



R&R Weekly Column
By Brunello Rosa



Another Collateral Effect Of Covid-19: Sovereign Rating Downgrades

As the [second wave of the pandemic is in full swing](#), its economic impact is becoming increasingly evident. The rapid increase of new daily Covid cases in Europe, [which have recently surpassed those of the US](#), is forcing a number of European countries to implement renewed restrictions, such as partial lockdowns, or tiered systems such as those adopted by the UK. [If the experience of the Spanish flu is of any guidance](#), the world might even experience a third wave in spring 2021, before a combination of incipient herd immunity, better treatment and availability of vaccines finally manage to tame the pandemic in H2 2021.

As a result of a longer than expected pandemic and more restrictive measures, the economic impact of Covid-19 is likely to be larger and longer than initially estimated. According to [the latest estimates of the IMF](#), although global growth should fall less this year than had been expected in June (by 4.4% in 2020, with a 0.8% upward revision) the rebound after that is also expected to be shallower (5.2% in 2021, vs the 5.4% that had been expected in June). So, the IMF too is getting closer to the idea that the recovery will be U-, rather than V-shaped. But we consider even [these projections to be too optimistic](#).

If that is the case, it means that policy support is likely be larger and more prolonged than had been initially envisioned. During the IMF meeting a message emerged clearly: [fiscal stimulus needs to be at the forefront of the policy response](#), with monetary policy either complementing fiscal policy or – bluntly said – simply monetising the ballooning fiscal deficits and debts. In fact, according to the latest [forecasts in the IMF's fiscal monitor](#), the US will reach a deficit of 18.7% of GDP, the UK of 16.5%, and the euro area of 10.1% in 2020, with France 10.8% and Italy at 13%. In terms of gross public debt in percentage of GDP, the IMF estimates the US to reach 131.2% in 2020, the UK 108%, the Euro area 101.1, with France at 118.7% and Italy at 161.8%.


As a result of these ballooning levels of public deficits and debts, rating agencies are starting to re-evaluate the sustainability of public finances, and starting to take action accordingly. During the last week end, [Morningstar DBRS downgraded France from AAA to AA](#), with the outlook moved from negative to stable. Equally, [Moody's has downgraded the UK from Aa2 to Aa3](#), also changing the outlook from negative to stable. The downgrades of these solid sovereign issuers will have little market impact, especially because the respective interest rate curves in those countries remain historically low. But for other countries, rating actions might have a larger impact.

For example, [the Italian rating will be reviewed by S&P Global, DBRS and Moody's between October 23rd and November 6th](#). After the recent downgrades of more solid sovereigns such as the UK and France, a downgrade of the Italian rating becomes more likely. However, Italy's position is more precarious as the country is already [at the bottom of the investment grade grid](#), being Baa3 for Moody's, BBB for S&P, BBB- for Fitch and BBBh for DBRS. A downgrade by Moody's and Fitch would make Italy one of the most significant “fallen angels” of this crisis.

In terms of immediate impact, the effects of a potential downgrade have been partially softened by the ECB, which has already said that “fallen angels” will continue to be used as collateral in refinancing operations or in PELTROs. However, asset managers following indices may need to start rebalancing their portfolios as a result of a downgrade. All this is to say that Covid-19 not only can attack the human body in unexpected ways, but may have larger economic repercussions than was initially envisaged.

Our Recent Publications

 [EU's Technological Symphony N. 8, “The Unfinished”](#), by Marco Lucchin, 15 October 2020

 [Flash Preview: RBA To Remain On Hold In October, While Reiterating Its Further Easing Options](#), by Brunello Rosa and Karmen Meneses, 2 October 2020

 [Flash Review – RBA Ratchets Up Its Rhetoric Ahead of More Easing, Likely In November](#), by Brunello Rosa and Fawaz Al Mughrabi, 6 October 2020

 [GEOPOLITICAL CORNER: The Abraham Accord Marks A Sea Change In The Middle East](#), by John C. Hulsman, 7 October 2020

Looking Ahead

The Week Ahead: October PMI Data To Hint To Stagnation

In DMs, October PMI data are expected to hint to stagnation, as: *i)* US indicators are likely to remain flat, with manufacturing at 53.4 (*p*: 53.2) and services at 54.0 (*p*: 54.6); *ii)* EZ manufacturing is likely to decline to 51.9 (*p*: 53.7), while services are expected to recover into positive territory at 50.5 (*p*: 48.0); and *iii)* Japan indicators are likely to show further decline, with manufacturing expected at 47.3 (*p*: 47.7) and services at 46.2 (*p*: 46.9).

