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INVESTMENT MANAGERS

Investment viewpoint

A stark new decade

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The last decade was about low volatility and the triumph of passive investments. Welcome to the new decade.

At a glance

- The COVID-19 crisis will likely act as an accelerator of trends that began to emerge in the prior decade. The digitalisation of the economy, the pressures to rethink globalisation, and the shift of power to Asia, to name a few. So far, the repercussions on the financial economy have been mitigated by unprecedented government response.
- This backstop has created a high level of confidence amongst investors and a perception that the past decade may serve as a model for the years to come. We think it will in fact be radically different. For us, greater dispersion amongst companies, industries and countries, combined with a return of volatility, are here to stay. This will mean that the trend of investing into large passive vehicles may reverse, shifting back to more nimble and active managers. Active managers with a broader mandate and ability to participate in inefficient markets, such as the volatility market, may be particularly attractive.
- We are entering a stark new decade with an unprecedented global event, where specialised expertise can help investors tap into material opportunities and navigate uncertainty.

An unpredictable healthcare crisis

The COVID-19 pandemic started as a healthcare crisis, whereby the ultimate outcome will obviously be dependent on its resolution. In the most optimistic scenario, an effective treatment protocol and herd immunity could come in 2020. In the most pessimistic scenario, the fatality rate could remain high, immunity would be short-lived and vaccine development complicated. Regardless, it is clear we are still in the early stage of this pandemic and the economic impact is already tremendous, with outcomes on certain industries devastating (some of which were not typically that cyclical). Trends that existed prior to the crisis are likely to be exacerbated: the influence of technology, geopolitical tensions, a shift from the west to east, rising populism and protectionism, whilst other new trends will likely emerge, such as an increased role of the state and a redefinition of the social contract. We expect an unusual dispersion of outcomes for companies as a function of regions, sectors, robustness, and strategic importance, which could prove fruitful for a disciplined, process-orientated active investor.

The pre-pandemic background

To mitigate the effects of the global financial crisis (GFC), quantitative easing (QE) was initiated in Western Economies. The objective was for central banks (the Federal Reserve (Fed), the European Central Bank (ECB) and the Bank of Japan (BOJ)) and others) to buy government bonds and inject money to the financial system (banks and other intermediaries) so that they could lend this money out to the broader economy. The key goal was to encourage transmission from the financial system to most economic actors alongside large businesses. However, because of the lessons of excessive leverage, multiple safeguards were implemented and banks were put under a dilemma of having to generate profits, whilst providing liquidity to the economy under a strict regulatory framework. Rather than lending to weaker credits, banks were excess lenders to the healthier entities, families, corporations or asset managers. As a result, (1) corporations increased debt on long durations and low rates, and bought back stocks, (2) families bought high-end real and financial assets, and (3) asset managers expended investments in illiquid strategies and higher risk premium assets. All of this was done with almost no fear of losses due to the abundance of QE money. Unfortunately, this led to economic misallocations of capital and increased allocations to higher risk assets to fulfill return requirements and an increase in populism. The latter linked to an increased frustration from a disenfranchised middle class combined with an increase in wealth disparity. Finally, it also left very little room to maneuver, and the path to normalization, which central banks attempted to start, complicated.

The economic collapse and its social impact

While the 2008 crisis was a heart attack to the financial system, the 2020 COVID-19 crisis is a heart attack in the real economy, combining both a supply and a demand shock. Bad economic news has been coming rapidly and in high numbers, from record drops in activity to record surges in jobless claims, and massive damage to government finances.

Demand completely collapsed for a vast part of the economy and many companies have to operate with almost no revenues. This already has massive impacts on the very short term, with new unemployment figures rising continuously. With factories, schools and shops shuttered around the world, the International Labor Organization says lockdowns are affecting almost 2.7 billion workers. Within that, almost half – representing about 38% of the global workforce – are extremely vulnerable, mainly in the hotel, food service, manufacturing and retail industries. Many of these industries are unlikely to recover soon.

