Investing and The Virus
Some Personal Reflections

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Investing beyond the virus

The viral pandemic came from nowhere and will eventually be contained; it also seems likely that an effective vaccine will be ready by the end of the year (please see: Covid-19 A Dialogue, Edinburgh Partners). Economic life will start to pick up before then and in the short-term equity markets have already rallied. Nevertheless, the prognosis for the financial markets is – and will remain – grim because all the props to the long bull markets in both equities and bonds have been kicked away. The peak of the bond market has passed, and a secular bond bear market is beginning. In this new environment equities will be repriced to reflect both a lower base profit level and a higher risk premium, given the changed economic background. All of this will dawn on markets in the next 12 months, and it is important to prepare now.

Background

For an extended period it has been difficult not to be seriously concerned about both general asset market valuations and discontinuities in valuation within individual markets. The years of interest rate suppression born in the aftermath of the global financial crisis have resulted in a dangerous overhang of low-quality borrowing which would not - and could not - withstand the test of an economic slowdown. Central bankers around the world have probably been only too aware of this inconvenient truth. This explains why they have been so quick to intervene at any sign of a slowdown.

So long as economic growth remained reasonable, the dangers of this debt iceberg lurking beneath the surface could be ignored, allowing markets to adopt a sanguine attitude. That the issue was being ignored only added to concerns that this complacent situation could not continue indefinitely. Through 2019, labour markets appeared to tighten and there were early signs of this feeding through to inflation which, in turn, put upward pressure on bond yields. The associated rise in the real cost of money would have planted the seeds for an economic slowdown which, in turn, would have exposed all the poor lending practices of the last few years, particularly in the private equity/debt markets.

In the equity markets a combination of subdued growth, suppressed interest rates and injected liquidity had already driven valuations higher, particularly so in 'growth' and 'quality' shares. The multiple that equity markets assigned to these stocks was higher than that of other sectors and beyond what was reasonable, based on their underlying growth prospects. On a country basis, the US was also accorded a similar unwarranted premium, bolstered by the "sugar rush" of the 2017 tax cuts.

The rises in equity markets during 2019 were largely the result of expanding valuations rather than improving profitability. This was an extremely frustrating period for an investor whose investment approach is firmly anchored by valuations. As 2019 ended it was hard not to become even more concerned about the build-up in low-grade debt and the fragility it introduced to the economic system. Despite an awareness that precise prediction is impossible and that these conditions could continue, the prudent approach was to raise cash levels in portfolios to provide ammunition to take advantage of opportunities as they arose.

Given how long the debt build-up had persisted and the level to which asset prices had risen, it became clear that it would not take a significant disturbance to expose the underlying fragility of the economic system. In the event, the shock and dislocation we have seen resulting from the Covid-19 coronavirus pandemic have been of a magnitude – a potential hit to global GDP of up to 15% in just a few months – that has not been matched outside wartime. Even though the virus itself will pass, the shock to the system is still going to change everything.

A world that has changed

The advent of the coronavirus has changed the world from one where there were two paths: either an immediate recession, or a period of higher inflation followed by an economic slowdown. Now there is only one path forward. The violence with which markets have reacted to the spread of the virus reflects the lack of underlying valuation support. Policymakers have responded with interest rate cuts, liquidity injections by the central banks, and the promise of massive future fiscal injections. The monetary measures helped the short-term functioning of financial markets. There was evidence of highly leveraged positions coming unstuck as markets misfired. However, given how low interest rates had already been pushed to sustain the economy, it is hard to see the recent cuts having a significant impact on the real economy. What the world has seen post the GFC has been a shifting around of the debt liabilities rather than a reduction. Indeed, indebtedness has risen. As such, many countries enter the crisis with a weak fiscal position limiting the extent to which fiscal policy can be employed. In the US for example, the fiscal gun fired by President Trump in 2017 leaves little room for manoeuvre without significant potential side effects.

