Investing life after Covid-19

Key takeaways:

• We believe the backdrop for investors in the next cycle will look similar to the last: low inflation, very low bond yields and central bank rates, rising earnings, falling unemployment, and, eventually, a return to high equity valuations.

• Pre-existing trends in geo-politics will be exacerbated; secular growing sectors will get a further boost; and inequality will continue to widen.

• Expert advice may be valued more in the public debate than in recent years, and fixed income markets will be reformed to improve liquidity in stressed situations.
As a firm, we have been closely monitoring the outbreak of COVID-19 and its consequences for markets. In this vein, there are a host of opinions on what life will look like “after.” Many of the most obvious impacts may be social, but investors are also rightly asking how the landscape for managing money will shift. It needs to be stated up front that we think a lot less might change than people currently assume. In the midst of a crisis it’s easy to think and feel that “the world will never be the same.” Thinking back to previous crises, it’s hard to pinpoint much anything that dramatically changed globally in their aftermath. With this in mind, we should be cautious before drawing conclusions, but still mindful of how the events of this year may impact investing decisions.

Below, we set out seven aspects of the investing landscape that are important for investors. Our view is that some will likely change markedly, while others will remain closely aligned to the investment landscape of years past.

**INVESTING BACKGROUND WILL BE BROADLY SIMILAR TO THE PREVIOUS CYCLE**

1) **AFTER THE INITIAL RECOVERY, THE MACROECONOMIC BACKDROP FOR INVESTORS WILL LIKELY LOOK SIMILAR TO THE LAST CYCLE.**

As the IMF and McKinsey have acknowledged, we face a deep recession, and there are multiple paths to a recovery. While it appears the recovery will be more rapid this time than it was from the Global Financial Crisis, most major economies still will be forced to confront elevated unemployment, low business and household confidence, and anaemic investment for a number of years. Large budget deficits might have to be addressed, and policy settings look to be about as loose as they can be (at least by traditional measures). Debt levels will be significantly higher in some areas, which may have a modest dampening effect on growth.

All of this will likely add up to reasonable but not spectacular growth, gradually rising earnings, rapidly subsiding corporate default rates until growth is re-established, very low bond yields, and, eventually, a return to full employment. These were largely the macro foundations we have been investing for during the last decade, and would suggest that, while the level of returns for all asset classes may have changed since we published our long-term capital market assumptions, our relative expectations between asset classes for the 2020s remains unchanged. Private Equity expected to be the highest returning asset class, while cash and government bonds struggle to keep up with inflation and listed equities somewhere in between.

2) **MORE INFLATION? MAYBE. BUT NOT MUCH.**

Key to the investing backdrop in coming years will be continued low inflation. The global “output gap,” the gap between potential output and what the economy is actually producing, is likely to be large as we exit this imminent recession. Excess supply, manifested most visibly in unemployment, will likely keep wages and prices from rising rapidly. As in the prior cycle, markets will have to tighten significantly for any inflationary pressure to appear, in part because the secular deflationary forces of tech-led disruption are still rampant and will exert a dampening influence on any pricing power firms may think they have. Furthermore, given the scale and suddenness of this shock and the dramatic loss of income for many households and businesses, it would not be surprising for both to hold onto more liquidity relative to their incomes going forward. The savings required to build this additional buffer would likely drag on growth in the short-run, and make money move around the economy more slowly. All things being equal, this would be deflationary.

There will, of course, be pockets of inflation. Commodity prices will at some point bounce back from current depressed levels. Even today some food prices have been rising rapidly. This really matters in emerging markets, where food is a large part of consumption baskets. Away from commodities, it is certainly possible that the lifting of social distancing will prompt a spurge of spending that could prompt prices to rise. But, for that scenario to play out, social distancing must end rapidly, and both households and businesses must have the confidence to ramp up expenditure. While this may happen, it is also possible that distancing will only be lifted slowly, and consumers, who have seen their friends lose their jobs and are still on edge over their health concerns, will not jump to draw down savings. Likewise, while inflation might be

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present in parts of the manufacturing chain, there is no guarantee this will be passed on to final prices and show up in inflation. Even if it did, inflation indices in most developed economies have a larger weight to services than to goods, so it is hard for such an effect to drive overall price metrics materially higher for a sustained period of time. On balance therefore, as we look out to the next cycle as a whole, the global picture will be one of muted price increases.