The rapid fiscal and monetary response

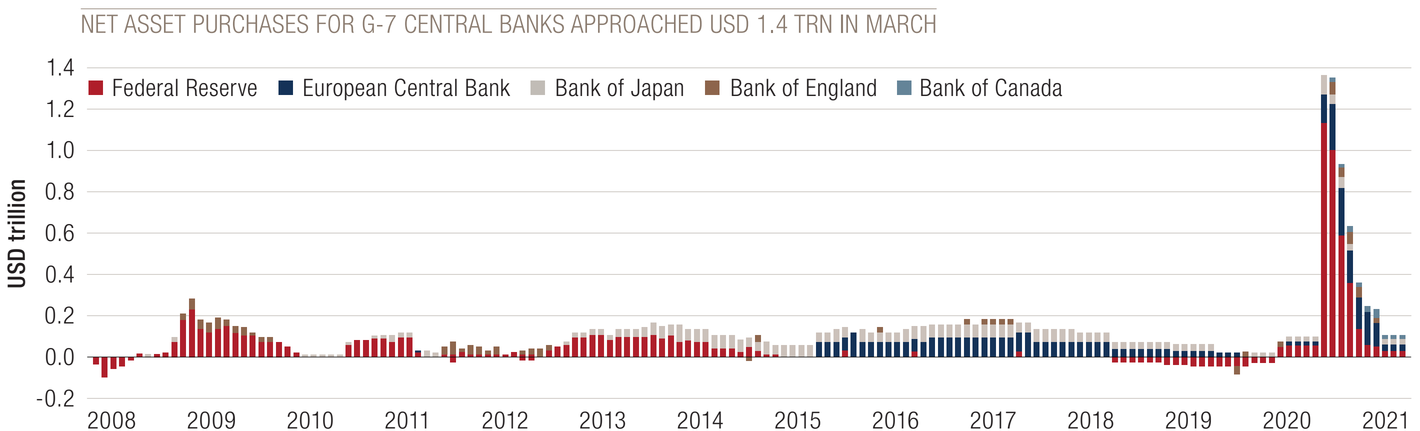
In contrast to 2008, the reaction of authorities this time around has been swift. There are no taboos about bailing out the economy. Whereas it was hard to justify saving big large banks, the extraordinary measures in 2020 have much broader support and the extent of these interventions are unprecedented. In effect, to compensate for a huge fall in GDP, governments have stepped into the role by extending their deficits, at a considerable pace. We are two months into a lockdown and the deficit increase in the United States represents 20% of US GDP, a considerable amount.

Major central banks, whose mandates have been clearly extended, have been forced to take extreme steps to support growth and underpin financial stability. Across the Group of Seven (G7), that has included the return or launch of large-scale asset purchases. Net asset purchases for G7 central banks were close to USD 1.4 trn in March. That is an extraordinary amount, close to five times higher than the previous peak of USD 270 bn in April 2009.

In contrast to the GFC, the current crisis initiated in the real economy and then spilled over into the financial economy. The current structural problems are therefore larger, and make simple financial measures – mainly focused on the financial sector – less effective. In addition, the transfer of relief to the most affected areas of the economy is imperfect.

FIG. 1 QUANTITATIVE EASING

NET ASSET PURCHASES FOR G-7 CENTRAL BANKS APPROACHED USD 1.4 TRN IN MARCH



Source: Bloomberg Economics.

The rise of government intervention

Along with the demand destruction, there is simultaneously a supply shock and solving both will prove difficult for governments. The depth and breadth of the problems just a few months into the crisis also suggest a complex recovery path, notwithstanding risks of resurgence. Even in the most optimistic scenario, demand in many industries is unlikely to recover anytime soon.

Societies will not be able to weather a prolonged downturn without risks of severe social unrest. Political pressures will rise within countries, with the continued rise of populism. To the left, demanding more socialism, and to the right, requesting more protectionism and less globalisation. There will likely be increasing social tensions across all dimensions (e.g. between generations, between immunised and non-immunised, between medical professions and those struggling on a low income, between different religious followers).

Governments will look to help citizens more directly, combined with increased pressure on corporates to do the right thing for society (potentially at the expense of their equity valuations). We can assume that even in the most capitalist societies, governments will need to support the vast majority of the population who is living on a month-by-month basis by raising taxes, increasing regulations, kick-starting vast infrastructure projects, and potentially nationalising industries.

States are likely to change their spending patterns with an increased focus on social and healthcare spending. The socialisation of healthcare and a better, more connected system will emerge. Sustainable considerations and government policies that focus on long term considerations, incorporating science, will also be further reinforced. After all, pandemics were a well-identified risk linked to:

- Social changes (urbanisation, global mobility, population growth in developing countries).
- Economic development (globalisation, global trade) and environmental challenges (increased domestication and deforestation resulting in more contact between wild and domesticated animals).
- Loss of biodiversity (losing the dilution effect), and climate change (blurring seasonal/geographical boundaries).
- Privacy (weakened as careful monitoring of citizens and their activities will be required. Big data will be used to track behaviors and controls will be increased across all sectors of the economy).

