AUGUST 18, 2020

LIFE AFTER COVID

"How you did in this pandemic, as a country, a village, a business, a group, or an individual, whether emotionally, economically, or morally, is an indication of how robust you are and how fit you will be for the next decades".

Nassim Taleb

First, Crises Reveal Incompetence

Although crises create opportunities, they also reveal incompetence. Crises always require faster action. The higher the speed, however, the larger is the need for competence. High speed combined with incompetence leads to disasters, in almost all areas of our lives – driving, healthcare, finance, government or military.

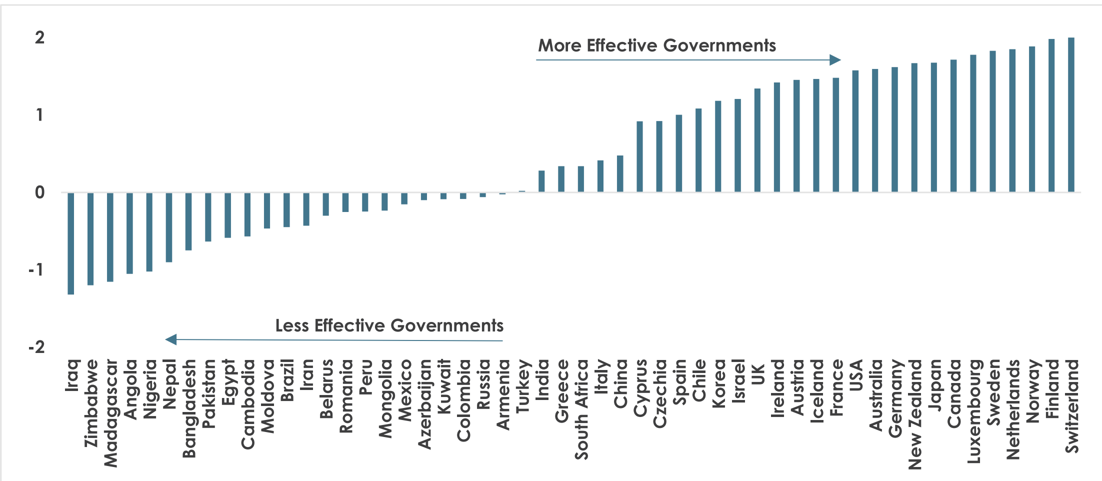
Any surgeon can treat a minor cut. However, the emergency surgery to unclog the congealed arteries of a motionless heart will quickly reveal the difference between competent and incompetent surgeons. The price of incompetence is often measured in human lives.

Anyone can manage money when stocks are rising and businesses are booming. When markets plummet, however, a portfolio of $10 billion can shrink to either $9,0 billion or $5,0 billion, depending on the competence of money managers.

Olivier Blanchard, the former chief economist of the IMF and one of the best contemporary economists, has recently suggested a very interesting model to save small businesses from bankruptcy. His idea is to extend loans to small businesses, at low interest rates. These loans will be *partially* guaranteed by governments. Whichever firms survive, after the crisis, pay a much higher profit tax (income tax) for several years, so that governments get their money back (for guarantees given to businesses which disappeared). The elegance of this model is that it creates equity-based financing at a time when many firms have zero equity. Future profits taxed at a higher rate is the invisible equity taken as collateral. This makes perfect sense because the equity value of any business today is the present value of all future profits.

Competent governments will quickly implement such programs, to save thousands of small businesses and millions of jobs. Incompetent governments will spend months debating solutions, while businesses continue to disappear. Countries with competence governments and competent businesses will come out of this crisis much faster and with significantly less damage. Chart 1 shows the list of most competent and incompetent governments.

Chart 1: Government Effectiveness Index



Source: World Bank Estimate (ranging from approximately -2.5 to 2.5)

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Hence, our first point is that crises raise the speed of change of all events. Higher speed of events, in turn, requires lots of competence. Incompetence becomes apparent during crises.

Second, Systemic Risks and Data Analytics

During the 2008 financial crisis the world was shocked to discover that policymakers, economists or financiers didn't have any quick fix recipes to stop the crisis. Instead, dozens of highly respected banks and insurance firms around the world went bankrupt, tens of millions of people lost their jobs and houses, and stock markets around the world plunged by 50%. Destructive effects of the 2008 financial crisis lingered for a decade!

Why did it have to be so devastating and so painful?

