Re-Open for Business?

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We have been noting for weeks that the key variable for the economy and markets is the length of the shutdowns. As a reminder, **every week of full-on closure effectively reduces annual GDP by roughly 0.7 percentage points**, and the longer they drag on, the bigger the risk of spillover damage. And this week brought **tentative signs of relief** on that front, with some European nations, and some states and provinces looking to begin easing up ever so slightly (even if the move looks premature in at least one case). Even those jurisdictions that have no intention of opening up soon are at least beginning to map out plans for lightening restrictions down the line. But with mixed news on caseloads, and no major news on treatments or vaccines, **patience remains the watchword.**

ECONOMIC RESEARCH
+1 (416) 359-6372
economics.bmo.com

Douglas Porter, CFA, Chief Economist
+1 (416) 359-4887
douglas.porter@bmo.com

It was a relatively light week for key economic data, but the few indicators on offer delivered clearer signals on the damage. Perhaps the most telling were PMIs from key European economies in April, with the services measure dropping to previously unimaginable levels. The Euro Area reported an 11.7 reading, while the U.K. clocked in at 12.3, and Japan was at 22.8. In the U.S., home sales fell 9% in March, while another 4.4 million Americans applied for jobless benefits last week, and the Markit services PMI fell to 27.0 in April. The key figure in Canada was the biggest monthly drop in seasonally adjusted CPI since at least 1992, slashing the inflation rate to 0.9% in March, with a test of zero coming for April.

Against this backdrop, it was a generally quiet week for financial markets, with one rather spectacular exception. Stocks and bond yields took a small step down, although the TSX was still fighting for its fifth weekly gain in succession. Even the mighty Nasdaq 100 slipped somewhat, although it remains up more than 10% from year-ago levels (versus an 11% y/y drop in the Dow). Currency markets have notably settled into calmer waters, with none of the majors seeing a big move, on net, this week.

Calm is not a word anyone would use for the oil market, with WTI futures temporarily going deeply negative amid a dire lack of physical storage capacity. While initially brushed off by many as a technical move as the May contract expired, the weakness then bled into June pricing as well, and Brent. While conditions eventually stabilized, at least in part thanks to sabre-rattling between the U.S. and Iran, prices still ended the week lower across the spectrum. For example, the WTI June contract finished at around $17 and Brent stood at $22, compared with $25 and $28 a week ago.

With oil prices down heavily, it seems a tad odd to be **raising the question of whether inflation may be a risk** when the pandemic is over. But that is one of the most common questions we are fielding these days; the second most popular is about the fiscal costs and whether they're manageable. These two issues are not unrelated, and both go back to the opening statement—it all depends on how long the shutdowns last and how much damage is done to the underlying economy. The longer it lasts, the greater the fiscal costs, and the more QE we are going to see from central banks, and ultimately the greater the risk of inflation flaring far down the road. Our **base line view is that low inflation is likely to be the end result** of the deep downturn and underlying forces that were in play prior to the pandemic, but we simply **cannot dismiss out of hand the tail risk of inflation**, especially amid the massive fiscal measures.

On the fiscal side, there was plenty of new activity this week on both sides of the border. In the U.S., Congress passed round four of stimulus, with a $484 billion package mostly aimed at supporting small businesses. This brings the running tally of measures up to nearly $2.9 trillion, or 13% of GDP. While the entire amount may not flow directly into a larger budget deficit, we could easily be looking at a $4 trillion shortfall this year (or over 18% of GDP) when combined with the pre-existing deficit. Meantime, Ottawa continues to roll out meaty steps, including $9 billion for students and details on rent relief for small and medium-sized businesses. It's a challenge to tote up the dollar costs of all the Canadian measures, especially since the take-up on the wage subsidy program is in question, but it certainly looks like the net new cost is headed above 10% of GDP here as well (on top of an initial deficit of 1% of the economy).

As we have asserted before, while these jaw-dropping deficit figures can be unnerving, the interest costs of the big shortfalls are manageable… to a degree. With 10-year GoCs still around 0.6%, the net new interest costs of an added $200 billion deficit would be $1.2 billion per year. And, the reality is that the Bank of Canada is busily buying $5 billion a week ($260 billion per year), so the extra interest cost flows through to the BoC. **The issues are: how long these king-sized deficits last, and how quickly they come down the mountain as the economy (presumably) recovers**. And this is where the tail risk of potential inflation begins to arise—if deficits remain massive for an extended period, and the QE program thus also remains in place for longer than expected. The Fed has plenty of experience with QE and the U.S. dollar is the reserve currency, so the risks of serious U.S. inflation are relatively low. In contrast, the BoC is new to QE and there's much less natural demand for the Canadian dollar, so longer term inflation tail risks can be less readily dismissed in Canada.

Having said that, we would note that Canadian 30-year government bond yields are currently identical to U.S. Treasury yields of the same maturity (at just under 1.2%). A few key conclusions: At current levels, long-term borrowing costs remain below the 2% inflation target, let alone the expected nominal GDP growth rate over the next three decades. And, investors see little fundamental daylight between Canada and U.S. economic trends longer term.

It's amazing how many analysts and economists are already pretty much writing off the second half of the year, when we're not even into the second half of Q2 yet. And it is somewhat understandable, given the wave of cancellations we're seeing on events deep into this year. In recent days, the Calgary Stampede was cancelled for the first time ever, and even Germany's Oktoberfest was axed (this is truly getting serious). But we would just reiterate a point made in last week's Special Report on the Post-Pandemic Economy: **Just because the economy will look very different 12-18 months from now, and there will be some activity lost forever, this does not rule**

out a broader recovery. The ongoing surge in some key tech stocks speaks to the rapid reordering underway in the underlying economy.

As a companion piece to that relatively upbeat report, this week's Focus Feature takes a closer look at the sectors which *will* remain under heavy pressure even a year out, and totes up the potential damage. The bottom line is that **there likely remains lingering downside risk to the consensus (and our) economic forecast**, even as the most extreme distancing measures begin to lighten.

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