GUARDIAN CAPITAL

Reflections & Insight

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'There is a fundamental distinction between the reward for taking a known risk and that for assuming a risk whose value itself is not known. A known risk is easily converted into an effective certainty, while true uncertainty is not susceptible to measurement.'

–Frank Knight, Risk, Uncertainty and Profit – 1921

Working from home, or perhaps more accurately, living at work, sees the days slide into one another while the volume of data and opinion has grown to reflect the fact that everyone has less to do, at least in theory. If you immerse yourself in this world of so-called facts, you see that all the information is backward looking, or at best current; yet everyone uses these to build strong views about the future, ignoring its inherent uncertainty. You may object that the future is always uncertain, except that for most of the last 75 years, it has not been. The best forecast was always that next year would be a bit like this year, usually (but not always) slightly better.

It's not like that now. What we do know is that lockdowns (of varying severity) have brought economic activity in some sectors to a virtual stop as both supply and demand have been choked off simultaneously. This has never happened before. For example, the hotel industry shutdown has stopped the supply of hotel services completely, while demand is, to all intents and purposes, zero. This is obviously not good news for the people who work in this industry (and in many others too), but the current crisis also means that the future is impossible to measure. Normal analytical techniques do not work. If you run a hotel business, what expectations about the future do you build into your model? Will people start to travel again; how many people and when; will they use AirBnB; will business travel ever recover, and so on? Before COVID (BC), human behaviour was fairly predictable. Travel grew at a measurable rate and hotel bookings followed this upward trajectory, although traditional hotels were gradually losing share to the likes of AirBnB and losing part of their revenue to online booking services. Nevertheless, it was all predictable within tolerances.

Now you can find analytical views that are optimistic, essentially arguing that the crisis is a blip and that as soon as fear wanes, life will pick up where it left off. Others assume a long-term fundamental shift in behaviour towards less travel and greater caution, especially among more vulnerable groups. Usually, the result lies somewhere

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between two balanced views, but this time around the gulf between these views is unbridgeable – the difference between prosperity and survival. We are experiencing a classic case of 'Knightian uncertainty' as expressed in the quotation at the top.

Of course, there are other sectors of the economy, for example, those exposed to the rapid increase in digitization, where the prognosis is very different, the uncertainty is smaller, and the range of outcomes less life threatening. Nevertheless, on balance much of the world economy faces existential questions to which the answers are not measurable.

[A] code for buying things

Governments have stepped into the breach. We have seen unprecedented monetary and fiscal stimulus in almost all countries. Without going into the gory details, the immediate goal has been to keep businesses on life support and furloughed workers fed and solvent. For the most part, these measures have worked, and will help support a vigorous rebound as lockdowns ease. In the longer-term, the plan is that much of this stimulus should find its way into the real economy – code for buying things – as opposed to finding its way into financial assets – like equity markets. After the Great Financial Crisis of 2008, this same plan didn't work. The liquidity created by Central Banks was behind spectacular rises in markets over the last decade. Meanwhile, economies were sluggish and income growth subdued. This time, the austerity policies on the fiscal front will not be repeated. If the double whammy of zero or negative interest rates and government largesse doesn't work, we should expect to see direct intervention in infrastructure projects to get the economy moving.

The risk of rekindling inflation

This governmental activity is necessary to ward off the risks of depression but it brings risks. A huge increase in debt will burden future generations, but is affordable in most countries today as interest rates are so low. Nevertheless, evidence from history suggests it will likely have a dampening impact on potential growth rates. Another is inflation. If the bazooka of largesse manages to stir up animal spirits, and lift economic activity, it risks rekindling inflation. This may seem a distant prospect in today's deflationary world, but if government policies succeed, inflation would be a desired outcome. The third risk is harder to pin down. With a lot of money sloshing around the system and very low rates, many companies, which should not survive, will be able to do so. These are so-called 'zombie' companies. The existence of zombie companies undermines a free market economy, negating the process of creative destruction through which our system develops and innovates.

