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The Future of the Financial Markets; After COVID-19

Viewpoints Philip Chao The Future of the Financial Markets; After COVID-19 Apr 07, 2020

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The COVID-19 pandemic that originated in Hubei, China (first uncovered in October 2019) is now a global phenomenon. Analysis of the fallout can be divided into three related strands: Public Health, Economy, and Financial Markets. It is natural for investment analysts to reach back to prior financial shocks or austerity as reference points to gauge the impact of the current exogenous shock and project recovery. I suggest these siloed perspectives are inadequate or at times erroneous in reaching base case outcomes with any reasonable degree of confidence. It is not that “this time is different”; it is that most living persons have not experienced this type of event in their lifetimes. Sadly, many search their limited and quarantined professional experience to anchor baselines in anticipating what to come.

This global pandemic is not a Black Swan event - an unpredictable event that is beyond what is normally expected of a situation and has potentially significant rewards or consequences. COVID-19, like SARS, MERS, Ebola and other viruses before, is quite a predictable event, and one day, another novel virus will attack us. We know about the existence of the virus, and we also know the effective way to minimize transmission as well as the limitation of medicine.

First (and foremost), this is a Public Health Crisis that is rolling across an unprepared globe. The duration and severity will be based on: (1) medical solutions (testing, treatment and vaccination), (2) robustness and capacity of healthcare infrastructure and personnel in each region, (3) good human behavior (social distancing, shelter in place, good hygiene and self-control), (4) political and social structure (ability and faithful adherence by the populace to lock down a city, state, region, and country and to make policy decisions promptly and implement successfully and speedily), and (5) take bold and disproportional steps early.

The most important question is the duration of the COVID-19 crisis. Answering this question requires: (1) understanding how many are infected (through universal testing) and (2) showing evidence of "bending the curve". The first step is to collect data regarding the spread of the virus. After a baseline population has been tested, data would be available to map and trace the progress of the infection, hospitalization, death and recovery rates.

In the U.S., testing remains largely unavailable for the masses across the country even though testing kits and methodologies are now catching up. This remains the biggest challenge. The upside surprise would be the FDA approval of medical treatment for the virus. However, as of today, there is no assurance or certainty that any treatment is available let alone effective. Further, vaccines are 12-months away at best and that would be to prevent attacks in 2021 and beyond. Strict social distancing, sheltering in place and self-quarantining remain the only ways to minimize or stop transmission. Second, this is an Economic Crisis which continues to unfold as a derivative to the Public Health Crisis. The policy for a sudden stop to daily economic activities and closing borders locally and globally have monumental consequences. The supply and demand destructions and the domino effects from cessation of daily commerce have immediate and devastating impacts on the U.S. and global economies. The expected explosion in unemployment due to a sudden economic shutdown will certainly bring the U.S. into a recession. Bankruptcies are inevitable as vanished consumer demand and business closures grind the economy to a crawl. Global trade and supply/value chains are obvious victims started in China (the factory floor for the world) which fed into a downward spiral and vicious cycle of diminishing demand and supply as the virus bleeds into the rest of the world. One example is the oil price. The COVID-19-led demand destruction for oil and oil products (less fuel due to less travel, commerce and production) has plummeted the price of oil globally. China's refineries, for example, cut their imports of foreign oil by about 20% due to a lack of demand in February. This led to the competition for revenue and dominance which fractured the uneasy relationship between Russia and Saudi-led OPEC. The existing coordination for production levels fell apart, and Saudi decided to cut oil prices by $11 to $35 per barrel. Since then, the free-falling market price has punched through $20. This COVID-19 initiated dispute is now impacting the American shale-oil producers. Debt reorganization, layoffs, and bankruptcies are here. In fact, some producers have begun paying customers to store the overflowing oil.

The Federal Reserve, sensing a significant economic fallout with severe financial stress, took unprecedented actions (monetary bazooka) to do whatever it takes as the lender and buyer of last resort. This intends to bring order, trust, stability and liquidity back to

the market. We are not only in the zero-interest rate policy (ZIRP) environment, we are also in quantitative easing forever (QE Infinity) reality.

