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COVID-19:

Thoughts on the Market and the Future

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COVID-19: Thoughts on the Market and the Future

> *"Train my mind to adapt to any circumstance … in this way, if circumstances take [me] off script … [I] won't be desperate for new prompting."*
>
> Epictetus

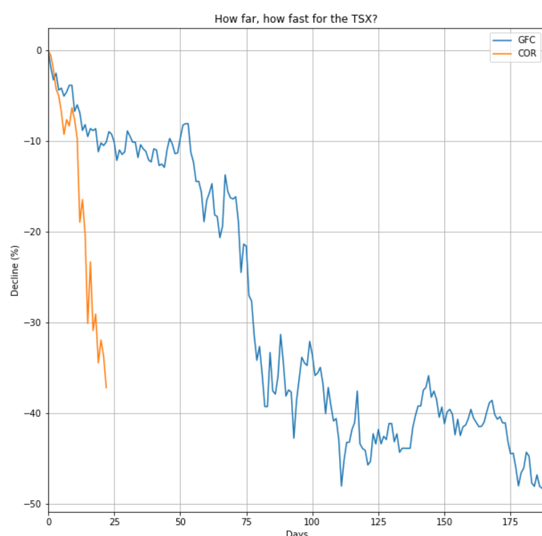
During this time of extreme uncertainty, Veritas will remain true to its guiding principles – seeking the truth from the facts. Everyone including us, is searching for answers. How long social distancing measures will be needed; how much income could be lost; how high job losses may climb; how much strain those losses are likely to put on the flow of payments in the economy (earnings, debt payments, interest, rent, etc.); and how well the financial markets are likely to function faced with these pressures.

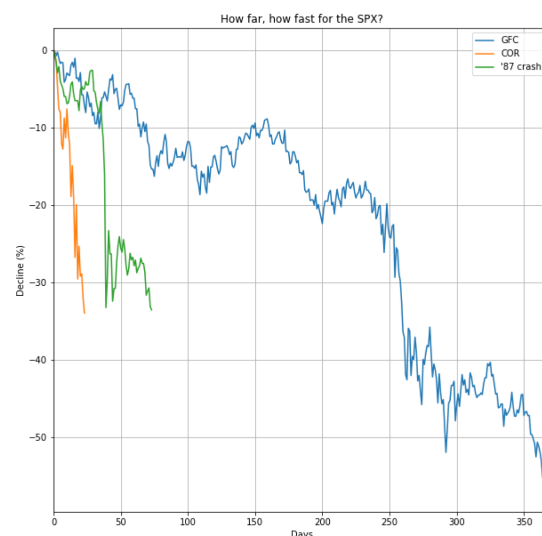
This shock is much different than that of the last financial crisis. The 2008/2009 crisis occurred on Bay and Wall Street, hitting most directly in real estate and cyclical industries. Among individuals, the worst affected were those who lost their jobs – there was a correction in U.S. employment of roughly 6% over two years – and those who had overextended themselves in the housing bubble. Shoring up the financial system with bailouts spared the world from the worst effects, but it still took until mid 2014 for U.S. employment to regain its pre-crisis levels. U.S. housing starts only regained their pre-2008 peak last year. Canada remained mostly unscathed.

The current crisis has and will hit Main Street much more quickly and in a way that is very hard, if impossible to counteract. Canada enters this downturn at greater risk because of record debt at all levels – household, corporate and government.

Shuttering or restricting businesses will mean dramatic declines in income for companies and for individuals. Given leverage, the drop in income could be devastating if extended for even a few months. The socio-economic impact of COVID-19 is likely to be much more significant than the last downturn as a result.

So far, it seems that the markets have it right – the 2020 decline from peak has been the sharpest in history.





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Unfortunately, reliable forecasts are almost impossible to deliver right now because *the evolution of the virus, its spread,* and the *effectiveness of public health measures* are very difficult to predict.

Politicians, business leaders, economists, analysts – everyone is reacting on the fly and trying to frame potential outcomes, but we're all doing so with incomplete information. The current pandemic is unlike anything the world has seen since at least the Spanish Flu in 1918, but this time, with a globalized economy, it really is different. The current downturn will have elements of prior pandemics (SARS, MERS, Spanish Flu, etc.) but also many elements of a financial crisis. The challenge for markets is that they are reacting in real time; the greater the uncertainty, the greater the volatility.

