

OPEN CLIENT ACCESS TO ALL OUR RESEARCH UNTIL 30TH APRIL

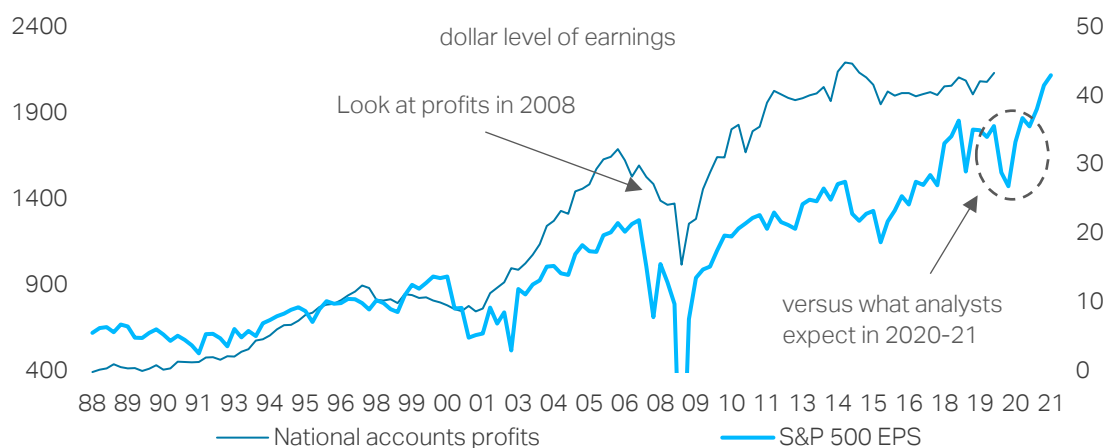
Visit our Key Views pages here

[The House View](#) | [Global Strategy](#) | [US](#) | [Europe](#) | [China](#) | [Emerging Markets](#)

Macro Picture

BULL TRAP**Dario Perkins**

Risk sentiment has recovered because policymakers have 'underwritten' global markets. Yet, the global outlook is as dark as it was a few weeks ago, with massive uncertainty about the timing and strength of the economic recovery. Since recessionary forces will persist beyond the official lockdown period, asset prices surely face another leg down.

Chart 1: Earnings adjustments have further to goSource: BEA, S&P Dow Jones website ([estimates dated 16/04/20](#))**FEAR OF MISSING OUT**

Risk assets have recovered significantly from their March lows. While COVID-19 infection rates have slowed and the first wave of the pandemic seems less disastrous than feared, investors are paying particular attention to the global policy response – especially massive fiscal and monetary easing. Many believe policymakers have effectively 'underwritten' global markets.

SHAPING UP

Policy-driven swings in sentiment are a classic cause of bear-market rallies. Yet the debate about the 'shape' of the economic recovery remains unresolved (V, U, W or L?). Bulls argue the pandemic is closer to a natural disaster than a severe recession, so activity can bounce back quickly once the economy has reopened. This seems impossible, even with forceful policy help.

REALITY GAP

The world economy is facing a serious shortfall in demand, which will persist even after the lockdown has ended. Unemployment will stay well above 2019 levels, precautionary savings will rise and investment rates will decline. The authorities can help to reduce near-term risks but they cannot control the economic cycle. We think the bear market in global equities will return.

BULL TRAP

Watching financial markets, it is tempting to think the worst of the COVID-19 crisis is over. Equity values have bounced and credit spreads have narrowed, even as the oil market continues to suffer alarming strains. With the number of dead rising relentlessly every day and unemployment rates surging to Depression levels, market optimism sits uncomfortably with the deeply negative news flow. But remember, the 'delta' is everything for financial markets. As Jeremy Grantham remarked *'the market does not turn when it sees light at the end of the tunnel. It turns when all looks black, but a subtle shade less black than the day before'*. On this basis, perhaps it is easier to rationalize the market's recent optimism. Sure, COVID-19 continues to spread, but the rate of infection in most countries is slowing. Yes, global health services remain stretched, but they have not hit 'breaking point' - contrary to what the authorities had warned. And, while most economies remain in 'lock down', governments have started to outline their exit strategies. There are also hopes for more effective COVID-19 testing, drug therapies and even a vaccine, which has further bolstered sentiment. Yet, when you talk to investors about what is driving asset prices higher, nobody mentions the 'delta' - instead, it's all about the policy response.

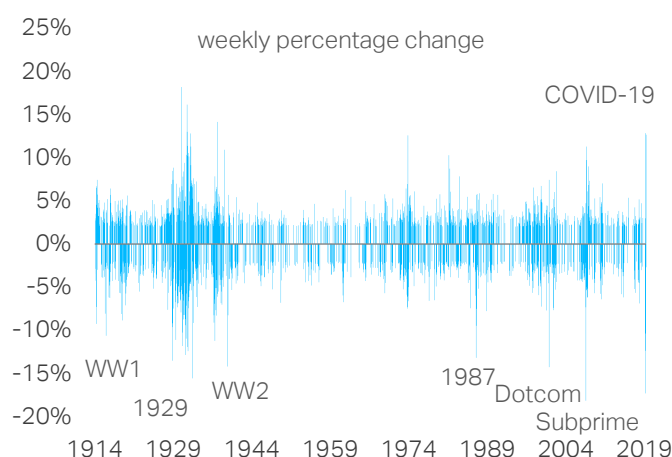
To misquote Blackadder, this is a large crisis...and a large crisis called for a large policy response. Governments and central banks have unleashed a policy stimulus of unrivalled speed and scale. Many investors believe this has effectively 'underwritten' global financial markets, removing the tail risk of a major economic and financial crisis. A less flattering interpretation is that this is just the standard 'bear-market rally', driven by classic overconfidence in the policy response combined with the traditional 'fear of missing out'. Investors know equity returns are highest at the start of a recovery. The reality is that the macro situation is no 'less dark' than it was a few weeks ago, with massive uncertainty about the timing and speed of the global recovery. The most bullish scenario assumes the current downturn is closer to a natural disaster than a recession, which means activity can bounce back quickly after the lockdown (the 'V'). This is the outlook equity analysts seem to be assuming in their earnings forecasts for the next 18 months. But it is increasingly hard to find any economist who still believes in the V-shaped recovery. Even the IMF has published an unusually bleak set of global economic projections, showing a hesitant post-lockdown recovery, permanent income losses and dangerous financial vulnerabilities.

Global policymakers have done well to prevent a global health and economic emergency becoming an immediate financial crisis. Yet the fundamental aspects of this pandemic remain as troubling as they were before the rally in asset prices. First, there is still a lot we don't know about COVID-19. Severe lockdowns have slowed the spread of the virus but with no herd immunity and no vaccine (which may not be deployable until 2021), it is unlikely the global economy can reopen without further waves of infections. Disruption is not a policy choice - evidence from past pandemics shows the absence of non-pharmaceutical interventions (e.g. lockdowns) is linked to even worse macro outcomes. The second reason for cautiousness is that COVID-19 has unleashed powerful recessionary forces that will persist even after the virus is contained. Unemployment will stay high (though not as high as the headlines, which include temporary layoffs), consumers will be reluctant to spend, and over-indebted businesses will struggle to survive (even with monetary support). There is also an international dimension to this crisis - especially the vulnerabilities in emerging economies - which will create additional spillovers. Policymakers can alleviate these pressures, but they are not as powerful as many investors like to assume. And they will always be behind the curve. Current asset valuations do not reflect this macroeconomic reality, which means the bear market is likely to return - probably soon.