The answer is that very few people had thoroughly studied *financial systems*. Many had studied capital markets (bond markets, stock markets, derivatives), economics (macroeconomics, microeconomics, international economics, political economy), finance (corporate finance, asset pricing, portfolio management), but very few people specialised in *financial systems – investment banks, retail banks, corporate banks, mortgage banks, insurance firms, hedge funds.*

The problem is that the science of finance assumes a direct link between investors and capital markets – those who have savings are assumed to directly invest in stocks and bonds. Nobody paid any serious attention to the financial intermediaries, between savers and investors. This complex web of financial pipelines, which channel savings from around the world into all sorts of investments and projects was largely ignored. And surely enough, the epicentre of the 2008 financial crisis was in financial systems around the world.

Today, just like in 2008, people have discovered (a) that very few people have thoroughly studied global spreads of pandemics; (b) that epidemiology is very far from being a precise science, (c) that doctors often disagree, just like economists and financiers do; and, (d) that analysing data, establishing causalities and drawing conclusions is much harder in practice than in theory.

We are witnessing a toxic mix of complexity, incompetence, financial interests, corruption and fear. That is why the world is in such a mess today. The 2008 crisis was a similar mix.

No other field is as rich in reliable data as the field of finance and financial economics. Financial economics data are not only highly reliable, but they are also readily available and easily comparable. The field of epidemiology is nowhere near the field of finance in terms of data or *analytical knowhow*.

Although data in finance has been easily accessible, in huge quantities, for many decades, to this day it is very hard to find stable and reliable relationships of causality in finance or economics. Yet, for some reason, people expect quick and reliable causality results from epidemiology. Let us not be too optimistic. Causality is always very hard to establish, in all fields, especially with unreliable and noncomparable data.

Third, so what do we do with all of the above?

There are two scenarios, which have small probabilities but huge consequences. We attribute a 5% chance to each scenario. Let us quickly get these two scenarios out of the way before we discuss the third and the most likely scenario.

Scenario number one, which is not frequently discussed, is that COVID completely disappears, by itself, within the next few months, just like SARS did in 2003. We can not say that this scenario has a 0% chance.

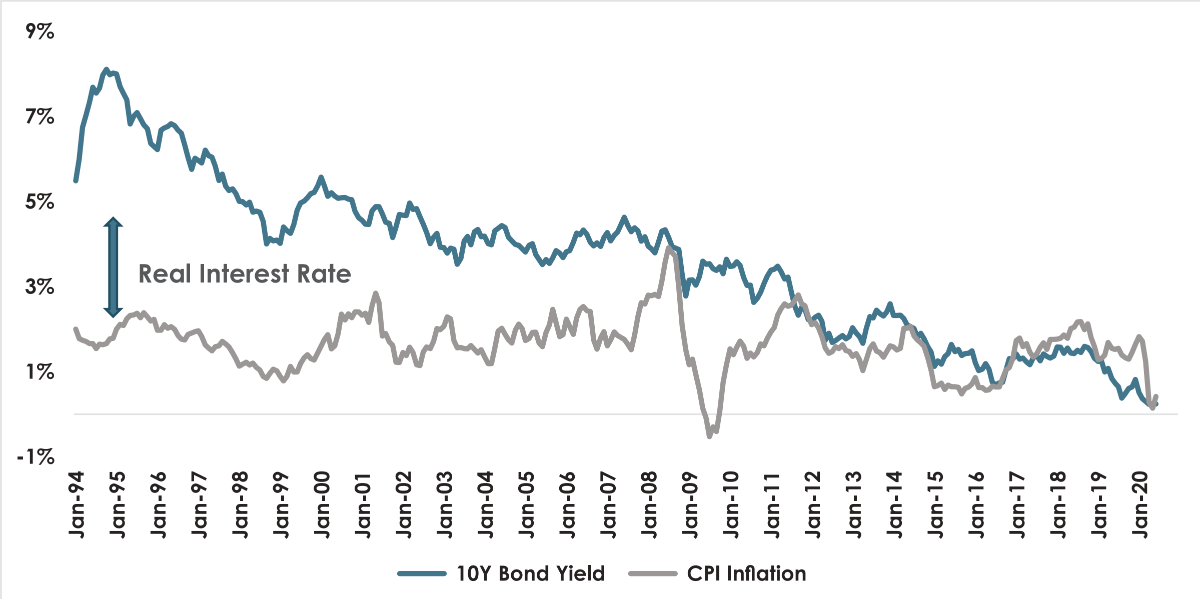
The consequences of this scenario are huge. Short-term interest rates will rise sharply, gold prices will collapse by at least 20%, stocks of various travel and tourism firms will skyrocket, oil price will rise by 20%-25% and so on.