HOW LONG WILL SOCIAL DISTANCING AND THE DOWNTURN LAST?

As an educated guess, getting back to normal within a quarter, as some have projected, seems quite a long shot. We expect some form of social distancing to continue in much of the world through Q3 2020.

China's recovery beginning in mid-March is now being hailed as encouraging, however even though Wuhan went into lockdown on January 23rd, the virus had been raging since early January at least and officials were not tracking cases in earlier periods. The seven-weeks-until-recovery timeline is therefore suspect, since the first cases may have appeared in early December. As it attempts to ramp up, China will be faced with a dramatic drop in demand from the rest of the world. There is also renewed risk of infection in other parts of the country as social restrictions are lifted.

North America is very different from China. China has ~29% of its GDP tied to manufacturing and ~20% devoted to exports. North American manufacturing is less than 12% of GDP; U.S. exports are ~12% of GDP. With much higher consumer and business service components in North American GDP, our recovery will look very different when it comes, and will be much more dependent on our domestic economies. An internally led recovery is not necessarily faster.

In the U.S., with only piecemeal public health measures in place, cases have already spread across the country. There is considerable uncertainty as to where clusters may appear and how extensive they may become. The U.S. is likely to experience new waves of infection and accelerating clusters of the virus over the coming weeks. Canada could deliver effective public health policies and bailout packages, but our economy could still get dragged down by a prolonged health crisis in the U.S., which takes over 75% of our exports.

It seems the epidemiology of the virus also supports our assertion that social and physical distancing practices are likely to extend into Q3 2020. Social distancing is needed to prevent an overloading of the health care system by new cases. As a result, it needs to remain in place until cases reach a clear and manageable peak. In our view, that is unlikely to be measured on a scale of weeks, but rather months. Three months of disruption is likely a conservative measure.

The following articles pull together a great deal of the medical and social science and provide a good framework to think about the economic impacts.

- Globe and Mail: "When does social distancing end", March 20, 2020
- Medium.com: "Coronavirus: the Hammer and the Dance", March 19, 2020

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WHAT ARE THE ECONOMIC REPERCUSSIONS?

If we think of a normal economic shock, a dramatic contraction in GDP might be 3% to 5% year-over-year in the worst affected quarter. In the last crisis, the U.S. economy contracted year-over-year for four quarters at -0.8% (2008 Q4); -1.8% (2009 Q1); -3.1% (2009 Q2); and -2.8% (2009 Q3), before recovering to +0.5% in 2009 Q4. When all was said and done, nominal U.S. GDP declined by 1.8% for the full year 2009. Canadian GDP declined by 2.9% in 2009.

This time the contraction is likely to be much more severe. Businesses are not facing normal, recessionary declines, rather they are facing a drop from 100% operating capacity to 70%, or 50% or even 0% during the effects of global lockdowns. The resulting disruption is therefore more like a depression era correction than the correction that happened in 2008/2009. Travel and tourism are estimated to be ~10% of the global economy. That will fall dramatically in Q2-2020 and could remain at very low levels for several quarters. The restaurant industry is directly ~5% of the U.S. economy – that could be down 20% to 50% in Q2-2020. Goldman Sachs has come out with a negative 6.6% forecast for U.S. GDP in Q2-2020 (-24% annualized), with negative operating earnings for the S&P 500. The actual number could be much worse. Negative S&P 500 operating earnings have only happened once in the last forty years – in 2008 Q4, during the last financial crisis.

The solutions proposed right now are massive government spending and Federal Reserve buying of all asset classes, with US$125B of purchases targeted *every day this week*. For reference, the Long-Term Capital Management bailout, about which books have been written, was just US$4B.

These programs mean, instead of the loss of income damaging consumer and corporate balance sheets, governments – and the Fed balance sheet in the U.S. – will absorb a share of the pain through increased borrowing – and money printing at the Fed.

In Canada, that is particularly problematic because all forms of debt – consumer, corporate, and government – are at record levels. Gross government debt (all levels) is estimated by the International Monetary Fund (IMF) to exceed 85% of GDP in 2019. Add consumer debt of over 102% of GDP in 2019 Q3 and corporate debt of over 113% of GDP, and Canada's total debt-to-GDP is already over 300%.