All of this could happen. None of it could happen. Knightian uncertainty.

Let us go back to the hotel industry. As hoteliers contemplate the easing of lockdown, do they bring staff back from furlough. If so, how many? In aggregate, companies contemplating the next year are being cautious. Redundancies are beginning. Some of these represent fundamental shifts in the outlook for industries – bricks and mortar retailers are in for a tough time. Some represent a reassessment of prospects – airlines' and airports' behaviour says they do not think they are going back to previous levels of activity any time soon; others reflect the realization that a business can work just as well with fewer people working in a more distributed manner.

Markets responded to governmental sugar

Markets have looked at all this and shrugged. After a catastrophic March, the bounce in the second quarter of the year has more or less brought things back to zero (with the sad exception of the benighted UK). Stock markets have responded to the stimulus from lower interest rates and all that governmental sugar, and gone roaring up. Many commentators are amazed about the disconnect between the market and what is happening in the economy. They forget that markets respond to liquidity stimulus and try to discount the future. To this end, there is a differentiation between stocks perceived as beneficiaries of the new world and the victims. In general, the beneficiaries go up when the news is poor and the victims go up when there is talk of a vaccine round the corner – which really might restore normality. Certain large tech companies have done well regardless. In general, markets are obsessed by news about the virus and are not especially interested for now in the earnings calamity, which is afflicting most companies. Occasionally, they worry about US politics and very occasionally about the more assertive stance being taken by China, most obviously in Hong Kong.

All the talk is about the nature of the recovery post lockdown. Will it look like a 'V' or a 'W', or an 'L' or a square root. You can find believers in each of these, all well argued and rational, but as we have tried to indicate, the degree of uncertainty around these outcomes is very far from normal.

So far, the evidence from those countries which unlocked early, like China, is that activity quickly rises to between 80-95% of its previous level (depending on industry), but then plateaus. Extrapolating this more broadly is dangerous, as human behaviour will differ by location for all sorts of reasons. The other complicating factor is that industrial production in China bounced very sharply as inventories of most goods were depleted, then stalled as demand from locked down customers did not materialize.

The recovery from lockdown will be jagged

Like any other prognosticator, we have our own views, but they reflect our own prejudices and experiences, and are held less firmly than we are used to. Therefore, as evidence builds, we may need to change our stance radically. So, for the time being:

1. The recovery from lockdown will be jagged and volatile. It will be strong in the first instance but will be sensitive to local lockdowns as a second wave of the virus hits;

2. Developed economies will not regain the BC level of activity for several years. Emerging markets, especially in Asia, will fare better, but there will be important differences between the prospects for individual markets;

3. There will be a major recession in the developed world as furloughed workers are made redundant and as disrupted industries recalibrate. This will worsen government finances and keep the lid on inflation; although,

4. There will be price volatility as supply chains are disrupted, and 're-shored' to domestic manufacturing, as well as shortages in certain categories of goods at particular times;

5. Government policies will remain stimulative for the foreseeable future. Attempts to kick start the economy through various fiscal incentives will be partially successful, but will only ignite inflation locally;

6. Large government is back. This will lead to greater economic inefficiency and persistent large deficits but will start to reverse the trend to social inequality. Higher taxes are likely, burdening future generations;

7. Geopolitical tensions will worsen as China becomes more assertive; the US election could unsettle US markets to the benefit of other regions;

8. Very low interest rates and fiscal incentives will support the prices of risk assets, such as equities and some credit markets. The attempt to bring inflation back into the global economy (and so debase currencies) suggests an insurance position in gold makes sense;

9. Very high stock market valuations for high-quality stable businesses will become the norm. Lofty valuation will be justified by very low discount rates and a shortage of growth opportunities, while the supply of capital will stay high because of Central Bank action. This market environment could last much longer than investors now expect and at any rate until interest rates start to rise.

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