Economic and Investment Research

Macro Views
March 2021

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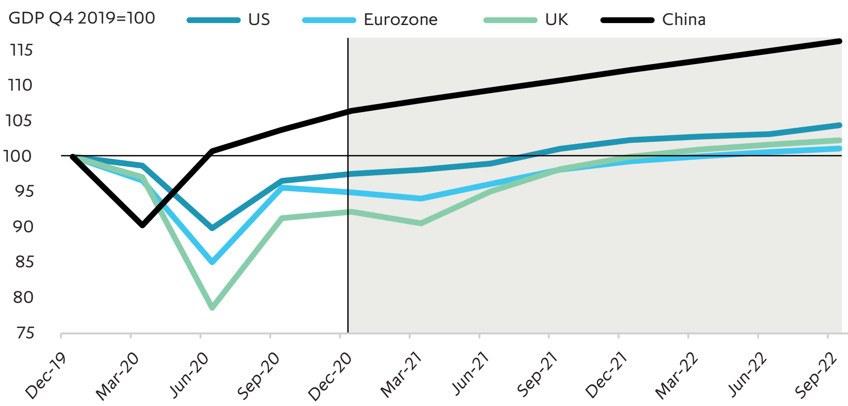
Covid-19 impact assessment update:
A fast-track recovery

Key Points

- **Economic conditions should improve rapidly in Europe and the US in the coming months**, after a bleak winter of surging Covid-19 cases and renewed lockdowns. Most major economies to recover to 2019 levels by end of 2021.
- **Most vulnerable groups in Europe and the US will be immunized** by the end of Q1 and over 50% of populations by end Q2 on current roll-out schedules.
- **Private consumption to rebound strongly in 2H 2021 -** particularly in the hardest hit services sectors (other than international travel) - as a relaxation of containment measures and the build-up of large savings during lockdowns combine to drive a surge in consumer spending.
- **Highly supportive monetary and fiscal policy to add strength to recovery**. Central banks will keep interest rates low as still-large output gaps keep structural inflation at bay. Massive US and Europe fiscal packages will add further momentum to the recovery. Higher inflation and core govt bond yields are likely, but increases should be moderate and manageable.
- **Asia will continue to be a strong performer** as virus control and monitoring programs keep contagion and deaths at low levels, allowing domestic economies to normalise. Tourism-heavy economies, however, will lag.
- **A positive environment for private markets and credit**. A strong rebound in growth should boost EBITDA and improve credit fundamentals across the rating spectrum. As government programs roll-off and sectors consolidate, private market deal flow will likely accelerate. A continued search for yield and hedges against inflation and interest rate risk should support demand for real assets and floating rate loans.
- **The biggest risk to the outlook in our view is a sustained renewed tightening of containment measures** on a large-scale resurgence of Covid-19 cases. Until large portions of populations are vaccinated this remains a risk - particularly in Europe where cases have started to rise again and vaccinations are lagging. Structural inflation (and its impact on rates) is also a risk, though we think persistent capacity shortfalls are unlikely any time soon.

Nicholas Brooks
Head of Economic and Investment Research

A fast-track recovery



Source: Bloomberg private sector consensus forecasts

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Overview: A fast-track recovery

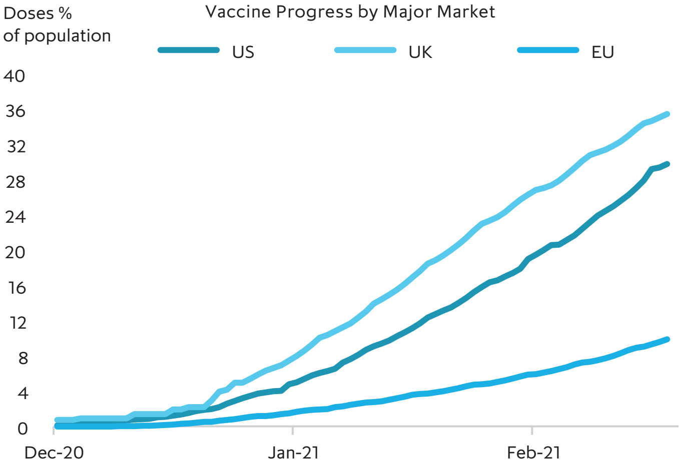
Over the autumn and winter months the US and Europe saw a surge in new Covid-19 cases, forcing governments to reimpose strict social distancing and travel controls. Although new cases have dropped significantly from peak levels in most countries, variant-driven rebounds in new cases may force governments to periodically re-tighten controls. Despite potential short-term set-backs, at a broad level, we expect conditions to improve substantially as we advance into 2021. Covid-19 vaccine roll-out programs are well underway and – after initial teething problems – are now gaining momentum.