1. FEAR OF MISSING OUT

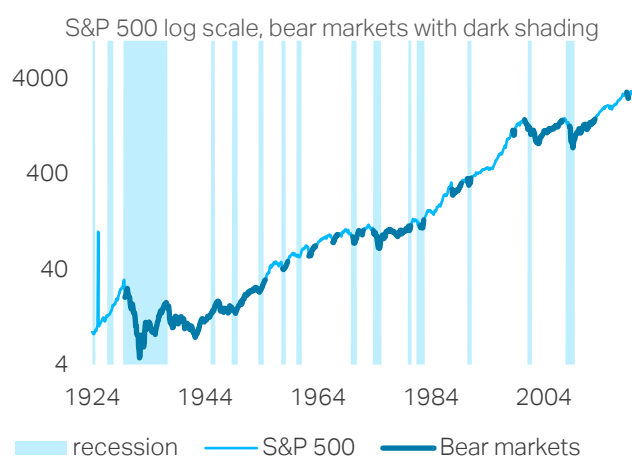
Global financial markets have regained some composure over the past month, with stock markets reversing roughly half of their March losses and credit spreads narrowing significantly (as with equities, the revival in credit follows a period of spectacular destruction). Oil is the only asset class that continues to show worrying strains, with short-term futures collapsing and even turning negative recently. With the global economy still in “lockdown” and a shortage of storage capacity (reflecting a massive glut in supply), nobody is able or willing to take physical delivery of oil, which is what the expiration of these contracts requires. Yet the general tone in global markets has certainly improved – so much so, the casual observer might conclude that the worst of the COVID-19 crash is behind us. This seems dangerously premature.

Chart 2: Record crash... to record bounce



Source: MacroTrends, Bloomberg, TS Lombard

Chart 3: History of bear markets



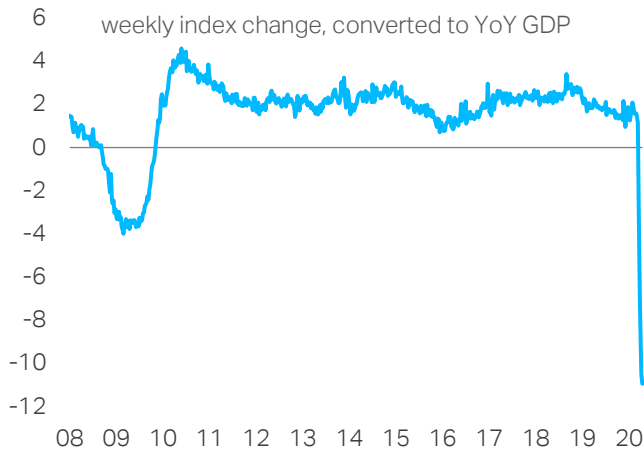
Source: MacroTrends, Bloomberg, TS Lombard

Reasons to be cheerful (sort of)

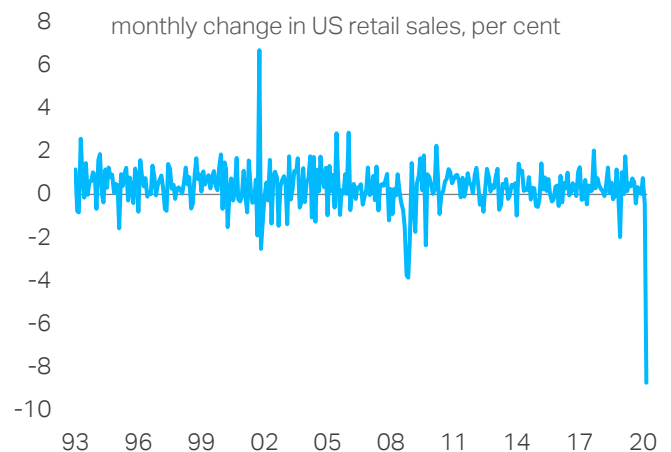
The most optimistic explanation for this improvement in sentiment is that investors are reacting to the ‘delta’ on the pandemic – the rate of change in the news flow. The situation remains grim, with large numbers of people becoming infected and dying with COVID-19 every day, but perhaps there are signs of improvement, especially compared to what some investors had imagined a few weeks ago. Infection rates have slowed, with the various ‘non-pharmaceutical interventions’ limiting the spread of the virus. This is important on two levels. First, it shows the authorities’ containment efforts are having the desired impact. Second, lower infection rates have significantly eased the pressure on health services. Hospitals continue their heroic struggle, but they are not overwhelmed. And governments have added critical-care capacity. Countries that were behind the curve, such as the US and UK, have coped better than feared.

As infection rates have slowed, investors have become increasingly confident that governments will be able to reopen their economies relatively soon. Most countries have now outlined ‘exit strategies’, which have also supported this narrative – even if these strategies remain vague to the point of being meaningless. For President Trump “reopening the economy” has become the new “we are close to a trade deal”, a comment he drops into every press statement with the hope of bolstering the S&P 500. Some investors are also more optimistic about the pharmaceutical approach to the virus. The authorities have stepped up their testing capacity, while the deployment of an antibody test, which could tell us who has already contracted the disease, could be a ‘real game changer’ (to quote the UK’s Chief Scientific advisor). Recent

clinical trials have shown useful therapies for treating COVID-19, though these same drugs have been appearing in the press for a while and have important limitations. Optimists also point to progress towards a vaccine, even if we could still be many months away from its deployment.

Chart 4: Tracking weekly US GDP


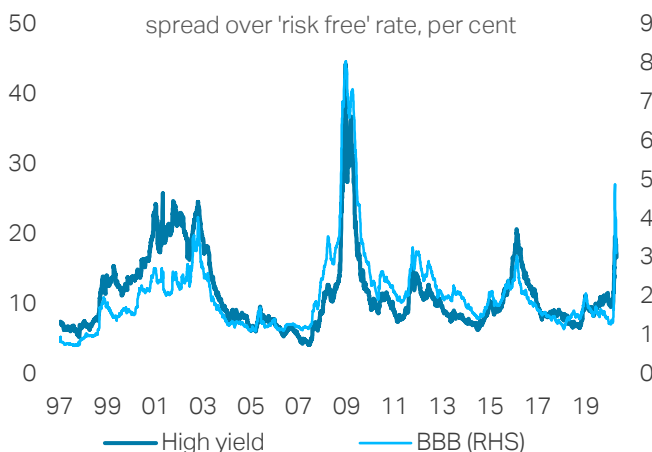
Source: Jim Stock's 'weekly economic activity index' ([available here](#))

Chart 5: Retail sales collapse


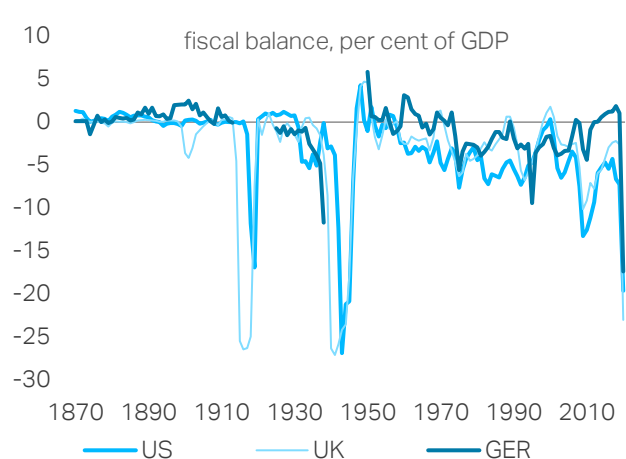
Source: Datastream

'Underwriting' markets

While the pandemic is not progressing as disastrously as feared, we are not convinced the improving 'delta' is really the thing driving sentiment. Investors tell us they are reacting to the macro policy response, not the 'fundamentals' of the virus. Certainly, the authorities have responded with impressive speed and scale. Central banks have eased monetary policy and taken unprecedented measures to calm financial markets. The Federal Reserve has been particularly important, addressing specific vulnerabilities that threatened to trigger an immediate financial crisis. Fed action has capped corporate borrowing costs (reducing spreads) and provided unlimited dollar liquidity. In doing so, the authorities have contained the immediate fallout from both the "Buyside Bubble" and the "Dollar Shortage". Meanwhile, governments have added 'wartime' levels of fiscal stimulus. The policy response has been so radical that some investors worry about governments going too far, perhaps stoking a future inflation problem.

