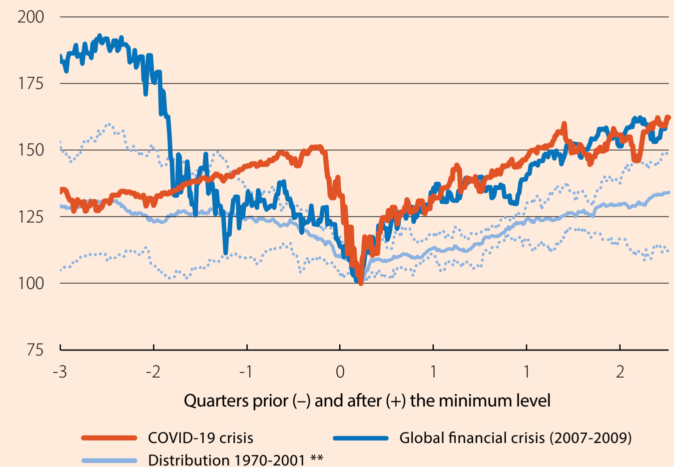
The market-macroeconomic connection in times of pandemic

28 October 1929, Black Monday (the Wall Street Crash). 19 October 1987, Black Monday. 16 March 2020… another Monday, also Black. 2020 has placed another Monday on the podium of the worst trading sessions of the last 100 years.[1] Indeed, as the first chart shows, the COVID-19 pandemic provoked one of the most sudden and severe crashes ever experienced in the financial markets: during the 2008-2009 recession it took a year and a half to accumulate losses of 60%; in 2020, the US stock market lost over 30% of its value in a single month. And yet, following this collapse, financial markets have managed to make a significant and rapid recovery before the year is out, to the point that the US stock market was once again registering all-time highs at the end of November.

S&P 500 stock index in economic recessions
*Index (100 = minimum level for the period) **



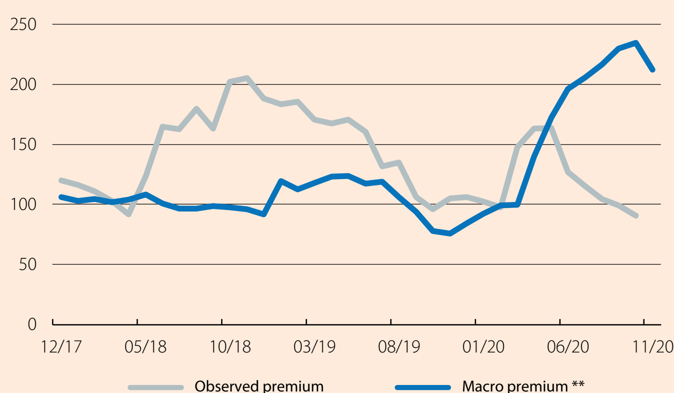
Notes: ** In the last two recessions, the minimum levels correspond to 23/03/2020 and 09/03/2009. 09/03/2009. ** Average (solid line) and minimum and maximum (dotted lines) of stock market performance at each given moment in the various recessions of the period.*
Source: *CaixaBank Research, based on data from Bloomberg and dating of the business cycle by NBER.*

Is there a disconnect between the economy and the markets?

The good performance of the markets in recent months has raised fears that prices are 'disconnecting' from the real economy. This risk of market complacency cannot be downplayed in a context of unprecedented declines in economic activity. However, at least part of the contrast between market performance and economic activity is a reflection of the very economic measures that have been launched to protect the economy, just as there has also been a 'disconnect' between the slumps in GDP and the rate of corporate bankruptcies or job destruction.

For example, in normal times, the sharp contraction that GDP is suffering would result in a significant rise in corporate bankruptcies. Indeed, some estimates suggest that if we extrapolate historical relationships, the cumulative decline in economic activity expected for 2020-2021 would be associated with a 10%-30% rise in bankruptcies in the euro area.[2] However, the reality of 2020 is that even fewer insolvencies have been registered than in recent years. In addition, the likelihood of corporate bankruptcy implicit in the financial asset valuations remains contained.

Sovereign risk premium for peripheral 10-year debt *
(bps)



Notes: ** Weighted average of Spain, Ireland, Italy and Portugal. ** Risk premium predicted by the macroeconomic fundamentals (global financial conditions, conventional and unconventional monetary policy of the ECB, public debt, and growth and inflation expectations) and estimated according to the historical relationships up until the beginning of 2020.*
Source: *CaixaBank Research, based on data from Refinitiv, Eurostat, Consensus Economics and Focus Economics.*

In the same vein, part of the recovery in the stock markets also reflects the measures which economic and monetary policy have employed to protect the economy. The battery of economic measures as a whole, and the accommodative monetary policy in particular, have anchored an environment of low interest rates (for instance, in the US, sovereign rates have fallen by between 100 and 150 bps in 2020) and have favoured a recovery in investor sentiment. According to IMF estimates, these two factors have more than offset the impact of the contraction of corporate earnings on the stock markets.[3]

Economic policies are also playing a vital role in fixed income markets, and in particular in the euro area's sovereign risk premiums. Our estimates[4] suggest that the deterioration in the macroeconomic fundamentals should have led to a significant rise in the euro area's sovereign yields. Indeed, the second chart shows how peripheral risk premiums initially rose in line with the macroeconomic fundamentals. However, the stress was widely reverted following the ECB's barrage of

