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How is 2020 different from 2008?

2008 was a US housing crisis distributed globally by the banking system.

US housing was overvalued and over leveraged. The mortgages they supported had weak underwriting and credit standards. Banks from Europe and Asia had entered the US market and were thus exposed. The resultant housing market crash led to a banking crisis which led to a credit squeeze causing an acute recession.

2020 is a massively distributed, spontaneous economic shutdown caused by a virus pandemic.

Most assets are overvalued. Corporate assets from equities to bonds to commercial and industrial real estate are over leveraged. The exception this time is the banking system which has spent the last 12 years in rehab and are thus stronger than the non-financial corporate sector.

In 2008, the prescription was to save the banks and to restore the credit transmission system. The alternative credit conduits were the bond, loan and ABS markets. It was important, therefore, not only that interest rates were low at the short end but across the curve as well. Also, investors had to be encouraged to increase their risk appetite and move down in credit quality. Enter QE and financial repression. *Once credit transmission was restored, the economy would heal*

itself. It did, to a point.

The 2020 recession will require different medicine. Failure to withdraw QE once the economy had recovered from 2008 has meant less capacity and efficacy of additional monetary stimulus. The nature of the problem also presents challenges to even conventionally unconventional monetary policy. Such policy was designed to address a failure in the credit distribution system. But either a) the non-bank credit infrastructure is breaking, and the old policies are useful for restoring it but no more, or b) it is not breaking and policy is in a sense wasted. The complacency of people and markets have resulted in a shockingly fast sell off that has threatened the functioning of the credit markets from treasuries to commercial paper, from corporate bonds to mortgage bonds, from loans to structured credit, and from high yield to investment grade. The Fed has stepped in to do what it can, and it has had to prioritize to minimize moral hazard. Avoiding it altogether is impractical. The result is that by early April, a month from the steepest market corrections, and albeit rather shakily, the non-bank credit system is functioning.

The 2020 COVID 19 pandemic prevents people from working and spending. Restoring some normalcy will require the invention of a cure, a vaccine or an organizational change to how we live our lives. We do not have much visibility into any of these 3 avenues. The current approach appears to be to limit the spread of the virus by reducing the opportunity for contagion. This severely limits the ability for people to work or spend. People who are unable to leave their homes and socialize cannot consume as before. This represents a large-scale reduction in demand which puts strains on business and threatens large-scale unemployment. This has already begun with jobless claims in the US reaching almost 7 million at last count. The same physical constraints on mobility limits the ability of people to go to work resulting in a significant supply shock. Absent exogenous shocks, demand and supply

deficiency means recession and an uncertain inflation outlook.

Many countries have begun massive fiscal stimulus programs. These include some form of universal basic income paid directly or indirectly via businesses. On balance, this is inflationary and can lead to FX volatility.

Is there hope?

Human ingenuity is a powerful thing and it is likely that a solution to the COVID 19 virus will be found as well.

Even before the virus is tamed, people will find new ways to live their lives. Humans have been reminded that pandemics recur and that there will always be a new disease and challenge. People will have to find new ways to work, to consume and to interact with one another.

In 2019, there were many instances of social discord: Gilet Jaunes in France, anti-extradition protests in Hong Kong, pro-independence in Catalonia, tax protests in Lebanon and Brexit. The world was clearly divided, to a great extent due to inequality. Adversity has been known to unite people, and COVID 19 is a global blight afflicting everyone. There is an opportunity here.

China may extend aid, financial and technical, to the rest of the world given its relative success at containing the pandemic. It may take advantage of America’s isolationism and nationalism to advance an agenda of engagement with the rest of the world.

Europe. A monetary union without fiscal union was unusual. The massive fiscal stimulus programs launched at the national level will place countries balance sheets under differential stress which will manifest in sovereign spreads. This may encourage Europe to consider a fiscal union.

Environmental and social factors may be prioritized in development and investment. Unrestricted development can be risky with unforeseen consequences. The destruction of natural habitats leads to closer interaction with new species often allowing a pathogen to migrate to human hosts. This is the likely path of COVID 19. Perhaps the pandemic may encourage more thoughtful development strategy.

President Trump’s clumsy management of the COVID 19 pandemic in America may see him replaced by a more thoughtful and moderate President who can turn the considerable resources of the US to more constructive engagement of the rest of the world.

What are the risks and challenges?

Adversity presents humans with two choices, unite to overcome that adversity, or pursue a selfish, isolationist policy.

In all major upheavals there are winners and losers. Millions of jobs have been lost around the world and many of these will not come back. Millions will have to adapt, and not all successfully. The cost of welfare will rise substantially straining public finances. The social implications could be serious and could lead to political turmoil.

America faces a Presidential election in November. There is a chance that the incumbent Trump may try to delay or disrupt the election on account of the COVID 19 pandemic.

Europe’s fiscal stimulus may encourage some member states to seek a fiscal union which other members may be reluctant to fund.

The existing competitive tensions between China and the US are a risky backdrop to geopolitics. America may use COVID 19 as an excuse for confrontation by seeking to pin the blame on

China. This scenario may spawn other difficult scenarios.

Many developing nations are ill-equipped to deal with the economic fallout from the COVID 19 pandemic. Sovereign defaults and devaluations could destabilize economies and regimes.

Economic support programs are dealing with a problem which is hard to measure. The initial programs dealt with liquidity and cash flow needs. They are also reacting to the human cost of the pandemic and extrapolating to the economic cost. Subsequent stimulus will need to be calibrated to deal with the recession. Macro data is too low frequency to be an effective guide.