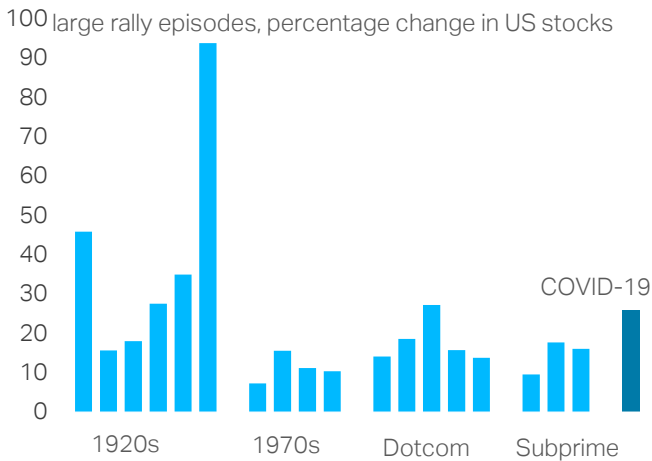
Chart 6: Credit blowout forced Fed response


Source: FRED database

Chart 7: A 'wartime' fiscal stimulus


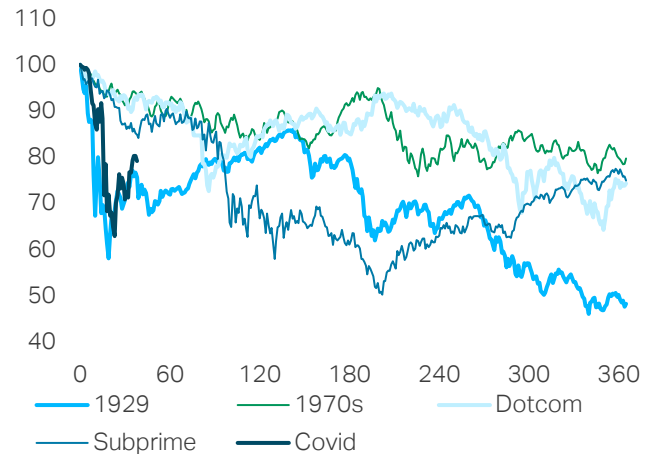
Source: MacroHistory.com, TS Lombard forecasts

Chart 8: Bear-market rallies



Source: MacroTrends, Bloomberg, TS Lombard

Chart 9: Another bear-market rally?

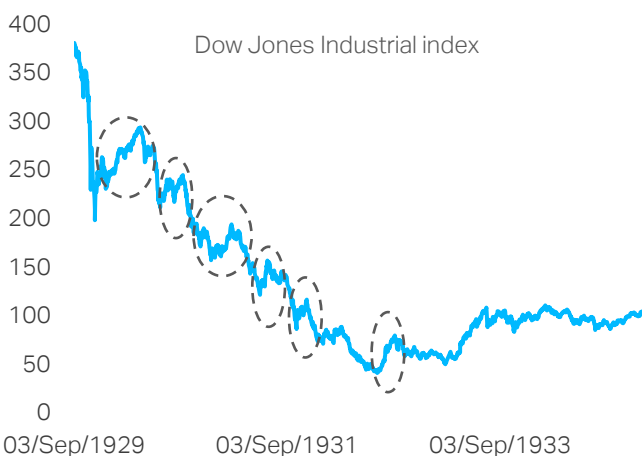


Source: Bloomberg, TS Lombard

Bear-market rallies

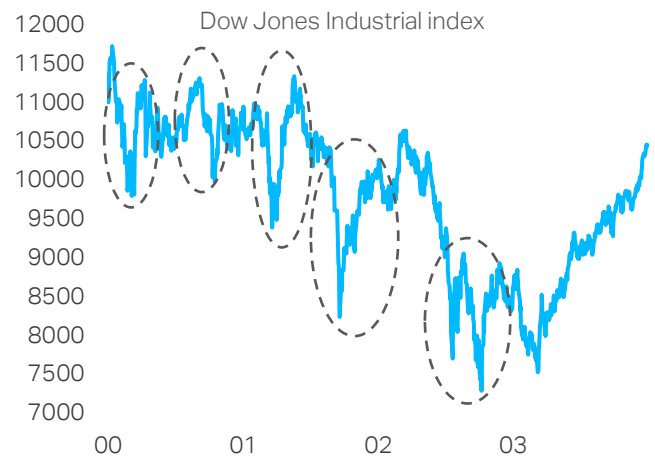
The policy response has been more radical than anyone could have imagined a few months ago. The authorities are doing all the right things, suppressing market amplifiers and providing help to businesses and households who are unable to earn a living. Still, the scale of this action reflects the size of the problem – an unprecedented collapse in global demand. It is unlikely even a stimulus of this magnitude will be enough to prevent a deep and persistent recession if severe COVID-19 disruption lasts more than a few months. Worse, the faith investors now have in policymakers (especially the return of the ‘don’t-fight-the-Fed’ mantra) is pretty typical of what always happens in the early stages of a bear market. After an initial plunge in asset prices, policymakers respond and this response injects fresh optimism into market sentiment. The same happened during the Dotcom and Subprime crises, when the early phase of the policy response convinced investors the problem was ‘contained’ – until it became clear it wasn’t.

Chart 10: Rallies during the Great Depression



Source: MacroTrends, Bloomberg, TS Lombard

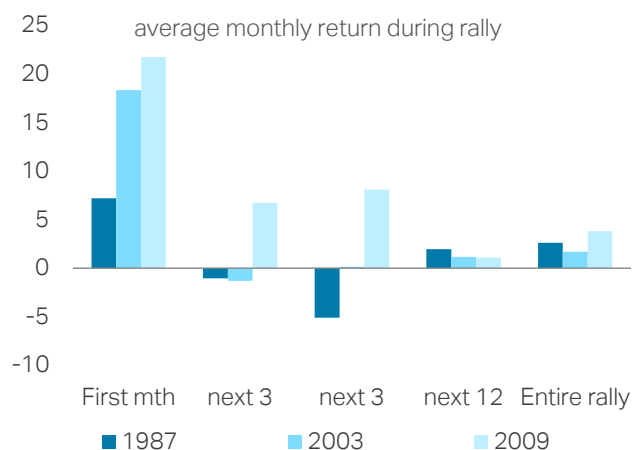
Chart 11: The Dotcom crash



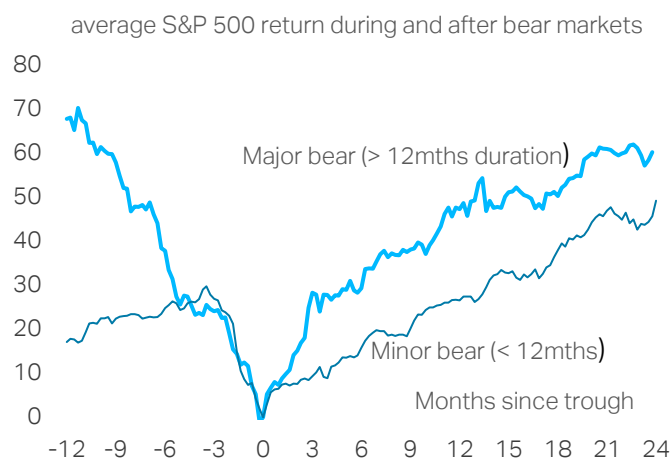
Source: MacroTrends, Bloomberg, TS Lombard

While the latest collapse and rebound in stock markets has been extreme – reflecting the historic nature of the COVID-19 crisis – we suspect this is just an unusually exaggerated ‘bear market rally’. These are common, especially during times of radical uncertainty. All the largest bear markets have included impressive – but ultimately temporary – reversals. Charts 8-11 show

some classic examples, especially during the Great Depression, which produced episodes in which stock markets rallied massively only to succumb to new waves of destruction. While these rallies are partly a response to volatility and uncertainty, they also reflect FOMO: the fear of missing out. History shows that the outsized returns tend to occur at the start of the recovery – so, if you miss the turn, you miss the biggest gains. This creates a powerful temptation for investors to buy into rallies, even if the sustainability of their recovery is in question.

