GENERALI INVESTMENTS

Focal Point

Vaccines to trigger uneven recoveries from Covid

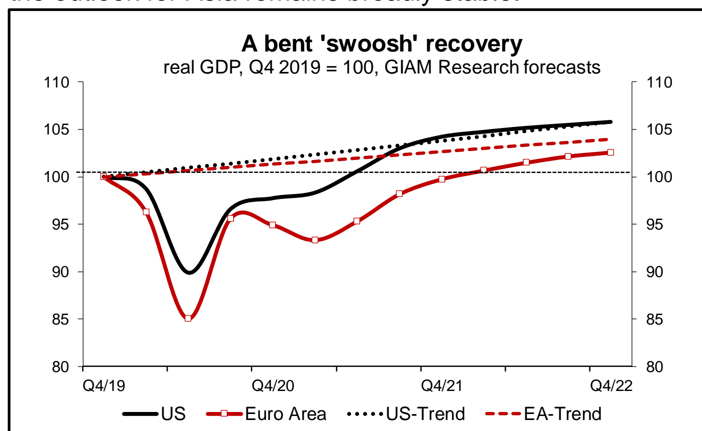
February 5, 2021

Christoph Siepmann, Martin Wolburg and Paolo Zanghieri

- Global activity is set to rebound this year amid progressing vaccination and a reopening of economies in spring/summer. Yet with the arrival of more aggressive Covid-19 mutations, bottlenecks in the vaccine supply and the health systems under stress, lockdowns especially in Europe may last longer than previously assumed, postponing the recovery.
- Especially the euro area is hit hard. Amid additional and prolonged restrictions and a delayed achievement of herd immunity, we lower our base 2021 GDP growth projection from 5.3% to 4.0%.
- In contrast, speedier vaccination and the prospects of another substantial fiscal stimulus make us raise our growth expectations for the US from 5.5% to 6.1%. We reaffirm our 7.8% growth forecast for China.
- Monetary policy will remain accommodative, but barring a severe deterioration of the pandemic, we do not expect another material easing.

The Covid-19 pandemic keeps its tight grip on economic activity. After the arrival of vaccines in late 2020 had sparked increased optimism about the speed of the recovery, latest news has somewhat soured the mood. One reason is the combination of much more infectious virus mutations warranting even longer lasting and possibly more stringent lockdown measures. Also, supply problems are hindering the rollout of vaccination thereby amplifying the need for lockdown measures.

We remain confident that the silver line at the horizon will become brighter. But we must acknowledge that the recovery path has become much more uncertain. Also, the economic outlook became significantly more heterogenous among the major regions. The euro area is clearly the weakest spot with downside revisions inevitable while the US growth dynamics improved as of late, also due to an expected big fiscal package. Thanks to sound Chinese activity the outlook for Asia remains broadly stable.



When will the pandemic be overcome?

Obviously, the pandemic will still be with us throughout 2021 and eliminating Covid-19 fully will be a long-lasting task. That said, economic activity will be substantially boosted once lockdown measures are lifted. Three factors will guide the change of stringency measures: First, the progress with vaccinating people. We see a first critical threshold when highly vulnerable (65+ years) and key medical people will have become vaccinated. This group covers about 20% to 25% of the population across EU countries but accounts for nearly 70% of casualties. The next milestone for the easing of lockdown measures is the achievement of herd immunity – according to experts reached when 2/3 to 3/4 are vaccinated – so that the pandemic loses momentum. Second, it is decisive whether people stick to social distancing. Finally, the evolution of the virus via mutations and the question whether it might become even more infectious and resistant to vaccines is of importance.

We base our analysis on an overall constructive view about vaccination. It will proceed faster in the US than in the euro area, basically because in the former the government managed to secure sufficient supply of vaccines to proceed fast. As a result, we foresee the US to achieve herd immunity already by mid-August but in the euro area only by about October. This – together with a bold fiscal stimulus and less stringency measures than in the euro area – will contribute to US growth outperformance.

