Into the Unknown

Well, we are now in uncharted territory.

For all intents and purposes, the world has ground to a halt with much of North America, Europe and Australasia effectively idling non-essential activity for at least the next few weeks (somewhat ironically, coronavirus epicentre China has continued on the road to normalcy to the point that Apple has shuttered all of its stores outside of Greater China).

The goal now is to slow the spread of COVID-19 worldwide – the “flatten the curve” approach, to help reduce the strain on healthcare systems as the hope of containing the contagion has seemingly, been dashed.

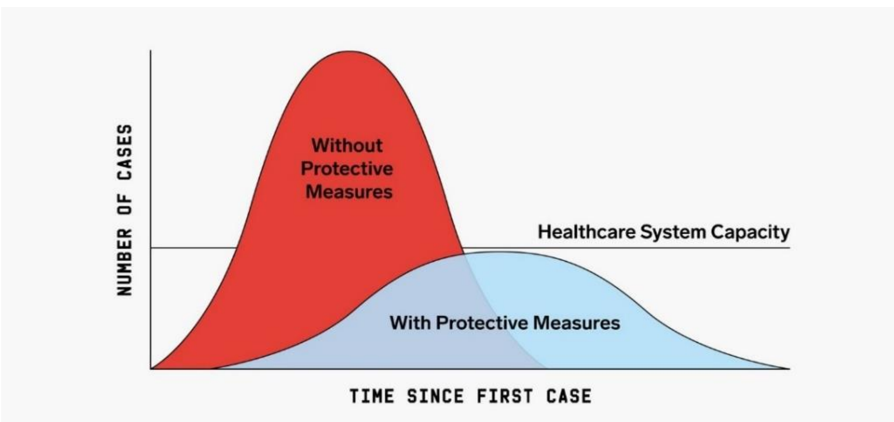

Illustration: SAM WHITNEY/WIRED; CDC

As such, most normal day-to-day activity is paused: restaurants, gyms, clubs, concerts, festivals, sporting events and general social interaction have been put on hold until further notice.

What this means is that we are collectively making aggressive changes to our lifestyles in the hopes of returning to normal sooner rather than later – social distancing now so that we can congregate without worry when the weather is far more pleasant in the Northern Hemisphere.

Similarly, policymakers worldwide are doing whatever they can to try to make sure the imminent hit to economic activity is as short as it can feasibly be.

Central banks around the world are slashing interest rates. The Bank of Canada made a surprise 50bps cut on Friday, the Fed has returned to its zero lower bound on Sunday evening – interrupting my kid’s birthday dinner by the way –and several monetary policy authorities in the Asia-Pacific region followed suit as the sun rose on Monday). These officials are also making forays into financial markets. The Fed is committed to buying at least $700 billion of government-backed securities ($500 billion in Treasuries and $200 billion in mortgage-back securities); while the likes of the Reserve Bank of Australia are hinting at a willingness to dip their toes into bond-buying to ensure markets maintain liquidity – and making coordinated efforts to alleviate any potential market funding pressures.

The hope here is to provide support to financial institutions worldwide (ensuring that a health crisis does not morph into a financial crisis) and make funding cheap and readily available to help stoke grease the gears of the global economy. This will help the machine get back to full-speed in short order once the coast is clear.

Governments, for their part, are announcing their commitments to throw money at the problem as well. The Canadian government announced $10 billion will be provided in funding to the Business Development Bank of Canada and Export Development Canada (EDC), to facilitate lending activities and trade financing, while also stating that further fiscal stimulus measures would be introduced in the coming week. The US has a House bill to be tabled in the Senate this week (which includes paid sick leave but only for about 20% of employees, free coronavirus testing, and support to states), and there are expectations that more measures will come. Even the traditionally tight-fisted Germans have pledged to spend whatever is necessary to protect its economy, as the European Commission agreed to ease fiscal rules and redirect budget funds to allow member states to invest in their economies and health sectors as well as address the sanitary emergency.

It is undeniable that the risk of a recession has spiked in just this last week alone amid the spread of the contagion and resultant widespread cancellations. But, it is still important to note that should we see the contraction of economic output that meets the definition of a recession, this would be a very different variety than what we have experienced in recent history.

The last two global economic downturns were precipitated by significant imbalances in the marketplace – the tech bubble in the early 2000s, and the housing bubble in 2007/08. These duration of these types of recessions is dependent on how long it takes for these imbalances to get back into balance – and as we saw in the aftermath of the crash of the housing bubble (that put innumerous households financially underwater), that can be a long and drawn-out period for demand to recover.

In contrast, a downturn that results from an unforeseen event like a natural disaster or a, say, global pandemic (what economists refer to as an exogenous shock) results in a supply-side shock. In essence, demand has not materially eroded, but there are sudden outside factors affecting the ability of business to return to normal. As such, once those external forces have subsided (the hurricane has passed, or the rate of contagion has ebbed), activity is able to normalize fairly quickly, resulting in a quick snap back in economic momentum.

While we are facing an unprecedented next few weeks, we can at least take some solace in the fact that this style of recovery from a health crisis does have precedent – such an outcome would be consistent with previous outbreaks. Research on instances ranging in severity from severe acute respiratory syndrome (SARS; which had 8,096 cases globally and resulted in 774 deaths) in 2003, to the Spanish Flu in 1918 (which afflicted nearly a third of the world's population and killed 40 million people worldwide), suggests that the overall economic impact is typically short-lived and fairly limited from a longer-term perspective.

That said, at the moment we are facing heightened uncertainty. As a result, the breakneck volatility that we have seen in financial markets over the last few weeks should not be expected to dissipate in the coming days, with prices for all assets to continue to whipsaw daily.

Such market swings can make life even more uncomfortable than the thought of self-isolation already does, but I again draw upon historical precedent and caution against investors selling into a panic. Such decisions historically have only ended up having a negative impact on wealth in the long-run.

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