Further government borrowing, coupled with the need to keep Canadian interest rates low, coupled with a collapse in commodity pricing, are a recipe for a dramatic correction in the Canadian dollar.

Already we are seeing the implications; among the scariest is that it took Canada eight months to lose 426,000 jobs in the last recession through mid 2009 … **new EI claims are expected to register at nearly 1 million in the third week of March**.

- Globe and Mail: "Unemployment Claims Reach Nearly One Million", March 24, 2020

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OTHER ECONOMIC FALLOUT

Fear and the wealth effect: There has already been significant wealth destruction, both real, through the immediate loss of income and emergency borrowing, and on paper from the stock market correcting. Increased debt, lower income and loss of wealth (whether real or perceived) are key sources of fear for individuals. Fear is likely to reign in both spending and investment, aggravating and extending the economic slowdown.

We can no longer count on the consumer: Household spending accounts for ~68.5% of U.S. GDP and ~63.6% globally based on World Bank data (2019 estimates). The U.S. consumer went from saving less than 4% of disposable income in 2007 to saving 7.5% in 2019. Canada went in the opposite direction. From a high of ~4.6% in 2009, savings rates have averaged ~3.6% over ten years and ended 2019 at 3.0%. The combined impact of a decrease in incomes and an increase in the savings rate could result in an additional economic drag over the longer term.

Ability of businesses to recover from a shock: It will take time for purely discretionary businesses to recover. Think airlines, cruise ships and movie theatres as extremes – but what about restaurants, home stores, barbershops, etc.? Many small businesses may not survive a 4-week shut down. As the EI data shows, businesses will be quick to fire, but they may also be slow to rehire faced with uncertain demand.

China is likely to be the first to recover, but that does not necessarily offer a blueprint for others: China is primarily a production economy rather than a consumer one. Getting people back to work is one thing. Getting people spending again is another. China now faces a second wave of weakness as the virus begins affecting their trading partners. It doesn't matter if China is producing, if Europe, North America and the rest of the world are not consuming.

WHAT TO EXPECT IN THE NEAR-TERM?

The Canadian dollar will fall: Expect a drop towards US$0.60 this year as economic pressures build, and Canadian governments take on debt. Our national debt could face a downgrade from its current prized AAA rating, leading to further devaluation. The Australian dollar offers an early warning of where we may be headed – the AUD had fallen ~18% YTD versus the USD before recovering to -14% this week; the CAD is down ~9.5% so far.

Unemployment will rise abruptly to very high levels: U.S. jobless claims could jump to more than 5 million this month, increasing unemployment from 3.5% in February 2020 to 6.5% in March. Forecasters are calling for 9%+ U.S. unemployment within six months. In Canada, ~1.13 million people were unemployed in February 2020, resulting in an unemployment rate of 5.6%. If this week's expected EI claims are added, unemployment would rise immediately to 10.2%, with several more weeks of layoffs likely still to come.

Expect historically high contractions in both Q2 and Q3 GDP: Travel & tourism is ~10% of global GDP. That will fall dramatically for at least one quarter and may not fully recover this year. The carmakers are shut down. Automotive is ~3% of U.S. GDP. Restaurants are partially shut and account for ~5% of U.S. GDP, ~10% of employment and ~10% of disposable income. In short, while Q1 could be modestly negative, expect more severe contractions in Q2 and Q3.

Canadian housing is likely to roll over: As an illiquid asset that is directly tied to incomes and employment, expect housing prices to decline in the face of fear and job losses. The sharp rise in unemployment could trigger a flow of financially motivated home sales.

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Typically, in an economic slowdown there is an initial decrease in listings as homeowners are reluctant to change housing arrangements or list in a weak market. With demand falling and houses remaining on the market longer, however, the sales to listings ratio falls, putting downward pressure on prices. If this is followed by a wave of financially motivated listings, expect prices to decline quickly.