Given that this scenario has only a 5% chance but huge consequences, it would make sense to think about getting some exposure to it, especially since this insurance is currently not expensive.

Scenario number two, at the other extreme, is that along with ongoing COVID infections, *long-term* interest rates start to rise (by long-term we mean 10 to 30-year bond yields). All asset prices – stocks, real estate, land – around the world, especially in developed countries, are inversely correlated with long-term interest rates. This is a mathematical fact.

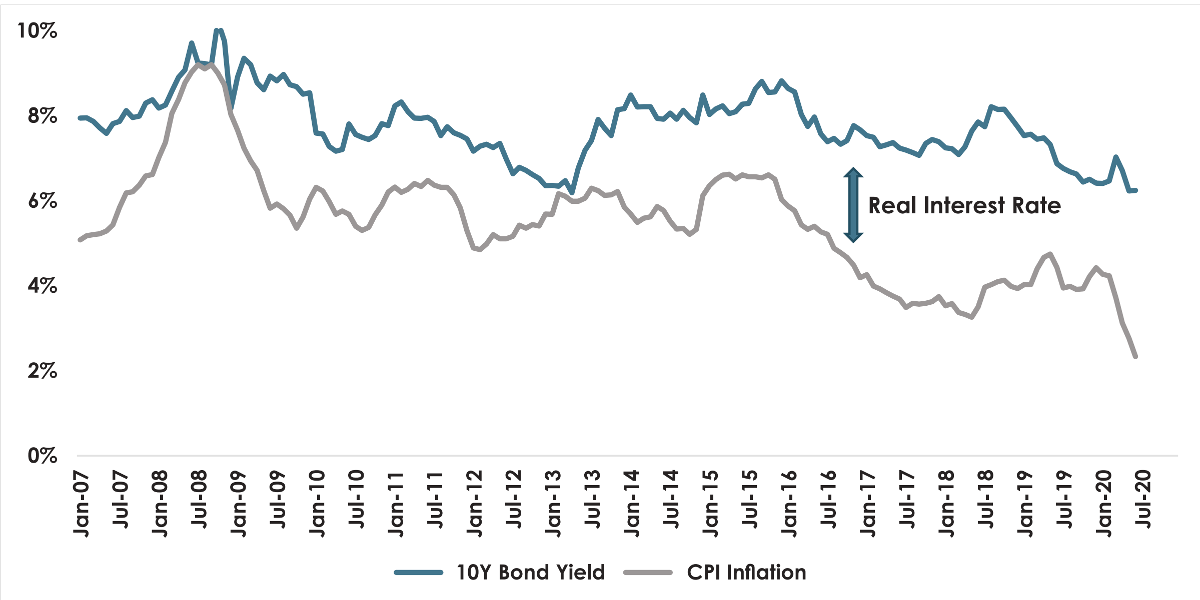
Nobody has really understood why long-term interest rates around the world have been relentlessly falling, since 1990s. In 2005, Alan Greenspan, the former chairman of the Federal Reserve, called this a conundrum. Today, fifteen years later, it remains a conundrum (see Charts 2 & 3).

Chart 2: Real Interest Rates Have Fallen in Developed Countries



Source: Central Bank Websites, Investing.com

Chart 3: Real Interest Rates Remain High in Developing Countries



Source: Central Bank Websites, Investing.com

Since nobody understands why long-term interest rates have fallen, it is reasonable to assume that nobody knows when they will start rising again. If long-term rates rise, for whatever reason – higher inflation expectations, lack of trust in government debt, sudden collapse in intended savings around the world – all hell will break loose. The 2008 financial crisis will seem like a walk in a park.

Most asset prices would collapse, many governments – including in developed countries – would default, gold prices would still collapse (gold and interest rates are negatively correlated) and the world economy would plunge into a depression.

Both of these low-probability but huge impact scenarios should be discussed and prudent people should have contingency plans in case either of these scenarios are realised.

Let us now discuss ***the third and the main scenario***, which has a high probability (~ 90%).

