June 15, 2020

Marketing Material

At a turning point

Five months into the Covid pandemic, there are signs of improvements. The risk of setbacks remains high, however.

_ Globally, infection rates remain worryingly high. In developed markets, a resurgence in outbreaks appears likely.
_ Despite recent progress in containing Covid-19, the indirect costs of the pandemic continue to mount. To an extent, that is reflected in our baseline forecasts.
_ However, it is far too early to assess the full effects on political stability, social cohesion and the world's productive capacity.

Johannes Müller
Head of Macro Research

At the risk of stating the obvious, the world has changed dramatically since February. Instead of growing by 2.5% globally, we now expect the world economy to shrink by just over 3% in 2020. Containing the virus required a broad-based lockdown of about two months in country after country. Sharp drops in activity have been followed by early signs of recovery.

Our baseline scenario is that the world's productive capacity will remain impaired for the foreseeable future. However, the extent of the impairment varies country by country, and sector by sector. This can be illustrated by contrasting Covid-19's impact on the tourism, hospitality and retail sectors on the one hand and that on manufacturing and white-collar office work on the other. During the lockdown, airplanes remained grounded. Non-essential shops and restaurants were forced to close, as were many offices and factories. These blunt measures are now being lifted again. However, strict conditions continue to apply, typically relating to the maximum number of people allowed at once in shops, restaurants or within any given office space. Hygiene measures, such as more frequent cleaning of factory and shop floors, have been stepped up.

In quite a few areas, the lockdown experience is likely to prove productivity-neutral, or perhaps even slightly positive. Among white-collar office workers, the need for distancing means more space is required for each employee actually working at the office. Such workers and their employers have gained plenty of firsthand practice in working from home. Over time, this is likely to lead to changes in how they work, perhaps even reducing the need for costly office space in crowded urban areas. Manufacturing activity can also swiftly bounce back to pre-lockdown levels, although social-distancing measures are likely to result in higher costs per unit produced.

By contrast, hospitality and retail businesses are facing semi-permanent capacity constraints on top of decreased demand. For example, many smaller restaurants may continue to struggle, even if and when demand recovers to pre-crisis levels since they can serve far fewer customers. Restrictions such as mandatory mask wearing are also likely to dampen demand. Similarly, tourism travel flows are likely to be severely impacted for many months to come.

Given all these business specific effects, we have looked in detail, sector by sector, at the potential recovery paths of all the countries we cover. The net effect is that we see activity bouncing back, once lockdown measures are lifted, but only until capacity constraints start to kick in. From then onwards, we believe the recovery can only continue in slow motion. As a result, we do not expect most industrialized countries to reach pre-crisis levels of output before 2022. That translates into the U.S. shrinking by about 6% in 2020, before growing by roughly the same amount in 2021 from a much lower base. In the Eurozone, we have penciled in a slump of 7.5% this year, followed by 4.5% growth in 2021. The deeper slump and slower recovery for the Eurozone partly reflects sector effects previously mentioned. Countries such as Spain and Italy, for example, are heavily dependent on tourism.

The above forecasts are meant to give you a rough idea of our current expectations in a situation with few, if any, reliable historical precedents. To again state the obvious, the Covid-19 crisis has not been a garden-variety recession, brought about, for example, by economic excesses during a previous boom. There are elements of that, to be sure, such as newfangled and heavily indebted real-estate companies offering shared workspaces. Mostly, however, the slump has been induced by mandatory measures in the face of a health emergency.

Our most crucial assumption is that at least in terms of lockdown measures, the worst is indeed behind us for most industrialized countries. That is, we do not expect another March-style, broad-based second lockdown, involving a large number of countries simultaneously. If this were to happen, the result would be a W-shaped pattern, with the second leg below the first one in economic-activity terms. We are cautiously optimistic that such a scenario can be avoided. We think more selective measures will suffice to contain local outbreaks, which we would expect to continue to see in coming months.