In most of Europe and the US, on current roll-out schedules, the most vulnerable groups will have been immunized by the end of Q1 and over 50% of populations by the end of Q2. Assuming new Covid-19 variants are kept in check by existing vaccines and boosters currently under development, the release of large stores of pent-up savings should drive a powerful rebound in private consumption in the latter part of 2021. Growth will be further boosted by continued highly accommodative monetary and fiscal policy. Therefore, following what was a very difficult winter, we think a spring revival and powerful consumption-led recovery in the second half of the year will bring economic activity in major developed economies back to pre-Covid levels by the end of 2021.

Vaccines to the rescue

The remarkable speed at which scientists developed effective Covid-19 vaccines and governments are now rolling them out has put the global economy on a fast track to recovery. On current schedules in the US, Europe and UK at least 50% of populations are expected to have received vaccines by mid-year and most of the adult population that want one should be vaccinated by mid-year in the US and UK and early to late summer in Europe. This should allow governments to progressively relax restrictions in the spring and accelerate the easing of social distancing requirements through the summer, with powerful positive implications for economic and corporate earnings growth.

Rapid vaccine roll-out in major developed markets

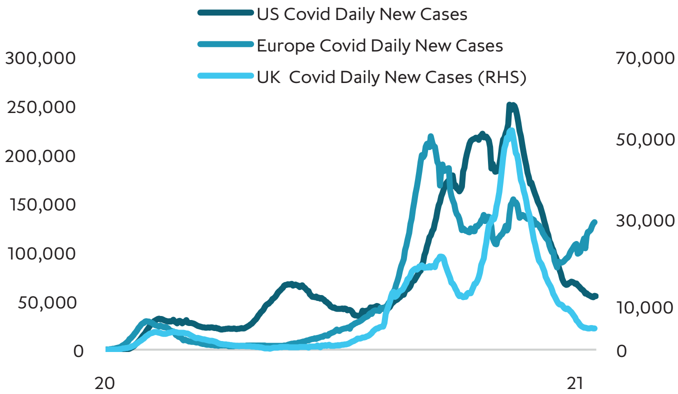


Source: Bloomberg

One important caveat to the positive outlook is that that until most of the world has been vaccinated or has developed herd immunity through infection, a return to full pre-Covid normality is unlikely. On current estimates this may not occur until 2023 or later. This means that some restrictions on international travel (such as travel passports, travel corridors and country-specific quarantines) may remain in place and some social distancing rules may periodically need to be re-imposed in certain jurisdictions and settings. Boosters and new vaccines that cover a wider range of virus strains will likely need to be developed and rolled-out periodically. In the near-term Europe appears most at risk, as cases have started to rise again and vaccination programs continue to lag, forcing some countries to have to reimpose temporary containment measures.

Therefore, while daily life is likely to move back much closer to normality in the coming months, Covid-19 and the adjustments necessary to manage it will likely be with us for some time.