The Quarter Ahead: Global Growth To Contract Less-Than-Expected; Central Banks To Remain Supportive

In its October WEO report the IMF projected global growth to fall by -4.4% in 2020 (*p*: -5.2%), up 0.8% from the June update. The upgrade in forecast is due to: *i)* less dire outcomes in Q2; *ii)* a stronger recovery in Q3; partly offset by *iii)* downgrades in selected EMs. In 2021, the IMF projects growth to rebound to 5.2% (*p*: 5.4%), -0.2% below the June projection.

In the US, before the November 3 elections opinion polls suggest President Trump keeps trailing his democratic challenger Mr. Biden (Trump 42% vs. Biden 53%). In the week ending on October 10, the number of 'fillings for unemployment benefits' rose by 898k (*c*: 825k; *p*: 845k), the highest in almost two months. The unexpected increase in jobless claims added to concerns about the labor market recovery, a day after Treasury Secretary Mnuchin said "getting a deal on coronavirus aid before the November election would be unlikely".

Tensions between Beijing and Taipei rose, as China claimed "a US Navy destroyer sailed through the Taiwan Strait". The US Navy stated it was a 'routine Taiwan Strait transit'.

In Europe, UK and EU officials will continue to negotiate intensively in the hope of having a deal in time for the end of the transition period in December. In a joint statement, German, Italian, and French business organizations called on EU leaders to explore all possible options to seal a Brexit-deal with the UK, avoiding a "no-deal" outcome.

The Fed's Chair Powell warned "the ongoing, tentative recovery from the pandemic recession could falter unless the federal government supplies additional economic support". Mr Powell was speaking at the IMF's annual meeting, while focusing on the subject of cross-border payments and digital currencies.

Last Week's Review

Real Economy: Growth Remains Wobbly While Geopolitical Uncertainties Remain

In the US, in September: *i)* retail sales rose by 5.4% y-o-y (*p*: 2.6%), the biggest rise in three months; however, *ii)* September's IP fell to -0.6% m-o-m (*c*: 0.5%; *p*: 0.4%) – the first decline in five months, remaining 7.1% below its February, pre-pandemic level. In September CPI inflation rose by 1.4% y-o-y (*c*: 1.4%; *p*: 1.3%), the slowest pace in four months, as the inflationary shock from the coronavirus pandemic on the price of goods and services is starting to fade.

In the EZ, October's economic sentiment index dropped by 21.6 points to 52.3 (*c*: 70.5; *p*: 73.9), the lowest since May. In September CPI declined by -0.3% y-o-y (*c*: -0.3%; *p*: -0.2%), the second consecutive month of deflation; core-CPI remained unchanged at 0.2% y-o-y (*c*: 0.2%; *p*: 0.4%).

Financial Markets: Sentiment Falls As Stimulus Hopes Diminish Further; Bonds Flat; Oil Up

Market drivers: weakness stemmed from: *i)* a continued stalemate in stimulus talks; *ii)* a rise in COVID-19 cases; and *iii)* worries over implications for the reopening of the economy.

Global stocks fell w-o-w (MSCI ACWI, -0.3%, to 583); the S&P 500 rose slightly (+0.2% to 3,484), due to mega-cap technology stocks. Stocks in Europe fell on: *ii)* raising coronavirus infections; *ii)* Brexit-related uncertainty; and *iii)* dissipating prospects of US fiscal stimulus before the November 3 elections (Eurostoxx 50, -0.8% to 3,245). **Volatility** rose w-o-w (VIX S&P 500, +2.4 points to 27.4, 52w avg.: 26.5; 10y avg.: 17.3).

