HEMISPHERE
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EXTRAORDINARY TIMES

In the quickest meltdown in financial history, global equities experienced their worst quarterly performance since the 2008-09 financial crisis. While the Canadian stock market declined almost 24%, U.S. stock markets dropped 16% in Canadian dollar terms.

Many investors initially believed the coronavirus pandemic would primarily affect China. As it quickly spread, governments in most developed countries responded by shutting down major parts of their economies and issuing stay-at-home orders. Ultimately, these government actions delivered an unprecedented shock to global financial markets.

The speed and magnitude of the slowdown suffered by global economies has no modern precedent. Layoffs have been widespread among small service businesses with entertainment, travel and hospitality industries being particularly decimated. Every component of economic activity (consumer and capital spending, exports) has declined abruptly. Oil fell to its lowest level since 2002. Some high-profile economists foresee North American unemployment levels surpassing 15%, levels not seen since the Great Depression.

Global Central Banks and governments responded with major policy actions to try to cushion income loss for households and businesses. The U.S. Federal government quickly moved to facilitate a record $2.2 trillion relief package. The U.S. Federal Reserve cut short-term interest rates to 0.25% and announced support exceeding $1 trillion to the U.S. financial markets. In late March, the Canadian Federal government announced a $107 billion emergency stimulus package with a commitment to future support.

The debate now develops over which sectors and companies deserve handouts, which sectors of the economy should be forced to absorb the costs themselves and how governments can avoid supporting ailing companies that may have gone bust anyway.

As this pandemic unfolds, we see eight major, long-run investing implications:

1. MORE INDUSTRY CONSOLIDATION

The trend within North America towards larger, but fewer companies across all industries, has been in place for decades. The coronavirus pandemic will further support this trend. Dominant companies are connected to governments through a litany of lobbyists/special interest groups. Due to the diversity of small businesses, their linkage to governments is far less substantial. As governments choose economic winners for their recently announced, massive relief programs, it is very likely they will favour large corporations and investors over small businesses and individuals.

These large, dominant companies should be able to re-establish their pre-2020 margins through a combination of less price competition, more technology and fewer workers. In the retail industry, for example, Amazon, Walmart and Costco (also Loblaw in Canada) will accumulate even greater market share. With the collapse of energy prices, the North American oil & gas sector will see a huge reduction in the number of E&P (exploration and production) and energy service companies. Crony capitalism will continue to thrive.

2. GREATER SOCIAL INEQUITY

The coronavirus pandemic will likely further entrench the trend towards greater social inequality. Technologically competent, white-collar employees are more able to retain employment by shifting work to remote/home locations. Blue-collar and contract workers in non-essential (pandemic defined) jobs are more likely to be laid-off or dismissed during the business shut-down period. The coronavirus will further highlight the social infrastructure deficiencies of North American societies.

In late March, the U.S. unemployment rate surged by 0.9% to 4.4%, the largest monthly increase since 1975. Over 10 million Americans applied for unemployment benefits during the final two weeks of March. April should see unemployment numbers rise further. With so many blue collar/contract workers unemployed, employers will have substantial bargaining power in the post-pandemic economy. Ultimately, this oversupply of workers will generate minimal wage inflation and add further stress to the growing societal wealth gap.

3. DECLINE OF GLOBALIZATION

In the blink of an eye, the U.S.-China trade war is now "old news" and the coronavirus pandemic is now the "only news". The start of this trade war likely coincided with the peak of globalization. While the current economic downturn places the trade conflict on the backburner, the underlying theme has become clearer during this crisis. The U.S. and China, among other nations, are becoming more competitive, not more cooperative as the pandemic spreads. This decline in globalization has now been unexpectedly accelerated by the coronavirus pandemic.

By focusing on specialization, globalization brought benefits of increased connectivity, interdependence and stability. Unfortunately, the same benefits provided by globalization also created vulnerabilities readily exposed by the coronavirus. Ease of global travel created a volume of traffic that quickly spread the virus. Additionally, the comparative advantage of specialization (produce the "best" and cheapest goods) has exposed the weakness of reliance on a single producer within the supply chain. As the global supply chain unravels, component shortages have created manufacturing shut-downs and lay-offs creating massive strains on numerous "down-stream" countries.