Covid-19 new cases down from winter highs



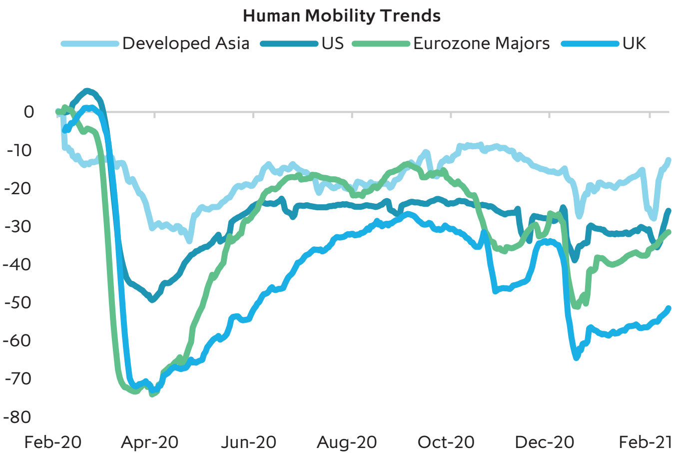
Source: Bloomberg

Mobility to rise sharply in the coming months

Google mobility data provides one of the better high frequency indications of where economic activity stands at any one time. As the chart below shows, activity in most European economies and the US screeched to a halt in Q2 2020 when the first strict set of containment measures were put in place to slow the spread of the Covid-19. It is interesting to note that lockdowns this past winter have had a far less pronounced impact on mobility (and economic activity) than during previous lockdowns. This reflects more focused restrictions by governments, companies learning how to better operate under government restrictions, and reduced adherence to government rules as "lockdown fatigue" takes its toll.

This indicates that while Q1 2021 GDP growth in most countries will be weak (likely falling into negative territory for many European countries and the UK), the slowdown has been much more moderate than Q2 2020. This should help reduce scarring and provide a higher base to grow from as activity and economic growth rebound in Q2 2021 and beyond.

Human mobility starting to trend higher in most countries

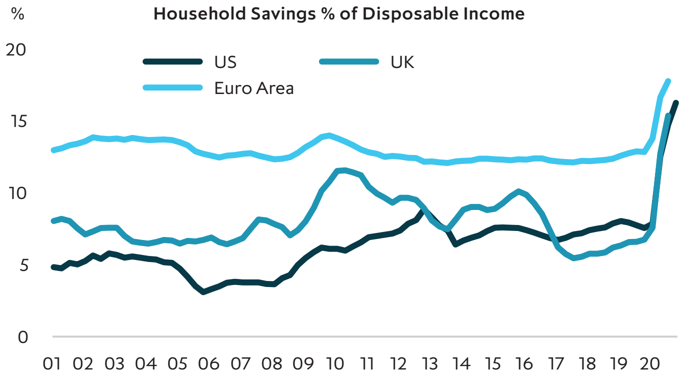


Source: Google mobility data. Average of retail, transit and workplace. Deviation from baseline

Release of pent-up savings to turbo-charge recovery

Over the lockdowns in 2020, savings rates in most developed economies surged to record levels as a larger than usual portion of earnings of those employed or supported by government programs was not spent due restrictions on social activities. On some estimates US household savings have increased by as much as $1.7tr above trend during the pandemic. As restrictions are eased in the coming months it is likely that these savings will start to be released, adding to the power of the recovery in the second half of the year.

Household saving have soared to record levels

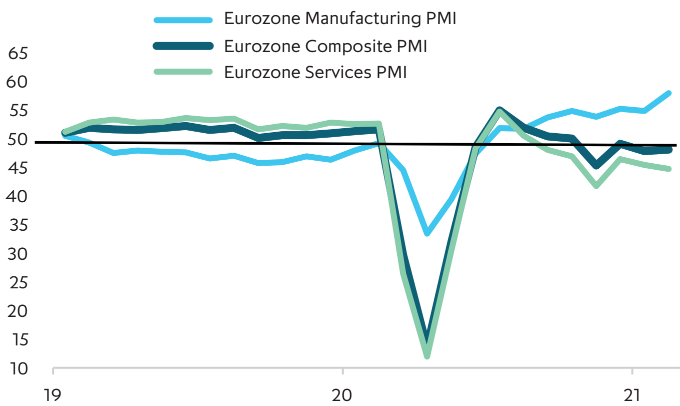


Source: Bloomberg, 4QMA

Sector performance: a shift ahead

At a sector level, manufacturing continued to expand at a decent pace in most countries through the winter lockdowns. The performance of services sectors, however, varied widely with most of Europe and the UK experiencing services sector contractions while the US and most of Asia continued to see broad expansion. Similar to the first wave of the pandemic, within the services sector there has been substantial performance dispersion, with physical retail, travel, restaurants, leisure, entertainment and the arts suffering, while many tech, healthcare, logistics and finance related services businesses have thrived.

