APR
13
2020

The Unintended Consequences of COVID-19

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The COVID-19 outbreak is a classic black swan event, in that it came out of the blue and the global economy will not be the same even when it fades away. The virus disrupted the intricate workings of globalization that we took for granted over the past four decades. The pandemic exposed how vulnerable the foundation of the global economy is, which was built upon the free flow of labor, capital, and goods. In addition, the world order will not be the same after this event. The global economy will be in a reshuffle from permanent changes to societal, corporate, and institutional behavior. With the magnitude of uncertainty, I attempt to assess the impact to the global economy and implications for global investing, though it might be too early to predict the permanent changes from this outbreak.

A Fast Track to Modern Monetary Theory (MMT)

The COVID-19 outbreak and the various containment measures centering around social distancing have created a massive supply shock—and more importantly—demand shock resulting from the income shock. With interest rates already so low, the marginal efficacy of monetary policy is diminishing. Hence fiscal policy will play a more dominant role in mitigating the massive shock. The ever-increasing fiscal deficit as a share of GDP will necessitate the increased issuance of government bonds. The COVID-19 outbreak could therefore accelerate the introduction of MMT to developed markets, which will have profound implications to bond investors.

The Invisible Hand

The seemingly more effective containment of the COVID-19 outbreak in China demonstrates its capability in mobilizing resources, surveillance of its citizens, and the strengthening role of state-owned enterprises (SOEs) in the war against the COVID-19. There will be more debate over which governance model is more effective when confronting a crisis or war. Fast and unprecedented policy reactions to address the income shock in the western world portend more government involvement in economies, which will become less market driven. Even after COVID-19 fades, in the future it will be far from easy for the “invisible hand” to let go of the control.

Global Trade & the Supply Chain

On the heels of trade war, COVID-19 further disrupted the global supply chain and trade. The free flow of labor, goods, and capital as the cornerstones of globalization—which we took for granted over the past 40 years—will face significant friction, if not total disruption. Border closures, quarantines of foreign visitors, calling back citizens from overseas, and suspicions of all the “vices” of globalization will dampen the hustle and bustle of global trade flows. Multinational firms will rethink their global supply chains as this COVID-19 outbreak exposed how disruptive it is to concentrate their sourcing in China.

The global supply chain could undergo a complete reshuffle to become shorter, closer to home, more diversified,

and more regional. However, the transformation will not be swift nor easy and will be long-drawn process. Maximizing profit used to be the primary goal of multinationals, now national security should become a more important concern. In the near term, however, as companies need to cut costs from this COVID-19 recession, China's cost competitiveness matters more. China is also the sole supplier of many critical medical supplies with its production capacity still unmatched anywhere else in the world.

U.S.-China Relations

The relationship between the U.S. and China has been going through a bumpier road, with more distrust and blame games during this COVID-19 outbreak. The war against COVID-19 will be more difficult without the collaboration between the U.S. and China. Hawks from both countries will use this opportunity to incite further decoupling. The Phase 1 trade deal will face more uncertainty as China has not delivered much on its purchase target. Instead, the U.S. will more likely incur a higher trade deficit with China as it imports more medical goods. Taiwan, Hong Kong, and the South China sea will continue to be the hot button issues for this confrontation. China's outreach to Europe in helping fight COVID-19 will further solidify its relationship with the U.S.'s traditional European allies.

The Role of Technology

The effective containment of COVID-19 in China and some other Asian countries exemplifies the use of surveillance technology to track the infection cases and earmark the infected population. The strategic rivalry between the U.S. and China will be more focused on investment in their digital technology races, digital infrastructure, data centers, artificial intelligence, and 5G networks. We expect increased investment spending from both countries on the technology front.

Changes in Consumer Behavior

It is hard to envision the complete eradication of COVID-19 soon, hence social distancing will linger for quite some time and will impact consumer and business behavior. Work from home will become a more important and alterative way of doing business. The shift from offline to online activities will continue. The trend of an increasing share of online shopping, telehealth visits, banking, and entertainment should gain popularity. The traditional brick-and-mortar way of doing business and way of living will face more challenges. On the other hand, we will see new industries springing up on the front of advanced logistic and robotic development.

Investment Implications

The pandemic is a rare event, but it is still caustic and signals the beginning of an end to the era of great moderation with low volatility, low yields, and low interest rates. The increasing uncertainty of changing dynamics to the world order and geopolitics will make markets more volatile in a more multipolar world. The debate on competing social governance models and ideology will continue. The role of government and central banks in the global economy and markets will become increasingly important factors in making investment decisions. Countries with more fiscal capacity will have more growth potential than countries without this slack.

Growth will continue to slow before globalization 2.0 reaches a new equilibrium and trade rebalances. Global interest rates will continue to be pulled by a tug-of-war between fiscal largesse and slowing growth. Cautious consumer and corporate behavior will increase savings rates and reduce capex spending—leading to more deflationary pressure.

In this anticipated environment, credit investors will require a higher premium to invest in risky credits as the black swan events become more frequent and probable. Government and central bank backstops will form a big divide between those credits that have their support and those that do not. In the longer term, we expect the

credit curve to steepen, particularly as investors go down in quality. Credit investors should start exercising caution now by looking for higher-rated, liquid credit instruments that are well-positioned to capitalize in any structural shifts caused by the virus, such as the aforementioned advancements in technology and changes in consumer and corporate behavior.

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