of trade was even stronger in Q1 (-18.5%) and could be much worse in Q2. As a

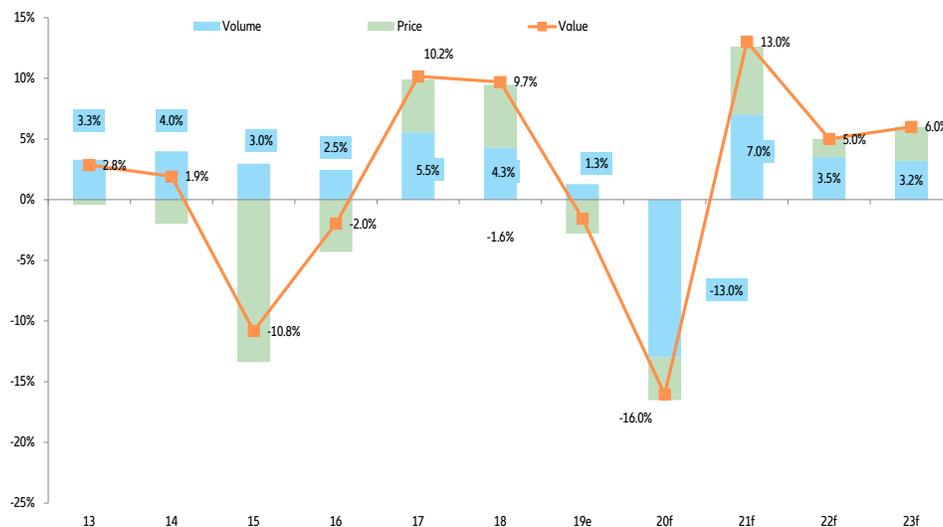
result of the faster recovery of merchandise trade, we revise upwards our forecast of a yearly contraction of trade in goods and services from -15% to -13% (compared to -11% in 2009) in volume terms. The recent depreciation of the USD should alleviate the negative price effect of the oil and commodity price shock in H1, bringing the trade contraction in USD value terms to -16% this year (vs. -20% in our previous forecast). This is equivalent to USD4tn of trade losses.

In 2021, global trade in volume terms should grow +7%, and in value terms it could grow by +13%, finally recovering all its losses by early 2022. The recovery in global demand will drive trade volumes, while values will be helped by a lower USD (EUR1=USD1.15 in 2020 and 1.22 in 2021 vs. 1.12 in 2019) and moderately higher commodity prices (Brent oil at USD44 in 2020, USD51 in 2021).

## The loss of purchasing power for most fragile households will be hard to recover

After a historical wave of layoffs, which brought the U.S. unemployment rate to 14.7% in April 2020, job market conditions improved alongside the reopening of the economy. However, U.S. initial claims recently rose to close to one million, confirming the fact that the recovery is running out of steam. The policy cliff effect is visible via the additional payment on U.S. unemployment benefits, which has been reduced from USD600 per week to USD400 per week from August until 06 December amid large uncertainties over the voting of a new stimulus package by the U.S. Congress.

**Figure 3: Global trade growth, in volume terms and value (% y/y)**



Sources: national sources, Allianz Research

In Europe, the adjustment of the job market is less visible because of the priority given to job protection with partial unemployment mechanisms (vs. enhanced unemployment benefits in the U.S.). In the five largest European countries, we estimate that 9 million workers or 20% of those currently enrolled in short-work schemes face an elevated risk of becoming unemployed in 2021 because of the muted recovery in late bloomer sectors and the “policy cliff” effect i.e. the end of emergency public support measures. The Eurozone unemployment rate increased from 7.2% in March 2020 to 7.6% in June and should end 2021 at 9.4%

This asymmetric exposure to job losses implies a K-shaped or “dual” recovery in consumer spending. The social characteristics of those most exposed to job losses can explain interesting patterns in terms of consumer spending. Spending on durable goods has outperformed as car sales experienced a strong rebound (due to the preference for avoiding public transportation), while spending in equipment for housing followed the strong rebound in housing activity. However, Eurozone and UK household saving intentions stood at a record high in July, reflecting consumer cautiousness as their expectations of rising unemployment in the next 12 months has hit to its highest level since 2009. We expect the saving rate in the U.S. and in Europe to remain significantly above pre-crisis levels for the rest of 2020 and until the end of 2021. But behind these macro-trends hides a more detailed picture of the unequally distributed hit from Covid-19 and divergent recovery thereafter.

A look at U.S. statistics helps comprehend the magnitude of K-shaped trends that can be seen in many developed economies:

- Workers under the age of 25 represent close to 26% of people working in sectors highly exposed to Covid-19, against 10% for those sectors that are less exposed.
- Part-time workers make up 32.3% of labor in highly exposed sectors versus 18.5% in other sectors
- Workers with a lower educational attainment have a much higher weight in highly exposed sectors
- The median hourly wage of full-time highly exposed workers is at USD17 versus USD 23 for the non-highly exposed ones
- The lowest quintiles in family income are over-represented in highly exposed sectors.

**A K-shaped recovery is also visible in the housing market.**

In sharp contrast to the 2008 crisis in the U.S. and the Eurozone debt crisis, the Covid-19 crisis has not seen a collapse of housing markets but has rather proven to be a source of stability, with property prices up across major developed economies. One factor driving this trend is central banks’ ultra-expansive policy response, which has sent mortgage rates to record lows. Beyond low rates and demand pent up during the pandemic, sales have been driven by households looking for more space for remote working and/or learning, as well as well as larger houses with gardens in suburban and rural areas as commuting times now matter less. Moreover, constrained supply with the shutdown weighing on construction activity has also pushed up prices. But the stellar headline figures – with for instance property prices in the UK rising to an all-time high in August – conceal a very polarized market: This is not a boom for everyone; rather, housing markets are currently propped up by buyers that were not affected during

lockdown and whose employment has not been impacted by its fallout.

**But we doubt that this boom is sustainable.** After all, in many development economies, housing markets are currently still shielded from the economic implications of the pandemic, thanks to government support measures including mortgage payment holidays, stamp duty cuts as well as short-work schemes. As these are phased out and the consequences are felt more – above all in the form of rising unemployment and tighter mortgage conditions – the pandemic could yet bite housing markets as many households will be priced out of the market. This is already visible in the U.S. where the most fragile households face difficulties as evidenced by the significant increase of the default rate.

The recovery of residential investment and the stock market rally hide the Covid-19 profitability shock. This should weigh on corporate investment intentions, notably as a majority of state support schemes arrive at maturity by the end of 2020. Cash-hoarding in the private sector shows a lack of confidence and suggests a difficult start for a new investment cycle. On the financial markets side, dual strategies between short-term and long-term investors, between retail and institutional investors, as well as the strong influence of administrated aspects, point toward higher volatility to come. At the same time, while the wave of liquidity sparked by central banks preserved the financial market from stress, it is also further inflating imbalances and underlying risks.



# CAPITAL MARKETS: NOT THE TIME TO TAKE RISKS

In the current market environment, it is important to consider that there is greater economic uncertainty than at the beginning of the year despite the current monetary and fiscal policy mix; there are more geopolitical risks than at the beginning of the year and valuations are tighter. In this context, equity markets have been showing a persistent detachment from fundamental determinants, making the recent global equity market rally hardly justifiable. Because of that, we still expect the EQ market to underperform in 2020 and to start a muted rally in 2021. When it

comes to corporate credit, both investment grade and high-yield corporate spreads look too tight. As in equities, corporate credit markets remain detached from fundamentals on the back of the central banks' perpetual put option. Due to that, we expect corporate spreads to converge towards higher values due to higher than expected market volatility and increasing default rates. Lastly, with the short-end of most developed countries' sovereign yield curves anchored by their respective central banks, we expect a timid curve steepening towards the end of

2020 and 2021. This gradual increase in term premium will occur on the back of higher inflation expectations and a halt in the recent decline of real yields. On the other hand, long-term Emerging Market sovereign spreads look overbought. The combination of this extreme bullish positioning and the current market fragility is a perfect combination for EM assets to become a victim of a second "risk-off" rotation in the wake of a second risky-assets market correction.