Policymakers in the developed world will likely maintain exceptionally low policy rates for years after growth is restored (as they did in the last cycle). Market expectations of future inflation and bond yields would have to rise significantly above levels consistent with central bank mandates to force an increase in policy rates. The debate over those mandates will intensify, with several central banks likely moving their targets to some form of multi-year average inflation rates. As during the previous cycle, all the asset buying we see from global central banks will likely inflate assets more than consumer prices.

Even if one is convinced that inflation will remain low, it doesn’t mean portfolios shouldn’t build in resilience to a period of faster rising prices. A first stop would be equities, which should perform well in a buoyant demand environment that pushes up prices. However, if inflation risk is a real concern, commodity exposure and inflation-protected fixed income can also be part of the solution.

**PRE-EXISTING TRENDS WILL BE ENHANCED**

3) **GEOPOLITICAL TENSIONS AND SHORTENING SUPPLY CHAINS.**

The COVID-19 pandemic has exposed weaknesses in the global economy. The deep interdependence that globalization produced not only allowed the virus to spread quickly, but also has left countries vulnerable to unexpected interruptions in supply chains of vital equipment and goods, such as masks and chemicals for testing. Thanks to the recent trade war, firms already had been questioning the merits of China-dominated production. The coronavirus pandemic will likely create more pressure on corporations to weigh the efficiency and costs/benefits of a globalized supply chain system against the robustness of a supply chain either in their home country or, at least, in a closer, more stable trading partner.

There will be clear sectorial differences here. Recent evidence from the technology sector suggests that firm are concentrating on spreading out and diversifying suppliers, rather than repatriating into consuming countries.¹ Yet governments seem set to pressurize the private sector for more domestic capacity, at least in terms of the industries that they have suddenly realized are mission-critical, such as healthcare. Indeed, health concerns may well magnify the developing Great Power conflict between China and the United States as this decade unfolds and accelerate this phase of de-globalization.² Crucially for U.S. politics, this pressure is likely to come from both Democrats and Republicans.

Furthermore, awareness of the vulnerabilities around healthcare could provide a further impetus to regulate trade more broadly, as well as prioritize health and safety over the desire to avoid interfering with trade flows. This would be a significant shift from even the very recent past.

This effect with exacerbate the creation of a clear divide in the global economy between the more free-trading liberal democracies, and the autarky-inclined China bloc. The renewed push for self-sufficiency in the latter bloc will accelerate the development of a parallel institutional frameworks (such as the Asia Infrastructure Investment Bank), alternative transport and logistics infrastructure (such as the “One Belt, One Road”) and banking systems outside the fiat US$ settlement system, and an alternative currency denomination for oil. This process is already underway with China, the world’s largest oil importer, now paying two out of its three top oil-trading partners (Russia and Angola) in Renimbi. The process will be slow however, and the U.S. dollar will remain dominant throughout this decade.

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4) MEGA-TRENDS REINFORCED: DIGITAL TRANSFORMATION, HEALTHCARE INNOVATION, AND SUSTAINABILITY ARE HERE TO STAY.

Perhaps the most obvious trend that the pandemic lockdown will accelerate is the move from the physical to the digital world. Working from home was theoretical for many workers and firms, but now they’ve had to make it work. More of our services are likely to shift online, containing pricing power and altering the footprint of businesses. The balance between city and country also could shift. (Why pay the higher prices, and deal with the traffic and pollution if you don’t need to be there in person?) This may well alter returns and players in the real estate industry, not only the office sector but also retail.

Many governments already had a strong commitment to building their 5G networks before the virus stuck. The demand placed on existing networks during the crisis period and the competitive necessity of stable, high-speed connections in the digital age will only accelerate that adoption.