At the end of 2019, the ratio of new listings to Canada's total housing stock stood at 5.1%. Historically, price corrections have been triggered when this ratio has increased above 6.0% – in 2008 the ratio reached 6.3% and in 1990 it was 7.1%. With a high component of investor and foreign ownership, we see an increased risk of crossing through that 6% threshold as investors seek to liquidate negative cash flow investments. Our survey of real estate investors from Fall 2019 [LINK to our October 2019 housing report from the conference] showed the strains already being faced by Canadian real estate investors.

Just as important as the percentage price decline, which could be significant, will be the negative wealth effects and impact on buyer and seller psychology. These could be severe and long-lasting; the real estate correction of the early 1990's took some 13 years to reverse. Although the government's proposed support for mortgagees and tenants will help, a small number of motivated sellers could still have ripple effects on what is an illiquid market.

WHAT TO EXPECT IN THE LONGER TERM?

Expectations for a V-shaped recovery may fade: With repeat waves of infection still a possibility, we doubt companies will be quick to rehire, which limits any rebound. The layer of financial uncertainty will also take time to lift. Remember, U.S. employment did not recover to its 2008 peak until mid-2014. The rebound is likely to be similarly weak this time around.

Interest rates will remain low: We do not expect any normalization of rates for at least two years, maybe more. The Fed Funds rate did not rise above 0.25% for five years after it was cut in December 2008.

The insurance industry will be hit: Mortality rates for working age adults are typically measured in basis points, which can range between 10 to 40 bps for the average adult aged 30 to 50. COVID-19 could add materially to these rates. On the commercial front, business interruption insurance could be triggered. Expect the industry to raise premiums to offset losses and future risk assumptions. The effects of assumption changes on reported results will depend on revisions to the mortality tables set out by the Canadian Institute of Actuaries.

The value of office space could decline: After trialing it out during the current period of social isolation, employers and employees may embrace the flexibility of working from home. The possibility offers savings if employers can also reduce their office footprint. If businesses decide that they can make do with less square footage, expect commercial rental rates to come under pressure.

The restaurant industry's costs will rise: Seating will be optional or offered at a premium. Restaurants will shift to take out or offer increased space between tables permanently. Expect a seating fee to cover the cost of being able to eat-in – something which is already in place in many European countries and higher end restaurants.

Watch the health care space for innovation: New businesses that specialize in viral and microbial protection are likely to emerge. A key driver will be the importance of sanitation – food and water especially.

International borders are likely to be tightened: Foreign student enrolments will decline at universities and colleges, reversing some of the growth that has occurred over the last decade. Immigration rates may fall. The global refugee crisis could get worse.

Debt terms may be redrawn: Expect loosened rules for student, consumer and corporate debt, which will affect related bankruptcies and restructuring proposals.

Accounting rules for loan loss provisioning will be relaxed: Hot off the heels of the implementation of a more stringent loan loss provisioning mechanism, both the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have announced relaxations to provisioning standards. Instead of moving to more transparent and consistent provisioning, as the new standards were intended to do, relaxing the rules will introduce even more uncertainty at a time when banks are actually facing rising credit risk.

- FASB.org: "Statement on Prudential Regulator Guidance Concerning Troubled Debt Restructurings", March 22, 2020
- European Central Bank: "FAQs on ECB supervisory measures in reaction to the coronavirus", March 20, 2020

Globalization could be rethought: Global supply chains have been shown to be vulnerable in the current crisis. This is likely to trigger a redistribution of global activity, away from China in particular. In the aftermath, we may see increased M&A and the re-emergence of conglomerates, as organizations look to control their supply chains. Protectionist policies for critical medical equipment and essential goods may be enacted.

Public health regulations are likely to be tightened: At a minimum, the use of rubber gloves may be required at all establishments that handle food – restaurants, grocery stores, etc. The price of groceries may rise to cover the cost of improving packaging, employee training and food handling at grocery chains.

HOW WILL SECURITIES MARKETS FARE?

Analysts are always late to lower their estimates: The stock market has been stretching for reasons to look through the current situation. That will become more difficult as the data and earnings shocks become apparent. It is critical that investors ignore buy-the-dip type analysis and do their homework on each name. Typically, the market bottoms only a few months before GDP does.

The glory days for private equity are likely over: It would not be surprising to find that a prominent private equity firm winds up under the weight of redemption demands and the illiquidity of their underlying investments.

