The economic impacts of COVID-19: Digest 3

You are here

3 December 2020

Volunteers of the ICAT workstream F&I1 and the Economics MIG have joined forces to produce the following 'round-up' of activity capturing interesting news and events over the last month. These updates will appear in the monthly ICAT Newsletter with links on the Economics MIG webpage.

Purpose of these updates

COVID and the developing economic crisis create a great deal of uncertainty within the core assumptions that we use as actuaries in our daily work. This compounds via the interconnected nature of our core risks, uncertainties and assumptions and with the complex nature of the real economy, financial economy and interconnected financial markets and global trade.

Where, in the past, we could provide a reliable guess as to a "central scenario" or for the baseline assumptions for a stochastic model, the present crisis requires us to analyse and synthesise many changing parts all at the same time. The outcome of this mental exercise cannot be a single central scenario, but must incorporate a multiple of potential what-ifs and various outcomes. Perhaps this means many more ORSA-type scenarios, perhaps this means many more investment scenarios, perhaps this means a dynamic back-of-the-envelope mental approach to stress testing to filter and identify the more important assumptions and scenarios.

The objective of this update is to provide the first step for you the reader as you undertake to gather information in a rapidly changing and uncertain world. In the sections below, summaries of publications are provided in plain text with the *actuarial implications in italics* to ease reading.

Section 1 – Macro-economic data, policy communications, and COVID updates

17 November 2020 – Speech by Andrew Bailey, Governor BoE, "The future for business investment in the age of Covid and the role of financial services"

At a conference in the City of London, Andrew Bailey, Governor of the Bank of England, spoke about the long-term effects of COVID and of the investment needed to support the recovery, noting that the financial system will be able to help businesses manage the ongoing malaise and urged financial services firms to work together with businesses to get the finance they need to build for the future. He mentioned the general savings glut and the lack of investment opportunities, noting that the current heightened uncertainty is hindering investment. He discussed how the structure of the economy may be shifting in three ways: consumption and preferences; the nature of work; and the nature of production. Towards the end, he emphasised the need for productive investment and mentioned the focus on the regulatory disincentives preventing DC pensions from investing in long-term, less liquid investments, while still focussing on the soundness of firms and on policyholder protection.

With the UK revisiting the overall regulatory backdrop after leaving the EU, there could be significant changes in the future to regulations and regulatory incentives and disincentives. There may be important considerations around financial stability and not least broad considerations for policyholder and pension member protection and fairness. This is an important time for actuaries to stay on top of developments and understand the potential implications for their stakeholders.

https://www.bankofengland.co.uk/speech/2020/andrew-bailey-the-cityuk-national-conference-2020

25 November 2020 – HMT's "Spending Review 2020" (UK)

The Chancellor announced that the UK government will provide billions of pounds to help counteract the effects of COVID, including increased funding for public services and £100 billion in capital investment and infrastructure to drive recovery and support jobs. The Chancellor said the immediate priority is protecting people's lives and livelihoods. He promised support for controlling and suppressing COVID. The £100 bn in capital expenditure is aimed to "build back better", with funding to selected projects including clean energy and delivering the PM's 10-point plan for climate change. The capital will be put into use via an updated Green Book, the new National Infrastructure Strategy, and a to-be-created UK infrastructure bank. For more detail, see the second link below.

https://www.gov.uk/government/topical-events/spending-review-2020

https://www.gov.uk/government/news/spending-review-to-fight-virus-deliver-promises-and-invest-in-uks-recovery

12 November 2020 – ECB's "Update on economic and monetary developments"

A resurgence of COVID infections brings renewed challenges to public health and economic growth prospects for the EU and the world. Q2 saw a strong rebound in economic activity with momentum slowing in Q3. The recent rise in COVID cases and the containment measures put a damper on the near-term outlook. Global trade recovered in Q3 following a deep and sharp contraction in Q2. HICP inflation remains just below zero at -0.3% for September.

"The coronavirus pandemic has continued to influence significantly money and credit dynamics in the euro area. Money growth increased further in September 2020 and domestic credit, which continued to be the main source of money creation, was increasingly supported by the Eurosystem's net purchases of government bonds. The timely and sizeable measures taken by monetary, fiscal and supervisory authorities since the outbreak of the pandemic have continued to underpin the extension of bank credit on favourable terms to the euro area economy. However, as evidenced by the October 2020 euro area bank lending survey, banks tightened their credit standards on loans to firms and households in the third quarter of 2020 on account of heightened risk perceptions."