**Figure 4: Capital markets forecasts 2020-2021**

year-end figures	Latest Value	Unit	2020	2021
<b>Eurozone</b>				
<b>Sovereign Rates</b>				
year-end figures	Latest Value	Unit	2020	2021
<b>Eurozone</b>				
<b>Sovereign Rates</b>				
10y yield "risk-free" sovereign (Bunds)	-0,5	%	-0,5	-0,3
10y Swap Rate	-0,2	%	0,0	0,3
Italy - Germany spread (10y)	148	bps	175 (220)	160 (170)
France - Germany spread (10y)	27	bps	40 (90)	30 (40)
Spain - Germany spread (10y)	75	bps	90 (110)	80 (70)
<b>Corporate Credit Spreads</b>				
Investment grade credit spreads	113	bps	180	150
High yield credit spreads	438	bps	750	600
<b>Equities</b>				
MSCI EMU: total return p.a	-9	%	-22	10
<b>United States</b>				
<b>Sovereign Rates</b>				
10y yield "risk-free" sovereign (Treasuries)	0,7	%	1	1,4
<b>Corporate Credit Spreads</b>				
Investment grade credit spreads	136	bps	230	180
High yield credit spreads	514	bps	800	650
<b>Equities</b>				
MSCI USA: total return p.a. in USD	3	%	-20	15
<b>Emerging Markets</b>				
<b>Sovereign Rates</b>				
Hard Currency Spread (USD)	341	bps	450	370
<b>Equities</b>				
MSCI EM: total return p.a. in USD	-4	%	-24	20

\* Old forecasts in parenthesis

\*\* We have reviewed our EUR spreads down as the ECB impact on peripheral spreads was larger than anticipated.

Sources: Allianz Research, Refinitiv

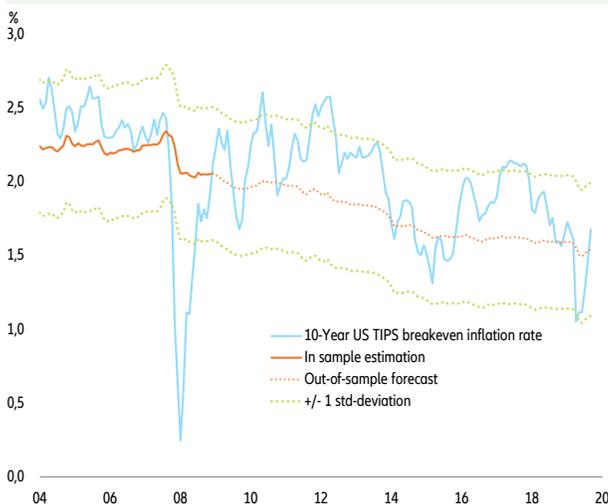
**Global bond markets: pricing stagflation.** Despite the recent repricing of long-term inflation expectations, nominal yields have barely budged, thanks to a fall in real yields. To put current levels into perspective, at -1.1% real yields are now at the lowest point in recorded history. The current bearish growth positioning within the U.S. government bond market contrasts with the latest equity market exuberance, although partially corrected, fueling doubts about the mid-term equity rally sustainability. As in the U.S., long-term inflation expectations in the EMU have

been rising while real yields remain at historical lows. Overall, U.S. and EUR government bond markets are unwilling to believe in a rapid economic recovery scenario and are positioned for a stagflation one.

**U.S. inflation expectations: back to square one.** The recent increase in oil prices and employment has led U.S. long-term inflation expectations to follow a V-shaped trajectory around their March low. Since the trough, inflation expectations have been on an upward trajectory, exacerbated by the Fed's recent decision to target an average

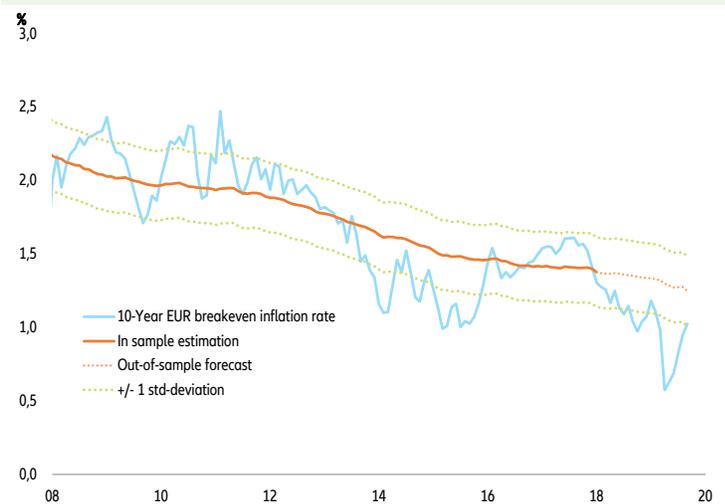
inflation rate of 2%, (i.e. allowing some overshooting above 2%). According to our "fair value" estimation, inflation expectations are unlikely to substantially overshoot the 2% upper limit. In contrast, EUR long-term inflation expectations are nowhere near their "fair value", as monetary stimulus has not yet convinced market participants. According to our model, EUR inflation expectations could still move closer to 1.5% in the near future, but any overshoot beyond that level would not be sustainable.

**Figure 5a: U.S. market-based inflation expectations model**



Sources: Allianz Research, Refinitiv

**Figure 5b: EMU market-based inflation expectations model**



Sources: Allianz Research, Refinitiv

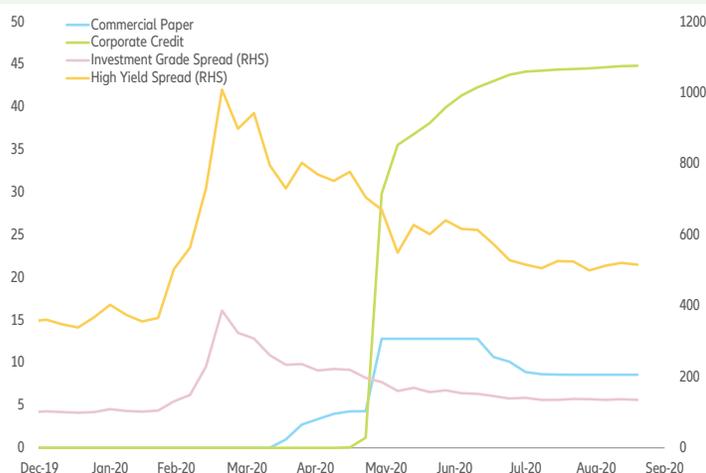
**Where are the institutional bulls?** The recent U.S. equity market frothiness is relatively hard to explain as both mutual fund and ETF flows show persistent transfers from equity funds towards fixed income and money market funds. This is a symptom of the actual market fragility as structural long-term investors seem unwilling to participate in the market, thus leaving the floor to stock pickers and option traders (e.g. Softbank). However, the Eurozone equity market does not show any signs of exuberance (yet) as most EUR equity indices have settled around -10%ytd. Nevertheless, looking at fund flow data, one can see a small acceleration in the inflows into EUR EQ funds, with Germany and France leading the pack.

**Technology, the outstanding student.** Historically, each financial cycle has been led by a limited group of compa-

nies usually clustered around one industry group / economic sector. These days, the technology sector accounts for more than 25% of the U.S. EQ market capitalization. Additionally, the concentration risk is higher since the sector not only accounts for more than one fourth of the index, but the number of companies within the sector itself has been reduced by 20-40% since the dot-com bubble. In the case of the Eurozone, the equity market has been permanently dominated, in terms of weight, by the financial sector. Nevertheless, this dominance is starting to be challenged by the technology and healthcare sectors, as their respective weights within the market have increased since the 2008 crisis. This over-concentration in tech-related risk has led major indices to underperform during the latest market correction.

**Corporate credit: hard to keep a promise.** Since April, the Fed has bought up to ~45bn worth of corporate credit. However, since the beginning of July, it has significantly reduced its weekly purchases as credit markets are once again extremely tight. Yet, credit market spreads have not reversed back to pre-Covid-19 levels and remain 10-20% above pre-pandemic levels. In contrast, the USD1.919trn U.S. corporate credit issuance in the first nine months of 2020 has already surpassed the historical record of USD1.916trn set during the 12 months of 2017. Interestingly, most of that fresh money will most likely not be invested into the issuing companies as 42% of all new issuances are expected to be dedicated to debt refinancing purposes.