For these reasons we also expect the US to outperform the euro area in case of adverse pandemic scenarios. With the arrival of the British variant (alongside South African and Brazilian ones) our base case could prove too optimistic

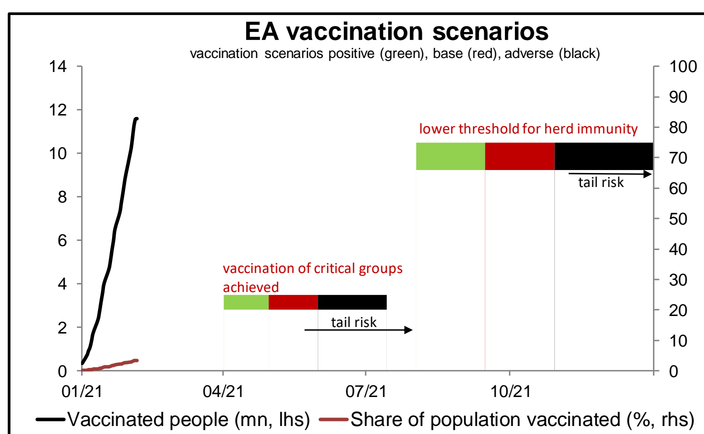
making the case for stronger stringency measures than in the base case. In a worst-case scenario, ongoing and fast mutations might even make the achievement of herd immunity impossible, at least throughout 2021, so that stringency measures will rather have to stay at least around the current elevated levels and will not be loosened over the course of the year. That said, a combination of a favourable pandemic development amid increased supply of vaccines could also give rise to an upside scenario. But on balance, we see the pandemic risks tilted on the downside.

Key pandemic scenarios for the US and the EA

		Critical groups vaccinated	Herd immunity (65% to 75%)	GDP growth, % 2020	2021 fc	2022 fc
US	Upside	End-February	End-July	-6.8	7.1	3.8
	Base	End-March	Mid-August		6.1	4.1
	Adverse	Mid-June	October		4.3	5.2
	Tail risk	Autumn	Mid 2022		2.4	3.2
Euro area	Upside	April	Aug- mid-Sep	-3.5	6.1	5.2
	Base	May	Mid-Sep - Oct		4.0	5.3
	Adverse	June - mid-July	Nov/Dec		1.7	5.3
	Tail risk	> July or not	Not in 21		0.2	3.6

EA: Vaccination trouble and virus mutations

Following a strong rebound of activity after the easing of the spring 2020 lockdown measures in the euro area, GDP grew by 12.4% qoq in Q3/2020, but the recovery took a hit in the final quarter of last year with GDP down by -0.7% qoq. The second Covid-19 wave forced the region into renewed lockdowns. The arrival of much more infectious variants led to an increase of stringency measures to levels not far away from the April 2020 peak. It appears most likely to us that an elevated level of lockdown measures will have to be maintained in the first months of this year.



The outlook is further complicated by the bumpy start of vaccination. Currently only about 3% of the population have got one of the available vaccines. Supply problems faced by the vaccine producers and a poor logistical infrastructure in some countries make the further vaccination progress uncertain. Still we think that by May at least the most vulnerable persons in the EU will be vaccinated and that around October herd immunity could be achieved

The worsened pandemic situation does not bode well for economic activity. The January composite PMI at 47.8 as well as deteriorated expectations signal contraction in Q1/2021, implying a technical recession. Its way out will be cumbersome. The pandemic fallout is complemented by a turn of the fiscal impulse into negative (as measured by the structural balance from -4.8% in 2020 to -4.3% in 2021 according to the EC). The allotment of the Resilience and Recovery Facility funds will only start in H2 and there is a risk that some countries will fail to fully exhaust their potential support. Moreover, we see the risk that notwithstanding all the government support measures firms will have to exit the market (also giving rise to increasing NPLs and a worsening labour market). This risk aggravates as the pandemic lasts for about one year now.