Fixed income: w-o-w global bond returns rose slightly (BAML Global, +0.4% to 298.5); in the US, UST yields fell (UST, -3 bps to 0.74%), due to the Fed's purchases of US government debt.

FX: w-o-w, the USD gained against most currencies (DXY, +0.7% to 93,682; EUR/USD, -0.9% to 1.172); the TRY remained under pressure, falling further (USD/TRY -1.1% to 7.857) due to a rising current account deficit (August: ~USD 4.6bn).

Commodities: oil prices remained steady (Brent, +0.2% to 42.9 USD/b) due to uncertainty over future demand, stemming from surging Covid-19 cases. Gold fell (-1.6% to 1,899 USD/Oz.) – weighed on by a stronger USD.



@RosaRoubini



Rosa & Roubini



Rosa&Roubini Associates

For more information, please call us on +44 (0)207 1010 718 or send us an email to info@rosa-roubini-associates.com

www.rosa-roubini-associates.com

118 Pall Mall, London SW1Y 5ED

Abbreviations, Acronyms and Definitions

a	Actual	LN	Northern League, Italy
AKP	Justice and Development Party, Turkey	MSS	Five Star Movement, Italy
ann.	annualized	m-o-m	Month-on-month
ARS	Argentinian Peso	mb	Million barrels
avg.	Average	mb/d	Million barrels per day
bn	Billion	MENA	Middle East and North Africa
BoC	Bank of Canada	MHP	Nationalist Movement Party, Turkey
BoE	Bank of England	mn	Million
BoJ	Bank of Japan	MPC	Monetary Policy Committee
bpd	Barrels per day	NAFTA	North-American Free Trade Agreement
bps	Basis points	NATO	North Atlantic Treaty Organization
BS	Balance sheet	OECD	Organization for Economic Cooperation and Development
c	Consensus	Opec	Organization of Petroleum Exporting Countries
C/A	Current account	p	Previous
CB	Central bank	P2P	Peer-to-peer
CBB	Central Bank of Bahrain	PBoC	People's Bank of China
CBK	Central Bank of Kuwait	PCE	Personal Consumption Expenditures
CBT	Central Bank of Turkey	PE	Price to earnings ratio
CDU	Christian Democratic Union, Germany	PM	Prime minister
CNY	Chinese Yuan	PMI	Purchasing managers' index
CPI	Consumer Price Index	pps	Percentage points
DJIA	Dow Jones Industrial Average Index	pw	Previous week
DJEM	Dow Jones Emerging Markets Index	QCB	Qatar Central Bank
d-o-d	Day-on-day	QAR	Qatari Riyal
DXY	US Dollar Index	QE	Quantitative easing
EC	European Commission	q-o-q	Quarter-on-quarter
ECB	European Central Bank	RE	Real estate
ECJ	European Court of Justice	RBA	Reserve Bank of Australia
EIA	US Energy Information Agency	RRR	Reserve Requirement Ratio
EM	Emerging Markets	RUB	Russian Rouble
EP	European Parliament	SWF	Sovereign Wealth Fund
EPS	Earnings per share	tn	Trillion
EU	European Union	TRY	Turkish Lira
EUR	Euro	UAE	United Arab Emirates
EZ	Eurozone	UK	United Kingdom
Fed	US Federal Reserve	US	United States
FOMC	US Federal Open Market Committee	USD	United States Dollar
FRB	US Federal Reserve Board	USD/b	USD per barrel
FX	Foreign exchange	UST	US Treasury bills/bonds
FY	Fiscal Year	VAT	Value added tax
GCC	Gulf Cooperation Council	VIX	Chicago Board Options Exchange Volatility Index
GBP	British pound	WTI	West Texas Intermediate
GDP	Gross domestic product	WTO	World Trade Organisation
IMF	International Monetary Fund	w	Week
INR	Indian Rupee	w-o-w	Week-on-week
IPO	Initial public offering	y	Year
IRR	Iranian Rial	y-o-y	Year-on-year
JPY	Japanese yen	y-t-d	Year-to-date
k	thousand	ZAR	South African Rand
KSA	Kingdom of Saudi Arabia	2y; 10y	2-year; 10-year



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