Chart 12: Miss the turn, miss the return


Source: Bloomberg, TS Lombard

Chart 13: Recoveries are front-loaded


Source: Bloomberg, TS Lombard

2. SHAPING UP

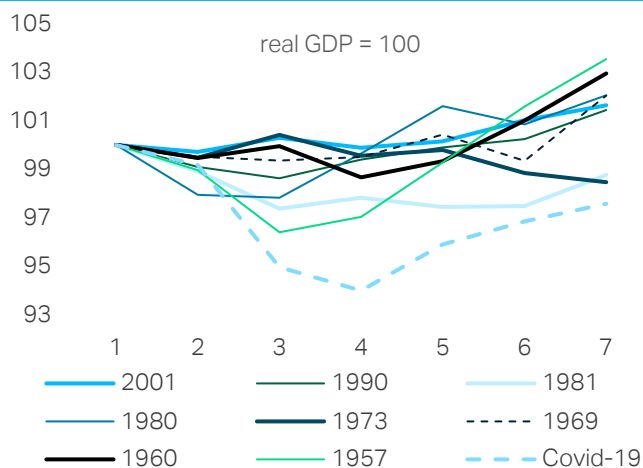
Investors are confident that global policymakers are doing enough – or are prepared to do even more – to prevent the COVID-19 downturn becoming a persistent economic slump. Whether this confidence is misplaced will ultimately depend on the timing and strength of the economic recovery, once the current period of lockdown ends. By now, everyone knows GDP is going to collapse in Q2, but investors are already looking beyond this. To be fundamentally bullish surely requires a reasonably strong economic rebound during the second half of 2020, which can continue into 2021. For equity investors, this would mean that the decline in earnings – inevitable over the next 3-6 months – will give way to a strong revival. As you might expect, the discussions we are having with our clients are now all about the ‘shape’ of the recovery. Will it be a ‘V’ (a strong and immediate revival), a ‘U’ (delayed), a ‘W’ (double-dip, with the initial rebound giving way to a second downturn) or perhaps even an ‘L’ (absent altogether)? Let’s look at some theories.

The bullish take

The V-shaped recovery is based on the most bullish analysis of the post-COVID-19 world. A [recent post on Liberty Street Economics](#) (the New York Fed’s blog) provides the clearest rationale for this sort of thinking. [Echoing remarks from Ben Bernanke](#), NY Fed staff claimed the economic fallout from the virus is much closer to a natural disaster than any past economic downturn. They focused, in particular, on the comparison with the 2008 recession, highlighting three important differences: (i) the current downturn reflects the decision of the authorities to shut down the economy, it is ‘not the result of economic or financial imbalances’; (ii) Most recessions happen gradually (the 2008 downturn occurred in three stages) whereas sudden stops in activity are typically ‘one-offs’, and (iii) The pandemic is ultimately temporary – once infection rates decline, the economy can bounce back to where it was before the virus. On their

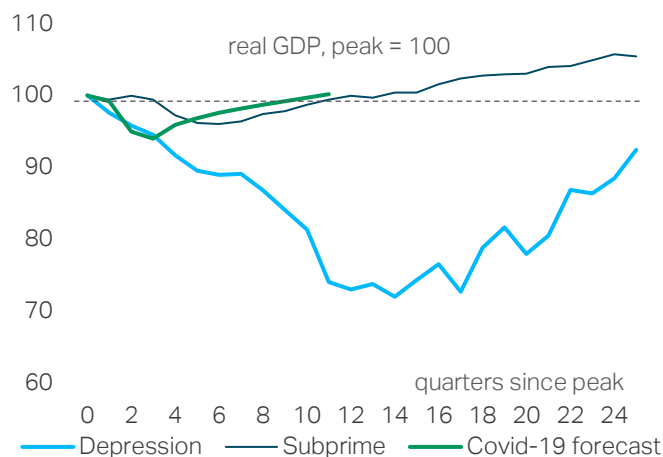
optimistic analysis, nothing has fundamentally changed versus the pre-pandemic economy. To illustrate the point, the authors highlight what would have happened to the US economy during previous natural disasters, such as Hurricane Katrina, had these occurred at the national level rather than on a regional basis (Chart 16). They show that the speed and size of the increase in US unemployment claims would be broadly similar to what we are seeing with COVID-19.

Chart 14: A severe US recession



Source: BEA, TS Lombard forecast ([see here for details](#))

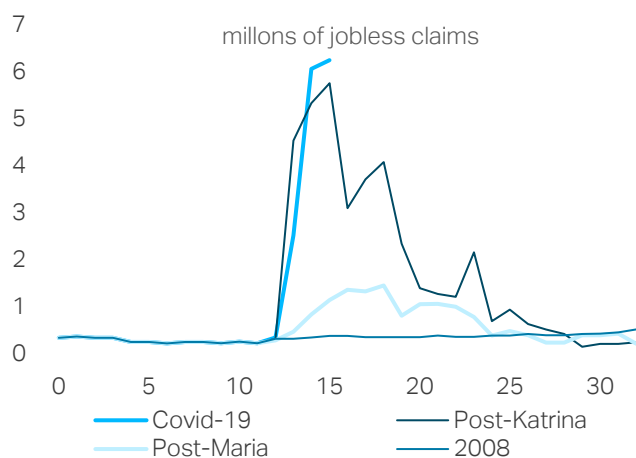
Chart 15: But not a Depression



Source: BEA, TS Lombard forecast

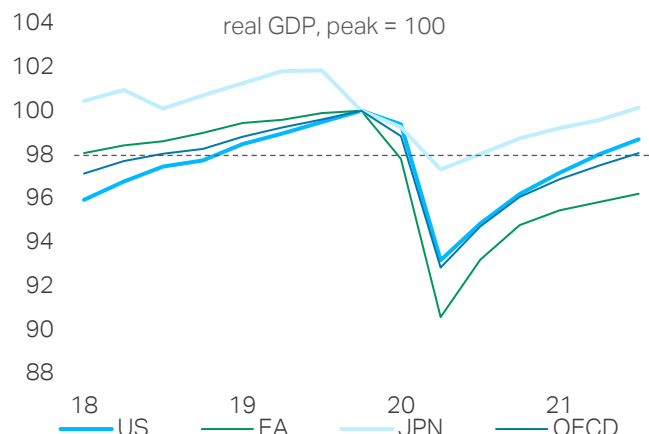
The New York Fed's analysis is useful not because it tells us what is going to happen – in fact jobless claims have continued to rise and now comfortably exceed their 'equivalent' set of natural disasters – but because it highlights *the assumptions that are necessary to create a V-shaped recovery*. If these are violated, perhaps because COVID-19 has amplified existing vulnerabilities, or because the disruption associated with the virus is not temporary, there can be no quick rebound in global GDP. Reopening the economy after lockdown might create a bounce in output, but this is largely technical. Once it is over, the world would be stuck with GDP that is chronically below 2019 levels and growing at a slower pace than many expected.

