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Asset Management

Looking Forward

Will COVID-19 Turn Out To Be Just a Bad Dream?

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The second quarter marked a remarkable rebound from the lows that we saw in March. We watched as retail investors shifted from a view of darkness and despondency to optimism and light. The speed of the shift is what made this period memorable. Today, the question facing investors is "now what?" While there is no certain answer, we are pleased to share our insight into how we are currently looking at the world.

As a starting point, we should distinguish between what we would like to be true from what is likely to be true. Ideally, we would like to see a relatively quick return to normalcy and economic activity similar to that which was seen in January. Recent economic data and news on possible vaccines has increased the optimism that we will experience a V-shaped recovery and that the COVID-19 episode will be the equivalent of "an undigested bit of beef, a blot of mustard, a crumb of cheese, a fragment of underdone potato", as Scrooge thought of the ghost of Jacob Marley. Unfortunately, we fear that there will be other ghosts to visit us in the future as many of the consequences of the pandemic have yet to evidence themselves in the economy.

For one to be extremely optimistic about the future, you must believe in the inevitability of a number of things. First, one must believe that all of the individuals that were temporarily laid off will either be rehired at their previous organization or quickly find another position. The early surge in employment figures certainly points that way but we find it hard to imagine that all of the recently unemployed will return to full employment. It is, however, more likely that many temporary layoffs will become permanent and we will see a rise in the unemployment rate. While initially it may appear as though everyone is returning to work, the surge in employment is unlikely to continue at its recent pace.

Second, one must also believe that the deferred mortgage payments, rent, and credit card payments will all be repaid in a timely manner. In many ways, individuals are living in a period best described as "the calm before the storm". With government support payments to individuals and subsidies to businesses, we are carrying along with minimal financial and emotional repercussions. We worry that once the payments come due, individuals will default or cut back spending to deal with the increasing and already record debt burdens - neither of which will be beneficial to the economy.

Thirdly, one must believe that companies will be able to either return to their previous business models or seamlessly switch to new business models without any financial stress. Consider what a clothing retailer may look like in the future. Will it be business as usual for these retailers or will they become more reliant on online commerce and shrink their store sizes? We expect to see dramatic changes to universities, offices, shopping malls, and schools, to name a few. It is unknown what the change will be, but we consider it unlikely that it will occur without some financial pain.

The fourth item to consider relates to government finances. The payments for the various support programs have largely been financed by the central bank lending money to the government – essentially increasing the money supply. To date, this has occurred without impacting inflation or interest rates. The question is whether this benign environment will continue or if society will face an increasing tax bill in the future. Even the prospect of higher taxes in the future may slow spending today.

For these reasons, we continue to reduce our expected growth rates for our equity investments and are prioritizing opportunities that are more defensive. Although we are optimistic that eventually the economy and society will return to normal, we just don't think it will be nearly as quick and painless as many hope. The Ghost of Christmas Future may bring us a much slower and weaker economy.

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