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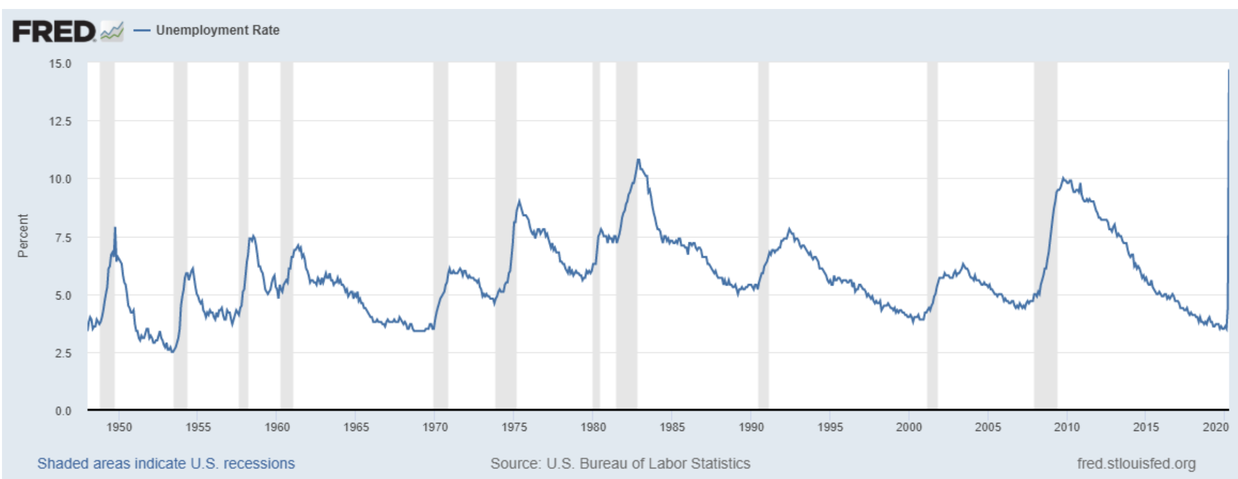
Dark Clouds Are Coming

Summary: Despite the enthusiasm of many retail and other investors – it increasingly appears that chances for a V-shaped recovery have faded. Now the issue is whether it will be a U-shaped recovery or a Nike-type swoosh. The latest *Wall Street Journal* survey of economists is more pessimistic than it was a month ago, with a deeper Nike-type swoosh being the dominant outlook. According to the economists surveyed, 2020's GDP is now projected to plummet by 6.8 percent, compared to last month's forecast of a 4.9 percent contraction. Market guru

Mohamed El-Erian is calling for a 8 to 10 percent contraction for 2020, including a contraction in Q2 of 30-40 percent. Although we will still stick with a U-shape for now, we cannot rule out a Nike-type swoosh being the final outcome. Either way there is more pain to come.

As for the stock market, the disconnect between stock values and fundamentals is likely to continue with periodic bullishness based on the forward-looking approach of many investors and analysts (yes the coronavirus pandemic will be over someday); who hope for a medical solution; and have a willingness to overlook short-term carnage. Add to this that considerable money still needs to be put to work – there is an abundance or liquidity - and those investing in the stock market enjoy greater resources to weather the crisis. The most attractive sectors are pharma, technology and healthcare. Despite the threat of another round of tensions with China, tech has demonstrated a considerable degree of investor stickiness (i.e. the money does not want to leave it). The sector is observed as a safe harbor by many investors who have loaded up in names like Apple, Google, Microsoft and Netflix. At the same time, most investors that have wanted to sell out have done so; others have carefully pruned their portfolios and are willing to wait it out, even if it takes for an economic recovery to begin in 2021.



At the same time one has to ask who will be the marginal buyer in these market leaders – and areas which have been unloved for many years - such as gold and precious metals – which offer a potential safe haven and hedge against excessive central bank easing and currency depreciation - are beginning to demonstrate real strength and relative outperformance.