Manufacturing has held up well relative to services



Source: Bloomberg. Above 50 indicates expansion, below 50 contraction

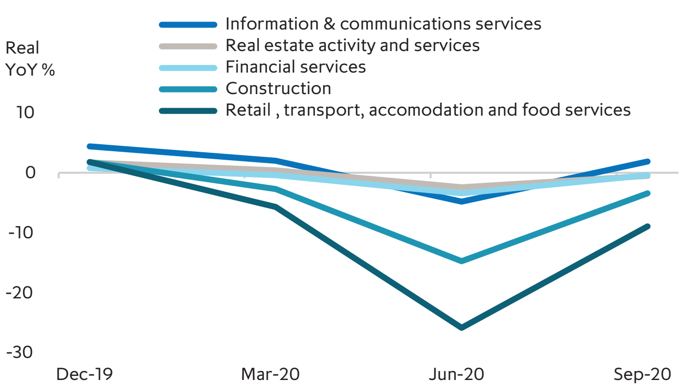
Going forward, as containment measures ease and people feel safer, it is likely that relative sector and country performance will shift in 2021.

While most companies will benefit from easing, those that have been hardest hit by the pandemic such as restaurants, retail, leisure and the arts are likely to see the largest relative rebounds in activity as pent up demand is released.

In the early stages of the recovery, however, international travel and tourism is not likely to benefit to the same degree as other damaged sectors as concerns about imported Covid-19 mutations are likely to cause many countries to maintain varying degrees of restrictions on inward travel.

Ultimately, over time, as global herd immunity grows, travel restrictions will likely ease these sectors will rebound too. The strength of countries respective economic rebounds will be affected not just by support programs and success in controlling Covid-19, but also relative sector weights of travel, tourism and other affected services industries in their economies.

Wide performance dispersion in the services sector

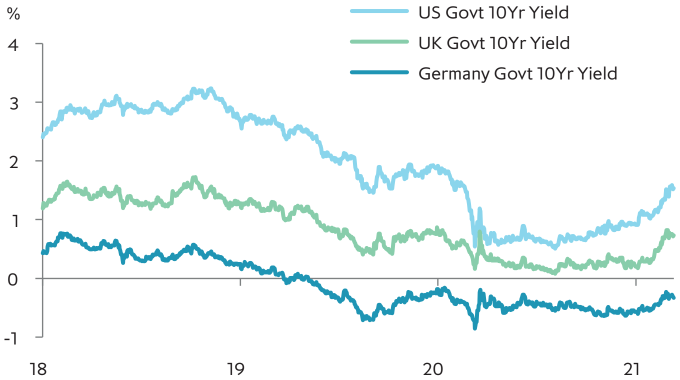


Source: Bloomberg

Inflation and yield rise: temporary or structural?

A sharp rise in core government bond yields in late February caused a broad market sell off as investors worried that higher yields might short-circuit the recovery and reduce the attractiveness of risk assets.

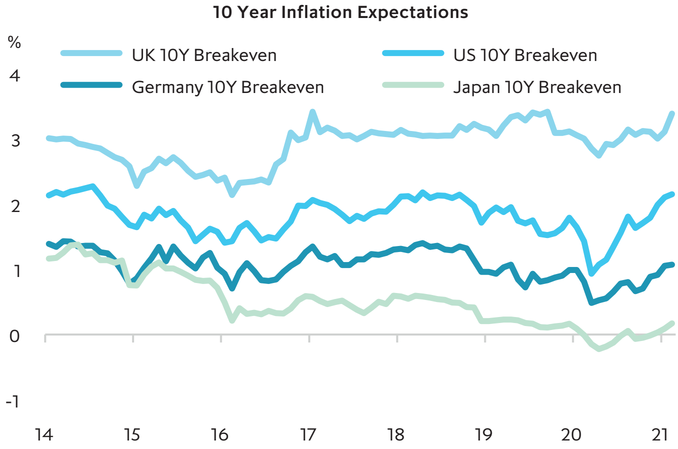
Recent sharp rise in govt bond yields spooked markets



Source: Bloomberg

While most of the increase in government bond yields from early 2020 lows has been driven by rising inflation expectations (as measured by break-evens), the most recent spike higher was driven by higher real yields (as measured by inflation protected government bonds) as investors brought forward the expected date of central bank rate hikes.