The ECB continues to support liquidity and has reiterated its commitment to accommodative monetary policy for the near future. Liquidity will continue to provide a technical support to asset market values, whether this can be relieved will depend on whether underlying economic activity can return to normal and whether households and businesses increased debt burden can be managed.

https://www.ecb.europa.eu/pub/economic-bulletin/html/eb202007.en.html

Nationwide House Price Index for October 2020 data

Latest monthly UK house price index, shows continued recovery of house prices, up 0.8% in month and 5.8% YTD. It notes that mortgage approvals in September were up to 91,500 their highest level since 2007. It still expects housing market activity to slow in particular once the current stamp duty holiday ends in March 2021.
https://www.nationwide.co.uk/about/house-price-index/headlines

Halifax House Price Index for October 2020 data

Latest monthly price index, shows prices up 0.3% in month and 7.5% YTD. Continues to see headwinds in the housing market and expects downward pressure on prices as we move into 2021. Increase in index of 5.6% over the last 4 months is the highest since 2006. It also notes that since March the prices of flats (up 2%) are not increasing as fast as the prices of typical detached properties (up 6%).
https://www.halifax.co.uk/media-centre/house-price-index.html

Royal Institution of Chartered Surveyors' "UK Residential Market Survey October 2020"

Latest monthly survey from RICS, still pointing to strength of market. Near term sales expectations modestly positive, but twelve-month sales outlook a lot more subdued in comparison. Page 6 - "Expectations and other data" has some interesting charts in particular the one on its respondent's views on the outlook for prices 1 and 5 years out.
https://www.rics.org/uk/news-insight/research/market-surveys/uk-residential-market-survey/rice-index/head

Nationwide House Price Index for October 2020 data

Latest monthly UK house price index, shows the continued recovery and momentum of house prices, up 0.9% in month and 6.5% YTD. It notes that housing transactions in October were 105,600 highest since 2016 and that mortgage approvals in October were up to 97,500 again their highest level since 2007. It also has some updated research on the premium for property in and around National Parks being 20% and 6% respectively. It still expects housing market activity to slow in particular once the current stamp duty holiday ends in March 2021.
https://www.nationwide.co.uk/about/house-price-index/headlines

---

Section 2 – Macro-economic prognoses, research, and surveys and trackers

Bank of England's "Monetary Policy Report – November 2020"

COVID is still adversely affecting jobs, incomes and spending and has put pressure on businesses' cash flows. The BoE will work to ensure that inflation returns towards the 2% in a stable manner, which will be important to support jobs and growth and the ability to plan for the future. Spending in the economy remains well below normal levels.
In order to keep interest rates on mortgages and business loans low, the BoE has cut interest rates to 0.1% and supported the UK economy with £300 billion of QE, with £150 billion more of

QE on the way. The BoE also committed to taking further actions to help the economy recover and meet the 2% inflation target.

During an economic crisis, even one triggered by a pandemic, existing investments provide the buffer and support for a struggling real economy and financial system to help it continue to function in the short term. This is unavoidable—the choice is between losses in the present or losses in the future. Reducing interest rates lowers long-term expected yields while QE supports market prices. These have obvious and very important benefits and less obvious externalities.

https://www.bankofengland.co.uk/monetary-policy-report/2020/november-2020

Prudential Regulation Authority's "Regulatory Digest – November 2020"

The PRA Regulatory Digest is for people working in the UK financial services industry and highlights key regulatory news and publications delivered for the month. It is essential reading.

https://www.bankofengland.co.uk/prudential-regulation/regulatory-digest/2020/november

10 November 2020 – ECB's "The impact of COVID-19 on potential output in the euro area"

This ECB paper looks at the effects to date on economic output from COVID-19 with a focus on *potential output*, i.e. "the highest level of economic activity that can be sustained by means of the available technology and factors of production without pushing inflation above its target". The COVID pandemic has affected both supply and demand. The article looks at potential output and the output gap in the economy during COVID. Initial analyses find that both supply and demand dropped after the COVID shock, with difficulty disentangling.