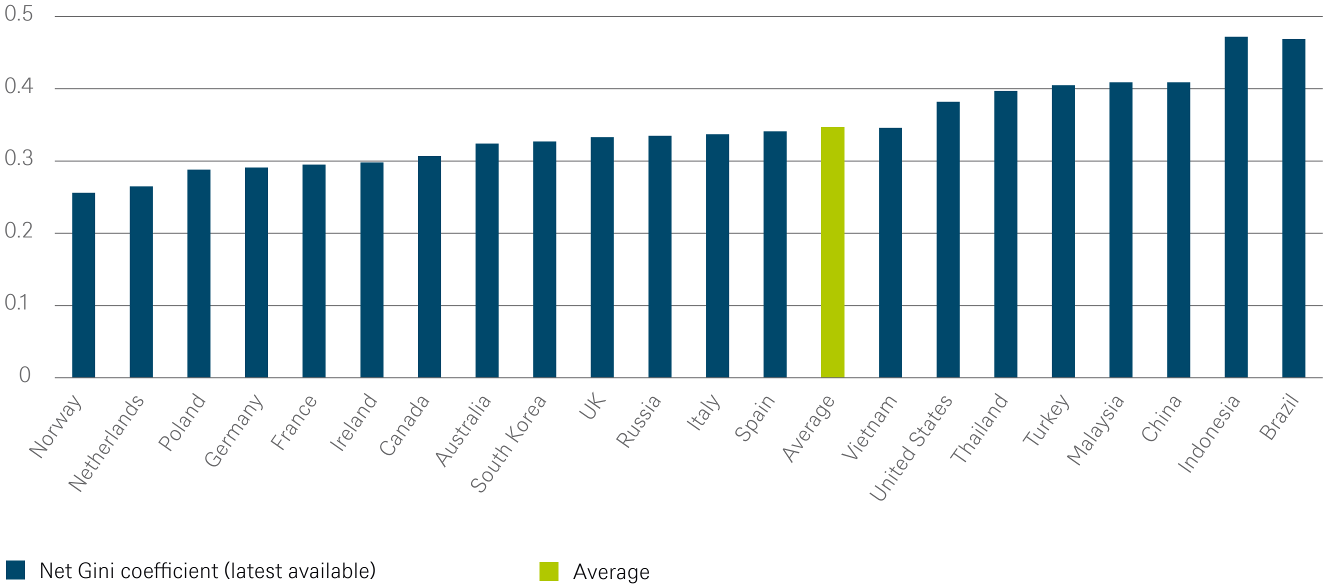
We will leave it to virologists to decide how large a spike in infection rates would justify talk of a second wave. To us as economists, it is quite remarkable, however, how much better most countries in East Asia have dealt with their first wave, than those in either Europe or the Americas. Broadly speaking, East Asia has been able to contain infections and deaths at much lower levels, and at smaller economic costs. This is very suggestive of institutional learning from the severe acute respiratory syndrome (SARS) epidemic of 2003. Similar learning effects are likely to facilitate dealing with further Covid-19 waves in the rest of the world and alleviate the need for a second round of broad-based lockdowns.

It is worth stressing that plenty of our modelling assumptions are even more debatable than they usually would be at any cyclical turning point. To start with, scientific understanding of Covid-19 continues to improve week by week. This does not guarantee rapid breakthroughs. Nor will new discoveries necessarily be positive. But it is at least possible that science might come to the rescue, if it turns out, for example, that background immunity because of previous infections is more widespread than currently thought. Closer to our own area of expertise, one positive source of surprises has been the energetic and so far quite effective response of both fiscal and monetary policy on both sides of the Atlantic. In Europe, the new recovery fund marks the European Union's (EU's) first sizeable mutualized-debt-issuance program. It also contains a sizeable transfer element. So, one positive indirect effect of the current crisis might be that we see substantial fiscal integration within the Eurozone, or the whole EU, making the common currency less prone to future crises.