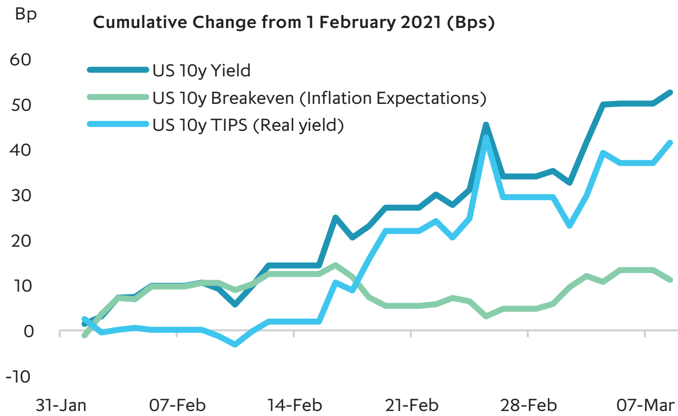
Until recently, yield rise driven by rising inflation expectations



Source: Bloomberg

In our view, a gradual rise in government yields based on increasing confidence in the strength in economic recovery shouldn't be a concern for markets. Historically risk assets and core government bond yields have tended to rise together during the recovery phase of the economic cycle – as we saw through most of 2020.

But yield spike in Feb was driven by higher real yields

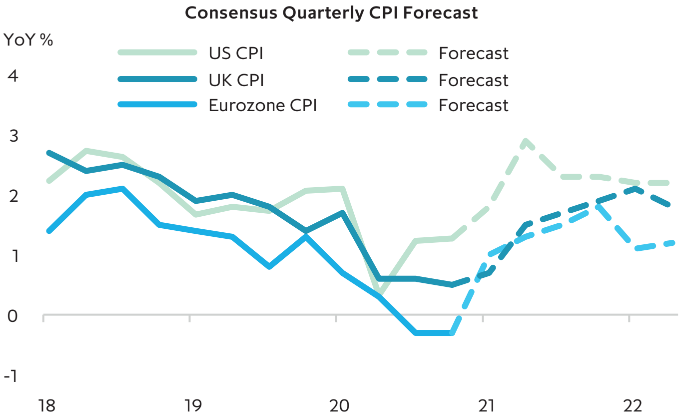


Source:Bloomberg

What would be more worrying is if inflation were to get out of hand, forcing central banks to raise their target rates earlier than underlying economic conditions merit. How likely is this?

There seems little question that consumer price inflation in 2021 will rise from the beaten down levels of 2020. The surge in energy and other commodity prices from 2020 lows will drive headline inflation higher, as will base effects and technical factors such as inflation basket re-weightings and the reversal of temporary VAT and other tax cuts put in place to help consumers and businesses during the pandemic. These expectations are largely factored in to most economists forecasts (see below) and presumably are now factored in by markets.

Consensus expects inflation to rebound in 2021

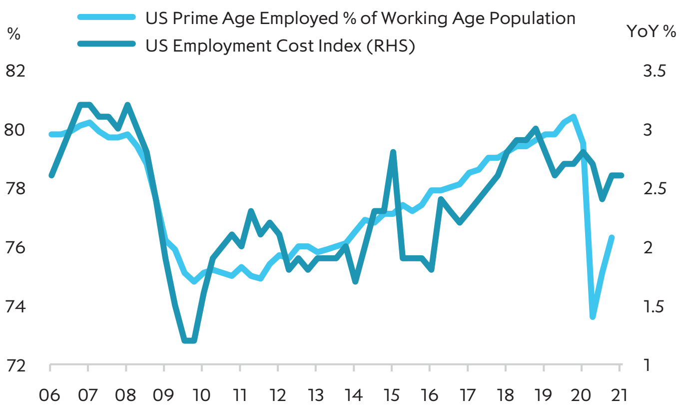


Source: Bloomberg

Therefore the real question that needs to be answered is whether inflation comes more strongly and persistently than currently anticipated and, if it does, whether central banks feel the need to act pre-emptively to nip it in the bud.