Mountains of debt and the monetary consequence

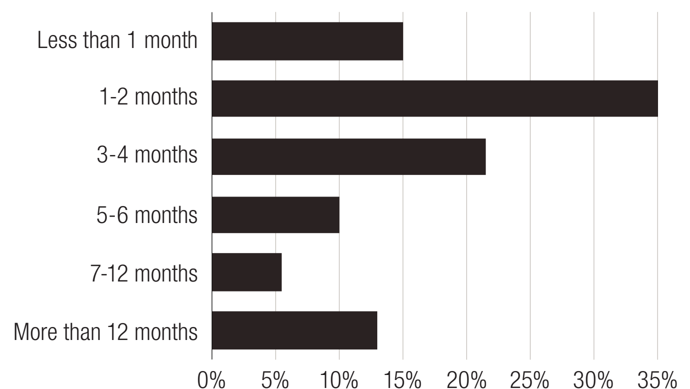
The full impact of the pandemic may take years to play out. However, one outcome is already clear: governments, businesses and many households will be loaded with mountains of additional debt.

In a normal setup, this accumulation of debt would correlate with some rate increase, however central banks have intervened to not only keep rates low but also effectively lower rates. As a result, central banks will hold considerable amounts of debt. The real question might not be that there is perhaps too much debt, but what this really means for currencies. In the past, such aggressive monetary policy would have immediately led to inflation, but today velocity is low and much of this mechanism ends up in assets and not in goods or services. Further, as debt/GDP ratios will rise substantially, not all monetary authorities will be able to keep rates artificially low (particularly those who cannot print a reserve currency).

During and after the GFC, the Fed expanded its own portfolio of securities and other holdings from less than USD 80 bn to USD 4.5 trn. The Fed unwound some of that as the expansion took hold. Now, in the initial stages of the COVID-19 crisis, it has stretched its holdings from USD 3.8 trn last September to USD 5.8 trn as at 1 April, and is on track to increase them by trillions more in the months ahead.

FIG. 2 SURVIVAL TIME FOR SMALL BUSINESSES

HOW LONG WILL YOU BE ABLE TO OPERATE UNDER CURRENT ECONOMIC CONDITIONS?



Source: NFIB March 30 survey. For illustrative purposes only.

The risk of inflation

The immediate demand shock acts as a powerful deflationary force. However, in the longer term, the collapse in supply combined with aggressive government spending (infrastructure), the relaxing of inflation targets (how will a central banker defend not saving businesses in the name of an inflation target?) and the target of reducing the high debt burden, are likely to be supportive of inflation.

Short-term money printing can fix a collapse in demand and prevent a catastrophic depression. However, if this persists for a long time, it will fuel a rapid rise in prices. If production has collapsed, but there is the same amount of money in circulation, then inflation is the inevitable outcome.

Whilst the velocity of money initially will strongly decelerate, the economic collapse will create inefficiencies and supply shocks on clusters of goods that will certainly kick off inflation in multiple components of the economy.

Geopolitical considerations

We expect to witness the emergence of a new world, with alterations to our forms of democracy and social contract, capitalism, and the redefinition of the role of the state. In our view, the west will emerge weakened. We will likely enter a real phase of reconstruction. The social contracts within our societies will likely be in question. The United States will increasingly shift its focus from Europe to Asia, and to China in a struggle for world dominance.

After being exposed to the first wave of the virus, Asia managed to present itself as a model for the planet. China is already in a position of strength because of its reserves and industrial production, which contrasts with the over-indebted United States and Europe, both at the mercy of another huge financial crisis. China will be in a position to buy assets across the world. This pandemic will likely accelerate the rise of Asia while further weakening its western competitor.

What this all means for investments

Increased industry differentiation, with technology as a clear winner, a lot of financial instability, the triumph of volatility and active management

At the end of 1999, gold had been in a bear market for 20 years. We remember researching articles written at the previous peak of the gold price in 1980 that ranked the best investments for the decade 1970-1980. They showed that stock indices had halved and in the meantime, gold prices had gone up 10x. Interestingly, the best investment in that ranking was not gold, but instead Persian carpets. The anchor of our short-term memory is strong but things change, investments trends vary and perhaps one day we will look at shorting volatility at 12% (such as when banks sold to retail to enhance yield in 2019) as a very exotic investment idea. It remains early to identify the winners (or survivors) but clear trends are already emerging.

Within the illiquid buckets, investors will increase allocations that are real diversifiers and backed by real tangible assets that are in short supply. Land, for instance, offers good agricultural productivity and has intrinsic value.