Chart 16: COVID-19 a 'natural disaster'?



Source: New York Fed's [Liberty Street analysis](#)

Chart 17: Bloomberg consensus

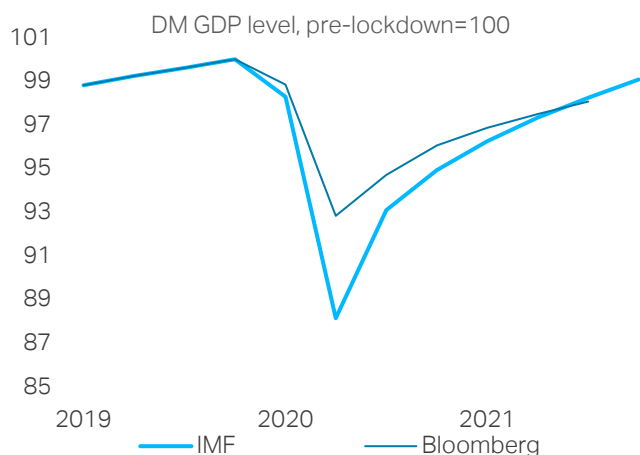


Source: Bloomberg survey of economists

Discounting the V

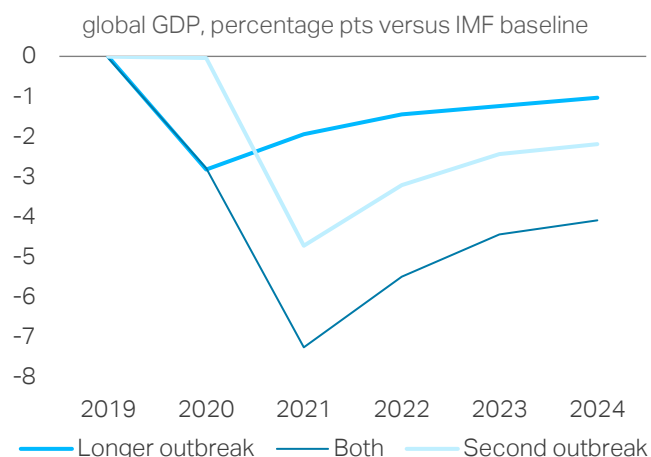
Most economists now realize that a V-shaped recovery is unachievable. Chart 17 shows consensus Bloomberg forecasts for the major economies over the next 12 months. After an initial collapse in output in 2020 Q2, as lockdowns took effect, the consensus sees a recovery in Q3. But output does not return to where it was at the end of 2019, let alone to where it would have been had there been no pandemic (i.e. assuming continued expansion in 2020). This is a much more persistent slump than what happened during the SARS outbreak in 2003. Back then, output collapsed across Asia in Q2 but immediately made up for those losses in Q3, rebounding strongly. The current consensus seems reasonable, though it is not the outlook that is implicit in global asset prices, especially given the strong rebound since March. More puzzling, this is not even a case of investors ignoring economists – when you ask investors about the shape of the recovery, only a minority (15% according to the BoAML survey) expect a “V”.

Chart 18: IMF below the consensus



Source: IMF, Bloomberg

Chart 19: Risks firmly to the downside



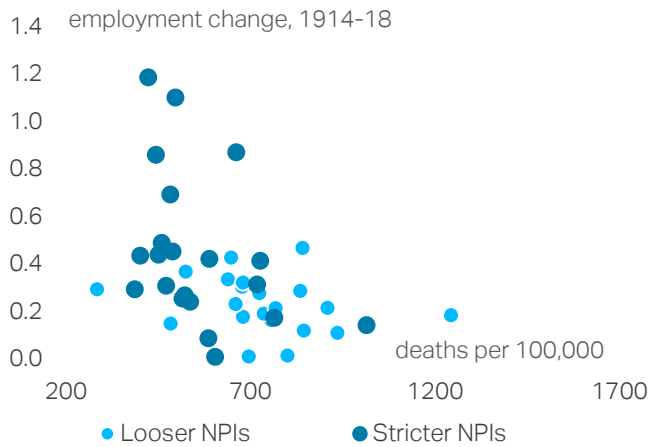
Source: IMF World Economic Outlook, April 2020

IMF risk analysis

The IMF recently published its World Economic Outlook for 2020-21 and is more bearish than the Bloomberg consensus. IMF staff not only predict large cumulative losses in GDP, but warn that the risks are massively skewed to the downside. Interestingly, the Fund explains these risks in detail, even providing alternative sets of projections based on bleaker assumptions. The simulations remind us that nobody really knows how the virus will progress, including how quickly infection rates will decline to manageable levels, or what happens when governments eventually relax their containment measures¹. As Chart 19 shows, the IMF's forecasts include three alternative baselines: (i) containment measures last beyond June; (ii) there is a second spike in infections in 2021; and (iii) the gloomiest case, a combination of both (i) and (ii). Any of these scenarios, which are consistent with recent epidemiological studies from [both UK and US scientists](#), would have a huge impact on the global economy over the next 12-18 months.

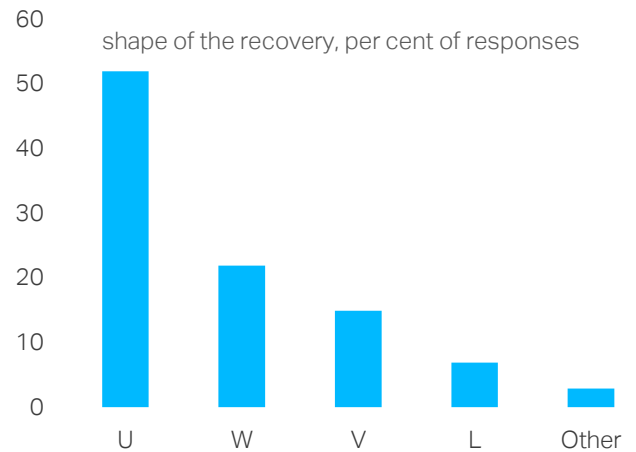
¹ [Some economists](#) have recently tried to model the 'optimal' COVID-19 lockdown. Their study shows that the most effective lockdown would last three months and would initially apply to 60% of the population, winding down over time (Charts 22 and 23). But these result depend heavily on the assumptions they make.

Chart 20: Containment helps the economy



Source: Fed study of the 1918 pandemic, NPI includes lockdowns etc

Chart 21: What do investors think?

