RockCreek

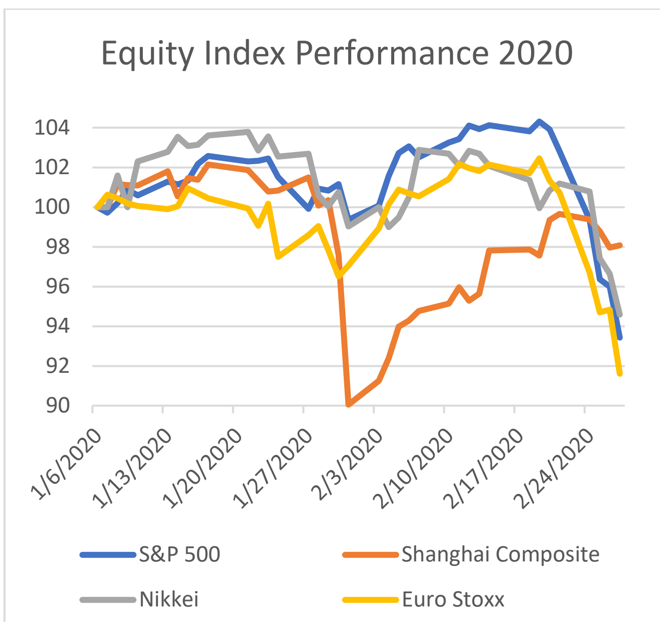
The Big One, or a Dress Rehearsal?

February 28, 2020

Public health experts have long dreaded that the “Big One" would come before the world was prepared to face it. Their fear, a pandemic that sweeps across the world infecting hundreds of millions, causing untold numbers of deaths and putting great stress on health systems around the world. As resources are diverted to cope with a new disease, spreading quickly and unpredictably among a human population with no "herd" immunity, the toll from other diseases will also rise. One of the big impacts of the Ebola outbreak of 2014 was an increase in deaths from malaria as patients went untreated. One of the surprising points is how unprepared governments are even today, both in democracies that do not seem to have clear protocols and in autocracies that are not transparent with their data.

The new Coronavirus (COVID-19) may not be the Big One, but many experts believe that even if it is not that, it is likely to be a full-blown dress rehearsal. What does this mean for investors and the economy?

Equity Markets in Wake of Coronavirus Fears



At the end of this week, we have some key observations:

1. *There is tension between what is good for public health and what is good for the economy.*

   Politicians and leaders need to safeguard the wellbeing of their citizens first and foremost. But this may not mean taking the most drastic approach imaginable to limiting the spread of disease. We have seen that the wholesale quarantine imposed in Hubei province in China became harder to maintain over time, for both political and economic reasons. It also put intolerable strain on local medical resources. We live in an interdependent and largely urban society. It is simply unrealistic to expect that the recommended "social distance" can become the norm without a drastic impact on other important elements of life and work. This week has shown that even more limited measures put in place by governments guided by public health concerns – from the closure of schools in Japan to the attempted sealing off of Italy's industrial heartland in Lombardy – will hit economic activity.

Watch for how different countries balance the competing objectives of addressing public health concerns and maintaining economic output and employment. Key to optimizing both will be to win public trust.

Neither of the two biggest economies have done well so far on that front. China was clearly too late in admitting and reacting to the initial outbreak. Changes in measurement of infection have shown uncertainty about the data that it has since published. In the United States, it was surprising for many to discover that testing for infection was initially severely limited by problems in the supply of testing kits. Messages from the U.S. presidential administration have been mixed at best about how serious the threat is to both health and the economy. The honest answer is that we don't yet know, but we need to be prepared on both fronts for swift and coordinated action. Doubt about the efficacy and reliability of the official response will only worsen the impact, encouraging panicked responses and deepening uncertainty, which are always bad for the economy.

2. *A health shock hits both supply and demand, complicating the economic response for governments and Central Banks.*

Traditionally, economists believed that there is little that Central Banks can do in response to a supply shock. Easing monetary policy to offset weaker output would merely put pressure on reduced resources and push up inflation. Think the stagflation following the 1970s oil shock. But with inflation still undershooting, despite historically low unemployment in the United States, there is some room for further easing. The bigger question is whether such a response will have any impact on investors and businesses if the nation is gripped by a health panic and constrained in production by absent workers and disrupted supply chains.

The Fed's rapid response in 2019 to the economic and financial concerns that hit markets in December 2018 did the trick – dramatically shifting market sentiment and bolstering the economy last year. Monetary easing was widespread around the world and helped to support global growth despite the knock from trade wars. Boosting sentiment and showing that the authorities are alert to economic dangers would be useful even if this shock is a more complicated one. There is also a case for fiscal action – clearly this should include additional, swift support for federal and local health spending. There the question is whether political divisions will allow the necessary bipartisan action at the federal and state levels, and whether it will come soon enough to offset the pain from what is already set to be a very bumpy first quarter.

As is often the case, the situation in Europe and Japan is more challenging than that faced in the United States. There is a greater need for governments to act to support employment and output given sluggish growth, or even stagnation, even before COVID-19. At the same time, the conditions for successful action are worse, with negative interest rates complicating monetary policy and (largely misplaced) fiscal fears inhibiting deficit spending.

