

Letter n°7

What's next ?

« When the past no longer illuminates the future, the spirit walks in darkness » Tocqueville

Far away, the joyful memory of the longest post-war growth cycle. Less than a month later, the evidence of a global recession and uncertainty about the pace of recovery, the constraints of containment on production and the concern of entrepreneurs on its consequences, the surge in jobless claims - nearly 17 million in three weeks in the United States (10% of the working population) - and the wondering of a probable change in consumption habits, the unprecedented scale of stimulus measures and the fears caused by the worsening debt explain markets' volatility.

No one can answer the question as to how long this crisis will last, but there are some indications that the recovery will be slower than expected, and that cyclical stocks should therefore be treated with caution. It is worrying to see Singapore, held up as an example by the WHO, prompt in the implementation of the first measures in mid-January, be forced to take new containment measures on 7 April, for a minimum period of one month. A delayed opening of the Schengen area borders, investment cuts in many sectors and a reduction in the Lufthansa fleet are all indications that a V-shaped recovery is not on the cards.

Much has already been written about this pandemic, but let us try to focus on the cost, future debt management, the evolution of the Sino-American rivalry, the weakening of emerging countries, the strengthening of European integration, the prospects for oil prices and the possible shifts in globalisation.

The cost :

Already high, it will get even worse. This global pandemic has had more deadly precedents, the Black Death, which started in Central Asia in 1348 had wiped out a third of the European population, 50 million deaths during the Spanish flu, 2 million deaths during the Asian flu of 1957-1958, and 1 million deaths during the Hong Kong flu in 1969-70.

However, none of these pandemics cost as much economically. So far the therapy has been 10 to 20% of the GDP of budgetary aid monetized by central banks, European countries, the United States, Japan and some other countries are facing recessions estimated at between 5 and 10% of GDP this year.

Surprisingly, China, which was active in stimulus measures in 2009, is in fact doing rather little, preferring targeted fiscal measures in favour of small and medium enterprises to an umpteenth stimulus plan, after the €354 billion already announced in December 2019. In November 2008, two months after the collapse of Lehman Brothers, China had announced a very large recovery plan of \$600 billion (or €450 billion), 7% of GDP over two years. In the first half of 2009, credit had increased by €730 billion, a fourfold increase in credit volumes and the government had launched an infrastructure plan equivalent to 14% of GDP over two years. These incomparable stimulus measures have left their mark - overcapacity, weakened banks, debts, and China does not want to lower its rates too much to avoid currency outflows as in 2015. Nevertheless, China is the best stock market this year because, along with other Asian countries, it will emerge from the crisis ahead of Europe and the United States.

How to manage debts ?

Faced with the burden of debt, and even though governments deny it today, it is hard to imagine avoiding tax hikes. We remember that the income tax in France was introduced by Caillaux in 1914, and the federal income tax by President Woodrow Wilson in the United States in 1916, in order to reduce the US federal

debt which rose from 15% of GDP in 1930 to 115% in 1945, and to overcome a budget deficit of 30% in 1945. The income tax rate in the United States was never as high as it was after 1945, 90% for the top marginal bracket, until the election of Ronald Reagan.

Some would argue that cash injections could lead to inflation. This would probably be the case for asset values with further bubbles, but price indices will not rise because high unemployment will prevent wage increases, a slow exit from the crisis will mean persistent overcapacity and commodity prices, oil and metals, will remain low.

In other words, it would be futile to expect to erase debt through higher inflation.

American fading and continued rivalry with China :

The longstanding rivalry between the U.S. versus China remains valid, but once again, the U.S. lost an opportunity to reassert its supremacy. Many times, the U.S. has aggressively imposed their strategy on international matters such as attacks against Iraq in 1990 and in 2003. However, we tend to forget how indecisive they can be: they entered World War I in 1918 after a year of negotiations and joined World War II, even though it was wanted by Roosevelt, by only one vote majority. Nevertheless, they continue to flout multilateralism.

In terms of diplomacy with China, far is the time of Kissinger's secret visit to Mao in July 1971 with a piece of lunar stone as a gift, the visit of Nixon in 1972 preceded by many gifts including an oxygen tent kept by Mao, the "Project Chestnut" in 1979 which installed American equipment in the West of China to listen to the Russians. In 1979, Americans sold \$4 billion worth of goods to the Chinese and bought only \$1 billion. The American trade surplus with China only persisted until 1985. In June 1989, a few days after the Tiananmen square incident when George Bush wrote to Deng Xiaoping to "ask him to preserve this relationship so important for both countries"! Since then, it is true, Sino-American relations have known moments of tension, when the Americans supported the first elections of the Taiwanese president in 1996. In 1979, China's overall exports represented only 5% of a low GDP, whereas it reached 40% in 2008. In 2000, on the eve of China's entry into the WTO, Beijing was selling \$100 billion worth of goods to the United States, but in 2008 it was selling \$350 billion and in 2019 more than \$500 billion. Today, the rivalry persists. China Telecom, after China Mobile in mid-2019, could be banned from entering the United States. Trump's re-election is not yet threatened because the states most affected by the virus are Democratic strongholds, such as New York and California, and in Republican states like Texas, Alabama, Oklahoma, the support of evangelists is unfailing as they take advantage of sanitary measures to remove beds reserved for abortion.