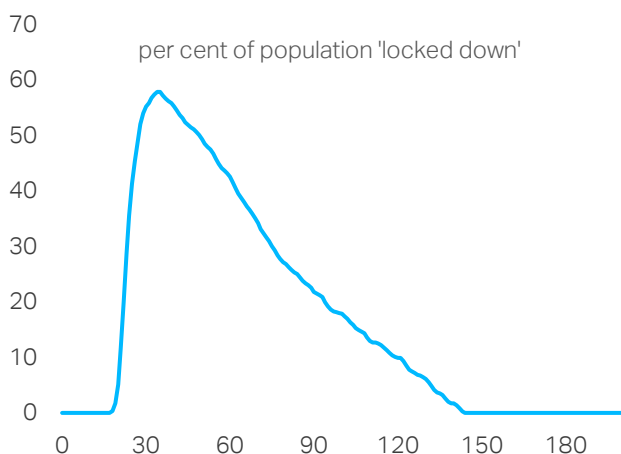


Source: Bank of America Merrill Lynch survey April 2020

False trade-offs

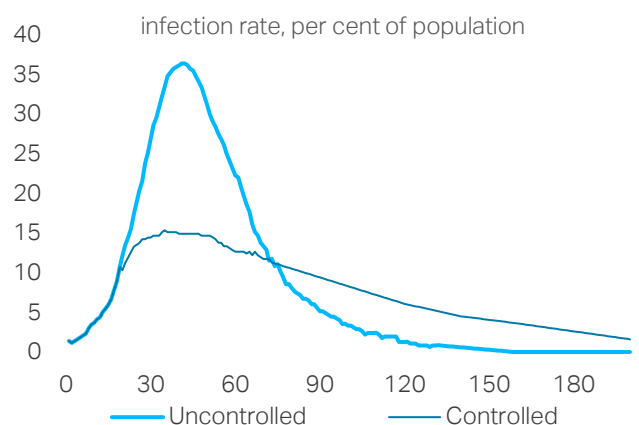
An obvious rebuttable to the IMF's analysis is that no government can tolerate containment measures that would have such a huge impact on their economies. There is a trade-off between the impact of public health and the economic fallout, which will eventually force governments to reopen their economies. But [analysis of past epidemics](#) suggests this is a false trade off and there is no genuine policy choice for the authorities. The Spanish Influenza pandemic, for example, was even more devastating for those parts of the world that did not introduce aggressive containment measures, creating a deeper and more persistent slump. Though people never fully internalize the 'social consequences' of their actions, especially if they are in low-risk groups (see e.g. [this study on the 'externalities'](#) associated with pandemics), fear has a powerful impact on behaviour. No economy is going to experience a strong and durable recovery in a society where a deadly virus continues to kill large numbers of people.

Chart 22: The optimal lockdown



Source: Alvarez, Argente and Lippi (2020) ([see here](#))

Chart 23: Impact on the virus

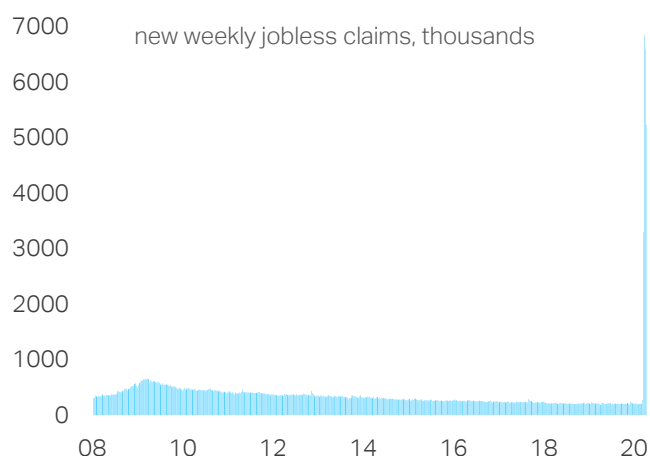


Source: Alvarez, Argente and Lippi (2020)

3. REALITY GAP

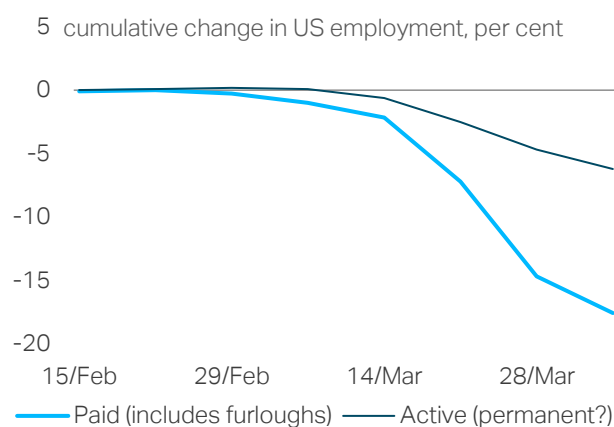
The IMF's simulations highlight the uncertainties associated with COVID-19, especially on the basis of how the virus progresses. Without the sudden deployment of a vaccine, the risks are skewed heavily towards a longer period of economic disruption, possibly further lockdowns. But there are also important 'macro amplifiers' that ensure a quick rebound is impossible. These create a sort of 'hysteresis', which produces a slow and hesitant recovery plus a persistent shortfall in output, especially compared to where the economy would have been in the absence of the pandemic. We could end up with a 'P-shaped' downturn, which combines the economic effects of the lockdown with an underlying cyclical recession i.e. a vertical plunge in activity (the lockdown), followed by a partial rebound (as economies reopen), followed by an 'fundamental' recession, which would deliver continuously weak growth after COVID-19. These deeper recessionary forces will play out through several channels, including: (i) labour markets; (ii) corporate debt and (iii) large international spillovers (especially the collapse in global trade).

Chart 24: US initial claims



Source: Datastream

Chart 25: Bad... but not THAT bad?



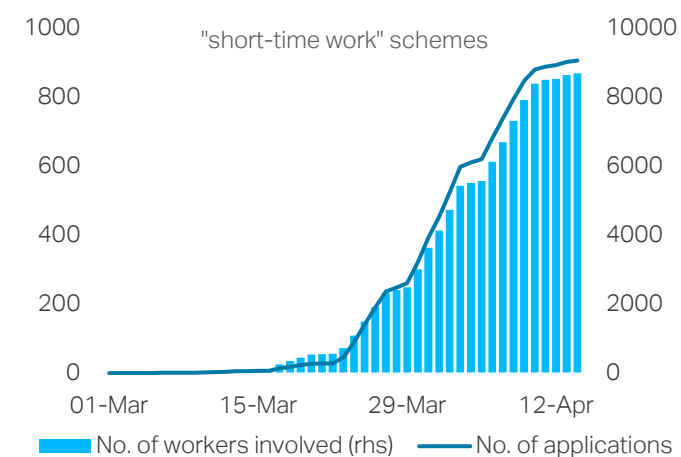
Source: Federal Reserve estimates ([see here](#))

Employment amplifier

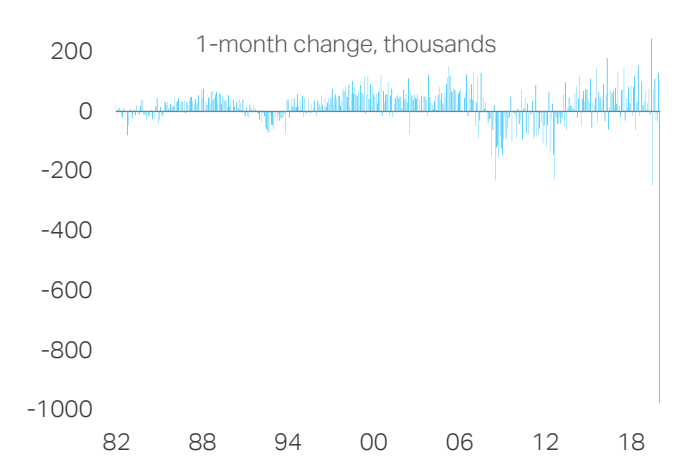
COVID-19 lockdowns mean millions of people all over the world are unable to do their jobs. Demand for some activities such as tourism, restaurants and non-essential retail has disappeared, while workers in other sectors (especially low-skilled occupations) are unable to work from home. Official rates of unemployment are rising at an alarming pace, especially in the United States where the weekly number of jobless claims has jumped by more than 20 million – Depression-level readings. Fortunately, only part of this reduction in recorded employment is permanent. Many workers are now on furlough and the US authorities are actually using the Unemployment Insurance (UI) scheme as a way to support businesses and workers during the lockdown. Since the government has incentivized UI (by topping up benefits) and actively wants people to apply for support, the bulls might even argue record claims are a 'policy success';

In reality, labour market statistics will be hard to interpret over the next few months, both in the United States and elsewhere. The true definition of 'unemployed' is someone who doesn't have a job and is *activity looking for work*. But some countries include the temporary jobless (such as furloughed employees) even if they are not searching for new roles. Other people will drop out of the labour force, including older workers and seasonal employees. This will reduce employment without adding to the number of unemployed. In short, the lockdown is creating a large statistical

break in official stats, which means we won't be able to compare the jobless rate in coming months with past recessions. And if we don't know which job losses are permanent, we won't know how quickly unemployment rates can come down when the global economy 'reopens'.