**Figure 6: U.S. Federal Reserve Corporate Purchases (USDbn) vs spreads (bp)**



Sources: Allianz Research, Refinitiv

**Equity exuberance: high expectations!**

The equity market is falling prey to a positive feedback loop whereby rising prices increase the demand for equities, which in turn fosters a further rise in prices. We estimate, for example, that the recent performance of Apple leads market participants to expect a 56.7% annual return from the company (as of

02 September). In the past, this perceived return has been higher in only 1.2% of observations (i.e. six days out of 500). As this expectation disproportionately depends on recent price movements (the ones observed during only the last 1.6 years), it is inherently unstable. Furthermore, as the Apple stock is already trading at a multiple of 40, little

appreciation is to be expected from further PE expansion; EPS growth will be the main driver of its future return, but 50%+ earnings growth looks ambitious and unsustainable. Consequently, equity markets may keep hissing in the near future.

**Figure 7: U.S. tech sector – expected return**

02/09/2020	Price	Expected annual rate of return (%)	Relevant past data for current return determination (in years)
Alphabet-Google	1,717.39	21.5	3.62
Amazon	3,531.45	56	1.66
Apple	131.4	56.7	1.58
Bitcoin	11,398.44	46.1	1.79
Oil Brent	44.51	-0.8	24.21
Facebook	302.50	20.9	3.64
Gold	1 940.23	7.6	7.27
Microsoft	231.65	33.3	2.5
Netflix	552.84	46.7	1.86
Tesla	447.37	228.2	0.6
TRY to 1 USD	7.38	18.4	3.92
Zoom Video Comm.	423.56	38.7	1.97

Sources: Allianz Research, Refinitiv

# POLITICAL RISK COULD BE BACK LIKE A BOOMERANG

Markets look complacent but are not blind to the return of short-term political risk: (i) Brexit, (ii) U.S. elections; (iii) tensions in the Mediterranean Sea; (iv) continued protectionism / a new “tech” war; (v) U.S.-Russia tensions.

**Odds for a no-deal Brexit at year-end have considerably increased (45%), but we expect a last-minute compromise, with a FTA implementation by end-2021.** UK PM Boris Johnson unexpectedly decided to make a last-minute change in the Withdrawal Agreement that was ratified by both the UK and the EU in January 2020. There are two main points on which the UK seeks greater flexibility, notably in the context of a no-deal by year-end: (i) state aid for Northern Ireland, which is deemed to be subject to EU regulations; (ii) the border in the Irish sea and the dual custom checks post exit from the Custom Union. As this last-minute turnaround goes against international law and the

EU has threatened sanctions, the likelihood of a Hard Brexit at year-end has considerably increased (from 20% to 45%); the deadline for an agreement at the European Council on 15-16 October seems difficult to meet. While the economic environment is not conducive for a Hard Brexit, as the UK was hit particularly hard by the Covid-19 crisis, but also given extremely low interest rates and market complacency with regard to public debt levels, the UK government might deem it “feasible” as it would count on increased fiscal and monetary support to help UK companies withstand the shock (including subsidies and a moratorium against company defaults). However, given the high risk of social tensions on the island of Ireland (against the 1998 Belfast Agreement), the loss of popularity for Boris Johnson in favor of the Scottish National Party and Labor Party, as well as the highly probable blocking of a Hard Brexit by the House of Lords, we

think the worst-case scenario can still be avoided.

Back in 2019, Boris Johnson tried a similar strategy of harsh threats before agreeing to the Withdrawal Agreement 10 days later. However, should a Hard Brexit materialize by the UK not asking for an extension of the transition period, we think that it will return to the negotiating table in 2021. A Hard Brexit is likely to be very costly politically for the Conservative Party as it will not only cause serious economic disruption (close to -5% contraction in GDP, drop of -15% of exports and above 4% inflation) but it also risks compromising the finalization of around 20 international FTAs that are currently under negotiation (incl. the one with the U.S., notably in the context of a potential Joe Biden Presidency). Hence, we think early elections are likely in this scenario, which could lead to a minority government and make the final FTA take longer.

**Figure 8: Brexit scenarios and economic impact**

Soft Brexit with very-last minute compromise and FTA implementation by mid-2021 (55%)		Hard Brexit on Jan 1st, 2021 with likely comeback into negotiations during 2021 after early elections (45%)	
2020	2021	2020	2021
-11.8	+2.5	-10.9	-4.8
-13.3	5.9	-12.0	0.7
-26.8	-15.1	-26.8	-25.8
-13.7	1.8	-13.7	-13.0
0.7	1.5	0.7	4.5
7.0	8.5	7.0	10.0
-2.0	-3.0	-2.0	-10.0
4.0	31.0	4.0	53.0
QE increased by 5% of GDP (around GBP100bn) and implemented until mid-2021, rates unchanged at 0.1%		Rates cut into negative territory and QE increased by GBP250-300bn, similar to the Covid-19 package	
2% of GDP in 2021 (after only 1.5% in 2020)		4% of GDP in 2021 mainly focused on infrastructure spending and measures to protect consumers purchasing power. State guaranteed loans prolonged until end-2021.	
mainly focused on infrastructure spending and tax cuts			
10y GILT at 0.4%(eoy)	10y GILT at 0.6%(eoy)	10y GILT at -0.2%(eoy)	10y GILT at 0.1%(eoy)
FTSE 100 at -22%yoy (eoy)	FTSE 100 at +10%yoy(eoy)	FTSE 100 at -50%yoy (eoy)	FTSE 100 at -10%yoy(eoy)

Source: Allianz Research

**U.S. elections have the potential to create a judiciary battle with a climate of extremely high uncertainty.**

We maintain our 2018-2019 call of a possible victory of Biden in the approaching U.S. elections. Initially this was based on traditionally pro-Republican voters, i.e. farmers and inhabitants of the rust belt, being the victims of the current U.S. President's protectionist policy. The Covid-19 crisis has led to an accentuation of the Democrat lead as Joe Biden now benefits from 50.7% of vote intentions, while President Trump currently stands at 42.6%. Paradoxically, the outcome of the election could not be as clear-cut as suggested by public opinion polls. Indeed, bet polls suggest that the race could be much tighter as the approaching debates between Biden and President Trump could represent a risk for the Democrat leader, who will be challenged by the intensity of the debate.

The end of 2020 will see an extremely high level of uncertainty in the U.S. because of these elections. Tangible signals of this nervousness are already visible in the option market, which mirrors a significant increase of the risk premium during this election period. U.S. banks are also rushing to issue debt in advance as they bet on much higher volatility and tighter credit conditions at the end of the year.

Moreover, only 25% of Democrat voters traditionally opt for the direct vote, the rest preferring to use mail votes, whereas two thirds of Republican voters use to opt for direct vote. The context of Covid-19 has incited states to send a record high level of ballots to allow

remote voting. There is therefore a high probability just after the end of elections that Republicans could be in a lead position for the time needed to access and collect all ballots. Then it could take a month to eventually confirm a Democrat win. President Trump has already announced that he could reject the result of an election organized with mass mail-voting. A risk scenario could therefore bring us to the Supreme Court for one or two months of extremely high uncertainty.

**Tensions in the Mediterranean Sea are likely to create more noise than facts.**

We think that the situation will remain under control as Turkey is more likely to seek a (financial) compromise rather than a military escalation while the EU will not agree on a unified military intervention. Nevertheless, an "accident" cannot be ruled out entirely. In the short run, this should keep uncertainty at high levels amid the already fragile diplomatic relationship between Turkey and the EU. Any economic impact will mainly be felt by Turkey, which is already in dire straits. The country is on the brink of another severe currency crisis, owing to its questionable policy response to the Covid-19 crisis, as well as other critical political involvements outside its borders (Syria, Libya). The latest event could be the tipping point for Turkey to slide into a full-blown financial crisis, and that could also prevent the situation from escalating too much.

