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A “black swan”

Market Comment, April 2020

The health of the global population is probably facing its most serious threat since the Spanish flu, while economies and financial markets are exposed to a so-called “black swan” – a rare and unpredictable phenomenon that can have unexpected consequences. The growing risk is that the coronavirus crisis will last longer, or prove more severe, than the market consensus has so far expected. There is wisdom behind Winston Churchill’s remark: “If you are going through hell, keep going.”. We believe that a cautious positioning in the financial markets remains the appropriate stance.

A black swan is a very rare event that is unpredictable and can have dramatic consequences. The enormous global outbreak of coronavirus and the global recession it sparked off in March is precisely one such phenomenon. Accordingly, all attempts to find parallels – be it the financial crisis of 2008/2009 or even the Spanish flu pandemic of 1918-1920 – are likely to fall wide of the mark. The intensity of the current crisis for the global population is unique, just as it is for economies, companies and financial markets. As Winston Churchill once said: “If you are going through hell, keep going.”. In other words, although we have to adapt, think carefully and be circumspect, we must nonetheless push on and get through this phase, which could well last longer than many people initially hoped. The exceptionally rapid proliferation of the virus in March, particularly in Europe and the US, caught Western governments and companies by surprise and hence found them unprepared, quite possibly also due to deliberate disinformation from China. As discussed in our most recent Market Comment, the three-dimensional negative impact of coronavirus – via disrupted production and supply chains, the necessitated containment measures in connection with consumer spending and services, and a general decline in business and consumer sentiment – could lead to a huge slump in global gross domestic product in the first half of 2020. To compound matters, it remains wholly unclear how long the economic downturn will last. Although the majority of governments and central banks have now initiated fiscal stimuli packages of a magnitude comparable to (or greater than) the 2008/2009 crisis, the collapse in global economic growth is also likely to match that of 2008/2009, if not surpass it. Despite massive financial assistance, the worst will probably only be over for the financial markets and companies when the rate of infection declines and companies have greater clarity over the future.

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The focus of the financial markets is currently on the situation in the US. Due to the insufficient level of health insurance in the US and the standard practice of short-term recruitment and dismissal (“hire and fire”), we would expect the unemployment rate of 3.5% to rapidly shoot up to around 10% or even higher. Due to the high proportion of aggregate economic output accounted for by services, this means that some 20–30 million jobs could be eliminated, with massive negative repercussions for consumer sentiment. Given that consumer spending accounts for 70% of all US economic activity, it is conceivable that the recession will be deep and long – with the corresponding severe impact on corporate earnings. In Europe too, where consumer spending accounts for 60% of all economic activity, a record slump in economic output appears inevitable. As a further complicating factor for Europe, the idea of coordinated EU-wide financial guarantees for the increasing government indebtedness of the particularly hard-hit southern European countries has so far been largely rejected by the better-off countries of the Union. The longer the Covid-19 crisis persists, the more forcefully the argument will be made for monetisation of rising government indebtedness. If governments guarantee or absorb the indebtedness of companies or households, increasing their own debt mountains as a consequence, it will be questionable how these can be financed in the future. The new securities purchase programmes announced by the Fed and the ECB, which were explicitly described as unlimited and will finance the necessary increase in government indebtedness for the time being. This US assistance package and similar financial aid in European countries and Japan may have the effect of mitigating the consequences of the impending huge recession, but they will prevent neither that scarring phenomenon nor the associated dramatic slump in corporate earnings.

Moreover, the unprecedented economic crisis that began in March could have a number of other longer-term consequences, which would be very much in keeping with the nature of a "black swan" event. Multinational companies will be rethinking their dependency on supply components from China, which will not only transform the globalization of production but also possibly have the effect of reducing it significantly. The profitability of these multinationals can be expected to fall as a result. The social polarization between the poorer and richer echelons of populations will rise as mankind seeks an answer to questions such as the socialization of losses, the privatization of profits, and increasing unemployment. The vulnerability of the emerging markets – including China – in the area of hygiene and healthcare standards will become a more pressing theme, as will the heavy US dollar indebtedness of emerging markets, which is also one of the reasons for the current strength of the greenback. The apparently insufficient degree of solidarity and willingness to share financial burdens in the EU will lead to further disagreements and greater tensions, which could end up calling into question the very existence of the EU in the absence of some kind of "transfer union" – the euro will therefore probably remain under pressure for structural reasons. A rise in nationalist tendencies could become apparent not just in the EU, but also globally. Greater autarky or national self-sufficiency in the area of medical equipment, including protective masks and oxygen devices, but also in the area of fundamental foodstuffs and medications, will become a major theme.

All in all, a combination of rising economic risks and the associated medium-term political risks appears to make it only logical for us to stick to our defensive – i.e. less economically dependent and therefore less risky – investment positioning, in line with Churchill's exhortation to "keep going".

Remain prudent and stay healthy!

Gérard Piasko

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