

# Panic is the Enemy

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From The Desk Of The CIO – Fixed Income



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**COVID-19 is leading to unprecedented economic destruction across the world. While the human and financial cost will be enormous, periods of dislocation also present investment opportunities. Investors will need patience and a longer time horizon to benefit.**

There is only one conclusion evident at this point: COVID-19 is going to create the most precipitous destruction of economic activity any of us have ever experienced in our lives. Much of the world has come to a complete stop. There is no modern-day precedent for this type of halt in global commerce and employment. The human cost is mammoth, in terms of illness and loss of life, but also because the livelihood of so many families — their ability to secure the necessities of life — is now in severe jeopardy.

We are only just beginning to comprehend the enormity of the imprint this will leave on the global economy and the way we live our lives in the 21st century. The global inter-connectedness that has characterized the last few decades, epitomized by the advent of Uber, Airbnb and just-in-time inventories, will undoubtedly take a step back — a social distance, to borrow a phrase that has become the meme of this time.

We should keep in mind, though, that the world has weathered many crises in the past: world wars, widespread famines and deadly viruses. Humanity has emerged from these tumultuous periods, not without cost, but often stronger for it. Thus, in the world of finance, rather than allow panic to dictate our path, we should dispassionately ask, what do we do now?

## Economic destruction and unemployment

The economic standstill is leading to mass unemployment. In the United States, this is becoming apparent in the explosive rise in unemployment claims in just a matter of days. Some states like Ohio, Connecticut and Nevada have reported claims that are 10 to 15 times the usual rate. In Las Vegas, the 100,000 people who work on the strip are now all out of work. The hotels, restaurants and gaming halls closed. Food preparation and serving-related occupations account for close to 10% of employment in the US economy.<sup>1</sup> Workers employed in the auto and aerospace industries, represented by the United Auto Workers (UAW) union, are similarly idle.

The more than decade-long expansion that followed the global financial crisis (GFC) rested on the back of the strength of robust consumer spending. Now all of a sudden, this central pillar of support has been ripped from the economy at a speed and scale never experienced before. The services sector that makes up 50% of the US economy has been decimated, affecting dentists, optometrists, waiters and small business owners alike. And while the government is trying to offset the enormous hit to household income and subsequent consumption, any fiscal package can only cushion the blow so much.



Significantly, the near complete economic stop has dropped a boulder on the doorstep of a levered US economy. It is true the current brand of leverage is not the same type we saw in the GFC. In the current environment, it is largely corporate debt, whereas it was financial leverage that proved so challenging in 2008/2009. Banks entering this crisis are in markedly better capital and liquidity positions than they were entering into the GFC. Like all financial crises, banks find themselves in the eye of the volatility storm. While we cannot yet quantify the full extent of pressure on those financial institutions, we do know the current capital support and liquidity is a better foundation.

That said, we do not have models that can assess the impact of an economic halt of this magnitude into a levered economy. Top-line revenue of companies will drop precipitously, some more than others. Differentiating between firms that can weather this storm from those that are unlikely to survive will characterize the investment environment in the coming quarters and years.

### **Policymakers to the rescue**

Central bankers across the world have responded both rapidly and meaningfully to the crisis, particularly in the last 10 days or so. The US Federal Reserve (Fed), European Central Bank (ECB), Bank of England (BoE) and other central banks have announced extraordinary measures of monetary accommodation. These have included cutting interest rates, implementing quantitative easing (QE), yield curve control and liquidity facilities. The latter of these categories is designed to respond to the serious liquidity challenges in the markets during this period of volatility and mammoth drawdowns.

The regulations adopted in the aftermath of the GFC has meant that Wall Street broker-dealers are not able to play the “shock-absorption” role they assumed in prior periods of severe market dislocation, further exacerbating the liquidity crunch. Therefore, it is imperative the policy responses include restoring liquidity to the financial system and providing good quality companies with the means to obtain credit to see them through this period when revenues will be challenged at best, near zero at worst.

Fiscal policymakers have unfortunately lagged their monetary counterparts, failing to address the astonishing drop in real economic activity — the core of this crisis — with sufficient urgency until the past few days. The fiscal response has unfortunately, but not surprisingly, been hampered by politics. With that said, even fiscal policy makers are moving faster and with a greater sense of determination than is usual during crises.

Furthermore, the rapid strengthening of the US dollar is compounding the crisis. The decline in asset prices and accompanying fear has created an enormous demand for dollars, in part due to the unwinding of hedge positions, as well as US dollar hoarding to pay expenses and liabilities that eventually come due. Foreign exchange swap lines are now in place with many central banks, but more may need to be done on this front.

### **Understanding COVID-19 is key**

It should be noted that the effectiveness of the monetary and fiscal response will be blunted until medical experts have a better understanding of the nature of the virus, the ways it spreads, and the development of treatments and a vaccine. Until we know how long people need to be confined to their homes and how long economic activity effectively is shut down, it is very difficult to assess whether the measures being taken by policymakers are adequate. This problem cannot effectively be solved with public policy that resides outside of the factors that concern the virus itself: containment, hospitals, ventilators and the like. It is unclear when we will be safe to return to normality, when we can return to workplaces, movie theaters and retail stores.



## Longer time horizons are needed

In this sea of uncertainty, there are a few things we do know. One is that selling assets at fire sale prices in illiquid markets locks in losses. This is certain. We advise against doing this.

Where is the opportunity, one might ask? We suggest investors assess the situation as if the past never was; only the present is relevant. The volatility and drop in prices has created more advantageous entry points into markets. Assets are cheap, certainly cheaper than they were six weeks ago. Indeed, ask yourself, this question: If I were not in the market now, would I be buying?

This presents an opening for investment managers to begin adding small positions in enterprises that can withstand six or 12 months of revenue dislocation. The depth and duration of the virus and its impact remains unknown. Markets have responded to this uncertainty by sending correlations near one. At times of such dislocation, quality investments are treated similarly to poor investments; this creates opportunities. Recovery for companies, consumers and the global economy will take time. Investors will do well to expand their investment time horizons and be patient.

This crisis is likely to mark a paradigm shift in how we interact in society, but human ingenuity and resilience have seen us through crises of similar magnitude in the past. The same will be true this time. To fail to embrace this view is to subscribe to an Armageddon scenario. ▲

## Endnotes

<sup>1</sup> <https://www.bls.gov/news.release/ocwage.nr0.htm>

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