**2021 will see an intensification of the new cold "technology" war.** After a successful listing in mid-July, SMIC, one of

China's leading chipmaking companies, saw its shares tumble after the U.S. took steps to blacklist it. Moreover, (i) U.S. Secretary of State Mike Pompeo has threatened a broad crackdown on Chinese tech companies with access to American data, including barring an unspecified number of the country's apps and limiting its cloud computing groups that operate on American soil; (ii) the White House's fiscal year 2021 budget proposal includes USD1.5bn for artificial intelligence (+USD0.38bn compared to 2020), and USD699mn for quantum information science (+USD120mn); (iii) members of Congress have introduced bills aiming at (a) boosting domestic semiconductor manufacturing – remaking the National Science Foundation, and creating a national research cloud, (b) making immigrant visas more easily attainable for AI-specialized profiles and people with knowledge of other valuable technologies for national security. On the Chinese side, policy moves include: (i) the National People's Congress' five-year USD1.4trn plan allowing municipalities, provinces and companies to invest in building new infrastructure on AI, data centers, 5G, the Industrial Internet and other new technologies; (ii) other policies to support the chip industries: tax benefits, R&D support, incentives for international semiconductor companies to relocate to China; (iii) as many as 3,000 chip engineers, including top-level talent from Taiwan's world-leading companies, having been attracted to mainland competitors; (iv) Beijing establishing a USD29bn semiconductor fund.



Figure 9: U.S. election scenarios

Scenario	Biden large victory	Biden short/contested victory	Trump short/contested victory	Trump large victory
Probability	30%	40%	20%	10%
Scenario description	<ul style="list-style-type: none"> <li>Trump cannot claim there was fraud.</li> <li>Democrat majority in congress.</li> <li>Rapid voting of a USD 3.7 trillion package over next 10yr</li> </ul>	<ul style="list-style-type: none"> <li>Trump victory claim before full counting of ballots</li> <li>Fraud claim after Biden's victory official</li> <li>Possible validation from the supreme court 1 to 2 months after election</li> <li>Negotiation blockade on budget in the Congress maintains a possibility of shutdown until Q2 2021.</li> </ul>	<ul style="list-style-type: none"> <li>Biden refuses verdict – argues for Russia interferences, potential voting fraud, institutional pressures, voter suppression</li> <li>No clear majority in the Congress. Democrat house, Republican Senate</li> <li>Validation from the supreme court 1 to 2 months after the election possible.</li> </ul>	<ul style="list-style-type: none"> <li>Biden cannot advocate for fraud.</li> <li>Whole congress turns Republican.</li> </ul>
Economic impact	<ul style="list-style-type: none"> <li>New investment cycle with big infrastructure projects and redistributive policies.</li> <li>Decline of unemployment rate at 5.5% by the end of 2022 (8.4% today).</li> <li>US GDP growth at -5.3% in 2020, +4.2% in 2021 and +3.0% in 2022</li> </ul>	<ul style="list-style-type: none"> <li>Less ambitious program. Consensus on Infrastructure projects but lower re-distribution in favor of households, not fulfilling half the promise of increasing corporate tax rate from 21% to 28%</li> <li>US GDP growth comes at -5.3% in 2020; +3.7% in 2021 and +2.5% in 2022</li> </ul>	<ul style="list-style-type: none"> <li>Supply-side policy, extended tax cuts for individuals, Smaller size Infrastructure project. Uncertainty on external policy, perspective of harsher tone on China and re-shoring weighs on the investment cycle despite tax cut announcements.</li> <li>Bold moves on the external side (tech cold war, tariffs, &amp; sanctions on US companies located abroad) penalizes growth (-5.3% in 2020; +1.7% in 2021 and +1.2% in 2022)</li> </ul>	<ul style="list-style-type: none"> <li>Tax cuts, new protectionist measures, bipartisan adoption of infrastructure program, but less extensive than Biden because of less ambitious green plan.</li> <li>US GDP growth comes at -5.3% in 2020, 2.7% in 2021, 1.8% in 2022</li> </ul>
FED response	<ul style="list-style-type: none"> <li>FED balance sheet levels off as early as Q1 2021 after a steady increase since Q4 2020.</li> <li>First rate hike as early as Q3 2022</li> </ul>	<ul style="list-style-type: none"> <li>FED balance sheet increases until end-Q2 2021 (to alleviate significant amount of uncertainty) then levels off.</li> <li>First rate hike from Q3 2023 only.</li> </ul>	<ul style="list-style-type: none"> <li>FED balance sheet increase until end Q3 2021, then levels off. Political uncertainty is as high as in the short Biden victory case.</li> <li>First rate hike Q1 2024</li> </ul>	<ul style="list-style-type: none"> <li>FED balance sheet levels off in Q2 2021 after a steady increase since Q4 2020.</li> <li>First rate hike Q4 2023</li> </ul>
USD	<ul style="list-style-type: none"> <li>The dollar is set to depreciate versus the EUR by up to 2.5% within the next 12 months;</li> <li>Then re-appreciates by 4-6% one year later</li> </ul>	<ul style="list-style-type: none"> <li>The dollar is set to depreciate versus the EUR by up to 5% (~1.25) within the next 12 months;</li> <li>Then re-appreciates by 2-3% one year later</li> </ul>	<ul style="list-style-type: none"> <li>The dollar is set to depreciate versus the EUR by up to 7.5% within the next 12 months;</li> <li>Then re-appreciates by 2-3% one year later</li> </ul>	<ul style="list-style-type: none"> <li>The dollar is set to depreciate versus the EUR by up to 10% within the next 12 months;</li> <li>Then re-appreciates by 4-6% one year later</li> </ul>
10-year Treasury yield	<ul style="list-style-type: none"> <li>1.25% at the end 2020; 1.8% at the end of 2021</li> </ul>	<ul style="list-style-type: none"> <li>1% at the end 2020; 1.4% at the end of 2021</li> </ul>	<ul style="list-style-type: none"> <li>1% at the end 2020; 1.4% at the end of 2021</li> </ul>	<ul style="list-style-type: none"> <li>1.15% at the end 2020; 1.6% at the end of 2021</li> </ul>

Source: Allianz Research

Recent official gatherings suggest that China's international relations (particularly those with the U.S. and some of its allies) are likely to affect the country's economic planning. Chinese authorities are currently preparing the 14th five-year plan (2021-2025), which will be discussed and finalized in October 2020 and we expect goals such as continuing the upgrade of China's manufacturing base and rebalancing further towards domestic demand are still likely to be included. After the implementation of the National Security Law in Hong Kong in July this year, there are concerns China could turn more aggressive in its (geo)political strategy. This is not in our central scenario. While China aims to increase its global position in the long run, a complete reversal of current orders in coming years is unlikely. There seems to be a growing view among Chinese officials that a pragmatic long-term approach needs to be adopted. That is not to say that

strong responses against other countries could be decided (especially when sovereignty issues are at stake), but we think it unlikely that Chinese authorities would actively damage external relations and risk economic links and access to foreign technology.

**Russia may experience intensified Western sanctions while trade will shift to China.** Two recent events have led to a further deterioration in Russia-Western relations: (i) Russia's support for Belarusian President Lukashenko, whose disputed re-election in August 2020 has caused ongoing social unrest as well as Western condemnation; (ii) the apparent poisoning of Alexei Navalny, currently the most prominent leader of Russia's independent opposition. Existing Western sanctions – likely to become more and more permanent – combined with the threat of new restrictions, especially by the U.S., and retaliatory Russian sanctions and regu-

latory restrictions will continue to damage doing business in Russia in 2020–2021, with firms linked to the Kremlin being the most likely targets for potential new sanctions. The events in and related to Belarus resemble those that occurred in 2013-2014 in Ukraine. Russia will not accept a democratic and potentially Western-friendly regime in its neighbor and will, if necessary, know how to prevent this.

Russia will continue to pursue its political interests strongly, notwithstanding any (potential) adverse economic effects. We believe that it is even willing to risk a last-minute collapse of the Nord Stream 2 pipeline project with Germany. Western FDI inflows to Russia already dropped sharply in the wake of the 2014 sanctions and have never recovered. Non-sanction-imposing countries, notably China, compensated for that, in part. We expect that this rebalancing of Western trade and investment flows to China will continue.