Assessing the Global Landscape: The global situation seems a little grim. The coronavirus pandemic still rages, the world economy has taken a nosedive and unemployment is surging everywhere. (See table above for the U.S.) The lack of international cooperation is stunning; it is as if world leaders read the history of the Great Depression (1930s) and decided to follow the same path – every country for itself, including pushing new trade tensions and twisting the narrative of events in their own favor with an eye to gaining ground in the court of world opinion. On the horizon sits a new set of challenges: food security is likely to become a major problem for a number of countries, bankruptcies of small and medium-sized businesses are ready to soar, the finances of state and local governments are going to be stretched to the point that essential services could be cut, and the potential for social unrest in major cities looms as governments seek to maintain lockdowns and social distancing in the midst of hot summer weather.

Macro Outlook – Selected Economies

	Real GDP 2020 %	Unemployment Rate %	Budget Bal./GDP %
United States	-3.8	14.7 Apr	-14.0
Canada	-4.3	13.0 Apr	-7.2
Mexico	-9.5	3.3 Mar	-4.7
United Kingdom	-8.7	4.0 Jan	-14.1
Euro Area	-6.0	7.4 Mar	-5.9
Germany	-6.1	3.5 Mar	-5.9
France	-8.8	8.4 Mar	-9.9
Italy	-7.0	8.4 Mar	-7.0
Spain	-6.0	14.5 Mar	-7.3
China	1.0	3.7 Q1	-5.5
Russia	-5.2	4.7 Mar	-3.1
India	0.3	23.5 Apr	-6.1
Brazil	-5.5	12.2 Mar	-12.0
Turkey	-5.4	13.6 Feb	-6.3
Indonesia	1.0	3.9 Mar	-5.4
South Africa	-4.0	29.1 Q1	-10.3

Source: The Economist, May 16th, 2020.

Political games complicate the response… In the United States, the situation is likely to be complicated by the looming election in November 2020. American states are facing their worst fiscal crisis since the Great Depression. Indeed, the Center on Budget and Policy Priorities estimates that more than 25 percent of state revenues disappeared due to the pandemic. A number of major states need help. But it is possible that the Republican-controlled Senate will block any new stimulus packages due to newfound concerns about the country's fiscal problems as well as a chance to force some states to tackle their unfunded pension liabilities.

The Republican majority leader Mitch McConnell has already indicated that some states should declare bankruptcy. On April 23, 2020 he stated: "We're not interested in solving their pension problems for them. We're not interested in rescuing them from bad decisions they've made in the past, we're not going to let them take advantage of this pandemic to solve a lot of problems they created themselves [with] bad decisions in the past."

McConnell does not want bond defaults, but to shift costs to state pensioners/retirees. This would be done if states were to seek bankruptcy under the federal structure. To be clear, bankruptcy in the U.S. is governed by federal law and handled by federal courts. States are not allowed to declare it as per the U.S. Bankruptcy Code and would require Congress to pass legislation, which is not likely in current environment. If it were to happen, a federally-appointed judge would decide who gets paid, when they get paid and who bears the cost. The thinking behind this (the idea has been around for a while in Republican circles) is the cost would be eaten by state pensioners (like teachers), not taxpayers or bondholders. The view is the majority of states with largest unfunded pension liabilities gave overly generous pension benefits (often pushed by unions), which have proven to cost beyond what can be paid for.

2018 Cost of Unfunded State Government Employee Pension Liabilities per State Resident

State	Funded %	Cost Per State Resident
1. New Jersey	35.8%	$16,009
2. Illinois	38.4%	$10,707
3. Connecticut	43.8%	$9,933
4. Alaska	66.6%	$9,733
5. Colorado	47.1%	$9,722
6. Kentucky	33.9%	$9,632
7. Hawaii	54.8%	$9,058
8. New Mexico	62.5%	$7,882
9. Minnesota	63.3%	$6,681
10. California	66.5%	$6, 279
11. Mississippi	61.1%	$5,720