"Made at home" policies are now the norm as countries try to defend themselves from the virus. From a distance these policies can possibly be viewed as protectionist. Essentially, however, they are the recalibration between the value of efficiency ("best" and cheapest goods) and the need to re-establish a greater level of national self-sufficiency. For consumers this will mean higher priced but, locally or regionally produced goods. For investors, large domestic companies will likely become more diversified. Additionally, there may be an opportunity to invest in more national, but smaller, niche manufacturing companies.

4. EXTREME STRESS IN DEVELOPING COUNTRIES

The pandemic has exposed an unfortunate side-effect of the classic "flight to security" that occurs in periods of global stress. As investors sell higher risk, emerging market securities to buy U.S. treasuries, they are creating huge downward pressure in emerging market currencies. Many of these currencies (Mexican Peso, Brazilian Real, South African Rand) have declined by over 20% year-to-date to record low levels vs. the U.S. dollar.

Given the issues the pandemic is creating for developed countries, the outlook for developing countries may be disastrous. These countries only have a fraction of the medical and financial infrastructure necessary to deal with the pandemic. Most of these countries are heavily reliant on resources and/or tourism industries, both of which have been recently devasted. Additionally, many developing countries have significant levels of U.S. dollar-denominated debt, further limiting their financial options and increasing their risk of insolvency. Any government support for unemployment or job loss is out of the question. Finally, with the current situation of "every man for himself", aid from the developed world seems extremely unlikely. The pandemic will dramatically increase geopolitical risk.

5. RECKONING FOR CORPORATE AND HOUSEHOLD DEBT

Over the past decade, declining interest rates and a growing investor appetite for corporate bonds has allowed most North American companies to dramatically increase balance sheet debt. Cheap debt capital enabled a pattern of regular share buy-backs to artificially boost corporate earnings per share growth. Cheap debt was also utilized in increased corporate merger/acquisition activity. The coronavirus pandemic has brought this pattern to an end. In an effort to conserve capital, most corporations now have ended buy-back activity for the foreseeable future.

In some industries, problems with high corporate debt levels have become even more critical. The problem goes beyond ending buy-back activity to actual solvency. Recently, a large U.S. energy company, Whiting Petroleum, declared bankruptcy. The plunge in global oil prices resulting from a combination of pandemic demand destruction and the Saudi-Russian price war, may mean that this is the "tip of the insolvency iceberg" for other highly-indebted energy companies. The next few months will be an incredibly challenging period for the North American energy industry.

Many Canadian households are also confronting solvency issues. According to the MNP Consumer Debt Index, almost half of all Canadian households say they are on edge of bankruptcy - $200 or less away from not being able to pay their bills each month. As most Canadians are well aware, the Toronto and Vancouver real estate housing markets are supported by a huge level of mortgages. A prolonged pandemic response period in Canada could create enormous strains on households with serious issues for the Canadian banks and the Canadian economy.

6. EXPLODING GOVERNMENT DEBT LEVELS

Even before the coronavirus pandemic, the U.S. Federal government was on track to post an annual deficit of over $1 trillion. In the final week of March, the U.S. announced a massive $2.2 trillion stimulus package, the largest in U.S. history. Assuming additional relief stimulus in mid-April of close to $1 trillion, one can only conclude that the U.S. Federal deficit (and debt level) is going to explode.

The combination of further relief/infrastructure funds from Congress and a substantial reduction in tax revenues should push the U.S. federal deficit in 2020 well through $3 trillion. During WWII the U.S. Federal deficit-to-GDP peaked at 27% in 1943. Although lower than peak WWII levels, the current deficit-to-GDP should easily hit a 16-18% level.

The figures for Canada are better, but still dire. The Federal deficit in Canada is forecast to rise from $30 billion to a potential record of $130 billion. Combining that with Provincial deficits of up to $80 billion translates to government deficit-to-GDP figure of 15% for Canada.