Meanwhile, however, the pandemic remains far from under control in much of the continental United States. It also continues to rage in many emerging markets, notably Brazil and India. In addition to the direct toll on human lives and local economies, this could have plenty of economic and political knock-on effects on the rest of the world, including disruptions to key supply chains and new refugee crises. All told, it remains far too early to assess the full effects on political stability, social cohesion and the world's productive capacity. However, our sector-by-sector analysis suggests one area of concern. During a typical downturn, relatively lower-paid service-sector jobs, such as those in hospitality and retail, tend to soak up some of those entering the job market, or those whose skills are no longer in demand. In the current slump, these types of jobs are unlikely to fully return any time soon, let alone offer employment for those laid off by other sectors. As a result, the current crisis will probably exacerbate social, economic and even racial divides. Recent events in the U.S. offer an indication of how politically explosive this could prove.

INCOME INEQUALITY VARIES WIDELY ACROSS COUNTRIES

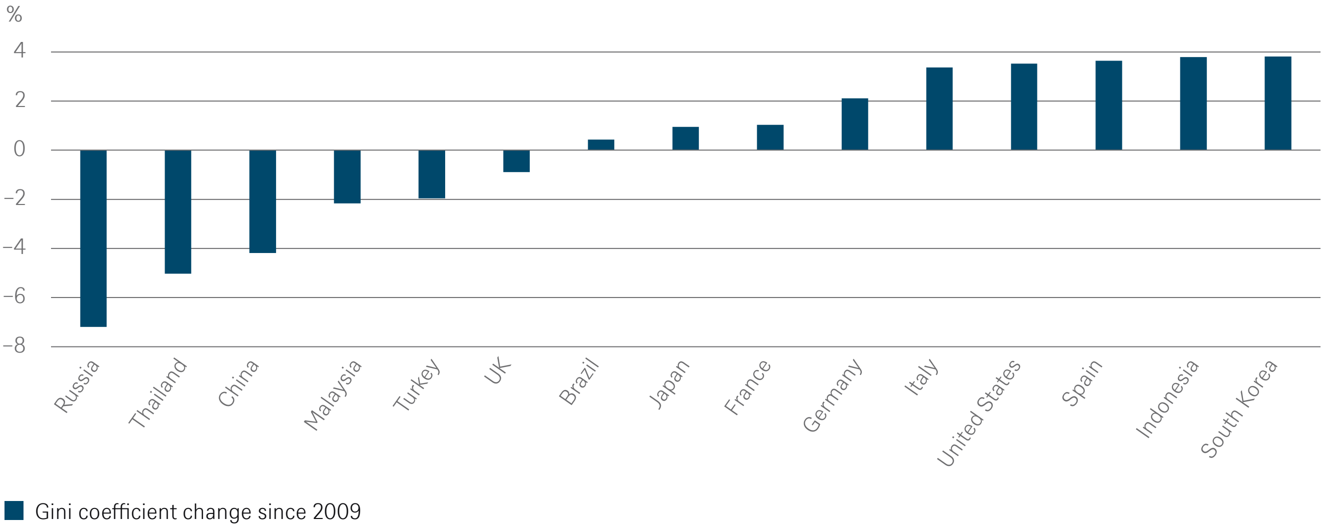
Net Gini coefficients measure income inequality after taxes and state transfer payments. A coefficient of zero would indicate a completely equal income distribution.



Sources: Harvard Dataverse, DWS Investment GmbH as of 6/3/20

SINCE 2009, INCOME INEQUALITY HAS GONE UP IN MANY INDUSTRIALIZED COUNTRIES

Even before the pandemic hit, many countries saw their Gini coefficients increase. Income inequality tends to limit access to healthcare and may now exacerbate the Covid-19 damage.



Sources: Harvard Dataverse, DWS Investment GmbH as of 6/3/20

GLOSSARY

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

The European Union (EU) is a political and economic union of 28 member states located primarily in Europe.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

CRC 076466 (06/2020)