In our view, this is unlikely. Measures of output gaps, capacity utilisation and labour slack indicate that a persistent rise in inflation in most major developed economies is still some way off. Supply chain damage, capital stock reductions and restrictions on migration are likely to be short-term rather than longer-term phenomena in our view.

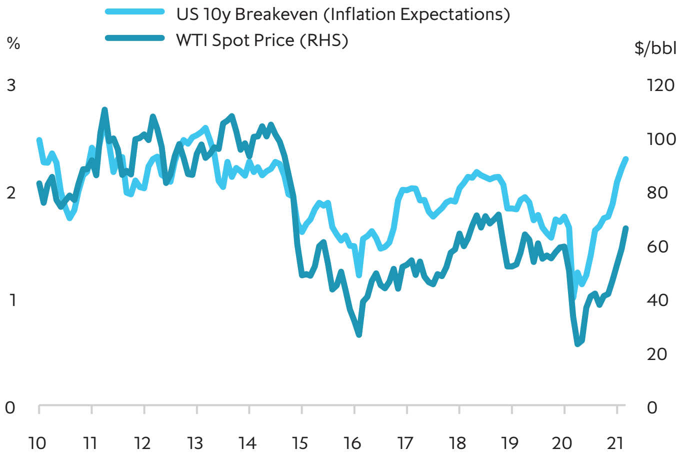
Still substantial labour slack



Source:Bloomberg

In most cases, we think private sector profit motives will likely prove stronger than nationalist "de-globalisation" tendencies. Aging populations, weakened unions, increasing automation, the continued rise of a global internet-based economy and the need to deleverage following pandemic-driven debt increases should keep structural inflation at bay in our view.

Higher energy prices a key driver of inflation expectations[1]



Source:Bloomberg

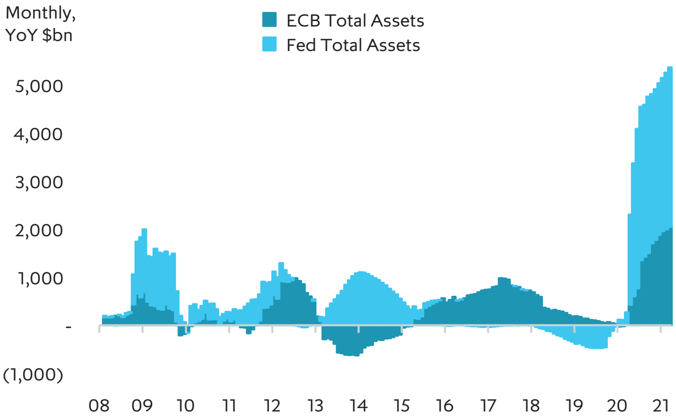
1 https://www.dallasfed.org/-/media/documents/research/papers/2020/wp2025.pdf

Even if inflation exceeds medium term targets, major central banks have made it clear they are willing to tolerate a period of above target inflation to let economies "run hot" to compensate for periods of below target inflation. This should anchor short rates for an extended period. Central banks have also made it clear they will intervene as necessary to keep longer-maturity bond yields from rising to levels perceived as putting economic recovery and/or financial stability at risk.

Longer term inflation and rate risks can't be ignored

While we remain in the low inflation, low rate camp, we recognise that this (generally consensus) view could be wrong. These are genuinely unprecedented times. The world is emerging from the most devastating pandemic in over a hundred years, governments have implemented stimulus programs on a scale not seen since World War II, and major central bank balance sheet expansion of this size has never been seen before. With household savings at record levels, the release of pent up demand later in 2021 and into 2022 is likely to be significant.

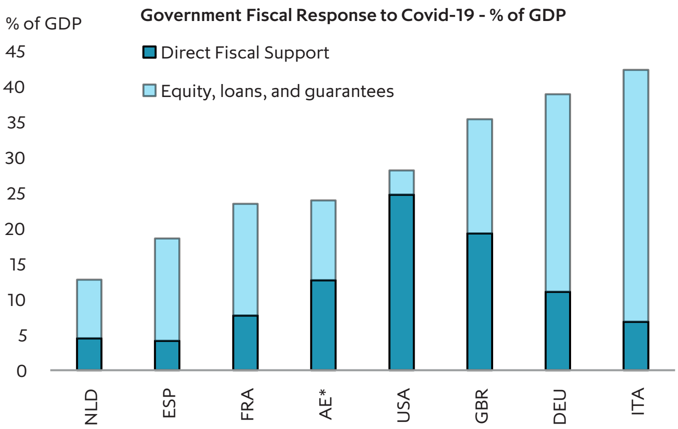
Central bank intervention dwarfs that of 2008/09 GFC