The weakening of emerging countries :

Largely spared by the 2008 crisis, emerging countries are this time affected by the slowdown in international trade, the halt in tourism, the drop in commodity prices, capital outflows, the risk of the pandemic spreading and a fatal increase in inequalities. Among the fragile are the 1.8 billion inhabitants of the countries of South Asia: Pakistan, Bangladesh and India, whose growth could fall to 1.5% against 4.9%. In Latin America, the most critical cases are Argentina with the ninth debt default in a century and Venezuela. Elsewhere, Turkey, South Africa and Nigeria are very vulnerable. In all, about a hundred countries have approached the IMF, which has \$100 billion for emergency aid and a global intervention capacity of \$1 trillion.

The slow affirmation of the European identity :

The rapid implementation of measures in Italy and Spain by two governments deemed politically weak was in itself commendable. But a European response was needed. Some people feared or hoped for a dismantling of Europe or at least a break-up of the Eurozone. They were wrong again. From the outside, for a long time now, Russia has been trying to divide Europe, the United States would like it to break up and China is sneaking in by supporting the weakest, Greece, Portugal and most recently, Italy. From the inside, the quarrels between the Netherlands, Finland and Germany with the southern states were getting worse, but they have been overcome. **Monnet's** words have never been better illustrated: « *Men accept change only in necessity and they see necessity only in crisis* ». €540 billion in community aid, including

€100 billion to finance compensation for partial unemployment on the basis of debts secured by €25 billion in guarantees provided by the EU member states, €200 billion from the European Investment Bank, to support the liquidity of small businesses in the 27 member states, and €240 billion in loans offered by the European Stability Mechanism, to enable each state in the Eurozone, without any conditions attached, to receive aid amounting to 2% of its GDP, i.e. €36 billion for Italy, for example. Various modalities of reinforced solidarity, which prolong the abandonment of the Stability Pact, are already reflected in the €1 trillion monetization announced by the ECB and should find a relay in the possible adoption of a European recovery plan amounting to €500 billion, 4% of European GDP, on 23 April. All these measures are essential because the debt of European companies, at 105% of GDP compared to 45% in the United States, will worsen. We may regret the Dutch refusal to create "coronabonds" but the adoption would have required the approval of parliaments and would have taken time.

Which evolution for oil prices ?

In 2008, the reduction in supply was 2.5Mb/d, this time 10Mb/d from 1 May, of which 2.5Mb/d will be borne by Saudi Arabia and 2.5Mb/d by Russia. This represents a record 10% reduction in world supply, but an insufficient amount in view of a 30% drop in world demand.

In the short term, overcapacity will persist, but it is likely that within a year, a recovery in the transport sector, 60% of consumption, combined with the slowdown in exploration efforts and the bankruptcy of American shale oil players will contribute to a recovery in prices.

What changes in production processes and globalisation ?

Globalisation is being blamed, but the three countries that have been exemplary in managing this crisis, Taiwan, Singapore and South Korea, are among the most open and the beneficiaries of this globalisation. Global competition for a vaccine is a convincing example of the superiority of a model of multilateral openness over nationalism. Between the reality of interdependence and the temptation to insularity, a compromise will have to be found.

Notwithstanding the advantages of globalization, production units deemed strategic will be repatriated, most often from China, sometimes, as in the case of Japan, with state subsidies. Also, contrary to widespread opinion, China, the world's workshop, could be the loser, but it will be able to find compensation in the accelerated promotion of a consumer society and "China 2025", the programme for technological independence. If China accounted for 12.7% of world exports in 2019, or \$2.5 trillion, almost the equivalent of the UK's GDP, it should fall.

Finally, just as the aftermath of the Second World War had been the great decades of the Ford model of mass production, the current period should benefit companies with digital activities, rich in liquidity and with capacity for innovation. Liberalism will persist but the sovereign state will emerge stronger.

Conclusion :

- From an economic point of view, as in 1982 in the United States, recession is not the result of the exhaustion of a cycle but of a political decision. In 1982, by raising rates to 20%, the Fed accepted a temporary recession in a bid to quell inflation. Today, by confining half of the planet, governments accept a recession to eliminate the virus. Let's bet, as we did in the past, on a sustained recovery.
- From a societal point of view, let's hope that we will soon look forward to the development of a vaccine to prevent its reappearance, and the effectiveness of the stimulus measures, but let's not forget the freedom, the consequences of geolocation temporarily accepted to defeat evil. We should not end up saying, as **Kundera** notes in « Life is Elsewhere »: « *The worst thing is not that the world is unfree, but that people have unlearned their liberty* ».
- From a political point of view, even if fragile, democracies should gain points in their rivalry with populist regimes such as Hungary, Iran, Brazil, the United States, locked in an initial denial that made them waste a lot of time. The two best countries in the management of this crisis are democracies: Taiwan with a death toll limited to 4 for a population of 24 million and Germany.

- From a stock market point of view, let's remember from this letter, an overweight in Europe and an underweight in emerging markets, an overweight in gold, the beneficiary of liquidity injections by central banks and, an overweight in energy-related stocks with a one-year perspective. Let's add caution to the UK market as the Brexit calendar will be disrupted and the UK index has a lot of financials and little technology. As of last week, we remain overweight in technology, health care and luxury goods, underweight in banks and neutral on cyclicals. The start of corporate earnings releases over the next few weeks could revive markets volatility.

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