The financial system was relatively sanguine about the coronavirus at first, no doubt conditioned by previous episodes such as SARS, MERS and Ebola, whose economic impact on the developed world was marginal. There was an expectation borne of history that the impact would be temporary and contained. Even if that view had been correct, it failed to take account of the interaction between severe economic slowdown and the underlying fragility of the global economy; some form of recession was inevitable, with even a contained virus sufficient to act as a tipping point. As such, it was felt prudent to retain a defensive portfolio position and increase the cash reserve.

As is now apparent, the virus has turned into a pandemic that has paralysed the global economy. This is not transitory and we can be sure that it will last for many months. The economic impact will continue even as the spread of the virus decelerates. The global economy is already in recession and debt downgrades have begun. Defaults will surely follow, leading to a more prolonged recession. Once this risk started to become apparent in early March, the markets reacted with unprecedented violence to the change in circumstances. Fortunately, our portfolios were already as defensively positioned as valuations would permit, other than some precautionary positioning against a potential steepening of the yield curve.

The economic decline means there is now little prospect of the yield curve steepening in the near term. This depresses the net interest margin on bank lending and hence the ability to earn returns. The position of banks will be further compromised by government intervention. We have already seen a diktat to halt dividend payments to protect balance sheets. It is inevitable that when customer defaults start coming through, the banks will be blamed, irrespective of the circumstances. In some jurisdictions, banks may well be required to absorb losses and extend credit on a non-commercial basis. The movement in bank share prices suggests the lessons of history are not lost on investors. Whilst sovereign bonds will remain at historic low yields for the foreseeable future, credit spreads are widening. That may provide some potential interest income, but it is scant solace given the bleak outlook. Most likely, there will be consolidation within the sector, particularly in Europe where the fragmentation has contributed to structurally low profitability. Opportunities to shift exposure to industrial or technology companies with strong balance sheets may present themselves. Clearly, great care will need to be taken with the timing, given expectations of the depth and duration of the economic recession on the one hand and the valuation background on the other.

Part of the valuation premium can be justified by the risks that now exist but much of it derives simply from the exuberance of markets over the past few years. This is likely to unwind as earnings disappoint against a backdrop of an economic landscape where recession is deeper and more prolonged than current expectations. Cash balances will, therefore, be maintained until one can point to companies which are obviously undervalued, rather than looking superficially cheap because of either cyclical sensitivity or balance sheet issues. In simple terms, when 'quality' stocks return to reasonable valuations, or the cyclically adjusted PE (CAPE) moves to an average or below-average valuation, then we will know that equity markets once again represent genuine value. Despite the downward moves, we are not there yet.

If the coronavirus were not enough, we have also seen the collapse of any consensus within OPEC, giving rise to an oil output war between Russia and Saudi Arabia. Whilst ultimately beneficial to the global economy, in the short-term it has further undermined credit markets, given the level of energy-related leveraged debt in the US. For the stock market the impact has been direct, with energy share prices tracking the collapse of crude (at one point Shell was yielding nearly 15%). Although there is a consensus that this could continue for an extended period, we don't see this as likely.

Whilst both Saudi Arabia and Russia publicly profess that they can handle the revenue shortfall, this is not plausible. The oil price has dropped by over 50%, but their oil output has increased by just a fraction of that. At the same time, the global economy has shut down. This means they are sustaining a significant loss in revenues. The political reaction in the US has been relatively restrained thus far, but widespread bankruptcies amongst producers will change this. There will therefore be pressure from all sides for a return to more normal conditions, and it is not hard to see a rise of 50-100% in oil prices from here within the next 12-18 months.

What can we expect next?

The priority of policymakers must be the health of the population. It is obvious that the measures being taken to control the virus and protect the health system must lead to declining consumption, which at two thirds of the GDP of a modern economy, will have an inevitable impact on growth. Also, the extended nature of the global supply chain means that we could easily see growth in productive activity grind to a halt.

(i) Monetary policy

From the financial crisis, we already know what form the central banks' playbook will take, although elbow room is now much more limited. Liquidity has been injected into the system to soothe short term issues, rates have already been cut and QE has been restarted. With fiscal expansion of historic proportions, it is highly likely that much of this will fall to the Federal Reserve to accommodate. Just as importantly, the overhang of low-quality debt will start to topple over as the recession bites.