The pandemic seems set to accelerate two other megatrends that we see as important this decade: healthcare innovation and sustainability. The tie to healthcare seems obvious. More focus than ever is going to be on how we can innovate to provide treatments for, and potential vaccines against COVID-19. The speed of development appears impressive, emphasizing how fast healthcare leadership can shift, especially as many firms are starting to integrate new technologies, such as AI, into their search for new treatments. This underlines the importance of expert active management when investing in the area.

The fact that many healthcare systems, weakened by years of austerity, were quickly overwhelmed by this crisis would seem to lay the stage for a significant build out of intensive care capabilities across the developed world. This investment cycle, alongside the march of societal aging, will force economies to devote a greater share of output to healthcare and prompt further innovation by healthcare firms to seek treatments, such as gene therapy, that address the root cause of a disease. This is will be a tail wind to top line revenues in much of the healthcare sector for years to come.

Sustainability also will get another push forward. It maybe too much to expect people to shift to a lower-carbon intensive lifestyle just because they were homebound for a few weeks. But any problem with the natural world does put the human impact onto the policy agenda. Any onshoring of production may well reduce carbon intensity, as goods need to travel less far to market.

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The crisis also may be the making of ESG investing. There is evidence that ESG focused funds have outperformed during the COVID-19 bear market. Indeed, investors seem to be embracing ESG funds like never before: Inflows into ESG ETFs and open-end funds in the US reached a record high.

The current market pullback gives long-term investors a compelling entry point into innovative businesses that are reshaping the global economy and our lives, be they leveraged to technology, healthcare or sustainability.

5) WEALTH AND INCOME GAPS WIDEN ON DIFFERENCES IN GOVERNMENT SUPPORT AND RESILIENCE.

For both firms and households, this crisis seems set to hurt the weakest most. Small businesses were running on slender finances well before the pandemic, as a survey by the Fed’s regional banks showed. Even in late 2019, only one in five healthy firms – and even fewer less-healthy firms – had sufficient cash reserves to continue normal operations if they experienced a two-month revenue loss, the NY Fed said. So, despite the efforts of policymakers, it seems that many small businesses could fold unless the economy disruption ends swiftly. Large businesses will likewise struggle but generally have more capacity to cut costs, raise bridge financing and tap government programs to survive, not withstanding the additional efforts some governments are making to assist small businesses in this crisis.
Amongst households, both in the U.S. and the rest of the developed world, we know that the gap between the wealthiest fifth of the households and the others has widened significantly in recent decades. That top fifth are more often members of married, highly educated couples. As high-salary professionals or managers, they tend to live in Internet-ready homes that accommodate telecommuting—and where children have their own bedrooms and aren’t as disruptive to a work-from-home schedule. In this crisis, most will earn steady incomes while having necessities delivered to their front doors. Those same factors will likely leave them better prepared for the post-crisis economy than the rest of the population, who are more likely single parents or single-income households, in jobs where they are less likely to work from home. They will probably struggle with family burdens and employment loss, while working to maintain their children’s educational progress at home. In short, the crisis period, and the changes we see as we emerge, are likely to entrench the advantages of the top fifth of households. This is highly likely to be an area of passionate political debate in the 2020s.

TIDES OF CHANGE: POLITICAL AND REGULATORY PENDULUM MAY SWING BACK....

6) POPULISM PUSHED BACK: EXPERTS BACK ON THEIR PEDESTAL AS PROGRESSIVE POLICIES GAIN GROUND.

Many fiscal stimulus packages to combat the crisis include policies that would typically be categorized as more “progressive.” These include paid sick leave, wage subsides to prevent unemployment, and even, maybe in time, universal basic income. The depth of the economic hit, coming on the back of the slow and steady recovery from the Great Recession, will accelerate the search for a new economic model for the western world. The radical overalls in economic policy that some academics call for likely won’t occur, but greater government intervention in markets, for better and for worse.

While there may well be changes around the fringes of domestic economic policy, the core tenants of the global economy will remain intact: economic integration through trade and investment flows, without political integration, just a rules-based trading system, with mostly open capital accounts that force countries to compete for investment and jobs. In short, the institutional make-up of the global economy will still reflect the ideology of market liberalism that has been dominant for 40 years, but its edges may be softened somewhat in the aftermath of the virus, if the policies that survive it prove popular and effective.