In the liquid buckets, allocations towards assets that are short of supply and tangible (ideally movable) will increase. If things get very bad, these assets will hold value and act as tail hedges until the world bounces back. Examples include gold and/or silver in physical form, recognised culturally as a store of wealth and tough to replicate or extract.

In wealth management, technology, volatility and active management are the natural beneficiaries.

The triumph of technology

Technology will continue to thrive. From working at home, to entertainment and education, this crisis will continue to support heavy investments into technology as well as great returns on investments over the longer term. Technology spending such as expanding the 5G network will continue to be a priority.

Governments will act for the benefit of 99% of the population and on top of infrastructure spending; most governments will look to increase self-sufficiency on key strategic industries. This will include knowledge/information (data farms and technology), defence, and healthcare (where price dynamics could shift completely). Governments will further look to: avoid spending that drains foreign exchange reserves; and more thoroughly analyse critical versus non-critical imports and exports.

The return of active management

We expect the trend of investing in equities and bonds through passive investments to reverse. Typically, passive investments have survived on low fees and the ability to adjust over time. As companies do well, they make their way into the indices and little by little gain weight. Passive investments are, however, ill prepared for a rapid change in business outcomes.

In essence, the performance of underlying companies will have very little to do with the weight they hold in an index. Some industries will see a catastrophic earnings revision, particularly within the BEACH (Booking, Entertainment and Events, Airlines, Cruise and Casinos, Hotels and Resorts) sectors. Few companies have a financial structure designed to withstand a 60% collapse of revenues, but companies with weak balance sheets are likely to struggle disproportionately. Further, it will be important to assess good quality assets vs. poor quality assets: which companies have high, recurring and predictable revenues, and which do not.

Strategic importance will be another key criteria, either because of the social weight of a company (employees, brand recognition) or because of the goods produced. Credit, volatility and equities might not be linked as closely as they have been in the past. Some strategic companies might receive specific state support that benefits creditors to the detriment of equity investors.

In many industries, there will be pressure on dividends, bonuses, corporate taxes, high income taxes, inheritance taxes and increased regulations. These differences will be further exacerbated as a function of regional and country factors.

This crisis is likely to fundamentally change the passive trend. Central banks and governments, which are typically passive investors, will look to act as stabilisation forces.

However, 1) they will focus on systemic risk, not idiosyncratic risk, 2) companies are not of equal importance to them and cannot all be saved and 3) this is a heart attack on the economy not on the financial system, so financial cures will not solve all problems. The Fed cares about top firms that are large employers, not an emerging market country with no fiscal prudence or a high yield firm that should have folded years ago but survived due to free money.

Investors seeking to generate returns will have to increase their allocation to the more aggressive active managers. As a result, dispersion will increase within sectors, across industries and across countries.

Risk recycling and the return of volatility

In the last decade, many investors could peek at the daily return of the S&P 500 and get a good sense of how everything else was doing in the market. This was the case as dispersion was low, there were few surprises, volatility was muted and the idiosyncratic company trends would evolve over multiple quarters. Going forward, the S&P 500 will be a much poorer indicator of the level of risk or stress in the market. It has an overwhelmingly large allocation to key tech stocks that are likely to prove very resilient.

In periods where monetary policy is expansive, global assets are purchased in every sector and industry and risk premiums compress globally. In periods of uncertainty, there is risk recycling and divestments from the industries and countries most at risk. When divestments happen, they specifically tend to hurt the weakest investments first, exacerbating their problems and increasing uncertainty, dispersion and volatility.

Coming into this crisis, investors seeking yield increased their allocations to riskier and riskier assets. Over time, investors will remove their weaker names and recycle risk. Some higher quality assets will offer similar return perspectives to weaker assets. Obviously, this path will be volatile. Some of the weakest assets will be most volatile, offering insufficient risk premia given the context, and will be subject to liquidity mismatches and the potential for forced sellers. Emerging markets are obviously riskier today, specifically those with bad fiscal and current account situations. They have no way out but a severe devaluation of their currency.

Volatility as an asset class has always proven very fruitful from a correlation perspective. The opportunity set has also improved over time, as there are more and more inefficient investors (hedgers, retail, structured products designed for yield), fewer and fewer inefficiencies arbitrageurs (banks have shut prop desks) and the opportunity set is typically too small for many large hedge funds. Many structures are also complex and not necessarily listed. Unfortunately, the opportunity set was also hampered by structurally low levels of volatility and dispersion. This is about to change significantly and could prove particularly fruitful for a nimble, active asset manager free of many traditional constraints.

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