In FOMC's press release and press conferences as well as announcements from the Administration, they often lead with the statements that the U.S. economy is strong and robust with the lowest unemployment rate in 50 years and consumers are in a good shape. These types of backward-looking statements are totally irrelevant. We suggest that all backward-looking data regarding the 11-year economic expansion will not contribute to our understanding of the domestic economy beginning in March forward. Without knowing the scale, scope and duration of the virus impact, it is anyone's guess as to the depth and width of our economic destruction and impact. Recession is assured; the questions are when the starting point of a recovery would be and will it be a rolling recovery over a longer period of time (U or L Shape) or a "V"-shaped recovery to the past.

Assuming 80% of the U.S. population has strictly adhered to the guidelines of social distancing and 20% has not, this would bend the curve. But this stable disequilibrium will still see infections popping up even though it is not exponentially multiplying. As the restriction is finally lifted and workers are encouraged to go back to work and participate in social and civic life again, would lingering uncertainty and fear prevent a full recovery back to normal quickly? Even though there would be a fair number who have either recovered or are asymptomatic, thus possessing the antibody against COVID-19, there would still be a large number who have no immunity. Would this larger population feel comfortable to take a cruise, attend sports events, frequent restaurants, and take the usual number of business flights? Probably not since the virus remains a pervasive threat, especially after witnessing hundreds of thousands perish from it. This would likely contribute to a longer U shape recovery. Then, there is also the possibility of a second wave of virus outbreak, even barring mutation.

Third, this is a Financial Market Crisis which is a derivative of the Economic crisis which in turn is a derivative of the Public Health Crisis. Bonds were quickly repriced based on the reaction to raise cash, deleverage and sell the most liquid securities in light of the economic shock. These extreme conditions exaggerated the illiquidity in the market. Equities, at the same time, moved from a position of an all-time-high on February 19th to a bear market in 3-weeks. With over a 31% loss in value (for the S&P 500 Index), many believe this is close to the bottom. Many investors maintain a buy-on-the-dip mentality and have been disappointed. The unknowable scale, scope and duration of, and thus the impact from COVID-19, will continue to put pressure on the stock market as investors continue to reprice the market for cascading bad economic news to come. If the stock market is a thermometer for the future of the economy, it is

likely that the market has more downside from here, at least re-test the recent lows. Although the market had welcomed the monetary bazooka and the subsequent, and unprecedented, $2 trillion fiscal bazooka, these would be insufficient if a prolonged period is needed to bend the curve and get the economy started again, not to mention the psychological and behavioral reluctance to immediately return to normal.

To gain a better perspective about the future of the financial market, we need to go beyond applying the standard, backward-looking factors and develop a better understanding about COVID-19 and its trajectory as well as its full impact on our economy assuming everyone is faithful to social distancing and personal hygiene to a varying degree of compliance.

Although it is too early to conduct a post-mortem of the COVID-19 pandemic, there are certain paths that seem obvious:

1. Globalization will continue to be challenged as consumer-based economies will likely rethink dependents on their supply chain and focus on the need to source products and components from a more diverse location, to include domestic production.
2. Income and wealth disparity will be further exaggerated after this healthcare crisis is over. This is fuel for (left and right) populism and anti-immigration policies coupled with redistribution of wealth (at least taxation increases) and nationalism.
3. More fiscal spending in a zero-interest rate environment such as infrastructure projects and with some form of monetary financing such as universal income
4. Losing more individual liberties as the liberal democracies act on the benefits of high-tech tracking and surveillance in the name of the "public good"
5. Employers will likely re-evaluate their headcounts and human resource efficiencies as well as the necessity to travel. Further, companies will likely adjust to a more decentralized operational framework and continue to find ways to use technology to improve productivity and efficiency.
6. Even under a ZIRP environment, savings and safe haven assets will again be favored over investing as many will seek the return *of* their capital rather than return *on* their capital. This is also supportive of the continuing demographic shift to an aging population

It is hard to support a return of inflation even as we climb out of the impending recession if these expectations are realized. As such, we expect the Federal Reserve to hold rates at the zero bound (hopefully never entering into negative yields) for an extended period. We will likely see another decade of financial repression where savers are supporting borrowers to again heal this economy back to health.