There is uncertainty around potential output in the short term, but also the long-term impact of the pandemic. COVID may negatively affect capital stock in the EU, may affect capital depreciation, with the sectors seeing the largest declines in activity being the most productive capital stocks in the EU. The labour contribution to potential output could be severely hit but is currently significantly supported by sizeable policy measures. Chart B gives a nice overview of "employment at risk" and "capital stock at risk" in various countries. Chart 4 provides a breakdown of contributions to the output gap for 2020-2022, with employment rate and average hours worked being the key components.

https://www.ecb.europa.eu/pub/economic-bulletin/articles/2020/html/ecb.ebart202007_01~ef0a77a516.en.html

12 November 2020 – NIESR's November 2020 GDP Tracker (UK)

The National Institute of Economic and Social Research uses ONS (Office of National Statistics) estimates and their own macroeconomic forecasting model. The ONS reported UK Q3 economic growth at 15.5%. NIESR expects a monthly decline of 12 percent in November due to the second lockdown. NIESR expects a rapid rebound after the second lockdown, with downside risks being failure to bring down infections, and the upside coming from households' online purchases. Their GDP forecast for 2020 is -11.3%.

Since NIESR's GDP forecast last month, Q3 finished according to forecast, but lockdowns returned. Risk on the downside depend largely on lockdowns, slowdowns, and the success of a potential vaccine. A vaccine could mean a quicker return to a new normal, while stronger lockdowns could worsen woes and increase the need for support.

https://www.niesr.ac.uk/publications/november-2020-gdp-tracker

Surveys, trackers and dashboards

2 December 2020 – Capital Economics' "COVID-19: Latest Developments" Tracker

Capital Economics Ltd tracks the spread of COVID-19 and its impact on the world's economies and asset markets *in real time* with many useful graphs. Most data is updated daily with more comprehensive monthly and quarterly. Definitely worth a read.
https://www.capitaleconomics.com/the-economic-effects-of-the-coronavirus/

Other useful trackers

IMF's Policy Tracker
OECD's Policy Tracker
European Commission's Policy Tracker
UK Office for Budget Responsibility's Coronavirus Analysis
European Systemic Risk Board's COVID Policy Tracker
European Systemic Risk Board's Risk Dashboard
Harvard Business School's Global-Policy-Tracker
Bloomberg's Recovery Tracker
Financial Times' Global Economic Recovery Tracker

Section 3 – Interpretations and forecasts from academia, asset managers and beyond

10 November 2020 – Harvard Business Review "A Better Model for Economic Forecasting During the Pandemic"

An interesting pairing of two different types of models with the aim of capturing the effects of COVID lockdowns on consumer spending in hard-hit sectors. The authors provide a model which combines consumer sentiment via credit and debit transactions with qualitative data into a standard economic forecasting model. The model correctly predicted consumer spending habits between April and June 2020.
https://hbr.org/2020/11/a-better-model-for-economic-forecasting-during-the-pandemic

26 November 2020 – Banque de France's Eco Notepad #189 "What are the factors behind current high stock market valuations"

In the words of the authors, in summary "despite the corrections at the end of 2018 and the Covid-19 shock, price-earnings ratios remain at high levels, particularly in the United States. However, based on indices adjusted for expected growth and the level of interest rates, this trend does not appear to be the result of irrational exuberance like in previous speculative episodes." The authors use common NPV valuation approach to decompose yields on US equities from 1980s to present. They model the price of an equity share as the NPV of future earnings, adjusted for expected growth and discounted by the yield demanded by investors. This decomposes point-in-time equity yields into the sum of a term premium and a risk premium. They construct a "relative return indicator" as the difference between the risk-free rate

(RFR) and the P/E ratio, showing that current US equity values are *relatively low.* Of particular interest is the 5th graph, which decomposes the risk premium into the earnings yield, the real RFR, and a GDP growth forecast—during late 2019 and since March 2020, the real RFR has *contributed* to the risk premium.