Chart 26: French workers seek income support


Note: workers cut hours & receive state income support

Chart 27: Spanish employment plunges


Source: national sources

Recent analysis from staff at the Federal Reserve is useful in this context, at least for understanding the situation so far. By looking at detailed ADP statistics, researchers were able to distinguish between those workers that remain on the payroll but are not currently receiving a wage (which presumably includes the furloughed/temporarily unemployed) and those that have now completely separated from their employers. These data suggests there are currently around 12 million furloughed workers out of a total of 18 million unemployment (i.e. two thirds). This is a significant rise in unemployment but it is not nearly as scary as the headline numbers. Our concern is that these numbers will get worse the longer the economic disruption continues, especially for those sectors where COVID-19 has had its most severe impact. Temporary job losses will become permanent, which will reduce overall levels of spending in the economy. Since many jobs in retail, hospitality etc. do not involve job-specific skills, there is no reason for companies to hang on to workers, especially if demand doesn't return relatively quickly.

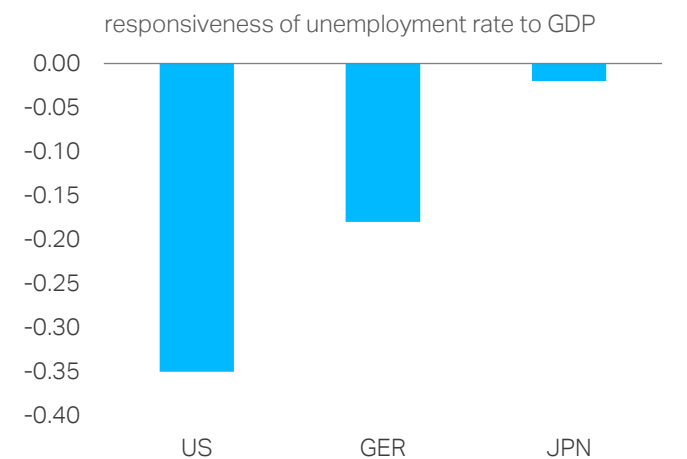
Eurosclerosis an advantage?

In the short term, Europe's labour market will deteriorate more slowly than the US. While some countries have reported a spike in jobless numbers, this is mainly due to furloughing. Europe's 'outperformance' reflects the stickiness of labour markets, specifically powerful trade unions and hefty hiring/firing costs. European companies will hang on to workers, particularly where the government is paying a large share of the wage bill². Of course, this also means corporate profitability will decline even more than in the US (where cost cutting will be more savage). This traditional divergence is the main reason the US has deeper recessions and faster recoveries. But if the COVID-19 downturn persists, EU labour markets will eventually crack – the US just gets

² Remember also that the US and European COVID-19 support schemes operate in slightly different ways. Whereas the US government asks workers to claim UI in order to receive support, making workers 'unemployed', euro governments are paying workers via their companies. In a weird way, EU governments are effectively asking companies to lend them the cash (the opposite of what you expect in a crisis).

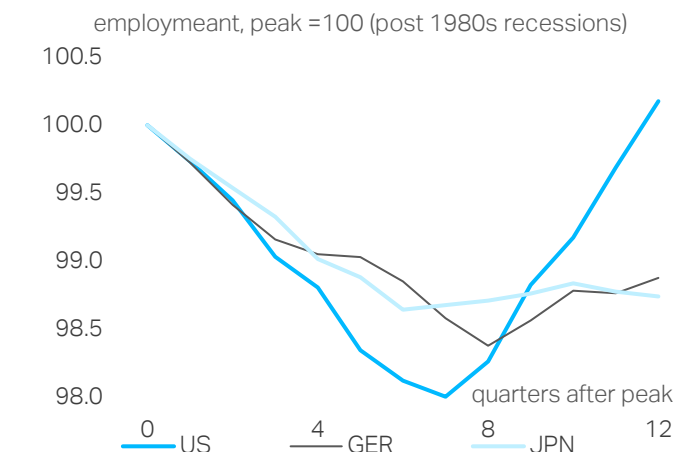
there quicker. Remember what happened after the oil shocks in the 1970s, when Europe's high unemployment problem persisted for decades.

Chart 28: Okun's law weak outside the US



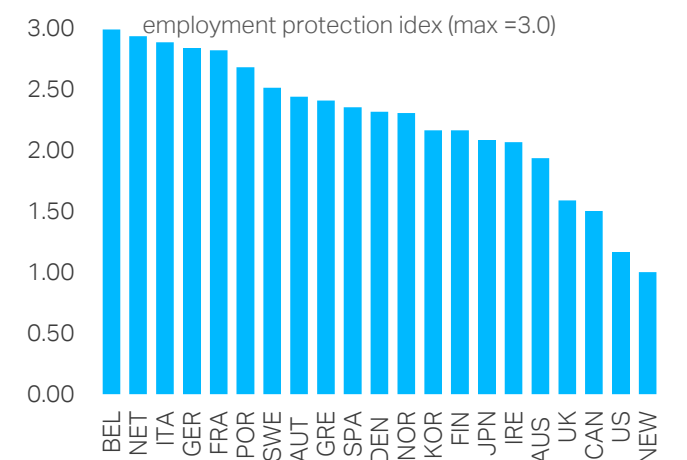
Source: OECD, TS Lombard

Chart 29: Typical employment response



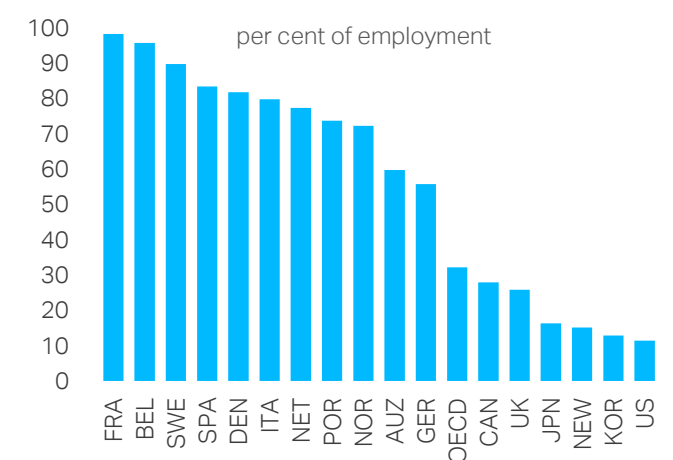
Source: OECD, TS Lombard

Chart 30: Hiring & firing costs high in EU



Source: OECD

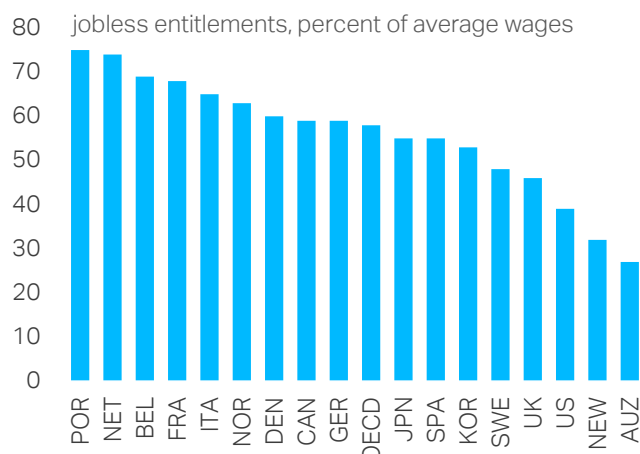
Chart 31: Trade unions still powerful in the EU