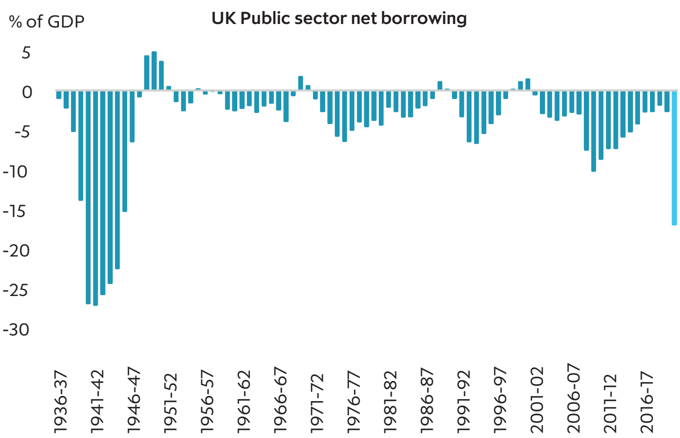
Source: Bloomberg

On the supply side, there is considerable uncertainty about how permanent the pandemic's impact has been on the global supply chains and international migration critical in keeping inflation at bay over the past 30 years. There are also questions about how long it will take for the hit to capital investment (and the supply it produces) to recover given the leverage overhang built up during the pandemic.

The largest fiscal expansions since World War II



Source: IMF Fiscal Monitor January 2021 update. *AE= advanced economies. Includes estimates from latest $1.9tr US fiscal package. Includes additional fiscal spending announced in UK Spring Budget 2021.



Source: ONS/HM Treasury
Note: UK public sector net borrowing. Borrowing shown as a negative number

Risk of letting the inflationary "cat" out of the bag

As highlighted by BoE chief economist Andy Haldane in his speech "Tiger by the Tail"[2] there is a danger that the combination of the above demand/supply factors, together with central bank complacency "allow the inflationary 'big cat' out of the bag".

If this were to occur, not only would inflation expectations increase, but real yields would also likely rise as investors anticipate earlier and more aggressive action by central banks, driving nominal yields across the maturity spectrum sharply yields higher. While this is not our base case, the uncertainty around the outlook is sufficient that we think prudent investors should look for ways to hedge against these risks.

2 https://www.bankofengland.co.uk/speech/2021/february/andy-haldane-recorded-mini-speech-on-inflation-outlook

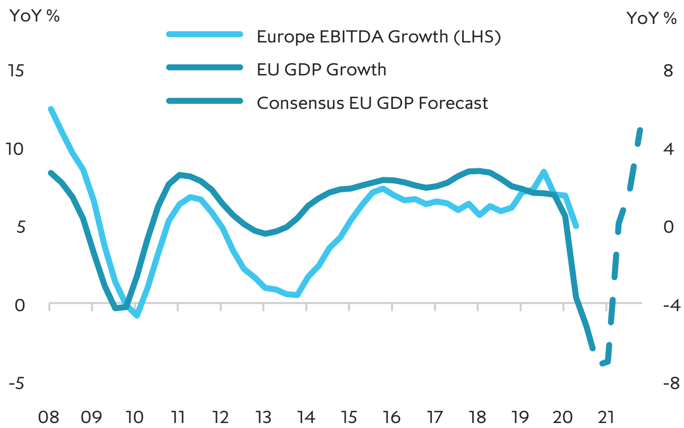
Investment implications

Bringing it all together, what does this mean for investors?

EBITDA and debt metrics to improve as recovery takes off

A strong recovery should help boost companies earnings, with those in the most beaten down sectors such as retail, restaurants, leisure and the arts seeing much-needed relief. On our base case scenario of continued low rates and a strong economic rebound, key debt measures such as leverage and interest coverage should improve and distress levels in the hardest hit sectors should fall.