Will the Federal Reserve act as a buyer of last resort for high-quality investment grade bonds only, or will it reach further down the credit chain and effectively socialise the cost of poor past lending? If it does, the orders of magnitude involved are prohibitive - not to mention the questions of moral hazard. Just to give some numbers: US GDP is approximately $21.5trn; the Fed's balance sheet, which was around $1trn at the time of the financial crisis, is now over $4trn, and comprises mainly Treasury securities and mortgage-backed securities.

US corporate debt stood at just over $9trn, of which around 40% was BBB and 31% A to AAA. For any bonds at BBB downgraded below investment grade, liquidity evaporates leading to a pricing cliff. These concerns also extend to sovereign debt for heavily indebted countries.

If support is restricted to investment grade debt alone, then the market bifurcation in pricing between good and bad credits will only get worse. There are serious implications for both holders of these instruments and those who manage them in funds. One should expect both overt and behind-the-scenes pressure to ameliorate the impact. As an aside, one would expect the same bifurcation to occur in equities in respect of their financial fragility.

If governments wish to actively bail out failing companies, in practice they can only do so through the medium of banks or other financial institutions or by buying collectives with exposure to the underlying debt (e.g. ETFs). Given the experience of the post-financial crisis, it is reasonable to assume that those charged with implementation will insist on lending on commercial terms including requirements for prior charges on assets etc. In other words, business owners, whether public or private, are going to face stringent conditions which lead to dilution of their ownership interest.

Banks are unlikely to emerge from this with a burnished reputation, since every failing business will - even if unfairly in this case - ascribe the loss to the intransigence of the banking system. Unless the banks are asked to do the job, the scale of the potential support required suggests that the central bank alone may well not have sufficient firepower to stabilise the market. Instead of being too big to fail, high yield debt may simply be too big to save.

(ii) Fiscal policy

Governments will seek to ameliorate the impacts of the virus, but their policy options are limited. The list includes loan guarantees, social payments, property tax reductions and possible income or sales tax cuts. On the expenditure side, there is also the normal range of public projects to fall back on, although few of them would have any immediate impact. The available fiscal elbow room varies considerably from place to place, high in Germany on the one hand and low in the US, Italy and Japan on the other.

Given the experience of the past 20 years, the working assumption must be that governments will continue to boost their spending until a binding constraint is reached, meaning that no further increases are possible. In the world's dominant economic power, the United States, the debt/GDP ratio averaged around 40% during the 1960s to the 1980s. In the late 1990s, it jumped to 60% and since the GFC it has exceeded 100%. Following the 2017 Trump tax cuts, the Federal debt/GDP ratio is approximately 105% and the current fiscal deficit 4.6%. Where is the limit? It is hard to be precise, but a further 2%-4% increase in the deficit is a reasonable assumption if we get a 'normal' recession, leading to a drop in tax revenues and increase in entitlement programmes. The $2+ trillion support package announced by the Trump administration could take the annual fiscal deficit to a jaw-dropping 17% of GDP. The mooted additional packages only increase the deficit. Furthermore, it is unrealistic to assume that it would immediately revert to previous levels for both political and economic reasons.

Credit markets

What happens to the cost of this debt in those circumstances? How long can governments issue debt at a zero or negative real yields? Given a severe recession and soaring defaults/downgrades, the current complacency of global credit markets will surely break down. Investors will demand returns commensurate with the underlying risks. Covenant-lite and highly leveraged deals will no longer be the order of the day. In the short-term credit markets will bifurcate, with top investment grade credits effectively being underwritten by the Federal Reserve, and BBB and sub-investment grade bonds, unless socialised, being left to the mercies of the market.

In that event, the market will mirror the experience of the LTCM crisis in 1998 when there was literally no bid for some categories of paper. The LTCM crisis parallel will not be limited to an absence of liquidity. It is highly likely that with the extended suppression of risk-free rates, some market participants will have accumulated highly leveraged positions which may not prove to be as well behaved as their historic models predict. The recent disruption in the repo market may well be a harbinger of what can happen when this unwinds.

