Absolute Return Partners

The Absolute Return Letter

March/April 2020

The Economic Cost of Social Distancing

"There are two kinds of people in this country, those who are in quarantine and those who will be soon."

Duluth News Tribune

Unprecedented times

I am writing these lines from my reclusive home office, far away from everything. I have not been outside my garden for the past 2 ½ weeks and am still doing well. Unfortunately, staying at home is no guarantee that the virus won't find you, but the risk is clearly lower, and that is good enough for me.

This month's Absolute Return Letter was meant to be the third in a series of five, digging deeper on *Five Lessons from History* by Morgan Housel, but the events of the past few weeks have forced me to focus on the coronavirus instead. As it happens, letter #3 in the Five Lessons series is 90% done, so don't be surprised if it shows up in your inbox before long.

Over the last week or two, the penny has finally dropped. Most people realise now that the coronavirus outbreak is going to have serios consequences, both in human and in economic terms, and I thought a note on the topic would be timely. The following has been prepared with a great deal of input from Pantheon Macroeconomics and Goldman Sachs, for which I am grateful.

In this letter, I will focus on the economic costs. It is not that I don't rate the human costs – far from it, but those costs are even harder to quantify ex ante and have little to do with a financial newsletter. One more point before I start. The economic impact is so overwhelming, and the magnitude so unpredictable at this relatively early stage, that you should take all the numbers I am about to share with you with a grain of salt.

Let me provide one example as to how extreme it all is at present. In mid-March, JP Morgan and Goldman Sachs both revised down their estimate for US GDP growth in response to the outbreak. Goldman Sachs revised its Q2 GDP growth estimate down to -5% whereas JP Morgan, coming out with its estimate only a couple of days later, changed it to -14%. Now, fast forward one week, and Goldman Sachs changed its estimate again – this time to -24%. I haven't seen any further adjustments from JP Morgan but, only one day later, Morgan Stanley entered the frame with a whopping -30%.

If any of those numbers turn out to be correct, I would put it down to luck more than anything else, but that is not my point. Whether the US economy shrinks by 24%, 30%

or even more in Q2 – or a bit less if we are lucky – the reality is that the global economy is now in lockdown, and that is not going to change for weeks, probably months.

The latest on the coronavirus cycle

Different countries are at very different stages of the disease cycle. China (ex. the Hubei province) saw the daily change in new coronavirus cases peak in early February with South Korea, another badly affected country, being about four weeks behind China. New cases in Italy, the worst affected European country so far, have only peaked in the last week, i.e. it is 6-7 weeks behind China in the disease cycle.

The good news is that there are few new cases being reported in either China or South Korea and, over the last few days, the trend line has reversed in Italy too. Even better, the rate of growth of total infections is slowing across Europe with one worrying exception – my adopted country, the UK (Exhibit 1). This suggests that much of Europe could be in a much better state by mid to late May, assuming the pattern from China and South Korea repeats itself.

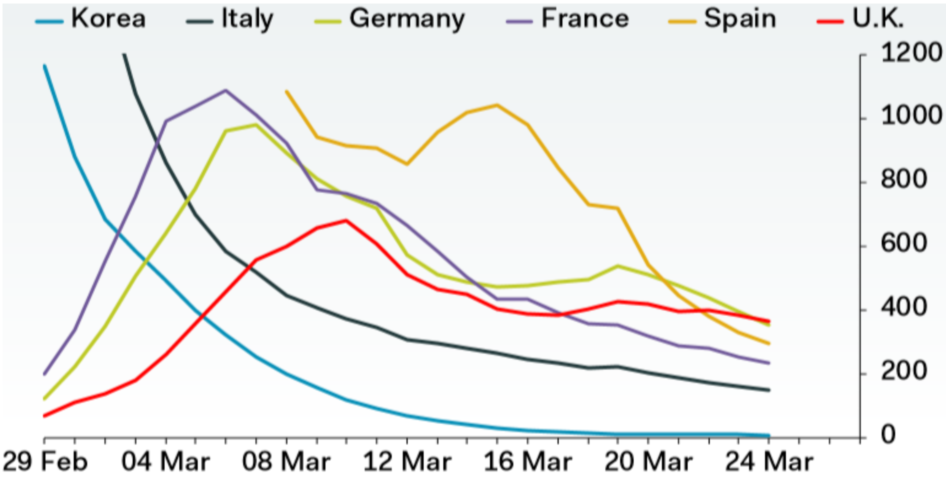

Exhibit 1: Total cases, latest 7 days on previous 7 days (%)
Source: Pantheon Macroeconomics

Unfortunately, the latest data from the US is not quite so promising. The number of new cases continues to rise exponentially over there (Exhibit 2). It is worth pointing out that the situation in the US could be even worse than the data suggest, as testing varies dramatically across the country.

Medical scientists have argued for weeks that, of the more populous states, the state of New York is probably furthest into the disease cycle, and the very latest data confirm that. If you take another look at Exhibit 2 and zoom in on the curve for the state of New York, you will see that, in the last few days, the curve has started to flatten slightly and that is great news, assuming the trend can be sustained, but I am not convinced – more on that later.