That said, the easing of lockdown measures will trigger a strong rebound in activity. The ECB made clear that monetary policy will remain strongly supportive and in case of financial market woes it would frontload its PEPP purchases to maintain stable and not diverging financial conditions. Additional monetary policy action would only come into focus if downside risks were to materialize (e.g. PEPP extension). Moreover, after the savings rate had already increased to an elevated level of 17.4% in Q3/20 and likely rose even further in the latest lockdown, a pure normalisation (towards the long-term average of 13.2%) would be equivalent to a bold fiscal package. This could help to kick-start activity. All in all, we still look for a strong rebound in euro area activity 2021 but postponed it more towards the end of the second quarter. In the end the pandemic worsening led us to adjust our expected GDP epansion for 2021 to 4.0% (from 5.3% before).

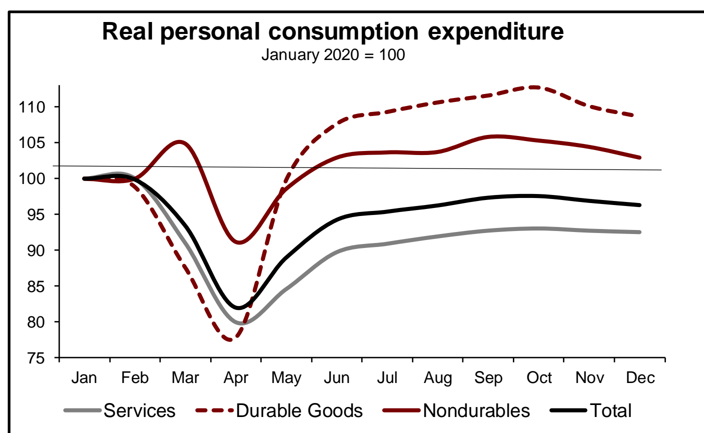
US: fiscal boost to push growth to 6%

The situation appears radically different in the US; we upgraded the growth forecast for 2021 to 6.1% with some upside risks. The first months of the year will be still impacted by the virus, but the economy will rebound strongly in the second quarter thanks to a likely another round of fiscal stimulus and the reopening of the economy as 60% of the population should be immunised by July. GDP will be back to the Q4 2019 level by mid- 2021.

On the fiscal front, we consider in our forecast a fiscal package worth around US$ 1tn, to be approved by February. The Biden administration aims at a much larger size (US$ 1.9tn) but it is constrained by the lack of the required 60 votes-strong majority in the Senate. Moreover, their majority in the Senate is just one vote, so a small group of centrist Democratic senators, which are not in favour of a very large increase in expenditure, will have a big say on the size and composition of the fiscal package. The Republican minority in the Senate has proposed a US$ 600bn package, which falls short in areas like unemployment benefits, income support to households and state governments, to which the Democrats are keen to devote substantial resources. As al likely alternative to a bipartisan effort the Democrats will thus likely resort to the so-called reconciliation process, which allows to pass deficit-increasing measures with a simple majority, but with strong constraints on the duration of the measure and the level of discretion allowed to the Treasury.

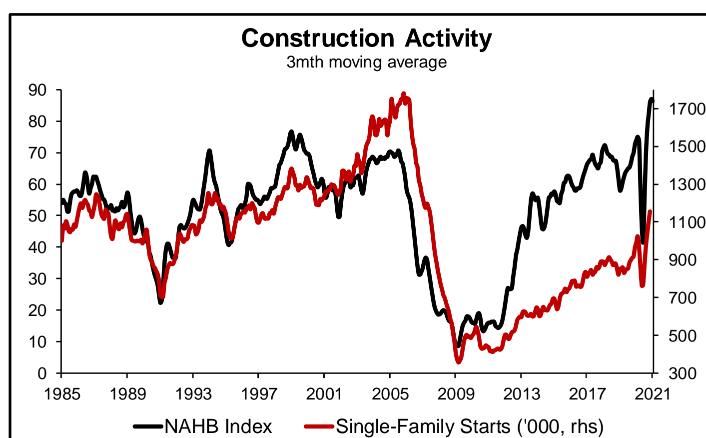
Nevertheless, the support to household income will be substantial and will start flowing in when a large part of services activity will be allowed to reopen, if vaccination progresses at the current speed. Currently almost 10% of the population already received vaccination and unlike to the euro area there are no supply shortages limiting future vaccination. The widespread income support measures since the inception of the pandemic and the closure of a large part of