To the extent that corporate debt is properly priced, there will be competition for investor dollars in the fixed interest market. This competition will make it increasingly difficult for governments to sell debt to the normal natural buyers at artificially suppressed levels. Countries with a bond-buying constituency that can absorb the issuance will fare better than those which are reliant on external funding. The pressure point for countries reliant on external investors will be the exchange rate, which in turn depends upon confidence in government economic policy. Typically, it is the exchange rate which acts as the canary in the mine for declining investor confidence.

Potential currency losses for indebted countries will quickly halt the demand for government paper (an experience not unknown in the UK, but one that applies with equal force to countries other than the United States). As the owner of the world's reserve currency, the US is not subject to these constraints to the same degree. The flip side of this is that fewer constraints create greater latitude for policy excesses. A President who can make large tax cuts at a time when the economy was close to full employment is not going to be easily constrained from opening the fiscal taps in a crisis such as this one.

The policy reaction

During the financial crisis, speed was of the essence. Such was the precarious nature of the financial system that unless capital was injected quickly it would have collapsed, potentially leading to a repeat of the 1930s depression. The resulting policy action allowed the recapitalisation of the financial system, such that systemic risk is much reduced. This does not mean that the banking system will be exempt from pain. It simply means that it should be sufficiently resilient to avoid requiring public money to survive.

The immediate losses from this crisis will instead be mainly felt in the real economy. Cash-flow issues will cause company bankruptcies. As noted earlier, for some classifications of investment paper, there will be almost no liquidity. Some companies will be able to refinance in the credit markets, but others will not. Ultimately those furthest down the ownership ladder (normally the owners of equity) will have to take the strain of refinancing or losing their principal.

Pain will also exist further up the credit ladder. Unemployment will rise significantly irrespective of any bailout, particularly in the sectors where employment is more transient. We have already seen an unprecedented rise in unemployment from the virus-induced shutdown. While many of these workers will return to employment, there will be enduring unemployment as a result of the fallout in the credit and leveraged loan markets. In all likelihood there will be a loss of productive capacity as a consequence.

It could be argued that this can be avoided, given the history of government intervention through the provision of soft loans etc. However, it is this very history which makes it inevitable that many of the support measures for business will come with strings attached. Memories of the bank bailouts and the subsequent gains by management and shareholders are too fresh in the memory to assume that the same kind of largesse will be offered this time around. Airlines, for example, will claim that there is nothing they could have done to avoid the crisis; that the virus is an external event which could not have been foreseen. This is a legitimate argument, as is one that it is in the interests of the state to prevent their bankruptcy. There is certainly debate in Europe about dropping, or suspending temporarily, the state aid rules to allow direct support of companies.

The counter argument is that during the good years many companies boosted their earnings with buybacks and leverage whilst amply rewarding themselves and shareholders. For example, Delta bought back 38% of its stock between 2015 and 2019, whilst its debt increased from $10bn to $29bn. American Airlines bought back 17% of its outstanding shares and pushed its net debt up from $5bn to $14bn. It is naïve to think that the public, and hence the legislators, will acquiesce in giving preferential aid to a company that has spent the last five years converting equity into debt.

The alternative to government cash injections (with strings), is that companies either raise fresh equity or enter into some form of protection arrangement, such as Chapter 11. Presumably, the overall outcome will be a mixture of both. None of these outcomes is good for investors. It seems inescapable that most government support will come with a price tag; one that will need to be paid by those who benefited most from previous actions. Any loans made by governments will presumably need to rank above those of all other creditors, which will require acquiescence from existing debtholders. Shareholders should meanwhile expect dilution and a clampdown on dividends.

One has to assume that the policy aim will be to ensure that businesses remain solvent and going concerns, rather than to support share prices or protect ownership interests. Additionally, this support is likely to be limited to those with short-term cash-flow issues. It is going to be difficult in practice for the government to step in and underpin businesses whose underlying viability is in question. For these threatened businesses, there are the existing tools to seek protection whilst recapitalising.