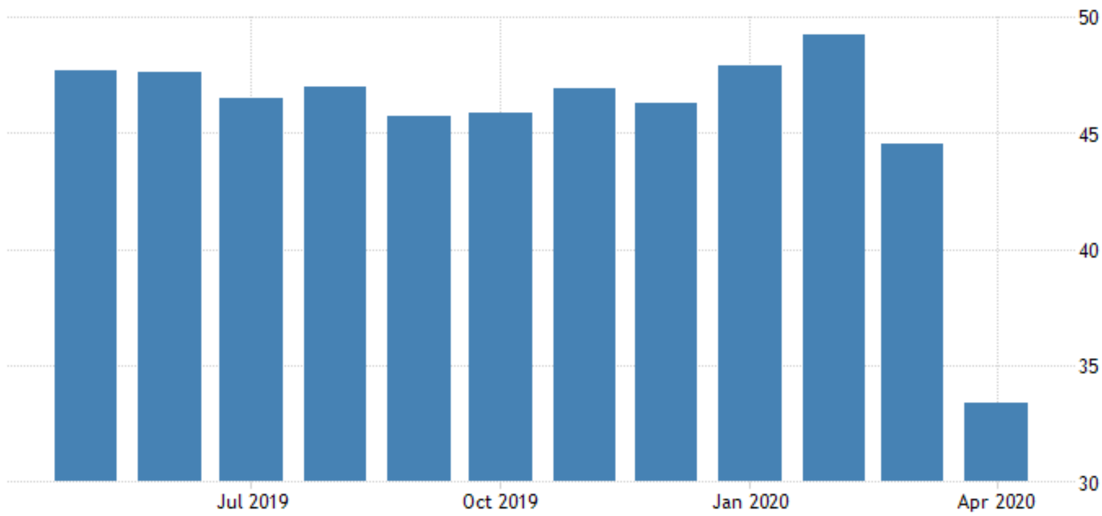
Source: Bloomberg (October 12, 2018), 2017 U.S. Census Bureau Population Estimates.

Promoting bankruptcies of states during a massive economic downturn is not a great idea. If a string of states were to go into bankruptcy it would undermine confidence in the U.S. economy and erode the overall creditworthiness of U.S. sovereign debt. This might complicate the Trump administration's plans to raise more than $3 trillion in U.S. Treasury bonds from April through June and another $677 billion from July to September - with more coming after that to cover future deficits in 2021 - to cover the U.S. government's yawning fiscal gap. It also guarantees the Trump administration will seek to keep interest rates at their lows for as long as possible.

McConnell's approach would also further stir political animosity (which may be part of what he wants). The issue becomes more complicated when considering that the country's wealthiest and most productive states carry some of the largest unfunded pension liabilities; they are also the least reliant on federal transfers. Of the 15 states most reliant on federal transfers, 11 have Republican governors. Even if the restructuring of state pension programs is badly needed in a number of states, the bankruptcy option is hardly one to promote economic recovery. If nothing else, McConnell's opposition to another round of fiscal spending reflects that the November 2020 elections are getting all that more closer and that politics are likely to increasingly complicate the economic decision-making needed to steer the country out of its steepest economic decline since the 1930s.

…and Europe has its own set of issues: The United States is hardly alone in looking out at a complicated and grim economic landscape. Much of the same can be said of Europe, where the pandemic has seen the region's economies knocked deep into recession, the worst since the late 1940s. In Q1 2020, the Euro Area GDP contracted by 3.8 percent. The German economy contracted by 2.2 percent, which was relatively mild compared to France and Italy, which respectively contracted by 5.8 percent and 4.7 percent. The Germans were quick to adopt widespread testing program and benefited from a robust healthcare system. This has helped keep COVID-19 fatalities below 8,000 in that country. That compares with France where virus-related deaths are over 27,000 and Italy where they are around 31,000.

Euro Area Manufacturing PMI (%)



Source: Trading Economics, https://tradingeconomics.com/euro-area/manufacturing-pmi.