3. *Context matters.*

   As we said in our last quarterly note, U.S. economic growth was already fragile when we started the year. With full employment leaving little room for rapid expansion and growth projected at close to the (now lower) potential rate of just under 0.02%, the economy was vulnerable to a shock. Moreover, a shock to consumer confidence was the most dangerous. Throughout 2019, buoyant consumer spending overwhelmed the impact on output and markets of depressed business investment and a weak manufacturing sector. Geopolitical uncertainty, in particular from trade conflict between the United States and China, shaved an estimated 0.5% from growth. But with the tailwind of an accommodative Fed, and during employment growth, consumption kept the economy growing.

   A public health scare hits directly at consumer confidence. At the same time, public health measures that limit interaction will make it harder to spend, except online. Amazon and Netflix may see a boost, along with video conferencing services like Zoom Video Communications, but many expenditures cannot take place online, like getting a haircut, taking a vacation, or celebrating a wedding.

   The big question going forward is whether we have a one-time hit to spending and output and then a rebound as most economists had predicted until this week, or whether the initial shock broadens into a long-lasting slowdown. Again, two things will determine which scenario unfolds: 1) the progress of the disease, which seems both highly transmissible and more dangerous than the flu but much less dangerous than SARS or MERS and 2) the policy reaction. Transparent and clear communications together with a thoughtful and coordinated global response is called for to safeguard both our health and our economic wellbeing. Will political leadership step up?

4. *There is a big distinction between the short term and long term.*

   In the best-case scenario, COVID-19 is largely contained without mass fatalities, a vaccine is coming on line, and governments coordinate both to develop best practices in treatment and to support the global economy. In this scenario, the economy could recover and return to its previous path perhaps by the end of the year. There would be a boost to growth, earnings, and equities once the initial panic subsided. Buying on the dip would be smart, including stocks that have suffered disproportionately from travel and supply disruption.

   A gloomier short-term scenario, with businesses forced to begin layoffs, consumers ratcheting down their spending rather than just postponing it, and governments fumbling their response, is also possible. This shock could be the one that tips the economy into recession and jolts markets out of a Panglossian belief that all will be well in the best of all possible worlds.

   In either case, we are likely to see a shift away from the rush to indexed investment that has characterized asset allocation in recent years. Differentiation and nimble positioning work best in an uncertain world. Those who wrote off volatility as a thing of the past have suffered this week. More suffering is likely on the way at least in the short term while we learn about the virus.

   There is also a more fundamental issue about what this outbreak does to the world. Whatever the short-term impact, COVID-19 seems bound to accelerate the global decoupling already underway. Even if markets bounce back and the economy doesn't stumble into recession this year, a further shift away from an open global economy will have a profound impact over the long term.

Some moves towards this different world were already clear. Concerns about supply chain disruption came into focus last year with the U.S.-China trade conflict. Worries about a splintering internet -- with growing restrictions on the data transfers that have oiled trade, particularly in financial and other services -- have reached a crescendo in the tech community, even while citizens have fancied action as they become warier of intrusions on privacy. And, fundamentally, political challenges to globalization have rocked the status quo across the advanced world. Resistance to the free moment of people and goods powered Brexit and helped to elect President Trump -- shifting the U.S. governing consensus away from free trade and large-scale immigration. It also changed the political landscape in Europe, notably hastening the demise of Angela Merkel as the pro-globalization leader of Europe's biggest economy. It is now more likely that these trends are here to stay.

Again, investors will need to be on their toes to respond to the changing economic and financial landscape. Companies that have successfully exploited opportunities for commoditized manufacturing and global sourcing to cut costs and boost productivity will face challenges. More broadly, there is no doubt that globalization has fueled productivity and growth overall over the past several decades. It has also enabled hundreds of millions of people to move out of poverty. A reduction in openness will make it harder for businesses to flourish. It will also constrain growth, especially in aging societies in the advanced world.

But the policy swing reflects genuine concerns about the uneven impact across societies of globalization. Growing inequality, reduced social mobility and geographic pockets of deep economic decline and hardship required a response. Governments must take the lead. But companies -- and investors -- would do well to demonstrate that they are also mindful of societies' needs especially at a time like today. Shareholders are important stakeholders. But a broad view of companies' interests requires a wider lens.

Here, the initial reaction in the United States bodes well. Companies have been quick to encourage tele- working and to respond to employee questions and concerns. A crisis like this one can also demonstrate some advantages of an open, liberal society just when it was becoming fashionable to question this model in the face of growing authoritarian success in China and elsewhere. The vast resources of the US economy and its deep markets allow for a creative and flexible response, whether by inventing new medicines or new ways to work. Searching journalism free from fear of repression and strong legal systems to guard the interests of consumers also help to reinforce trust.

5. *One last thought…*

The Coronavirus has shaken complacency and risk assessment. As investors come to terms with global health threats, they should remember that companies must grapple with another global challenge that is getting closer all the time: climate change.

There is an irony: a global response to both these global threats is essential at just the time when global leadership is out of favor. Perhaps this crisis will help to bring it back into fashion.

Meanwhile, disruptive change brings not only risks but also opportunities, indeed a requirement, for creativity and innovation.

How to Respond to Markets?

As always RockCreek is monitoring and analyzing our portfolios closely for both rebalancing and new investment opportunities that may arise during these periods of volatility. We are confident that we have dry powder to take advantage of recent market dislocations should it be warranted and cognizant that the near-term volatility may continue or worsen.

We have been cautious going into 2020 given the "priced for perfection" markets we were in after an unprecedented rally in 2019. Our portfolios are well diversified and structured to weather equity market volatility through strong active management. We will continue to keep you updated on any significant changes in the portfolios as we navigate likely more negative news and uncertainty over the next few weeks actively looking to take advantage of opportunities.

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