Opinion | 10 March 2020

Don’t Panic!

Good advice from the "Hitch-hikers Guide to the Galaxy" - but it is looking quite scary out there

Don't panic

Source: Shutterstock

Why not?

I suppose I should follow up a title of "Don't Panic" with some withering insight into why financial market conditions are not as bad as they appear to be. I'm not going to do that. But not panicking is usually good advice, so let's just leave that there and have a look at some market indicators. You can make your own mind up.

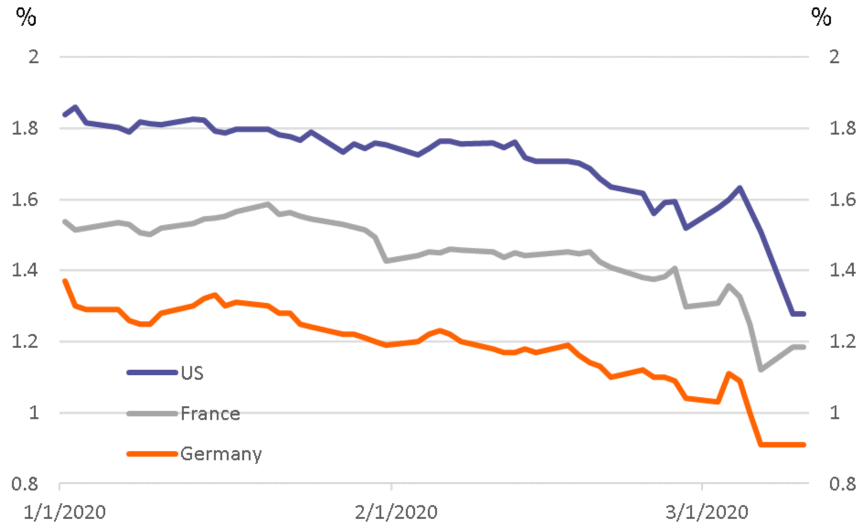
I'm going to focus on the inflation expectations series for Germany, France and the US. And I'm going to do this because "well-anchored inflation expectations" are the bastion of any definition of stability as far as most central banks are concerned. So if they are still well-anchored, and close to the medium-term targets of the central banks, then we can probably put any other market volatility down to short-term swings, and retain a broadly optimistic outlook.

So the first chart below is a short-term look at the 5Y 5Y-forward breakeven inflation rate for these three economies, and this can roughly be equated to what inflation rate the market thinks it will get on average over the medium term.

The chart below is a daily chart since the beginning of the year, and it has clearly been on a downward gradient since Jan 1 for all three economies. Not only that, but except for the US, which started 2020 only 20bp below 2%, both France and Germany have inflation expectations well below the ECB's 2% mandate. The last few days of plunging inflation expectations have merely given an extra leg down to all three series, but the arguments for additional central bank action were already fairly clear

Christine Lagarde looks like she will embark on some new support measures at tomorrow's meeting, but as she and other central bankers well know, fighting the coronavirus is not a job for monetary policy. All she is really doing is showing solidarity until much more concerted fiscal policy is unleashed.

5Y 5Y forward break-even inflation rate



Source: Bloomberg, ING

This isn't the first time

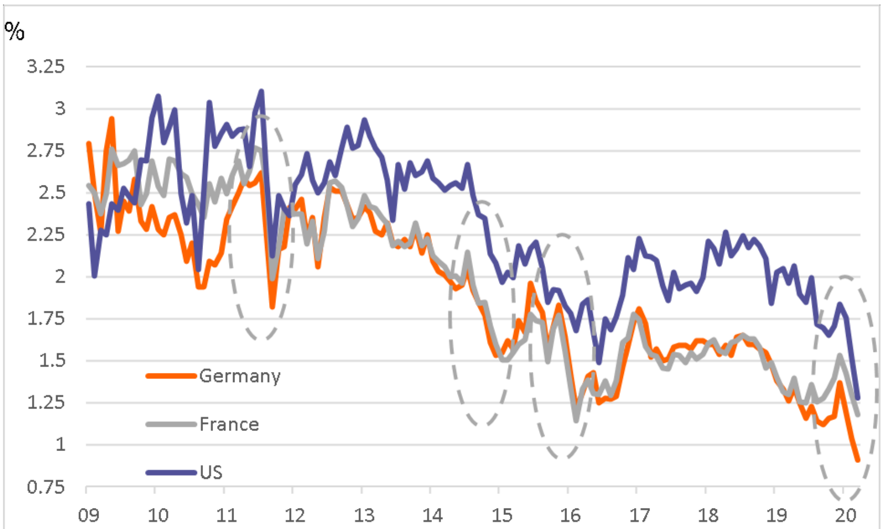
To put this drift away from stability into context, I've drawn the same chart, but this time, stretched out over the last decade or so. I've also drawn an ellipse around some of the comparable downward lurches in these break-even rates over that period.

Some of those episodes at the beginning of the series encompass elements of the global financial crisis, and between 2010 and 2012, the European sovereign debt crisis. The end of 2014 running into 2015 might reflect the collapse in oil prices back then, though this is probably the only other occasion where oil prices may have contributed to the downshift.

However, what is equally obvious from this longer-run chart, is that these inflation expectations measures have been on a downward trajectory for the entire period. Having started the post GFC period centred around a breakeven level of 2.5%, neither country now even manages 1.5%, and Germany is clearly sub-1%.

So not only are inflation expectations not well anchored, they are well below target. We cannot expect central banks, even those with apparently no clear ammunition left, to do nothing.