Pension fund deficits are set to rise…again: When economic struggles force interest rates lower, pension fund obligations rise, which puts additional strain on the cash flows of both corporate sponsors and individual employees at exactly the wrong time. The increased deficits will also have a negative impact on reported corporate earnings because of recent accounting changes.

Overextended hedge funds may fail: The hedge fund crowd is already attempting to raise new capital by rolling out arguments for a bottom. This may be to cover for redemption and margin problems at their funds.

The private lending market is likely to seize up: Private lending, both personal and commercial will suffer its greatest blow as investors realize the importance of liquidity and bankruptcies hit consumers and smaller businesses (i.e. SMBs). Many of these offering memoranda-based products limit investors' ability to redeem. We expect regulatory fallout much larger than any to date (even the Fortress Capital fiasco).

Bottoms are hard to call, but if this is worse than 2008/2009 then we're not there yet: It is unlikely that stock markets find a bottom until new cases of COVID-19 in the U.S. decline, or it is perceived that U.S. state and local governments have the pandemic under control. Complete normalcy in the real economy likely won't be restored until a vaccine is available. Assume at least 12 months for that.

For reference, the S&P 500 index lost ~57% of its value from its October 9, 2007 peak of 1,565, through to its close of 676 on March 9, 2009. At the time of writing, the S&P 500 is down ~28% from its February 19th peak; the TSX is down ~30%.

Arguably, governments and the Fed are acting sooner and more aggressively in this crisis, which could set a more immediate floor. However, a lot depends on how well the spread of COVID-19 can be managed and how investors react to the resulting uncertainty.

Factors working against a sharp rebound: People's wealth has been slashed and not all economies are likely to rebound on the same timeline. In addition, the investment portion of global GDP was softening prior to this year and is unlikely to rebound quickly. Equity margin positions were at all time highs prior to the current downturn and new money may not be as plentiful as in prior recoveries. A drop in share buyback activity will also hurt trading volumes – share repurchases were at record levels in 2019. As part of its stimulus package, the FED has forbidden companies that accept the support to conduct stock buybacks. The recent dividend cuts that have been announced (expect more to follow) will further lower demand for shares through reduced dividend reinvestment programs (DRIP).

Demographics could prove to be a drag: It is estimated that the top 1% of U.S. households own 50% of U.S. stocks; the top 10% own close to 90%. The ability of the wealthy to transfer to other asset classes is high but not necessarily a foregone conclusion. However, the risk of COVID-19 increases with age and those over 50 are far more likely to own equities. Mortality in this group, or fears thereof, could introduce longer-term selling pressures on equities.

Banks may bear the brunt of the downturn: Consumer and corporate insolvencies are likely to rise even with government bailouts of households and businesses. Although the Canadian government has lowered the stability buffer on capital ratios, credit losses are likely to be much higher than in 2008. Capital sufficiency and dividend deferrals could be the next big questions being discussed.

Energy is down but more pain is likely coming: Demand destruction during and after the crisis requires a wholesale correction in supply. High cost, indebted, high-decline producers are likely to go bankrupt first. These assets continue to produce even in bankruptcy, however. Natural decline rates and the idling of most or all drilling rigs will do most of the heavy lifting to adjust supply, but a re-tightening of the supply/demand balance depends on the strength of the eventual recovery.

In the meantime, the call on North American production will drop, weakening demand for new infrastructure. Any nationalization efforts or government bailouts are likely to be accompanied by reduced equity value. In addition, the sector's increased credit risk will have ripple effects to mid-stream and pipeline operators that are dependent on the commodity supply. Tread very carefully as only those with the strongest balance sheets will survive.

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CONCLUDING COMMENTS

The most important thing to remember is that the crisis brought on by COVID-19 will not last forever. We will come out the other side.

We recommend starting with scenarios based on the 2008/2009 recession but not stopping there. Be prepared for at least two quarters of terrible news and financial results. Remember that all companies are only as strong as their customers, so keep an eye on how a company's customers are doing.

As always, Veritas will be here to help.

We continue to frame our analysis and update our scenarios making best use of the facts and data that are available. Good, rational analysis will be key in managing through this downturn.

Stay safe.

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