Massive monetary and fiscal stimuli to support demand while supply constraints persist could lead to high inflation while having limited impact on demand.

Crises that involve massive fiscal and monetary stimuli often precipitate rethinking of currency systems, such as the Bretton Woods system in the aftermath of WWII.

What are the opportunities and threats?

The scale of the economic crisis could encourage a rethink about how people live, how production is organized and the nature of constructs such as money, or companies, or economic systems.

We might already live in a post scarcity world. Here we define post scarcity to mean that we have the means to satisfy all human needs, not wants. Nothing can satisfy all human wants except a radical change in mindsets. The problem could lie in that we do not yet live in a post monetary world. We have all we need but the claims on these things have been poorly distributed leading to poverty and surfeit. How do we get from

current conditions to those post scarcity conditions?

The massive printing of money may render the stuff worthless. Yet we do not know how to organize an economy without money. When major currencies begin to lose value alternatives may be sought. A currency that discourages hoarding might be useful. This might be effected by issuing a digital currency with a maturity limit on legal tender, for example.

Humans are adaptable and will find workarounds to live through the COVID 19 pandemic. Some of these workarounds will become a normal part of life as we emerge from the pandemic. Humans require food, shelter, interaction, entertainment and work. Essential supply chains will need to be made more robust through redundancy and compartmentalization.

Technology and automation can help. On the demand side, online shopping has already made serious inroads in replacing brick and mortar retail. Some goods and services do not lend themselves to online transactions. Travel, F&B and other experiential services are examples. Technological solutions such as augmented and virtual reality may present alternatives. Delivery will evolve as well from manned to unmanned drones. Manned delivery might well become a luxury.

Manufacturing will be increasingly automated with the displacement of labour. Smarter AI and more generally applicable automata will make factories even more automated with less and less human intervention.

There will be significant changes in real estate. Already, people are discovering that they can be effective working at home. The demand for commercial real estate will likely not recovery pre pandemic levels. Residential real estate will be priced not as much for proximity to cities and work, but to recreation and natural features like rivers, parks and hills. Population density will become a factor. Industrial and logistics real estate will also see change as manufacturing

and distribution dynamics change.

What are the practical implications for investing?

We now know how quickly the virus can spread and how dangerous it is. In that knowledge we have reacted by shutting down swathes of the economy on a global scale. This suppression is working at slowing the spread of the virus and case numbers are already beginning to slow. Some countries are even considering relaxing physical distancing measures. However, we do not know at what level we can operate the economy without allowing the virus to resume its spread. We do not know how quickly we can restart the economy.

Financial markets reacted to the initial shock by selling off acutely, at a pace comparable to 1929 and 1987. Fortunately, governments responded with massive stimulus and relief programs worth trillions of dollars. This has restored some order to the markets and even prompted a sharp recovery in certain more liquid, retail accessible and sentiment sensitive markets like public equities and bonds.

Less liquid and more leveraged structured credit markets such as CLOs and ABS have seen prices fall more acutely to levels which suggest they might offer value.

It has only been less than 2 months since markets began to take the COVID 19 pandemic seriously. The future of the global economy remains very clouded and there is much we do not know. It is likely that emergency financial aid continues for the foreseeable future, until either the economy stabilizes, or a sovereign balance sheet breaks. It is likely that unemployment will be persistently higher as some industries fail to fully recover. It is likely that the economy is already in recession and that such recession will persist for another 2 to 3 quarters. It is possible that such recession lasts longer than that. It is likely that growth will not regain pre pandemic

levels for some length of time.

The outlook for earnings growth is therefore negative and uncertain. The ability to forecast cash flows for any length into the future is poor. Therefore, for long duration assets or equities, valuations need to be significantly discounted. Shorter maturity assets less reliant on long horizon forecasting are preferred.

Summary:

Equities are probably cheap, except that visibility of earnings is very poor, and its hard to discount cash flows that are unpredictable into the distant future. That said, equities have the most volatility when it comes to recovery. Then its probably prudent to await clearer signs of recovery and miss the first days of recovery, which are more of speculative than investment.

IG bonds are probably cheap, and visibility or cash flows is average to poor. The duration that comes with IG bonds may not be an effective hedge if inflation flares up.

HY bonds are fair on a default and recovery adjusted basis. Cash flow visibility is very poor and the defaults have yet to even begin.

Mortgage Backed Securities. This is not a single market but a spectrum of them from agency to non-agency, from IG to HY. The price declines generally across all submarkets of ABS suggests that there is some real value here. Automatic, systematic selling due to deleveraging or ratings limitations have led to indiscriminate selling and assets trading below fairly draconian economic assumptions. Investors need to calibrate their allocations to their convictions.

Syndicated loans. Loans are probably cheap with fairly good

visibility to cash flows. There will be downgrades and defaults but market pricing is assuming very severe default and recovery assumptions relative to historical experience and underlying economic prognoses.

CLOs are an interesting structure over syndicated loans. These have also been the subject of automatic, systematic, rules based selling which has led to dislocated prices. Current pricing also implies very draconian default and recovery assumptions. IG CLOs have fairly predictable cash flows and are attractively priced. HY CLOs and CLO equity are also very attractively priced but are subject to very uncertain cash flows and are likely an opportunity for later in the cycle of this crisis.

Distressed opportunities such as traditional corporate distressed investing, chapter 7 and 11 solutions, are probably an opportunity for later. The proliferation of covenant lite debt will delay actual default until non-payment which is likely to come 2 to 3 quarters later. This has the potential to be a multi-year opportunity to rescue some fine, viable operating business which had over leveraged themselves in the decade of cheap debt.

Private market opportunities will be dealt with separately in another post.