How governments split the funding for their policy measures between the taxpayer and the owners of businesses is a political question, that will be conditioned in part by both recent experience and the fragile state of public finances. The most logical outcome is that most of the cost will be borne by the owners of capital with the state effectively acting as underwriter (or extracting an economic interest) where appropriate. The required scale of the fiscal transfers to the unemployed and the healthcare system are of such magnitude that it is hard to see any other outcome. The implications for shareholders are obvious and worrisome.

Timescale and magnitude

Expert opinion suggests that the economic shutdown, in varying degrees, will last a minimum of three months, and more likely of the order of six months. Thereafter one would expect retention of various forms of restrictions until a vaccine has been developed. It seems reasonable to assume vaccine development and deployment no later than this time next year, but with possible anti-viral medications earlier, judging by the comments coming out of the scientific and medical community.

What remains unknown is the length and depth of the recession. Talk of a 'V' shaped recovery is misplaced to the extent it implies a speedy recovery back to a 'steady state'. Comparisons with 2008 are not particularly relevant; in 2008, the systemic risk was largely confined to the financial sector and the costs of refinancing were huge. The cost of recapitalisation was borne by both the taxpayer and shareholders. The real economy was not at the heart of the breakdown but it suffered nonetheless.

Unfortunately, the prolonged period of interest rate suppression and liquidity injections which followed created a private debt edifice that requires very little to bring it tumbling down. This edifice extends through the real economy. That this debt has existed for an extended period seems to have created a view in capital markets that sharp falls are always immediately followed by recovery and that the authorities can protect asset markets from extended periods of pain - irrespective of the core issues. It may be a natural behavioural response conditioned by repeated examples; in some ways the markets have been vaccinated against downturns, but at some point the elastic snaps.

This economic picture of a leveraged economy is no longer just a hypothetical outcome. The downgrade cycle in credit markets has already begun. The virus alone could easily cause 10-20% of GDP to be lost if the infection rate reaches the latest projections of 50-60% in developed economies. It is hard to see how the debt downgrade and default cycle which has been looming for some time can fail to accelerate with such a sharp decline in economic conditions.

Fast forward 12 months

In its reaction so far, the market seems to have conflated two different events. Before the end of 2020, the impact of the virus itself on markets will be much diminished, reflecting a decline in the spread of the virus and evidence that the global economy is reviving. Through vaccines and broader levels of immunity in the population being achieved, the medical panic will recede and we have already witnessed an example of the significant rally that follows. This is likely to be a relief rally at best, a pause before the reality of what is coming along behind sets in. GDP could be 15%+ lower, fiscal deficits will reach 10% or more of GDP (and fairly easily 15%+ in some areas), debt/GDP ratios will rise above 120% in the US, unconventional monetary policy will be extended and sovereign debt will be on negligible yields.

At that point, with the policy cupboard bare, any sensible investor will start asking about the exit path. How does the government component of the economy get back to a sustainable position against the poor economic backdrop? Other than default, there are only two alternatives. One is 'the long repair', an extended period during which national balance sheets are gradually rebuilt and the national debt burden is paid down. That timescale can be measured in decades, not years. That option may be tried, but is unlikely to run its planned course, not least because we have an electorate conditioned to the view that government can solve all economic problems.

The faster and more politically expedient alternative is additional monetary easing, more government spending and, inevitably, sooner-or-later the return of inflation. If that course is adopted, it will essentially be effectively a new form of wealth tax, redressing some of the intergenerational inequalities of the recent decades. However, the impact of inflation does not fall evenly. It is particularly brutal for those with limited assets and fixed incomes with consequences for governing parties. Memories of the havoc wrought by inflation in the 1970s may be sufficiently distant that the resistance to this policy path has been diminished. It may also be that there is a view that the absence of collective bargaining and the shift of power to employers occasioned by the digital world have conspired to make wage inflation permanently more transient.