5Y 5Y-forward break-even inflation rate



Source: Bloomberg, ING

What's coming next may be new

I'm not going to go into detail of what the ECB and Fed might or should do next as that isn't my job. And I've been accused by some colleagues of unjustly describing the Bank of Japan as being "out of ammunition". I stand by that opinion and feel it is reinforced on each occasion that BoJ Governor Kuroda says that he stands ready to act without hesitation, without anything new being announced. It reminds me a little of the Monty Python sketch where new recruits are being trained to defend themselves in the event that they are attacked by someone wielding a price of fruit. Sure, there are "loads" of things the Bank of Japan could do. But having cut rates to negative, targeted zero yields on government bonds, bought government bonds outright, and then when none of that worked, bought ETF's, I think that merely coming up with some new form of providing liquidity to the banking system or industry directly might readily be dismissed as yet another attack on "deflation" with an over-ripe banana.

That said, and this is not the first time I've said this, measures which provide cash flow support during the ongoing Covid-19 crisis ought to be viewed as eminently sensible and worth substantial government backing. It is not clear whether this sort of bridging-finance and financial forbearance amount to fiscal or monetary policy. It doesn't really matter except that if governments are finally getting behind their central banks, it is an important step in the right direction. For too long, Central Banks have been fighting a rear-guard action with few if any useful tools, and little or no help from their governments.

Today, the Abe government has come up with some more support measures in the face of their own Covid-19 problems. It includes the following fiscal measures:

- JPY48.6bn to stop the further spread of the virus.
- JPY246.3bn to support fallout from school closures
- JPY119.2bn to support businesses and employment
- JPY16.8bn Emergency contingency

plus some financing measures

- JPY606bn safety net lending
- JPY 543bn special loans relating to the coronavirus
- JPY204bn financing support for large and medium firms from the Development Bank of Japan and others
- JPY250bn: FInancing support for supply chains from the Japan Bank for International Cooperation.

All this sounds good news, but it turns out to be fine-tuning from the JPY500bn funds already earmarked in last year's budget plus some existing contingency funds. This is a start, and it is a lesson for other countries. But it is unlikely to be enough.

A final thought on Covid-19

I'll finish today with a chart of Covid-19 confirmed cases and average capital city temperatures. I sent this out as a Tweet a few days ago, and I've updated the numbers.

The countries chosen are those that had at least one case of Covid-19 confirmed as of February 1. There were 23 countries with at least one case back then. Iran was not one of them. Incidentally, Tehran at this time of year is quite cool, averaging a high of around 11.1 degrees Celcius in February. The temperature shown for each country is the average "high" temperature for the capital city in February. I've also left out the big hotspots, China, South Korea, Italy etc as they dominate the chart. None of those capital cities averages above 12 C in February. I know that for some big geographies, the capital city is not necessarily representative of the national climate, or where the outbreak is centred. But it is a fixed "rule" I've followed, and you can't accuse me of cherry-picking cities to match the data.

The countries are arranged on the X-axis in order of their average February temperature.

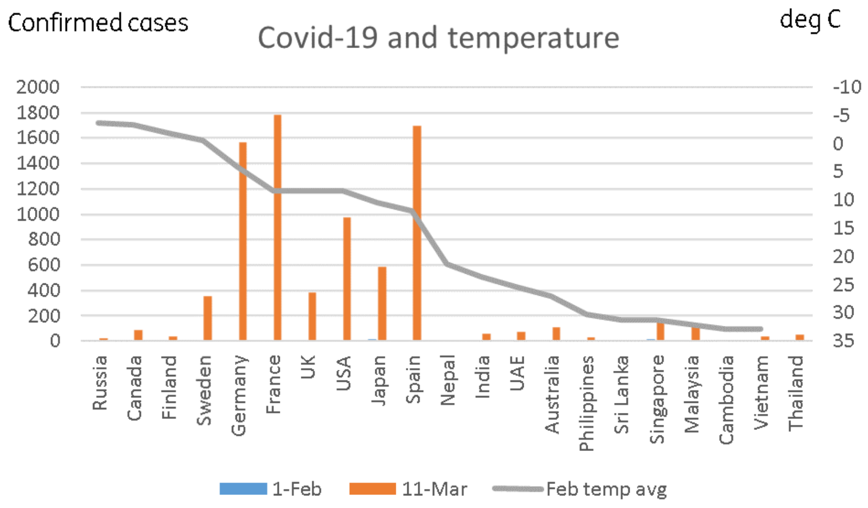
I won't attempt to suggest any theory here. Once again, I'll leave you to make your own minds up. The motivation, though, was the scepticism of some that temperature may be a factor in the spread of the disease. This is especially because early on in this virus crisis, Singapore was frequently mentioned as the example to disprove the warm-weather optimism expressed by some, including the US President.

I will, however, mention that Singapore, where I live, has slipped down the global table to about 16th place. It is always hot here. Though it is also always very humid and not always sunny (ultra-violet also suggested as anti-viral - another potential source of investigation). It was also a very popular destination for tourists from Wuhan, at least compared to most, if not all of the current "hot" zones. So it has been quite thoroughly "tested", compared to some other countries that now have more confirmed cases.

There are outliers. Russia, Canada and Finland, and I have had a number of twitter suggestions/criticisms on Twitter as to why this is so. But here is one other one: "Gloves". Think about it.

Keep watching the numbers for these countries, since if they start to accelerate, then this chart will look a lot more compelling. And if you want, you can also follow some of my twitter rants. @RobCarnell1

Covid-19 cases and average capital city temperature (February-high)



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