# FISCAL AND MONETARY POLICY: THE DEVIL IS IN THE DETAILS

## Disinflation in the short-run, temporary overshoot in the medium-run

**2020: The immediate crisis aftermath – messy, as both supply and demand collapse.** In the very short run, inflation is likely to remain muted as a result of the sharp decline in economic activity, lower oil prices and limited monetary policy pass-through on the back of high uncertainty. Upside pressures on prices could come from income-support policies that prop up demand and pockets of cost-push inflation, from ongoing sanitary restrictions and reduced capacity. Less favorable terms of trade and supply constraints could also support inflation. We expect these pressures to be limited. Temporary factors will distort inflation figures (changed consumption patterns, disruption to price collection, VAT reduction, delayed summer sales etc.). All in all, in 2020, we expect inflation to reach +0.3% and +1.1% in the Eurozone and the U.S., respectively.

**2021: Disinflationary recovery as supply recovers faster than demand.** Lower income and elevated unemployment will continue weighing on inflation stabilization as fiscal support schemes will only allow a progressive reduction in the enormous amount of slack created in the job market. Disinflationary pressures are likely to persist as the recovery of demand would lag behind that of supply. In 2021, we expect inflation at +0.9% and +1.6% in the Eurozone and the U.S., respectively.

**2022 and beyond: Demand exceeds supply, leading to temporary inflation overshoot.** Disinflationary forces will

progressively fade as the global economy will gradually return to pre-crisis levels in 2022-23 amid a synchronized acceleration in global growth. Pent-up demand will emerge, supported by the reduction in excess savings, while the full transmission of fiscal stimulus packages will be visible. Consequently, oil prices are likely to accelerate moderately. Rising unit labor costs will also be driven by higher wages on the back of growing social discontent and higher state interventionism, coupled with productivity losses post Covid-19. The green transition and regulatory factors could also be at play (carbon tax, digital tax, border adjustment tax) in augmenting energy costs.

Some momentum around reshoring and lingering protectionism could prop up inflation, but it is likely to remain in check, given the negative impact on economic growth. Against this, central banks' switch to average inflation targeting without the introduction of new tools is unlikely to produce much higher inflation rates. There could be some

overshoot (to around above 2.3% - 2.5% y/y in the U.S.), but for a limited period of time. Crucially, central banks' tolerance will depend on the key driver behind inflationary pressures.

A sustained shift to fiscal dominance is unlikely. Confidence in central banks independence should thus remain intact. Massive crisis stimuli (monetary as well as fiscal) will be gradually drawn down, in line with the recovery. Several long-term structural factors should also keep inflation at bay, e.g. aging and digitalization (robotization, automation).

All in all, inflation expectations are likely to remain in check in the absence of another supply shock and/or oil price shock. We do not expect drastic paradigm changes regarding globalization and the interaction between monetary and fiscal policy that could lead to large inflation pressures. Our forecasts based on the output gap point to +1.2% in the Eurozone in 2022 and +2.1% in the U.S.

**Figure 10: Inflation forecasts, %**

	2020	2021	2022	2023
<b>Eurozone</b>				
Central scenario	0.3	0.9	1.2	1.4
Protracted crisis	-0.1	-1.5	-1.2	-1.1
<b>United States</b>				
Central scenario	1.1	1.6	2.1	2.7
Protracted crisis	0.5	-0.4	0/7	0.7

Source: Allianz Research

**Fiscal policy: the devil is in the details as disbursement of the stimulus 2.0 and political agendas will shape the recovery in 2021-2022. Monetary policy will have no choice but to follow.**

In the U.S., high uncertainty will force the Fed to alleviate market fears and avoid a widening of spreads by re-injecting significant amounts of liquidity, leading to an increase of its balance sheet from 33% of GDP to 34.5% of GDP by mid-2021. It should stabilize at this level as new impulses coming from U.S. fiscal policy should help reactivate a new investment cycle from H2 2021. In our scenario of Biden's victory, the realization of a more redistributive economic program should support growth in 2021 by +1pp, albeit to a lower extent compared with 2020 (+1.7pp impact on growth of the so-called USD2.2trn CARES Act (Coronavirus Aid, Relief, and Economic Security Act)) as direct cash payments to households in particular had quicker and higher multiplier impacts. After the elections, we estimate the size of the new stimulus at USD2.7trn over 10 years, leading to an accumulation of deficits close to -16% in 2020, -10% in 2021 and -5% in 2022.

In this context, we expect a tapering of the Fed policy to only start from mid-2022 until mid-2023, a point from which the Fed could consider re-initiating rate hikes. In our view, a first interest rate hike could take place from Q3 2023

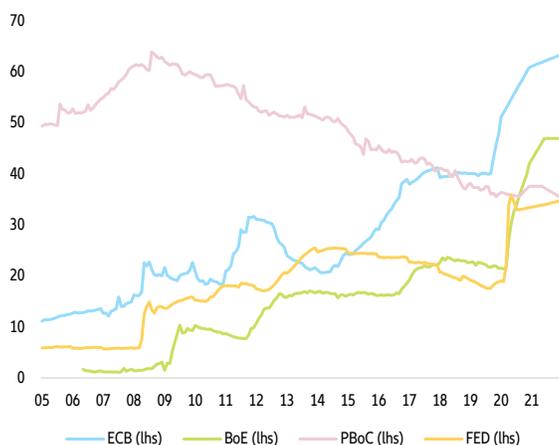
only, given the Fed's policy shift to average inflation targeting (AIT) that effectively focusses on pushing inflation up to 2% for an extended period. However, the monetary policy won't be powerful enough to solve the K-shaped scenario currently visible in the labor, consumer and housing markets. To tackle the significant impoverishment of the most fragile fringe of the population, the Fed has clearly called for further fiscal support.

In the Eurozone, the ratification of the EUR750bn EU Recovery Fund is ongoing as the European Parliament is debating its size. Despite this blocking, we expect it to be operational before June 2021, boosting Southern and Eastern European countries' nominal GDP by more than +1.5% over two years. On average, the annual EU nominal GDP will be boosted by +0.4%. The European political calendar (general elections in Germany and the Netherlands in 2021, local elections in the UK in 2021 and French Presidential elections in 2022) are likely to shape economic policies and allow for more redistribution towards middle-class households.

We expect the ECB to act decisively by year-end with a EUR500bn top-up to its 2021 QE. Even if PSPP comes with less flexibility, we think it will be easier to rally support within the governing council around a QE boost. Doves are in the air – also in the medium-term: the Fed's

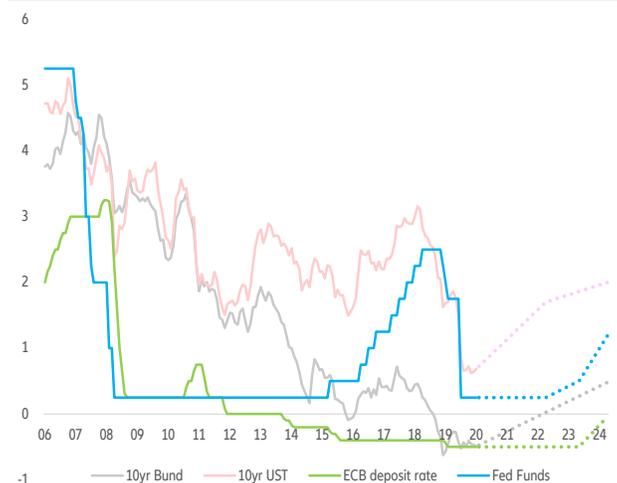
strategy shift towards implicitly concluded the ECB's own strategy overhaul before it even kicked off – at least as far as the inflation target is concerned. This does not mean that the ECB will copy the Fed's precedent to a T. After all, it does not feature a dual mandate and more importantly switching to a regime that requires making up for a below-target inflation would not be very credible, given the very subdued inflationary pressures in recent years. But we think that the ECB will probably signal its readiness to also tolerate a temporary inflation overshoot by making its 2% price stability target symmetric. How to meet this slightly higher goalpost while keeping financial stability risks at bay remains anyone's guess. Going forward, the best proxy for ECB policy action may be the state of the U.S. labor market. Due to this prevailing policy dependency, as the Fed is ready to stay lower-for-longer (we don't expect a rate hike on either side of the Atlantic before 2023) in an effort to support the labor market, the ECB will have little choice but to do the same. After all, the ECB's few attempts (remember 2008 and 2011) to swim against the U.S. financial cycle failed miserably. With the ECB bound to wait for the Fed to make the first move, we expect it to remain on hold until at least 2023.