Let's go back to my earlier point that testing varies enormously across the US, making the data less reliable. According to Pantheon Macroeconomics, the data from New York City is more reliable than the national data, and the numbers from NYC are truly alarming. The number of cases per million inhabitants now stands at 1,521 – much higher than in Italy and in the Hubei province in China which peaked at 1,185 cases per one million inhabitants.

One final point about the data sample. Due to the unreliability of the test data – because testing varies so much across countries – one could argue that death rates are a more reliable indicator than infection rates. The data provided by various countries suggest that death rates lag infection rates by about two weeks, and the fact that death rates no longer rise exponentially in Italy is another good sign.

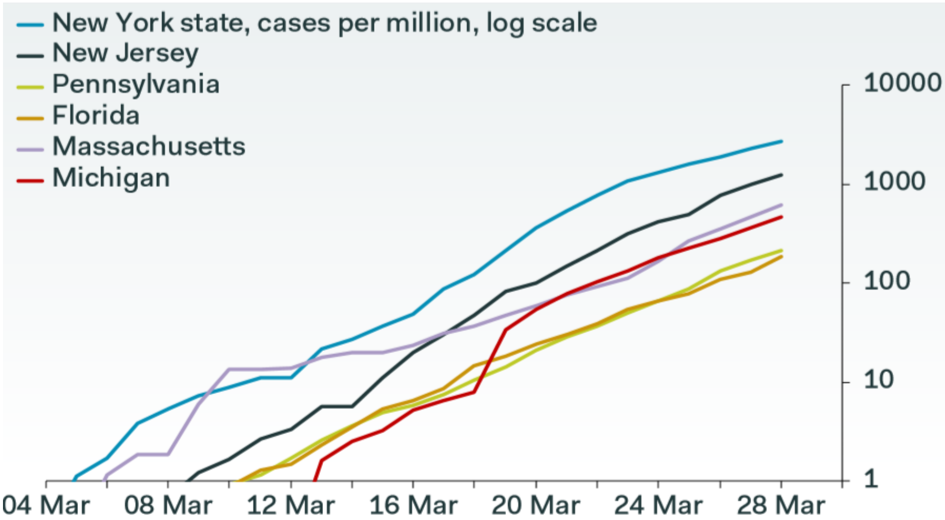

Exhibit 2: **New US cases reported by worst affected states (log scale)**
Source: *Pantheon Macroeconomics*

The economic impact

The lockdown is spreading like wildfire with one country after another taking extraordinary steps to control the coronavirus outbreak, meaning that the economic costs will be staggeringly high.

Given the precautions taken across Europe, I expect the impact on GDP in this part of the world to be the most dramatic – worse than even the most pessimistic estimates suggest the impact will be on the US economy. I am not close enough to make the same assessment across emerging markets but do follow South Africa quite closely (I was there only a few weeks ago), and they are certainly not taking this incident lightly. I hear similar anecdotes from some other EM countries but not from them all.

Unless my memory is playing tricks (which has happened before, I hasten to add), I believe the global economy has grown 2.8% on average over the last ten years. Global recessions, i.e. two consecutive calendar quarters with negative GDP growth, are actually quite rare. Since World War II, we have only had four of those (in 1975, 1982, 1991 and 2009) according to World Bank, and we have only had one full calendar year with declining economic growth – 2009 (Exhibit 3).

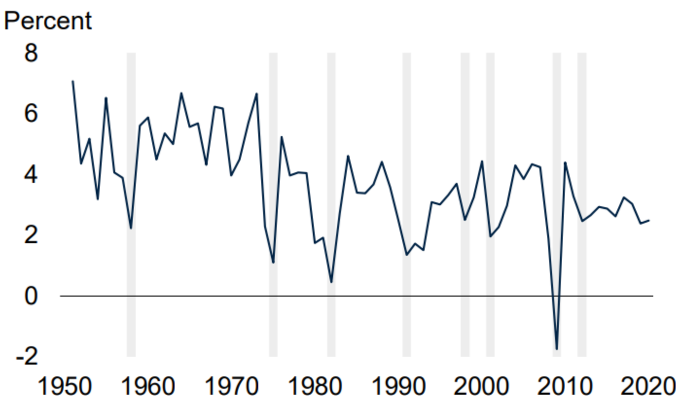

Exhibit 3: **Global real GDP growth since WW II (%)**
Note: *Shaded aeras indicate US recessions.*
Source: *Policy Research Working Paper 9172, World Bank*

There can be no doubt that we are now in for another global recession with this one likely to be worse than the one experienced around the Global Financial Crisis. Preliminary estimates from Goldman Sachs suggest that the Chinese economy has contracted about 40% in Q1, that the US economy has shrunk by 6% and European countries somewhat more than that. With about 60% of global GDP originating from those three regions (Exhibit 4), global GDP must have taken a very big hit in Q1. The estimates I have seen suggest global GDP to have shrunk 1-2% in Q1 but, if the estimates from Goldman Sachs are correct (and the Chinese report the factual fall in economic activity), the true decline in global economic growth in Q1 is more like 8-9% – the biggest quarterly decline *ever* in global economic growth.