services providers have left households with an unprecedented level of savings (13.7% of disposable income in December, against a 7.3% average for the 2010-2019 period). If mass vaccination allows for the full reopening of contact-based activities and restores confidence, services consumption (around one half of GDP) would quickly return to the pre-crisis level in Q2, with a possibly sizeable short-term overshooting due to pent up demand.



The bounce back of services will add to solid growth in the rest of the economy. Record low interest rates and income support measures boosted demand in the sectors less affected by restriction. As a result, durables consumption spiked above pre crisis levels and construction activity exceeded, by some measures like the NAHB sentiment index, the 2006 peak.

Of course, such a rosy scenario is not immune from pandemic risks we outlined before. We see the risks in case of the US concentrated in the first part of the year. Moreover, if demand for restaurant and hotel services were to remain structurally lower in the post-lockdown environment, employment prospects for this part of the labour force, normally less skilled than the average, would deteriorate dampening the growth dynamics. On the upside, the fiscal stimulus could turn out to be stronger than expected. On balance, we see upside risks dominating.



Asia: Growth recovery driven by China

Asian countries responded to the Covid-19 challenge with very diverse strategies. China, which witnessed the first major outbreak in Wuhan in early 2020, embarked on very stringent quarantine measures, lockdowns and travel restrictions amid mass testing as soon as tests were available. The strategy proved successful, providing the basis for a V-shaped recovery of the economy. The rebound was spearheaded on the production side while consumption still undergoes some delays, proving more sensitive to infection worries and income shortfalls.

Recently, China witnessed a rise in fresh Covid-19 cases. While their absolute level remained low (about 100-150 per day), Chinese authorities responded forcefully again, quarantining at least 11 regions with about 29m people and discouraging Chinese New Year travelling. Thus, China has still a good chance to contain the outbreak. Assuming this proves successful, China's recovery is set to continue in our base case. We expect limited headwinds for domestic services (given increasing lockdowns and infection worries) but also from international demand. The latest PMIs seem to confirm some milder growth dynamics. Moreover, monetary and fiscal policy support will be cautiously scaled back. Although China has developed own vaccines which are already distributed, the country (given the country's strict response to fresh Covid-19 outbreaks) seems the least dependent on these efforts. All in, we expect a healthy growth rate of 7.8% in 2021, after 2.3% in 2020.

By contrast, India is second in the world with the total number of infections (after the US). Lockdown measures in Q2 2020 proved ineffective. Fresh infections peaked in September at just below 100K cases per day and continued to slide to below 20K of late. In addition, India started a large vaccination programme. Both reasons let us expect a solid recovery in 2021 supported by a more targeted fiscal budget.

Conclusions: Recovery still ahead

The second Covid-19 wave amid virus mutations has increased the pandemic related uncertainties again. That said, the appearance of effective vaccines has substantially brightened the economic outlook. Over the course of the year more and more vaccines will become available. Currently, however, vaccination in the euro area suffers from supply problems. This is not the case in the US and China and a key reason why they are set to grow in 2021 by 6.1% and 7.8% respectively, thereby clearly outpacing the euro area growth of just 4.0%.

We see the pandemic risks on balance tilted to the downside and critically related to the vaccination progress. But even if they were to materialize, we would still expect the US to grow more strongly than the euro area.

We expect the US to reach its pre-pandemic output level by mid-2021 but the euro area only by year-end 2021. For the Fed as well as the ECB we do not look for a change in course even if an upside scenario were to materialize. Policy action only seems likely in case of downside risks becoming reality. Therefore, financial markets will be supported by the combination of an ongoing highly favourable monetary policy stance and the emergence of the post-lockdown recovery.