**Figure 11: Balance sheets, % of GDP**

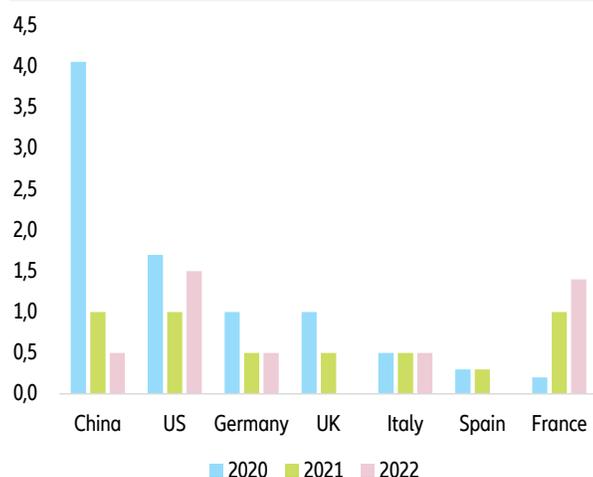


Source: Allianz Research

**Figure 12: Key interest rate forecasts, %**



Source: Allianz Research

**Figure 13: Expected impact on GDP growth from fiscal stimulus packages, pp**

Source: Allianz Research

### Emerging Markets (EMs) are likely to benefit from higher risk appetite until 2022, albeit unevenly.

Negative real interest rates in advanced economies should support risk appetite for EM assets and, as long as the USD depreciates, positive net capital flows into EMs should continue. However, investors will discriminate against markets that are subject to negative political risk events (e.g. Hong Kong, Russia) or pursue unsustainable monetary policies (e.g. Turkey) or, more generally, have overall weak macroeconomic fundamentals. The latter includes Argentina, Turkey, Brazil and South Africa, whose currencies have already depreciated substantially in 2020 and are expected to continue facing downward pressures, with Turkey already at the brink of its next balance of payments crisis. We project a more visible rise in inflation in H2 2021, especially for economies with weaker currencies and those that have embarked on significant QE-like monetary stimulus in the wake of the Covid-19 crisis. The latter include Turkey and several Central European economies, as well as India and Chile, which

all have negative real policy interest rates and thus may be forced to tighten monetary policy next year. We expect 2022 to be a tricky year for EMs as maturing debt is peaking and investors anticipate the start of the normalization of the Fed's monetary stimulus. Brazil, Thailand, India, Turkey and Indonesia currently have the highest amounts of maturing debt by the end of 2022.

### In China, policy easing is likely to peak earlier than in other economies.

This is because the economic recovery is now well on track (although not broad-based yet), and policymakers could gradually turn their focus to structural concerns in 2021. Indeed, from c.260% of GDP worth of total debt at the end of 2019, the ratio is likely to near 300% by the end of this year. Based on past credit cycles and policymakers' recent announcements, we expect our credit impulse index to peak in the coming months. It should then gradually decline, and turn negative in Q4 2021. This means that in the coming year, the PBOC could refrain from further high-

profile policy rate cuts, but liquidity injections to ensure the smooth functioning in the banking system are likely. On the fiscal side, support could decline from 7.1% of GDP in 2020 to c.5.5% in 2021, as the government bond issuance quotas and tax and fee cuts are likely to be smaller. That said, the fiscal stance we expect for 2021 is still large – as a comparison, we estimate that the support in 2018 and 2019 stood at 2.4% and 3.3% respectively.

# SCARRING EFFECTS? COVID-19 HAS CHANGED THE RULES OF THE GAME FOR ECONOMIC GROWTH AND CAPITAL MARKETS

The geopolitical rivalry between China and the U.S. is about to intensify. The fight for regional primacy will lead to a regular “weaponization” of technology, trade, currencies and payment systems: The split of the world economy into two separate spheres is looming. In response, more and more states will turn inwards – becoming more assertive and interventionist in the process, not least because the debt limits for fiscal policies seemed to be removed. The balance between the state and the market will change, to the disadvantage of the latter. And as the state gets more and more entangled in the private sector, market dynamics for innovation will get weaker while zom-

bie companies rise. Private players in social security – such as life insurers – might be pushed against the wall. The growing role of the state also has ramifications for monetary policy. High (unsustainable) debt levels will force central banks to backstop sovereign and corporate bond markets to ensure favorable refinancing conditions. In the end, these ultra-expansionary monetary policies may strip markets of their ability to price and allocate resources appropriately and encourage excessive risk-taking by both debtors and investors.

But every cloud has a silver lining. Covid-19 showed how quickly change is

possible; it is a welcome break-up of encrusted structures and a boost to digitalization. The way we work has changed for good. Future work will see more remote working and flexible team structures but less business trips. The experience of the lockdowns has opened new, innovative ways to accommodate employees’ needs, not least those of young working families. And last but not least, the Covid-19 shock has raised society’s risk awareness, including low-probability, high impact tail risks. The upshot: More demand for and better pricing of risk cover. This should be a boon for insurers – if they are able to offer comprehensive and simple solutions.



# REGIONAL OUTLOOKS

**U.S.:** The election cliff to generate instability in Q4 2020 with a more pronounced rebound of growth as early as Q2 2021. Amid high political uncertainty, a possible judiciary dispute on the election outcome, as well as a new government shutdown due to disagreement over a new stimulus package, we expect the pace of recovery to significantly decelerate in Q4 2020 (+6% q/q annualized versus +30% q/q annualized in Q3 2020). While we expect Joe Biden to win the election, his USD2.7trn fiscal package (over ten years) could have to wait until 2H21 before seeing real implementation. In this environment, U.S. GDP growth will reach -5.3% in 2020 and +3.7% in 2021. We expect the U.S. unemployment rate to reach 7% at the end of 2020 and 6.2% at the end of 2021.

We don't expect the most leftist orientations of Joe Biden's potential administration to be realized. His infrastructure spending program (USD970bn excluding its Green New Deal aspects), as a bi-partisan re-education, has the highest chance of being voted by a still divided Congress, albeit with a lower size compared to its current proposal. His student loans program could be in the lower range of his ambitions (at USD750bn), while his Green New Deal (achieve 100% clean energy and reach net-zero emissions no later than 2050) could suffer from a reality check with economic actors. At an external level, we expect the cold technology war with China to continue, while a more accommodative stance should prevail in terms of trade negotiations.

**Eurozone:** The sustainability of the recovery will depend on how governments manage of the sanitary crisis and the effectiveness of policy stimulus, which for now looks limited. The next steps of the Eurozone's recovery journey will be decidedly more challenging as pent-up demand has largely been unwound. The recovery growth spurt of +9% q/q in Q3 will fade to just about +2% q/q in Q4. For one, the Eurozone consumer is not out of the woods yet with elevated economic uncertainty, ongoing sanitary restrictions and lingering contagion fears set to keep a lid on spending. Retail sales are currently being propped up by diverted demand (for instance for bicycles), which is unlikely to keep up. Even without a meaningful second infection wave, the V-shaped rebound in retail trade will turn out to be solely the first leg of a W-shaped recovery formation.

Eurozone industry alongside trade has also enjoyed an initial partial rebound helped by strong demand from China, but the uneven global recovery as well as the sharp EUR appreciation vis-à-vis the USD will keep a lid on export prospects – particularly to its largest trade partner, the U.S. - going forward. At this point, industry production levels in annual comparison are still around 10% below pre-crisis in the large Eurozone heavyweights and let's not forget 2019 was not the best year for industry and trade. Overall, we expect the Eurozone economy to contract by -8.2% in 2020 before rebounding by +4.8% in 2021. As a result, pre-crisis GDP will not be reached before 2023.