Interpreting this for the real world might be most interesting, but most difficult. Emergency monetary policy has supported quoted asset market values over the periods of greatest uncertainty since the onset of COVID. The risk premium on US equities spiked understandably spiked mid-March, but has been falling slightly since. Does the contribution of the real RFR to the risk premium signal expectations of deflation in the real economy or the reversing out of asset price inflation as emergency monetary policy relaxes?

https://blocnotesdeleco.banque-france.fr/en/blog-entry/what-are-factors-behind-current-high-stock-market-valuations

https://blocnotesdeleco.banque-france.fr/en

Section 4 – News, events, and opinion pieces

9 November 2020 – Andrew Bailey BoE "the time to push ahead on tackling climate change"

Andrew Bailey, Governor of the BoE, recently gave a speech to explain what the BoE is doing to ensure the financial system plays its part in addressing climate change. The BoE prioritised preserving people's jobs and livelihoods during COVID, though without using climate change to discern where to provide support. Mr Bailey suggested we not wait for today's problem to be over before setting the course for the future.

The BoE's goal is to build a UK financial system resilient to the risks from climate change and supportive of the transition to a net-zero economy. Compared to the financial crisis and the pandemic, the risks from climate change are even bigger and more complex to manage. And acting now gives us the best opportunity to manage those risks. Mr Bailey emphasised the importance of getting ready for TCFD and the importance for the financial sector of their upcoming climate stress tests. His final point was to stress the importance of facilitating investment to support climate change and the on-going centrality of capital markets in transitioning to a resilient carbon-neutral

https://www.bankofengland.co.uk/speech/2020/andrew-bailey-speech-corporation-of-london-green-horizon-summit

November 2020 – EIOPA's Risk Dashboard "European insurers remain exposed to high risks since the outbreak of COVID-19"

According to EIOPA's October 2020 Risk Dashboard, macro risks remain at very high levels given the persistent global impact of the outbreak of COVID-19 on economic activities, intensified by the second wave already initiated in several EU countries. Economic outlooks at the end of September show the strongest expected decline in the last quarter of 2020 and first recovery in the second quarter 2021. The effects of the new wave of the pandemic might skew GDP growth further downward.

Risk exposures for the European insurance sector remain very high for macro, while it decreased from high to medium level for credit, market, profitability and solvency.

https://www.eiopa.europa.eu/tools-and-data/risk-dashboard

9 November 2020 – US Federal Reserve Financial Stability Report

Since the May 2020 Financial Stability Report was issued, asset prices have continued to move up, amid periods of volatility. Business and household earnings have fallen and business borrowing has risen, which leave households and firms more vulnerable to future shocks. Since the May 2020 Financial Stability Report was issued, asset prices have continued to move up, on balance, amid periods of volatility. Business and household earnings have fallen and business borrowing has risen, which leave households and firms more vulnerable to future shocks. Banks absorbed large losses related to the pandemic but remained well capitalized throughout; moreover, capital ratios have since generally recovered to pre-pandemic levels. However, the COVID-19 shock highlighted how vulnerabilities related to leverage and funding risk at non-bank financial institutions could amplify shocks in the financial system in times of stress. The Federal Reserve current view of vulnerabilities:

1. Asset valuation: Given the high levels of uncertainty associated with the development of the pandemic, asset prices remain vulnerable to significant declines should investor risk sentiment fall or the economic recovery weakens.
2. Borrowing by businesses and households: As a result of the ongoing pandemic, business and household debt has risen sharply as businesses continue to borrow to weather the impact of COVID-19 on earnings. In addition, many households have lost jobs and seen earnings fall. As many households continue to struggle, defaults may rise leading to material losses at banks.
3. Leverage in the Financial sector: The pandemic stressed the resilience of banks, but they remain well capitalized. Leverage at broker-dealers also remains low. In contrast, measures of leverage at life insurance companies are at post-2008 highs and remain elevated at hedge funds relative to the past five years. Some nonbank financial institutions felt significant strains amid the acute period of extreme market volatility, declining asset prices, and worsening market liquidity earlier this year. Pressures eased as a result of policy actions, including Federal Reserve asset purchases and repurchase agreement (repo) operations, regulatory relief for dealers affiliated with BHCs, and support from the emergency lending facilities.
4. Bank funding risk remains low, as they rely only modestly on short-term wholesale funding and maintain large amounts of high-quality liquid assets, which has helped banks manage heightened liquidity pressures. Banks also benefited from a surge in deposit inflows through the second quarter of 2020. In contrast, the large redemptions from money funds and fixed-income mutual funds, as well as the need for extraordinary support from emergency lending facilities, highlighted vulnerabilities in these sectors. While in place, those facilities substantially mitigate these vulnerabilities.