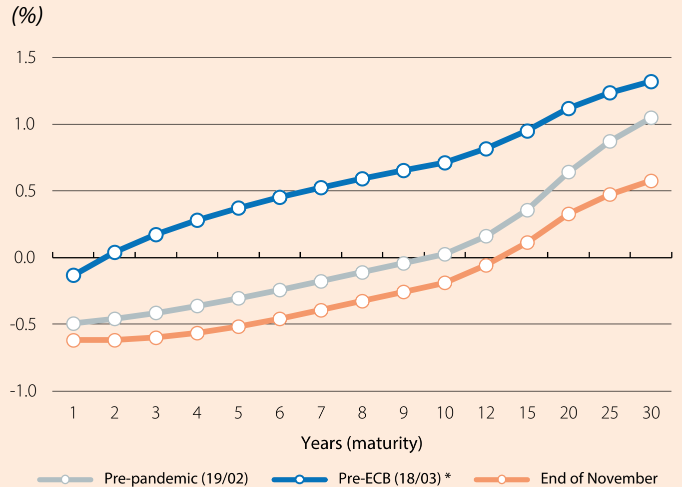
1. On 16 March 2020, the S&P 500 index fell 12.0%, close to the –12.9% drop registered in 1929, but still far from –20.5% of 1987.
2. See R.N. Banerjee, G. Cornelli and E. Zakrajšek (2020). «The outlook for business bankruptcies». Bulletin nº 30. Bank for International Settlements.
3. IMF Global Financial Stability Report of October 2020, chapter 1.
4. Based on historical relations, we estimate the sovereign yield that would be consistent with the macroeconomic fundamentals (global financial conditions, the state of the ECB's monetary policy, public debt ratios, and GDP and inflation expectations). See the Focus «The macroeconomic fragility of interest rates» in the MR10/2020 for further details.

announcements throughout the spring and the EU's fiscal packages.

All of this shows that the support from policies, coupled with the expectation of economic recovery in 2021 (which, due to its anticipatory nature, is already reflected in the financial asset prices), has been key to explaining the performance of the markets in 2020. Therefore, the evolution of the pandemic, the resilience of the economy and the protection which policies have provided to the economy will continue to set the tone in the financial markets in 2021.

Sovereign yield curve for the euro area

(%)



Note: ** Just before the launch of the PEPP, the purchasing programme aimed at combating the economic effects of the health emergency.*
Source: *CaixaBank Research, based on data from the European Central Bank.*

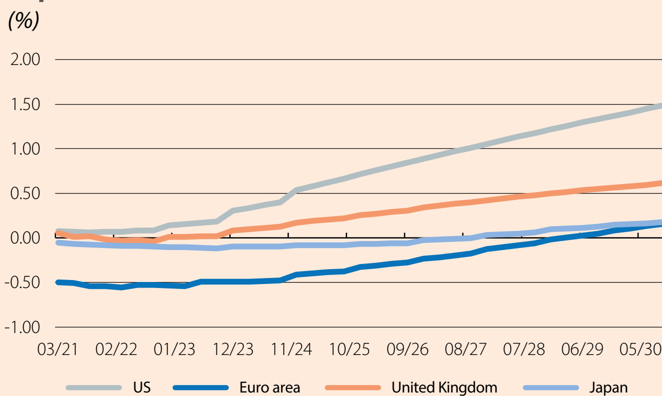
Monetary policy, a bastion of liquidity and low rates to combat the pandemic

In the face of the COVID-19 crisis, monetary policy has anchored an accommodative financial environment and has done so successfully, as the third chart clearly shows. This defensive strategy had a triple effect: (i) avoiding liquidity problems, (ii) helping firms and households to get easier access to credit, and (iii) anchoring a low-interest-rate environment which, in addition to supporting the economic recovery, provides coverage to allow fiscal policy to act aggressively and without raising doubts about the sustainability of the public accounts.

The current environment is highly demanding and all the indicators suggest that the bulk of the measures launched by the central banks must remain in force in the new year. 2021 will be a year of change and will remain a difficult year. Beyond the initial rebound, economies will take a long time to return to normal. Furthermore, in addition to the impact of the restrictions to contain the pandemic itself, there is a risk that some of its scars will begin to surface in the form of destruction of the economy's productive fabric.

Expectations of central bank official rates implicit in market interest rates *

(%)



Note: ** Forwards at the end of November 2020. References for the calculation: OIS curves (EONIA in the euro area).*
Source: *CaixaBank Research, based on data from Bloomberg.*

Indeed, monetary policy has already made its intentions perfectly clear, and as the fourth chart shows, investors' expectations point towards a long period of low interest rates. Furthermore as we have shown in a recent Focus,[5] in 2021 the ECB's monetary policy will continue to make a key contribution to market liquidity, thereby indirectly continuing to provide coverage for the necessary action from fiscal policy.

Even at this challenging time, 2021 will also be important for the underlying transformations of the central banks. By mid-year, the ECB is expected to complete its monetary policy strategy review (the first since 2003). There are unlikely to be any big, sweeping developments (its definition of price stability could shift from the current «close to, but below, 2%» to a simple and symmetrical «2%»). However, the review will also focus on other major issues, such as the effectiveness of the various monetary tools or the importance of employment, social inclusion, climate change and financial stability in the ECB's decision-making.

Similarly, in the US the change of administration could lead to a more constructive relationship with the Fed (remember that President Trump was highly and publicly critical of the central bank, and that the Treasury has unilaterally opted not to renew various aid programmes that had been launched in collaboration with the Fed). This institutional relationship will be important for the composition of the Fed's Governing Council: in early 2022, Jerome Powell's term as chair is due to be renewed for four more years, while Vice Chairman Clarida's term also expires in early 2022, and the Council still has two vacancies yet to be filled (Trump nominated Judy Shelton and Chris Waller, but they have not yet been confirmed by the Senate).

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5. See the Focus «Sharp rise in public debt: will the euro area resist?» at www.caixabankresearch.com.