**Germany:** Leading the recovery, but mind the trade headwinds. Germany could be the posterchild of Europe's Covid-19 economic recovery. However, despite a relatively more shallow drop in economic activity in H1 2020 compared to its peers (-12% compared to -18-24% in France, Italy, Spain and the UK) and a very dynamic economic restart over the summer months with many record-breaking data releases, it will still take the Germany economy until 2022 to return to pre-crisis GDP levels. Not only do we expect a marked slowdown of economic activity in the fall as pent-up demand fades, but we also see a heightened risk of a negative quarterly GDP reading at the turn of 2020/21. In particular, there are three key obstacles to a V-shaped recovery that will constrain economic momentum before a return to a more resilient recovery path from 2021 onwards: 1) consumption hangover: Thanks to a powerful fiscal policy response that helped prop up income and encourage consumption (Kurzarbeit, Konjunkturpaket etc.), the German consumer has so far emerged from the Covid-19 downturn in relatively good shape. However, the real test still lies ahead. For one as the weather turns colder and economic activity is moving indoors, ongoing contagion concerns will put a damper on "social" spending – in particular services. Moreover, for early 2021 a spending hangover is on the cards as the temporary VAT cut expires by the end of this year, which is likely to trigger a W-shaped formation in retail sales. 2)

Sticky shadow unemployment: Employment prospects will also feature heavily on consumers' minds. So far the increase in unemployment has been contained, thanks to the wide-spread use of Kurzarbeit and the labor market has shown signs of stabilization, but overall it remains in disarray (the number of Kurzarbeiter has proven quite sticky at 5.4 million in June, down from the peak of 6 million in April despite the Q3 economic rebound) and we do see more pain ahead, which is bound to weigh on consumption prospects. Already in Q4, as the recovery is in for a momentum setback and the freeze on insolvency rules expires, unemployment could well rise again, which in turn will keep households from deploying their precautionary savings. Moreover, we think more active labor market policies together with incentives for corporates are needed to allow for structural adjustment within the economy to mitigate the risk of zombie jobs. 3) Exposed exports: Germany's exports staged a much quicker recovery from the Covid-19 downturn compared to the Great Financial Crisis. However, what feels and looks for now like a V will soon turn in to a U-shaped recovery at best, given the uneven global economy, the strong EUR and heightened economic uncertainty, which will keep a lid on German capital goods exports. Lastly two key trading partners – the UK and the U.S. (15% of total exports in 2019) – have displayed very depressed demand for German exports, which elevated political risk (U.S. protectionist stance following the November election and no-trade-deal Brexit) could further aggravate. All in all, we expect German GDP growth +3.5% in 2021 following a decline of -6% in 2020.

**France: First-in-class for reforms at the cost of a strong short-term recovery.** In Q2 2020, French GDP decreased by -13.8% q/q after -5.9% in Q1. The strong rebound of household consumption in May (+35%, m/m) and June (+10.3%) was a positive surprise, however it lost steam in July (+0.5% m/m) and the household confidence indicator has decreased (from 96 in June to 94 in July and August). Meanwhile, household saving rates reached a record high level of 27.5% in the first half of the year

and these forced savings may turn into precautionary savings amid a deteriorating employment outlook. In the public and private sectors, 715,000 jobs were lost in the first quarter, even with partial unemployment scheme in place with full benefits. We expect total job losses to reach 1 million by the end of 2020. With the partial unemployment scheme phased out for most sectors in March 2021, we foresee the unemployment rate reaching 12.5% in 2021. The French government's EUR100bn (4.3% GDP) stimulus package is likely to add 2.4pp to GDP growth over 2020-2022. The flipside of this fiscal stimulus will be the widening of the already high trade deficit by -EUR12bn. Compared to the German stimulus package (3.8% of GDP), which is essentially demand-oriented, the French stimulus is supply-side oriented. Because of the complexity of the measures that it entails, the growth-enhancing effect of the package could take a long time to materialise. We expect France's GDP to plummet by -9.8% in 2020 and rebound by +6.9% in 2021. Given the slow pace of the recovery, we project GDP to return to pre-Covid-19 levels only in the second half of 2022.

**Italy: Record GDP contraction in 2020, limited stimulus for 2021.** Reflecting the intensity of its sanitary crisis and the length and the severity of its lockdown, Italy will experience a record contraction of GDP this year. However, it will probably be less massive than initially assumed and compared to other southern countries in the Eurozone: We now expect a decline of -10.1% this year. One reason for this is the greater importance of the manufacturing sector and the lower proportion of pandemic-sensitive services in private consumer spending. Another reason may be the rather ambitious fiscal package of the Italian government, which now amounts to 6% of GDP, flanked by state guarantees worth 35% of GDP. Initially criticized for being dispersed, complex and bureaucratic, the package seems to have succeeded in helping companies navigate through the crisis, supporting employment and consumption. As the GDP decline in 2020 should be less severe than expected, we expect less strong growth of +4.2% in 2021.

But there are still risks for H2 2020. The robustness of manufacturing activity is partly due to stock building, which could be reversed. There is still great uncertainty over the ability of the tourism sector to recover, with foreign arrivals being particularly depressed (first estimates see -70% this year). The Italian banking sector also remains fragile, with pockets of vulnerability among medium and small regional banks. This could affect the channeling of state-guaranteed loans to companies, especially SMEs, as the level covered is only 80% on average. There is also a risk of a premature return to fiscal prudence, given the massive increase in the debt ratio (160% this year, 158% next year) and possible fears about the reaction of the financial markets especially if volatility on Italian sovereign spreads reappears. We do indeed see a certain financial market risk linked to political risk. The coalition remains notoriously fragile. The creation EU recovery fund (of which Italy will obtain EUR209bn in grants and cheap loans, i.e. 11% of GDP) might have taken some wind out of the sails of the euro critics. But the Italexit topic can easily regain momentum in a context of increased social tensions (among generations and regional economic fragmentation. Despite the ECB backstop, Italy's sovereign spreads remain exposed political uncertainty.

**Spain: The second wave and political gridlock jeopardize the outlook.** We have revised our growth forecast downwards for Spain in both 2020 (-11.8%) and 2021 (+6.4%) due to (i) an increase in lockdown stringency and (ii) continued political gridlock and tensions that delay the phase II stimulus. Indeed, Spain has become the European country the most hit by a second nationwide outbreak of Covid-19, which led to a premature end of the tourism season and a tightening of physical distancing restrictions, especially in Madrid. In addition, the failure to agree on a 2021 budget delays the implementation of much-needed stimulus measures. Indeed, Spain could receive EUR140bn from the EU recovery fund in 2021. Yet continued political fragmentation (no 2021 budget voted) should be delay the "relaunch" stimulus.

This could result in a shortfall of a cumulated ~5pp of GDP growth during the recovery. For these reasons, we believe the hit to growth will be the strongest in the EU in 2020 and the recovery will prove even more moderate than expected.

**In China, the recovery is uneven, but surprisingly resilient.** We have revised up our GDP growth forecasts to +2.0% in 2020 and +8.4% in 2021 (vs. respectively +1.5% and +7.6% previously). Exports have performed better than expected, in part thanks to demand for goods related to the global pandemic. On the domestic side, while the recovery in consumption remains sluggish, the more policy-driven areas of the economy are proving dynamic – particularly construction and infrastructure investment. This is has been enabled by fiscal stimulus (we estimate 7.1% of GDP in 2020), and a rapid increase in monetary impulse. While the peak of policy easing may already have passed, we continue to expect an accommodative policy stance overall into 2021. This should help the recovery to turn more sustainable and broad-based. Beyond 2021, what concerns us are the medium- to long-run prospects of China in an increasingly difficult geopolitical environment. While China's innovation potential has improved markedly in the past years (ranking 14th in 2019 vs. 29th in 2015 in the world according to the Global Innovation Index), there is still significant room for catch-up in high-tech sectors.

In this context, Chinese authorities have rebranded their long-term strategy in to the expression of "dual circulation": 1/ "domestic circulation" to further balance the economy towards domestic demand, and encourage firms to become less dependent on foreign supplies; and 2/ "international circulation" based on further reforms and opening measures in favor of foreign investment in China.

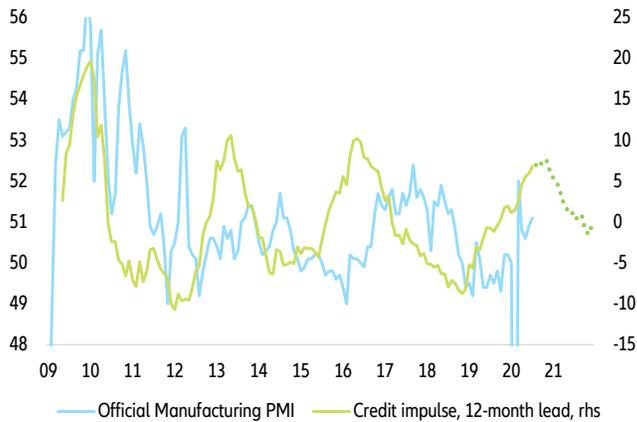
Emerging Markets with strong trade links to China are forecast to follow the latter's business cycle with a lag and to recover faster on average than other EMs, many of which will experience a

deeper recession. The largest downside revisions for GDP growth in 2020 were made for India (to -7.2%), South Africa (to -8.2%) and several Latin American countries.