True, not all nations will be able to follow this route. Many countries rely on external investors to fund their deficits, who may take fright at what are perceived as profligate policies. Where insufficient demand exists, a significant proportion of the funding is likely to end up on central bank balance sheets. Central banks would probably dispute this. The Bank of England, for example, has recently signalled that funding fiscal deficits is definitively not their policy, other than in the short-term. History tends to suggest that in crises 'short-terms' tend to become chain-linked and evolve into a long-term. In this environment, the central banks will not be so much nudging the tiller on monetary policy as driving the outboard motor themselves. Any pretence of central bank independence will evaporate, bringing with it an eventual loss of the hard-earned confidence in their inflation-fighting credentials.

The world may change in other ways too. Globalisation is in reverse both for political reasons and because of the virus. Highly efficient just-in-time, single-sourced, offshore supply and inventory chains have been exposed as high risk. Dual-sourcing and onshore alternatives will be the order of the day. It is hard to say whether the nationalistic policies pursued by the Trump administration and other nations will continue, but they are unlikely to reverse. There will be more support for policies that were already gaining sway with the electorate. The world is also already drifting towards more authoritarian regimes, and with economic hardship comes a rising potential for international discord. As a historic example, at the time, the US tariff legislation of Smoot Hawley in the 1930s was opposed by much of the economic establishment. This did not stop it from being enacted and contributing to the Great Depression.

Finally, it seems inevitable that the downward trend in taxation levels will be reversed. Further tax cuts appear inconceivable against a backdrop of exploding government balance sheets. More likely, taxes will creep up. Stealth taxes will return. Whatever the source - business taxes, potential wealth taxes, income tax – will increase, however well disguised. Equally, one would expect attention to focus on companies with low effective tax charges obtained through arbitrage of different national tax codes. The bottom line is that the state will have no option but to take a greater share of revenues. A hypothecated health tax of some form to fund health services in the wake of the virus is another obvious option, and an easy political win in the wake of the public's support for the doctors and nurses who have been in the frontline of measures to control the pandemic.

Conclusion

If this analysis is accurate, the investor is facing an unhappy future, even when the immediate cloud of a global pandemic passes. The present will see recapitalisation on an unprecedented scale. The future will be characterised by: higher costs of production, higher taxes, higher cost of capital, higher non-wage costs and potentially higher wage costs as inflation kicks in. All the props, in other words, that have sustained the previous bull markets in both bonds and equities are being kicked away. The long-forecast secular bear market in bonds may have finally begun. In this new world, equities will have to be repriced to reflect both the impact of the secular changes on profits and the recapitalisation of balance sheets. Investors will demand a bigger risk premium. All of this will gradually dawn on markets in the next 12 months once the relief-rally peters out and liquidity is sucked out of the system by default and recapitalisation. Of all the investment disciplines that will come into play, the two most important will be valuation and patience. Opportunities will emerge.

Where is this likely to be wrong?

The foregoing narrative from a Scotsman, to paraphrase PG Wodehouse, would not be easily confused with a ray of sunshine. The narrative may be logical and persuasive, but it does not mean that it is necessarily correct. Like all projections, it relies on a series of assumptions and a different outcome is certainly not impossible.

One key factor will be what happens to economic growth. Leaving aside population and demographic changes, economic growth is fundamentally about productivity. Is it possible that we could see a surge in productivity? It is possible, but it seems unlikely. Costs of production are unlikely to drop in a world that is turning its back on ever-onward globalisation. A significant uplift in capital expenditure will be constrained by the level of indebtedness. It is true that there are many areas where great advances are being made, including, but not limited to, understanding of the human genome, alternative energy and quantum computing. On this view, the future will not be dark. It is simply clouded by historic excesses which cannot continue to build with every crisis.

A second error might be that the debt overhangs are not as precarious as portrayed, and the default/downgrade cycle is much more muted than suspected. In this case, the recession would be neither as deep nor as prolonged. This assumes however, that more than ten years of close- to- zero cost of money have somehow failed to induce over-leveraged and high-risk lending. It is true that the banking sector, the traditional culprit, has been restrained in the aftermath of the GFC both by regulation and by capital. The flip side is the likelihood that this mantle has been assumed by the non-bank sector in response to the insatiable desire for yield by those with long-term liabilities.

I am not hopeful.

Important Notes