Developed countries remain in unchartered territory in determining the impact of ever-rising government deficits and debt levels. Record government spending only increases the level of government involvement in the economy. We are currently witnessing a rare instance with the U.S. government offering direct, broad-based payments to U.S. citizens. It is very plausible that the coronavirus pandemic may redefine the relationship between democracy and capitalism.

7. STRUCTURE CHANGES IN WESTERN ECONOMIES

The structure of the post-pandemic economies of the developed world will be measurably different than their pre-pandemic predecessors. This change is directly related to the degree to which the pandemic has altered global patterns of consumer spending. Undoubtedly, the "new economy" will reset the amount of work performed at home as well as the level of goods and services also consumed at home.

Travel, tourism and hospitality industries contributed to over 300 million jobs and accounted for over 10% of global economic activity in 2019. These types of companies are experiencing a gigantic shakeout and it seems inevitable that they will continue to shrink, fold or consolidate in the future. Even with the development of a vaccine, it is difficult to see how these companies can recover to pre-pandemic levels for years to come.

Impacts of a new economic structure will span across every major industry. Less travel will significantly reduce energy demand. Coordinated global production cuts may moderate energy price declines but, without renewed demand, the energy industry will not see pre-2020 energy prices for many years. The entertainment industry will completely restructure as online revenues accelerate and more sales from traditional venues (theaters, concerts, etc.) plummet.

Given their better access to capital, large, publicly traded retailers should have a better chance of survival, however, if the pandemic persists, access to capital may be irrelevant. Problems for retailers will become problems for commercial real estate owners. Demand for office space will slacken as employees work from home. The rapid influx of change as a reactionary measure to the coronavirus may end up being the foundation to a new economic structure.

8. DECLINE IN CANADIAN IMMIGRATION

Immigration has been a core component of the Federal Liberal platform. For the last two years, Canada's "open door" approach to immigration has resulted in population growth of over 1% per annum, by far the highest level amongst G7 countries. Without immigration, Canada would have only marginal real (inflation adjusted) economic growth in 2019.

Given the anticipated rise in Canadian unemployment levels (potentially peaking at 15%) as well as the travel constraints resulting from the coronavirus pandemic, it is unrealistic to believe that this "open door" policy could be restarted before a vaccine is found. The Liberal government has set targets of more than 350,000 new permanent residents for 2020 to 2022. These numbers will not materialize. The coronavirus pandemic is significantly changing the trendline of Canadian demographics.

CONCLUSION

These are incredibly challenging times for policymakers, business leaders and investors. With a total absence of historical context, it is extremely difficult to formulate any predictions regarding the outlook for the North American financial markets.

The U.S. is now clearly the global pandemic center. The delayed response to the coronavirus from some large Republican states (Florida, Texas and Georgia) is extremely worrying and will only prolong the U.S. recovery. In Canada, our more rapid national response may generate a better relative outcome. However, the headlines will likely get uglier as social and economic disruption intensifies in the foreseeable future.

Under some scenarios, the impending economic downturn and financial crisis will be more severe than any encountered since the Great Depression. Most importantly, social distancing is working with the earliest countries to contract the virus (China, South Korea, Singapore) showing good progress moving from containment to normalization.

We are now witnessing an unprecedented mobilization of resources in all areas of science to develop a vaccine for the coronavirus. Despite the scale of this "Manhattan Project", there is a medical consensus that the vaccine is at least 12 - 18 months away. In many ways, the fate of the global economy is dependent on the work of researchers. Although there is no shortcut (this is basic biology and testing), eventually a vaccine will be found.

Unfortunately, it is impossible to provide any certainty regarding the outlook for the North American markets. It is important to remain defensive for potenital future negative developments. Through disciplined analysis, we have identified desirable securities and price targets, allowing us to take advantage of further stock declines, before the inevitable recovery occurs. As the bottoming process of stock prices could be a drawn-out affair, patience, prudence and a gradual investment from cash positions is the most sensible approach.