While Germany gets good grades for its handling of the coronavirus pandemic, the major challenge looming is what happens to the European Union (EU). Considering the harsh impact of the pandemic on Europe and the struggle for a more coherent and unified approach, the EU is considering a recovery fund. While it is acknowledged there is a need for such a fund, there are major differences as to how to raise capital for it and how it will be distributed. Southern European countries are pushing for a budget of around euro 1.5 trillion to jumpstart their economies. The response from northern Europe has been more conservative. Moreover, southern European governments prefer grants, while northern governments want loans which have to be repaid and accounted for. Eastern European countries also have concerns that funds for their development will ultimately be diverted to southern Europe, which would slow down their economic recovery.

One major point of contention is whether the EU itself should be allowed to issue bonds. Most northern European countries are strongly opposed to this as it would mean they would share the burden of southern financial shortcomings - or it could be taken that way by hard-pressed voters in their countries. For southern Europeans there is a feeling that the euro and the trading zone have been largely to the benefit of the Germans and other northern European countries. Many of these arguments were acrimoniously thrashed out during the sovereign debt crisis in 2009-2012; many southern countries still resent the way they were treated.

The European Commission President Ursula von der Leyen finds herself presiding over a 27-member organization which is undergoing another crisis of confidence. As the *Financial Times'* Sam Fleming, Jim Brunsden and Michael Peel (May 18, 2020) observed: "The coronavirus crisis has magnified the economic and political divisions between north and south that have long threatened to tear apart the EU. In particular, the mood in Italy has shifted sharply over the past three months, with even some strongly pro-European voices questioning the country's long-term future within the EU." Many in Italy felt that other EU states were slow to respond to its medical crisis, even to the point of withholding medical equipment.

As it is the European Central Bank is on track to buy euro 900 billion of extra bonds in 2020, while a package of euro 540 billion of emergency relief measures is being put in place. However, ECB head Christine Lagarde has made it clear monetary policy cannot lift the European ship by itself; there is a pressing need for fiscal stimulus. While northern European governments have the wherewithal to tap fiscal resources to stimulate growth, southern European countries have less to work with and feel such an approach will once again leave them behind.

Von der Leyen has a massive challenge ahead. While she needs to convince northern European governments it is in their interest to allow the EU to issue its own "sovereign " debt, there has to be accountability from southern European governments that the funds will not be wasted, and if they come in the form of loans, ultimately repaid. At the same time, she needs to gain support from the European Parliament (which has gained more authority over the past few years) and coordinate policies with the ECB. She has only been in office a short time since December 2019, and still has to fully gauge all of the working parts of the EU. Indeed, she has been criticized for an alleged over-reliance on a handful of advisers she brought with her from Germany and is not yet integrated into the EU's 32,000-strong bureaucratic ranks. Considering the size and scope of the challenge, von der Leyen has less room than her counterparts did in 2009-2012. While they often kicked the can down the road, it can be argued the coronavirus has made certain there is very little road left.

Algeria's Virus Pandemic and Regional Security: Algeria's already precarious economic and political situation has undergone further deterioration with the growing presence of Covid-19. The economy has struggled over recent years to gain any traction, with the pandemic and the recent Russian-Saudi price war setting up an expected contraction of 5.2 percent for 2020. The reason we care is that Algeria is one of Europe's major natural gas suppliers and sits in a region marked by the large flow of migrants from Sub-Saharan Africa, factors that elevate its geopolitical importance to the European Union. This is especially true in France and Italy, which are major customers and would be on the receiving end of any new waves of migrants.

According to recent projections from the WHO, over 190,000 people across Africa could die in 2020 from the Covid-19 pandemic if containment measures fail. Based on the latest African data from the BBC, South Africa has the highest number of confirmed virus cases – more than 8,200 cases and 160 deaths – but Algeria has the most reported deaths at 483. Considering the opapacity around much of Algeria's official data, it is suspected the death count could be higher.

President Abdelmadjid Tebboune addressed the nation on March 17 announcing broad measures to fight the virus. These included curfews, the closure of all schools, universities and mosques as well as the shutting of land borders, suspending sea and air connections, and prohibiting protest marches and rallies. Several days later, the Hirak, the popular protest movement, recognized the escalating harm to the nation's general welfare from the pandemic and finally ended its weekly demonstrations after more than 13 months across Algeria's major cities. The demonstrations had begun in mid-February 2019, a few days after former president Abdelaziz Bouteflika announced his candidacy for a fifth term. Realizing the need for political changes, the military, the country's main powerbroker, orchestrated Bouteflika's resignation in early April 2019 that led to Tebboune's victory in the December general election.