As growth recovers so should company fundamentals



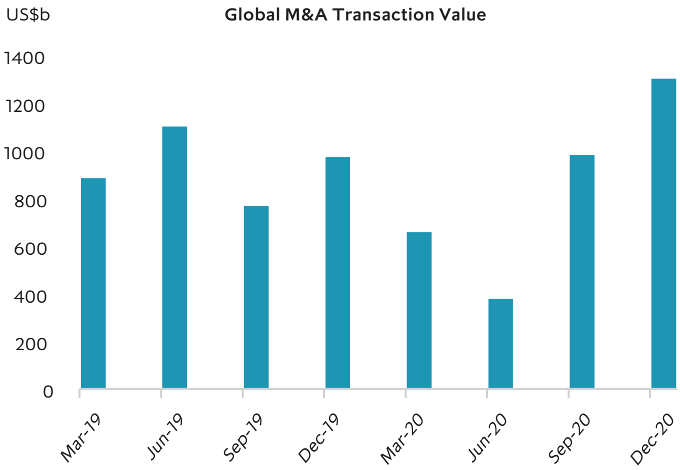
Source: Bloomberg, ICG Private Company Database

A busy year ahead for private markets as funding demand rises

However, companies will also soon have to contend with the tapering off of government support programs. This means that companies that have benefited from direct government payments, subsidies and easy to access guaranteed loans through banks will need to find other sources of financing. With banks – particularly the smaller to medium sized banks that tend to lend to mid-market companies – constrained by capital and other regulatory requirements, we think private markets will play an increasingly important role in funding the recovery.

Private market deal volumes will likely be further boosted by growing sector consolidation, as better managed companies with access to funding absorb those that don't. Given large stores of private equity and debt dry powder, private markets are in a strong position to support these companies.

Deal activity on the rise

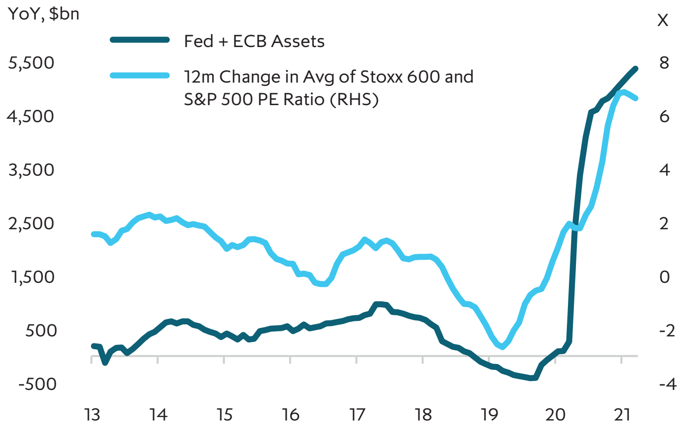


Source:Bloomberg

Central bank "put" to help underpin asset valuations

If our base case scenario of an extended period of low rates is correct, demand for yield will remain strong. While this doesn't preclude risk asset sell-offs and periods of asset price weakness, we think the central bank "put" will be with us for some time yet. Although major central banks may start to slow the pace of asset purchases as recovery broadens and deepens, a move to reduce balance sheets any time soon is unlikely. This should help underpin risk appetite and, together with continued low discount rates, provide structural support to asset valuations in our view.

Central bank expansion supportive of asset valuations



Source: Bloomberg

Higher inflation to support real assets

Although we don't expect runaway inflation, as recovery gains momentum inflation and bond yields are likely to rise. Real assets such as real estate, infrastructure equity and other assets backed by steady cash flows should perform well in this environment, as should floating rate loans.

2021 shaping up to be a positive year

Overall, we think 2021 is shaping up to be a positive year – for growth, for deal flow and for company fundamentals. As highlighted in this report there are still significant risks that could throw the positive trajectory off, with new Covid-19 variant induced lockdowns and inflation risks topping the list. However, on balance we think a strong consumer-led economic recovery in the second half of 2021 and into 2022, together with continued low interest rates and proactive central banks will provide a strong backdrop for investing.

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Intermediate Capital Group plc
Procession House,
55 Ludgate Hill,
London, EC4M 7JW
Tel. +44 20 3545 2000 icgam.com