In the coming years, policymakers are likely to face the choice of turning to austerity to try to close budget deficits, or choosing investment to boost growth and wealth taxes to raise revenues. Experience will, of course, differ by country, but perhaps memories of the societal impact of austerity in the 2010s will promote a different path of adjustment this time.

The lack of preparedness for, and resilience in the face of the pandemic may turn the political dialogue away from anti-elite populism and towards evidence-based expert policymaking again. This could allow countries to be better prepared for future pandemics, but also could mean a greater role for government in the economy and in people’s lives. The need for collective action has been so clearly demonstrated. Wider welfare systems have been built out. Greater healthcare and surveillance capabilities will be needed to avoid a repeat of the COID-19 disruptions.

7) FIXED INCOME REFORMED: TRADING REGULATIONS AND SPREADS BETWEEN TIERS OF BONDS WILL CHANGE.

One of the clear characteristics of March 2020 was the near-total breakdown of fixed income markets. Not just the most risky markets, but also the core: government and high quality corporate bonds. Part of the problem is the decline in dealer balance sheets relative to the size of bond markets (see chart). In stressed markets, with few buyers present, dealer books fill up very quickly and dealers are unable to buy more and facilitate trading. The market is, in effect, broken from a lack of liquidity.

### DEALER INVENTORIES HAVE DECLINED AS BOND MARKETS HAVE GROWN IN SIZE


*Note: dealer inventory levels and Corporate Debt outstanding indicated by the last available data in each year.
If this not addressed, every sell off could bring a large amount of dysfunction. That dysfunction will have to be unwound through massive central bank interaction in the markets (as we are seeing now). Given the scale of the action required during this latest collapse, it is clear that there will be pressure to change regulations. Already we have seen regulations change: The Fed has excluded US government bonds from the calculation of its supplementary leverage ratio. Although action that will facilitate larger dealer balance sheets should not be expected immediately and it is unclear whether policymakers will role back the Volker rule or push for some type of centrally cleared system, coming years may well see significant reforms that will allow fixed income markets to better weather periods of risk aversion.

If “better” regulation is forthcoming, it should reduce the risk of illiquidity in stressed situations. This could be enhanced by the broadened set of assets that the Fed is willing and able to buy. Take investment grade (IG) bonds. Now that IG has been designated as an asset class the Fed can buy in a crisis, its spreads may well trade tighter as an asset class to Treasuries in the next cycle than before—as investors will assume there is implicit support to IG bond prices in stressed situations that wasn’t there before. Relatedly, we could see a larger spread between High Yield (HY) bonds and IG bonds, as HY as a whole is still outside the circle of assets that Fed can gain authority to buy (not withstanding the recent announcement that the Fed can by “Fallen Angels” and some High Yield ETFs). In short, the “Fed put” has been extended to a broader set of assets, and those assets will now likely be valued closer to comparable risk-free securities.3

Some outcomes may push against one another. For example, as governments become more interventionalist, and potentially continue progressive policies that have been triggered by the crisis, this should help restrict the widening of wealth and income gaps between top-tier companies and households versus the rest, which the crisis is magnifying. Indeed, while margins at large firms may be hurt (as they shorten supply chains and hold more cash on hand), that may be partially offset by the further concentration in markets as smaller, weaker players are unable to survive the downturn.

Despite these changes, much of the bedrock of global economic relations will remain unchanged, and the cycle we are about to start will have many of the same characteristics, such as low inflation, very low bond yields, falling unemployment rate, as we saw in the prior cycle.

SUMMING UP

We remain in the fog of war against the virus. Conclusions can only be tentative at this point. But it appears we will see more government intervention in the economy, reforms to improve the functioning of fixed income markets, widening income and wealth gaps, and a return to top prominence of expert advice in policymaking in the aftermath of the COVID-19 crisis. Companies will focus on building resiliency through greater liquidity provisions and shorter supply chains, and concentration will rise as large firms weather the storm better than small ones.4

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3Once changes index composition by credit rating and sector are taken into account.
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