The pandemic's dramatic consequences have halted the government's major reform plan announced in February. Called "a new deal for a new Algeria", the plan was to "cleanse the disastrous heritage" of past governance with proposed constitutional amendments and legislative elections by year-end. However, the opposition parties and Hirak immediately saw those plans as shallow attempts rather than moving toward the implementation of true reforms.

Algeria – Real GDP Growth & Inflation

	2016	2017	2018	2019	2020
Real GDP Growth %	3.2	1.3	1.4	0.7	-5.2
Inflation %	6.4	5.6	4.3	2.0	3.5

Source: International Monetary Fund. https://www.imf.org/en/Countries/DZA#ataglance.

There is a risk that if the anti-pandemic measures by the Tebboune government fail, it will further jeopardize the government's already meagre legitimacy. While threats from the pandemic will likely increase, citizens will be forced to observe lockdown measures quelling demonstrations over the near term. However, the lockdown has brought the economy to a halt, pushing up unemployment and uncertainty over peoples' livelihoods. Moreover, once the pandemic comes to an end, Hirak will be expected to resume its demonstrations.

While Algeria's domestic political situation remains tense, the Chinese government in April sent needed medical supplies and a team of medical professionals to Algiers to assist the government in its battle against Covid-19. Beijing's assistance also reportedly includes plans for a new hospital to care for approximately 10,000 Algerian and Chinese employees of the local operation of the China State Construction Engineering Corp., which directs many new infrastructure projects across Africa. In recent years China surpassed France as Algeria's main commercial investment partner to build roads and railways, aside from infrastructure upgrades in the hydrocarbon sector, which is still dominated by European firms.

China's growing engagement in Algeria stems from China's original recognition of Algeria following its independence in the early 1960s. For China, Algeria is an important energy producer and well worth what has been a long-term investment. In January 2020, Chinese exports to Algeria totaled approximately $550 million, equal to 20 percent of total imports.

And Algeria needs a steady customer like China. The recent collapse of hydrocarbon prices has placed tremendous pressures on Algeria's national and external accounts. As an OPEC member, Algeria supported Saudi Arabia, Russia, and other major crude oil exporting nations' recent agreement to limit daily production levels. In the face of radically reduced hydrocarbon prices, the government recently announced a 50 percent reduction in the state 2020 budget, citing that current market conditions require "urgent structural, economic, and financial reforms". The original budget was based on an average crude oil price of $50/bl; however, according to Reuters, Algeria's Saharan Blend has recently been trading around the $20/bl level.

Algeria continues to rule out approaching the IMF for emergency funding based on its short-term plan to rely on domestic borrowings. However, that plan is not without challenges - unpopular cutbacks could risk social and political stability. Unemployment levels and consumer prices have reportedly risen dramatically during the pandemic crisis. Moreover, as an already weak hydrocarbon export-dependent country, the government will be hard-pressed to meet the annual food import bill of $6.0 billion without possible concessions and other generous terms of trade from its established economic partners, especially among the EU nations. That predicament further raises Algeria's profile among the most at-risk food security countries.

The fluid Algerian situation bears watching. In addition to the heightened challenges stemming from the dual challenges of the uncertainties among hydrocarbon markets and the rising levels of Covid-19 infections that threaten the country's general welfare, Algeria bears the perpetual security contagion risk of its proximity to unstable geopolitical developments in its neighborhood, including Libya, Mali, and Niger. The prospect of greater flows of desperate refugees penetrating Algeria's eastern and southern borders presents a rising challenge for the Tebboune government. This could further destabilize the country's already delicate political and socio-economic system. A major disruption in Algeria's gas and oil fields could have a negative knock-on impact on Europe. (Robert Windorf)