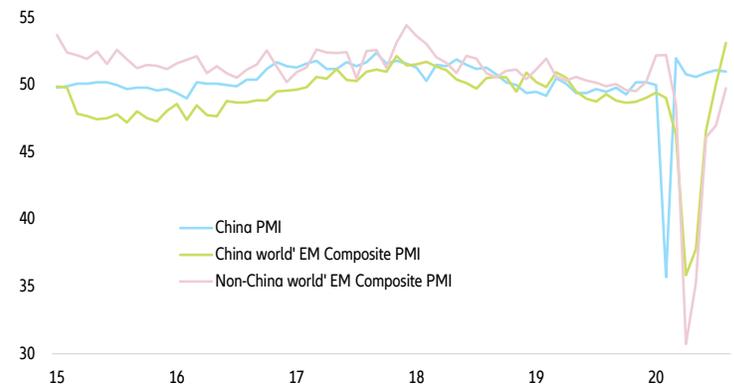
Figure 15 - Composite Manufacturing PMIs of 'China-dependent' (incl. Taiwan, Hong Kong, Singapore, Indonesia, South Korea, Brazil, Russia, South Africa) and 'non-China-dependent' EMs vs. China's PMI.

**In the Asia-Pacific region as a whole, real GDP is forecast to contract by -1.5% in 2020, followed by a recovery to +6.2% growth in 2021.** The regional aggregate is barely changed from our previous scenario, but there are disparities. In particular, we look at the exposure of each economy to external drivers (in particular, the earlier recovery in China), and the strength of domestic drivers. Taking into account the sanitary situation and the size of the Covid-19 economic shock in Q2, we derive different clusters of economies. In the first one, we find Vietnam, Taiwan and South Korea, for which we revise upwards our growth forecasts. While these economies have not put in place particularly large stimuli, they benefit from large exposures to external demand, and managed the pandemic well. In the second group we put Hong Kong and Singapore: These financial hubs benefit from large exposures to external demand and significant leeway for policy support. After a significant drop in GDP this year, a recovery should be visible in 2021. The third group is a little more mixed, including both advanced (Japan, Australia, New Zealand) and emerging economies (Malaysia, Thailand). This group is characterised by moderate exposure to external demand, mixed results in the management of the sanitary crisis and large domestic stimuli. The size of the shocks in 2020 vary but all should experience a recovery in 2021. The fourth group includes India, the Philippines and Indonesia, which should be laggards in the economic recovery due to the difficult management of the pandemic locally, comparatively small exposure to the global recovery and limited domestic stimuli.

**In the Emerging Europe region as a whole, annual real GDP is forecast to contract by -5.4% in 2020, followed by a moderate recovery to +3.8% growth in 2021.** New Covid-19 infections have risen again since July in most countries and reached new record highs in Central Europe in August-September. Hence we expect a tightening of confinement measures in fall and winter, although they should be more localized than in the spring. As a consequence, the recovery of economic activity will be W-shaped in several countries, i.e. the strong rebound in Q3 as indicated by high-frequency data will be followed by another fall, albeit much smaller than in Q2, leading to a weaker carry-over into 2021. Meanwhile, accommodative monetary and fiscal policy will continue to support the economies over the next two years or so. However, a too loose for too long policy stance could become counter-productive in the medium term for some countries in the region, especially for those that have embarked on QE-like monetary policies. We have identified Turkey as well as Hungary, Czechia, Poland and Romania as facing increased inflationary risk in 2021. Moreover, a strong fiscal commitment is required in Croatia and Hungary, which otherwise may face debt sustainability risk in the medium term. Regarding the output recovery path, we forecast Poland to reach its pre-crisis level of GDP at the end of 2021, Czechia and Hungary in H2 2022 and Russia only in 2023. Meanwhile, Turkey is on the brink of another balance of payments crisis, which could delay any recovery by a year or so. The TRY continues to slide despite heavy intervention by the central bank (which has burned 40% of its FX reserves year-to-date, bringing them to a very critically low level) while inflation remains elevated, monetary policy too loose and international investors continue to withdraw capital., the data on pre-Covid fundamentals, reform momentum, debt sustainability, social and political risk suggest that Brazil and Mexico could lag behind in the medium-term, while Peru, Colombia and Chile could take the lead. Latin American GDP could grow +3.2% in 2021.

**Figure 14: Credit impulse in China**

Source: Allianz Research

**Figure 15: Composite Manufacturing PMIs of 'China-dependent' (incl. Taiwan, Hong Kong, Singapore, Indonesia, South Korea, Brazil, Russia South Africa) and 'non-China-dependent' EMs vs. China's PMI**

Source: Allianz Research

**In Latin America, the first shall be last, and the last first.** The latest data and high-frequency indicators suggest economic activity in Latin America bottomed out in May and the case curve seems to finally be flattening. We revised our recession forecast by -1pp to -7.5% for 2020, mostly due to revised outlooks in Mexico (-9.8% in 2020), Argentina (-8.6%) and Peru (-15%) and despite a +0.5pp increase in Brazil's forecast (-6.5%). Yet the countries that exited lockdowns first are those who should struggle the most going forward due to their fundamentals. Indeed, when assessing the Q3 stringency of lockdowns, exposure to the Chinese and U.S. recovery, daily activity index and phase I monetary and fiscal support, Brazil and Mexico seem likely to recover the fastest, while Chile, Colombia and Argentina lag behind. However, the data on pre-Covid fundamentals, reform momentum, debt sustainability, social and political risk suggest that Brazil and Mexico could lag behind in the medium-term, while Peru, Colombia and Chile could take the lead. Latin American GDP could grow +3.2% in 2021.

**The Middle East region as a whole is forecast to experience a sharp contraction of real GDP by -7.6% in 2020, followed by a sluggish recovery to +2.1%**

**growth in 2021.** Lockdown measures were gradually eased during the summer and the curve of new Covid-19 infections fell markedly in July, though it has stabilized at a still elevated level since August. Domestic consumption should recover progressively, though it will take another hit in Saudi Arabia due to the VAT increase from 5% to 15% in mid-2020. However, tourism revenues will continue to falter across the region. Moreover, as oil prices will remain low in 2021, we expect the oil output cuts agreed at the OPEC+ level to be extended beyond 2020, limiting growth impulses from exports in the oil-exporting countries next year as well. Furthermore, the GCC countries will continue to post large fiscal and current account deficits in the next two years. While this is still manageable for Saudi Arabia, the UAE, Qatar and Kuwait in the near term, thanks to the ample FX assets in their SWFs, Saudi Arabia and Kuwait especially need to speed up the diversification of their economies. If not, if oil prices remain subdued for longer, their assets may dwindle by 2025 or so, potentially causing economic and social distress then. Meanwhile, Lebanon is in the midst of a deep political, social and financial crisis which will be difficult to resolve. We forecast a sharp, prolonged recession until early 2022.

**In 2020, African GDP is expected to contract by -4.3%, which will be the first recession on the continent in 25 years.** The recovery seems to be Chinaless. Oil-exporting countries such as Nigeria (-5.3%), Angola (-5.1%) and Algeria (-9.7%) hit the hardest. The restrictions on tourism activity are likely to affect growth dramatically in Tunisia (-6.2%) and Morocco (-5.2%). South Africa is expected to go through the most severe recession (-8.2%) in its history as a result of an unprecedented demand shock (internal and external), capital outflows and strong exchange rate depreciation. The USD4.3bn emergency loan from the IMF will help South Africa to meet external financing needs in 2020. In parallel to the G20 debt relief initiative, we expect many African economies (e.g. Zambia, Angola, Ghana) to seek debt restructuring agreements with China and other private creditors. In 2021, we project African GDP to rebound by +3.4%, with the support of stronger world demand, higher commodity prices and resuming tourism activity.

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