Sweden's chief epidemiologist – Anders Tegnell – describes the current situation as follows:

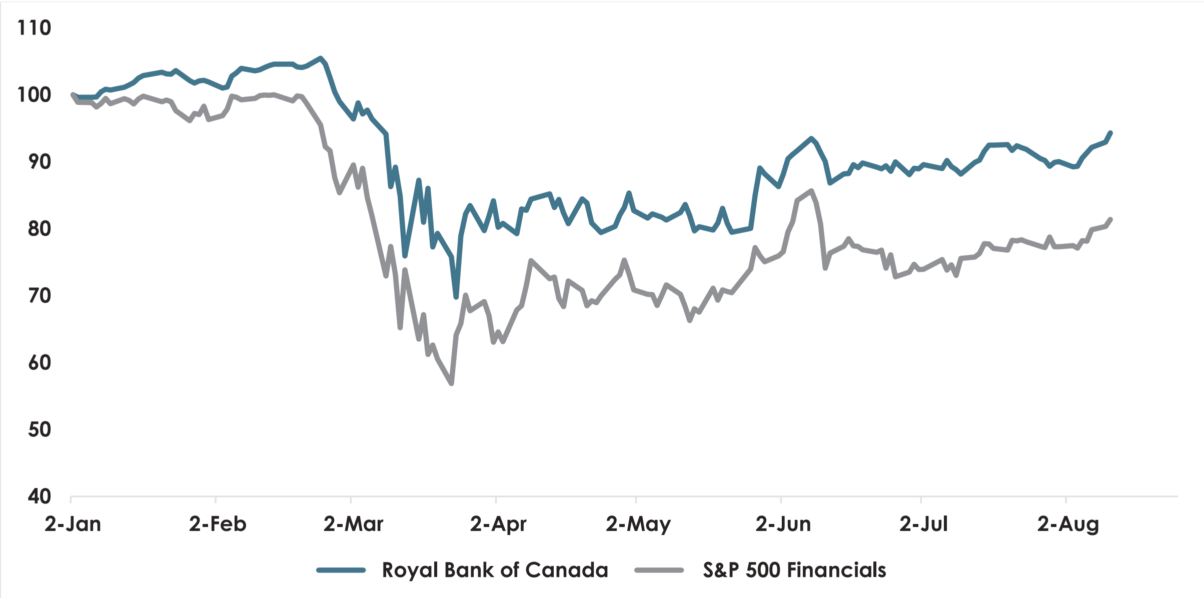
1. COVID will be with us for at least a few more years;
2. high-density cosmopolitan capitals are more prone to all epidemics, not just COVID;
3. the key to lowering death rates is to avoid spread among the elderly;
4. most epidemiological projections have been *completely* wrong;
5. when this is over, the mortality rate will eventually be around 0.1% to 0.5%, no different from a flu epidemic;
6. it is highly unlikely for anyone to get COVID twice, Sweden hasn't had anyone tested positive more than once;
7. it is very hard to measure *ex-ante* immunity.

Let us assume that he is right, and further develop our argument.

Royal Bank of Canada (RBC) is Canada's largest bank. Despite COVID, RBC's share price is down less than 10%, from its historical peak. Many banks of developed countries, such as HSBC, have seen their share prices fall by around 50%.

The CEO of RBC, David McKay, wrote an article in The Globe and Mail newspaper, in early April, called *"How to make Canada a more self-reliant country in the aftermath of the coronavirus pandemic."* The main idea of the article was a confident call to make Canada much more self-reliant, in different areas of the economy.

Chart 4: RBC Outperformed S&P 500 Financials (rebased to January 2, 2020 = 100)