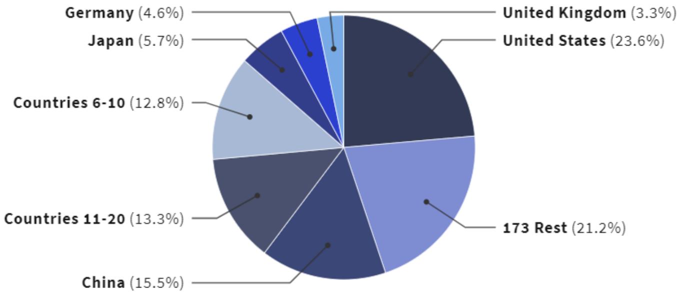

Exhibit 4: **% share of the global economy**
Source: *IMF*

And it is going to get worse in Q2. GDP growth in many parts of the world outside China will be disastrous. Governments all over the world are busy providing emergency capital to businesses, but don't forget that the true nature of this beast is falling consumer spending, i.e. capital to businesses may help them survive, but consumer spending will still tank.

I also note that service industries are the worst affected. Whereas a typical recession is about inventory corrections amongst manufacturing companies, this is not. This is about the consumer being asked to stay at home and with 86% of the US work force employed by service companies, this recession is going to hurt *badly*.

Subject to Trump's next move (see later), the US – which is behind Europe in the disease cycle – should rebound in the second half of the year. You'll find Goldman Sachs' estimate on that bounce-back in Exhibit 5 below but, as I pointed out earlier, I am not sure anybody knows yet precisely how big the drop will be in Q2, and what will happen later this year.

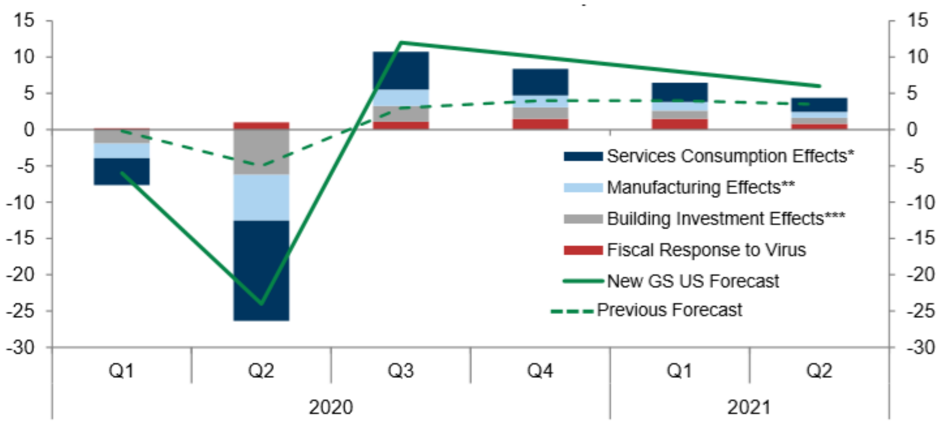

Exhibit 5: **US real GDP growth (annualised by quarter)**
Notes: * *Includes cutbacks to consumption categories requiring face-to-face interaction.*
** *Includes reduced demand for goods, supply chain disruptions and plant shutdowns.*
*** *Includes cutbacks to investments, homebuilding and home sales.*
Source: *Goldman Sachs Global Investment Research*

When to invest

Whatever happens, I am pretty sure I haven't mentioned the coronavirus for the last time in these columns. Covid-19 will form headlines for many months (years?) to come, and the question I am confronted with every day of the week is … when will it be time to buy equities again?

It is hard to say. If we could all afford to buy now and then close our eyes for three years, I am pretty sure we would make a decent amount of money at current levels, but that doesn't imply markets won't get even cheaper. In the last couple of weeks, government bond markets have effectively told us that *enormous* sums of money will be spent on getting the show up and running again, which is good for equities but bad for bonds. Equities, particularly US equities, have already responded well to Trump's rescue package, but that could easily prove a false dawn.

Let me share with that is – why Trump could get it horribly wrong. His problem is essentially that election day is only seven months away and he knows that, unless he can get the economy firing on most cylinders between now and then, he probably won't get re-elected. For that reason, he could relax restrictions on social interaction prematurely which could, and probably would, have a devastating impact on both the infection rate and the death rate in the US. He has already talked about relaxing restrictions at Easter, which would be a huge mistake. The US is nowhere near ready for that, considering Easter is only a couple of weeks away, and that new cases in the US are still growing exponentially.

Learn more on ARP+

One last point to make:

As many of you will be aware, last year we launched a subscriber service called ARP+. As part of the services we provide to ARP+ subscribers, we make specific investment recommendations – ideas that we have come across as part of the work we do for our investment management clients.

Tomorrow (Tuesday the 31st March) at 3 pm UK time I will host an extraordinary webinar about the Coronavirus outbreak. I will talk about the economic costs associated with it and what investors should do. If you are not an ARP+ subscriber already, it is not too late. By subscribing today, you can listen in tomorrow. Even if you subscribe post the webinar tomorrow, a taped version will be available to you.

Niels C. Jensen
30 March 2020

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Absolute Return Partners

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