The outlook for the pandemic and economic activity is uncertain. In the near term, risks associated with the course of COVID-19 and its effects on the US and global economies remain high. In addition, there is potential for stresses to interact with pre-existing vulnerabilities in dollar funding markets or those stemming from financial systems or fiscal weaknesses in Europe, China, and emerging market economies. These risks have the potential to interact with the vulnerabilities identified and pose additional risks to the US financial system driving potential material credit and market risk losses on banks' and insurers' balance sheets impacting capital resources and solvency ratios.

https://www.federalreserve.gov/publications/financial-stability-report.htm

18 November 2020 – Office of Financial Research's (OFR) 2020 Report Finds Elevated Financial Stability Risks

The Dodd-Frank Wall Street Reform and Consumer Protection Act requires the OFR to analyse threats to the financial stability of the United States each year and provide Congress with its key findings. The 2020 report concluded that unexpected turbulence from the COVID-19 pandemic elevated risks across financial markets and revealed limitations in conventional market monitoring. The OFR discusses in depth risks the following risks:

1. Macroeconomic Risk is High
2. Credit Risk is High
3. Market Risk is Elevated
4. Liquidity and Funding Risks are moderate
5. Leverage in the Financial System has been restrained since the financial crisis.
6. Insolvency and contagion risks appeared contained.

The economic and financial outlook remains uncertain with significant downside risks to US financial stability. The risks to US financial stability are a reflection of the uncertainty in the future trajectory of the pandemic and the measures the government will continue to pursue to contain the spread of the virus and to limit the associated negative consequences on economic and financial conditions. For insurers and annuity providers, the high levels of macroeconomic, credit, and market risks are driving elevated insurance and financial risks , which impact and may further impact their bulk annuity business and equity release portfolios. This may put pressure on insurance solvency ratios and on Solvency II matching adjustment asset portfolios to reflect the rising risk of default and rating migration risks in portfolios of assets matching the bulk annuity liabilities including exposures to equity release products.

https://www.financialresearch.gov/press-releases/2020/11/18/office-of-financial-research-report-2020/

https://www.financialresearch.gov/annual-reports/files/OFR-Annual-Report-2020.pdf

---

Section 5 – Indications of a changing economy and other things of interest

24 November 2020 – ECB's "COVID-19 and monetary policy: Reinforcing prevailing challenges"

Isabel Schnabel, member of the Executive Board of the ECB, gave a speech digging into the challenges ahead for the real economy and for monetary policy. She noted that this crisis is likely to "fundamentally reshape the way our economies operate". This may mean that central banks need to review monetary policy strategy, e.g. for price stability, with changing consumer preferences and technological changes. COVID-19 has put further pressure on achieving target inflation, with inflation at 0.8% on average since 2014. PEPP (QE) has proven effective at stabilising markets during COVID, but low rates present a challenge for monetary policy near the lower bound.

This is an interesting speech and an interesting space to watch in the evolving financial system. COVID, low rates, falling productivity and an ageing workforce present a combined, complex problem for monetary and fiscal policies. Precisely what it means for actuaries and our stakeholders is unclear, but needs to be watched.

https://www.ecb.europa.eu/press/key/date/2020/html/ecb.sp201124~bcaebee7c0.en.html

25 November 2020 – BoE's Bank Overground "How has COVID affected household savings?"

The Bank Overground shares the BoE's internal analysis with the public via bite-sized summaries of work supporting a policy or operational decision. The pandemic has reduced household spending and thus increased household savings. Chart A provides a breakdown of demographics where savings have increased and decreased. The low-income employed, the unemployed and the furloughed saw the biggest reductions in their savings, while retired persons and those employed in medium- and high-income jobs saw savings increase.

The analysis demonstrates the societal importance of the UK's Coronavirus Job Retention Scheme in mitigating what might otherwise have seen a quick worsening of wealth inequality as more at-risk groups suffered from COVID shutdowns, restrictions and adverse effects on the companies employing them.

https://www.bankofengland.co.uk/bank-overground/2020/how-has-covid-affected-household-savings

Special thanks to Lawrence Habahbeh, the ICAT F&I1 volunteers and the Economics MIG.

Previous digests

September 2020

October 2020