Source: Yahoo Finance

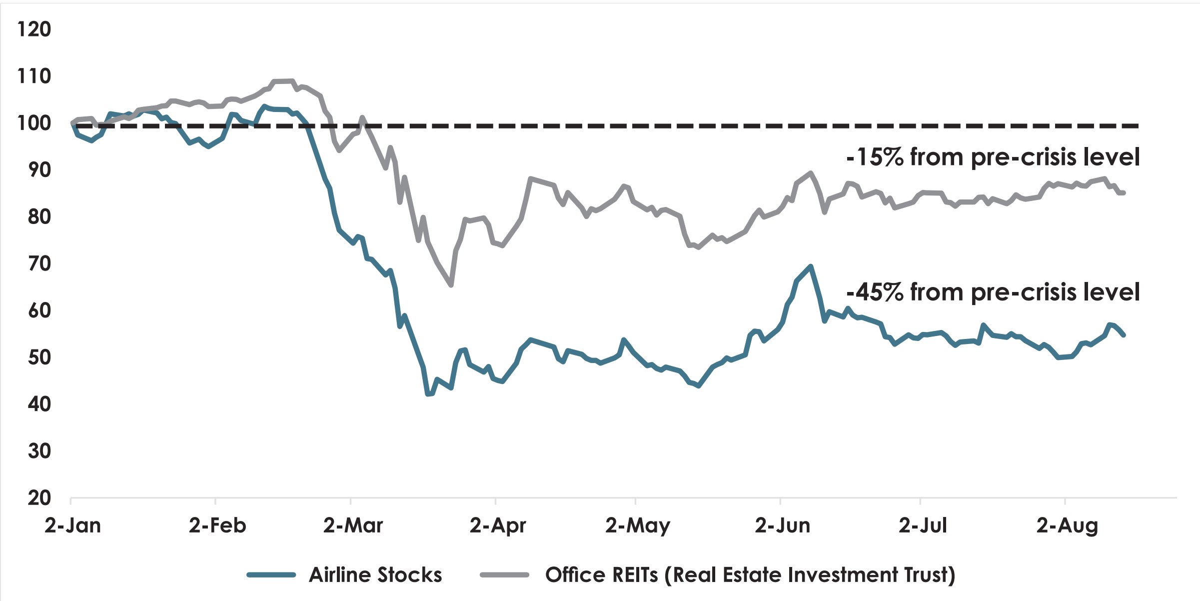
If Canada is thinking about becoming more self-reliant, what about the US, Eurozone, Brazil, India, Russia and China? As argued in our previous email on wealth creation (available on our website), world trade as a share of world GDP will continue to fall, because many countries will try to become much more self-reliant.

Let us list several additional trends, which are likely to continue, with about a 90% probability.

1. **Travel & Entertainment:** Hotels, restaurants, reception halls, cafes will come back only gradually, and many of them won't come back at all. All the social distancing and mask-wearing have effectively increased the cost of doing business in all of these areas, without raising revenues. Large airplanes won't be in high demand because long-haul flights will take a few years to recover.
2. **Real Estate:** Commercial real estate (office buildings and shopping malls), as well as their builders and designers, will have spare capacity for many years, as some people permanently shift to online. Retail stores will continue to lose market share to firms such as Amazon. Moreover, many people won't even need as much clothing as in the past.

See the performance of Airline industry and office REITs (Real Estate Investment Trust) since the beginning of the year in the chart below.

Chart 5: Airline Stocks and Office REITs Have Not Recovered Yet (rebased to January 2, 2020 = 100)



Source: Yahoo Finance, STOXX

3. **Healthcare:** Elderly people's homes & hospices have made an absolute mockery of themselves and this business model will need to be rethought completely. Online healthcare and diagnostic methods will continue to rapidly develop.
4. **Education** will change. Many private colleges, schools and universities, which charge $30,000 to $50,000 per year will disappear, especially the ones with a lot of debt. Only the best will most likely survive. Online education will gain market share.
5. **Taxes & Protectionism** will rise – inheritance taxes, income taxes, VAT. We will see new taxes we never heard of before. Governments will have to raise taxes to repay debt and meet rising social obligations. The world will become much more protectionist and less globalised (as argued by the CEO of RBC). This will push up prices in many countries such as Canada, because producing in developed countries is more expensive than producing in developing economies. But this will be a "one-off" price increase and won't cause a spiraling inflation trend.
6. **Finance Industry:** Risk-premia will rise, permanently, across all asset classes. Correlation between assets and asset-classes will fall, which will make international diversification much more valuable. People's precautionary savings will rise, which means people will save a much bigger percentage of their earnings.

Conclusion

The most important word in the post-COVID world is ***"hysteresis"*** or "*hysteresis effects*". In economics, hysteresis refers to a persisting change in human behaviour, even though factors which caused that change disappear.

Hence, the question is which parts of our lives will never return to their previous condition.

In the beginning we tried to describe two low-probability but high-impact scenarios, then we described the main scenario, with likely *hysteresis effects* in various sectors.

If we combine our previous reports on Ecosystems, Optimal Government Size & Wealth Creation, we should be in a good position to foresee several *hysteresis effects*.

Nassim Taleb is right, the best "stress-test" is the actual event. People, businesses and countries spend millions of dollars conducting stress-tests. The reality often differs from simulated scenarios. Hence, Nassim argues that people, businesses or countries, which came out of this crisis unscathed are positioned to do well over the coming decade.

David Tavadian, CFA
Founding Partner

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