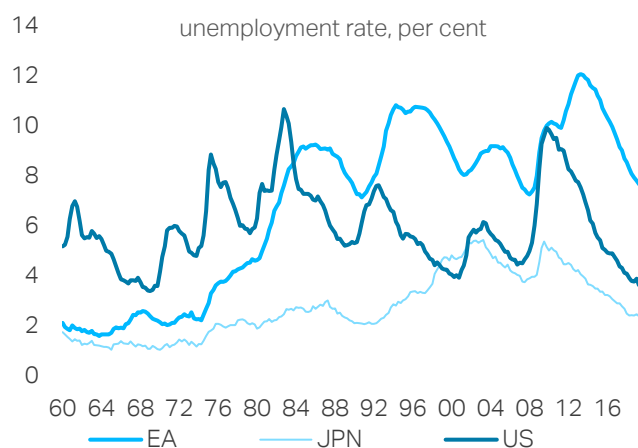
Source: OECD

Corporate debts

If unemployment stays high, consumer spending will be stuck below pre-crisis levels – an extra level of destruction beyond the direct consequences of the pandemic. Even those countries with the most generous unemployment insurance schemes only pay unemployed citizens a fraction of what they would normally receive in wages (Chart 32). Worse, the dramatic pace of the deterioration in labour markets will have a 'scaring' effect on consumer demand. For the corporate sector, reduced consumption means lower revenues, which will be a serious problem for the many companies that are already struggling with large debt loads. Remember, corporate debt ratios have exploded everywhere over the past decade and many companies have allowed their interest coverage ratios to decline even with borrowing costs at historic lows.

Chart 32: Spending power will go down


Source: OECD, US rate is now higher thanks to the temporary top-up

Chart 33: EU hysteresis after the 1970s


Source: OECD

The current crisis can only add to these debts in the short term, as revenues plummet and most governments are only providing short-term 'bridging loans' rather than tax rebates or 'helicopter money'. The authorities can help to keep these companies in business in the short term, but they can't ultimately suppress the credit cycle. If the global economy remains in recession even after the current lockdown has ended, many of these companies will stay unprofitable and could fail. They will certainly not be in a position to grow their businesses by investing or taking on staff (they will be 'zombies' at best). These macroeconomic vulnerabilities have been clear for a while. Even if they were not the trigger for this recession, they will inevitably amplify its impact.

Global spillovers

The corporate debt problem is particularly acute in the emerging economies, which have suffered enormous capital outflows in recent weeks. Our EM team think many of these countries will suffer serious financial crises as a result of COVID-19. This will compound the impact of the global economic downturn, especially as these countries represent more than half of world GDP. As Gita Gopinath, the IMF's Chief Economist explained, this is the first truly global economic collapse since the 1930s, with both the DMs and EMs set to contract at the same time. The response in commodity prices has been particularly severe, which threatens to cause further financial strains, not only among the emerging markets but also among DM energy producers.

We are also seeing a collapse in global trade, which will amplify the downturn in global economy, exposing complex cross-border supply chains and intricate trade finance. Value chains create linkages that cannot easily be identified within the traditional trade statistics of imports and exports. But [recent studies by NEISR](#), for example, show that global value chains can compound the impact of a global economic shock, increasing the ultimate effect on GDP by up to 60%. Longer term, the exposure of these vulnerabilities will add to de-globalization push, undermining global economic efficiency and damaging long-term profit margins (the wage share will rise).

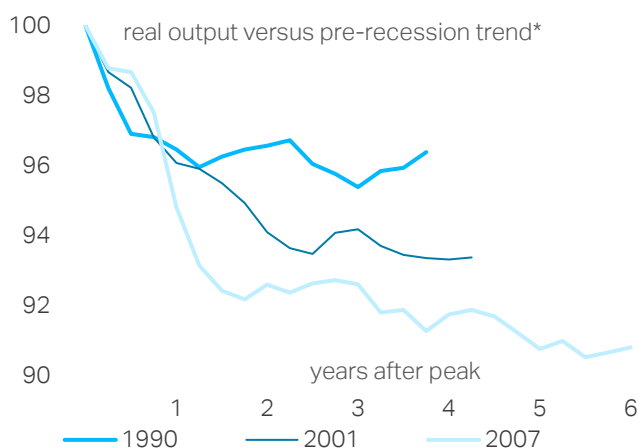
Market implications

The COVID-19 "lockdown" is morphing into a deep global recession. Risk assets, especially stock markets, are not priced for this scenario. In a downturn of this magnitude, it is natural for equity prices to fall substantially. Remember, there are two reasons for this:

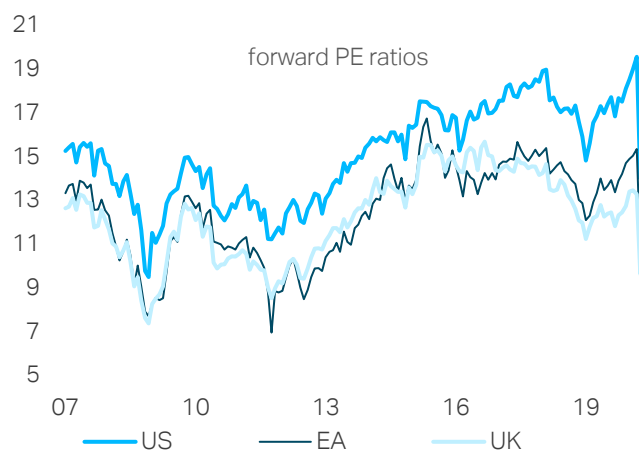
- (i) **Persistent earnings loss:** Earnings always decline sharply during a recession. Worse, the level of earnings never actually gets back to where investors thought it would be

before output started to contract. This is because GDP rarely resumes its pre-recession trend (Chart 34). Rediscovered 'plucking' theories of the business cycle show that economies can remain chronically depressed with no natural tendency to return to full capacity, contradicting old theories of how business cycles worked;

- (ii) **Massive uncertainty:** Recessions not only involve persistent income losses, but there is always huge uncertainty about the strength and timing of the recovery. The current downturn is even more extreme since it includes a once-in-a-century global health crisis. Extreme uncertainty should raise the equity risk premium, even causing stock markets to become 'undervalued' on a historical basis. Stocks have rallied because central banks have taken out a 'tail risk' (immediate financial crisis), but the situation remains as unclear and dangerous as it was a few weeks ago.

Chart 34: Recessions cause permanent scars


Source: BEA, TS Lombard

Chart 35: Crisis, what crisis?


Source: Datastream

Our front page chart (Chart 1) shows equity analysts are expecting only a modest decline in earnings, which they think will unwind quickly, giving way to a huge boom in 2021. Worse, forward PE ratios have bounced back to where they were before the pandemic. In some countries, such as the US, equities are even trading on higher multiples. This is not a market that is pricing a serious and persistent economic recession, but rather a market that seems to have too much faith in policymakers. Yes, the authorities are doing all the right things – but they cannot control the global economic cycle. Since there was no sense of capitulation among the bulls, even at the 'bottom', we think it is too early to say the bear market is over. In fact, if the macro outlook evolves the way we expect, we could be facing another plunge in risk assets.