Imprint

Issued by: **Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Research Department**

Head of Research: Vincent Chaigneau (vincent.chaigneau@generali-invest.com)

Head of Macro & Market Research: Dr. Thomas Hempell, CFA (thomas.hempell@generali-invest.com)

Team:
Elisabeth Assmuth (elisabeth.assmuth@generali-invest.com)
Elisa Belgacem (elisa.belgacem@generali-invest.com)
Radomír Jáč (radomir.jac@generali.com)
Jakub Krátký (jakub.kratky@generali.com)
Michele Morganti (michele.morganti@generali-invest.com)
Vladimir Oleinikov, CFA (vladimir.oleinikov@generali-invest.com)
Dr. Martin Pohl (martin.pohl@generali.com)
Dr. Thorsten Runde (thorsten.runde@generali-invest.com)
Dr. Christoph Siepmann (christoph.siepmann@generali-invest.com)
Dr. Florian Späte, CIIA (florian.spaete@generali-invest.com)
Guillaume Tresca (guillaume.tresca@generali-invest.com)
Dr. Martin Wolburg, CIIA (martin.wolburg@generali-invest.com)
Paolo Zanghieri, PhD (paolo.zanghieri@generali.com)

Head of Insurance and AM Research: Michele Morganti (michele.morganti@generali-invest.com)

Team:
Raffaella Bagata (raffaella.bagata@generali.com)
Alberto Cybo-Ottone, PhD (alberto.cybo@generali.com)
Mattia Mammarella (mattia.mammarella@generali-invest.com)
Roberto Menegato (roberto.menegato@generali.com)
Giovanni Millo, PhD (giovanni.millo@generali.com)
Antonio Salera, PhD (antonio.salera@generali.com)
Cristiana Settimo (cristiana.settimo@generali.com)
Federica Tartara, CFA (federica.tartara@generali.com)

Sources for charts and tables: Refinitiv/Datastream, Bloomberg, own calculations
Version completed: see front page

In Italy:
Generali Insurance Asset Management
S.p.A Società di gestione del risparmio

Piazza Tre Torri
20145 Milano MI, Italy

Piazza Duca degli Abruzzi, 1
34132 Trieste TS, Italy

In France:
Generali Insurance Asset Management
S.p.A Società di gestione del risparmio

2, Rue Pillet-Will
75009 Paris Cedex 09, France

In Germany:
Generali Insurance Asset Management
S.p.A. Società di gestione del risparmio

Tunisstraße 19-23
50667 Cologne, Germany

www.generali-investments.com

This document is based on information and opinions which Generali Insurance Asset Management S.p.A. Società di gestione del risparmio considers as reliable. However, no representation or warranty, expressed or implied, is made that such information or opinions are accurate or complete. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio periodically updating the contents of this document, relieves itself from any responsibility concerning mistakes or omissions and shall not be considered responsible in case of possible changes or losses related to the improper use of the information herein provided. Opinions expressed in this document represent only the judgment of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio and may be subject to any change without notification. They do not constitute an evaluation of any strategy or any investment in financial instruments. This document does not constitute an offer, solicitation or recommendation to buy or to sell financial instruments. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio is not liable for any investment decision based on this document. Generali Investments may have taken, and may in the future take, investment decisions for the portfolios it manages which are contrary to the views expressed herein. Any reproduction, total or partial, of this document is prohibited without prior consent of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio. Certain information in this publication has been obtained from sources outside of the Generali Group. While such information is believed to be reliable for the purposes used herein, no representations are made as to the accuracy or completeness thereof. Generali Investments is part of the Generali Group which was established in 1831 in Trieste as Assicurazioni Generali Austro-Italiche. Generali Investments is a commercial brand of Generali Investments Partners S.p.A. Società di gestione del risparmio, Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Generali Investments Luxembourg S.A. and Generali Investments Holding S.p.A..