



LONGER-TERM THEMATIC CONSEQUENCES OF COVID-19

WHITE PAPER

Longer-term Thematic Consequences of COVID-19

By Morten Springborg,

Global Thematic Specialist, C WorldWide Asset Management.



Key takeaways

- It's been coming for years, but now comes monetary and fiscal fusion in the form of expanding fiscal deficits financed by central banks.
- Complex supply chains have increased the fragility of the global economy, and their fragmentation will accelerate leading to more localized supply chains.
- The world will become less optimized, less global and more regional and national – but also more robust and less fragile.
- Digitization of businesses and societies as well as the transition to the cashless society will accelerate.
- There will be a fundamental reassessment of travel and how work is organized.

We are witnessing financial market history. The 'black swan' materialized with the advent of the coronavirus (COVID-19), but the virus was the trigger and not the cause. This is not a conventional crisis; it is a crisis facing individuals, families, communities, regions and countries all over the world. It is also a demand as well as a supply shock. The risks are still not completely known, which makes short-term analysis challenging. The impact could be short-lived and modest or extended and more serious. But COVID-19 is already challenging perceptions of what a normal course of action is: school and business closures, city lockdowns – already leading to early signs of economic and financial distress. Virus eradication needs aggressive measures, which counter freedom of movement and perhaps other freedoms as well, and lead to significant short-term harm to economies and financial markets.

When choosing between alternatives in fighting the virus and its consequences, we should ask ourselves not only how to overcome the immediate threat, but also what kind of world we will inhabit once the storm passes, because COVID-19 has the power to for ever change our economic and social systems. We need to remember the wise words of Milton Friedman that nothing is so permanent as a temporary government program.

As is often the case, it is probably easier to assess the longer-term consequences. From a thematic point of view, what are the most likely significant consequences of COVID-19 once the dust settles?

Fusion of fiscal and monetary policies

Central banks can print money, but not vaccines. Monetary policy loses its potency the closer you get to zero. Crisis management driven by central banks is not an ideal solution. It's been coming for years, but the excuse for now applying a much more active fiscal response to economic problems is present. Now comes monetary and fiscal fusion in the form of expanding fiscal deficits financed by central banks. The beginning of a form of MMT (Modern Monetary Theory also known as Magic Money Tree), helicopter money or so-called People's Quantitative Easing (PQE). One example of this will be a need to support small and medium-sized enterprises (SMEs) in travel, entertainment and other companies affected by the COVID-19 induced collapse in demand. We have already seen the first cash handouts in Hong Kong and an aggressive fiscal crisis response in the US and UK and other countries around the world.

The loss of fiscal orthodoxy, at least temporarily, is not a concern as the crisis is unprecedented and the toolbox needs replenishing. But longer-term, one can fear that politicians will not give away their newly gained powers. This opens the door to a completely different policy response which, if unconstrained, leads to a much bigger government involvement in the economy at the expense of a free capitalistic market economy.

Do bailouts and buybacks go together?

Many industries are experiencing a massive collapse in demand and are in dire need of public support. History tells us there will be strings attached. Some corporates might end-up being nationalized, having to give-up equity stakes to governments or end-up being, in effect, temporarily nationalized in all but name.

The airline industry is a case in point. As with most airlines, the US airline companies have asked for aid of USD 50 bn., which is close to the cumulative amount spent on buybacks during this cycle. As we think about this in terms of precedence – we have the example of the restrictions imposed on the financial sector post the Great Financial Crisis (GFC), whereby recipients (even those who did not need it) had restrictions imposed on

them. During the GFC, US public funds were also used to bailout the auto sector. Consequently, there were significant business restrictions placed on the auto companies and they were also forced to exit certain operations such as auto insurance.

Once we transition out of this mess and society conducts the “post-game analysis”, there is a risk that companies will be required to buffer balance sheets to give them better ability to navigate future crises without being a burden on the state. This would suggest that affected industries would have limited ability to do share buybacks resulting in lower ROIC going forward, which as we know, is generally not supportive of PE multiples.



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Conversely, companies that can navigate the current tumultuous period without public support probably have robust business models that will differentiate them going forward and will not see the same restrictions on how they allocate capital in the future.

Complex supply chains have increased the fragility of the global economy

The world will become less optimized, less global and more regional and national. The more optimized a system is, the more fragile it potentially becomes. For example, Ming Dynasty porcelain is undeniably finer and more beautiful than any tin cup. But what the tin cup gives up in beauty, it makes up in resistance. The current COVID-19 disruptions are revealing and exposing the global system's fragilities.

In the aftermath of the GFC we saw the rise of the Nation State and the early innings of the decline of globalization. The fragmentation of supply chains will be

accelerated by the virus and lead to regionalization and localization of supply chains. The wartime mindset of having inventory in times of crisis has been reignited. Production networks of the last decade and today often have complex interrelationships that go back and forth across borders. An American retailer might contract with only one Chinese company, but that entity in turn might act like a general contractor, pulling in components from many sources. In 2018, for instance, more than 1,000 facilities were involved in one way or another in the production of Apple products. This is not a robust business model for the future. Business models have been optimized to perfection and because of the rise of platform business models and ever longer and more complex supply chains the world economy has become a lot more fragile over the last 20-30 years. This fragility becomes highly visible as trade wars and a black swan pandemic hit the world economy.

Furthermore, the fourth industrial revolution, with 3D printing and the growth of autonomous smart factories, together with rising wages in China, and international trade wars, is decreasing the gap in production costs between China and the West. At the same time, the ongoing tech war with the US is driving China towards more self-sufficiency in key technologies.

The psychological and practical impact of the disruption in supply chains due to COVID-19 will accelerate the reversal of this extensive trend of supply chain globalization.

Will COVID-19 reveal underlying fragility in the megacities?

As the world's population continues to grow and urbanize, the number of megacities – those with over 10 million people will continue to increase. According to the UN, there will be 43 such cities by 2030.

Scientists have taught us and Geoffrey West in his book “Scale” put forward the concept that cities, like organisms, do indeed exhibit “universal” power law scaling while also introducing the so-called rule of 15. Infrastructural measures, such as numbers of gas stations and lengths of roads and electrical cables, all scale sub linearly with city population size, mani-

festing economies of scale with a common exponent around 0.85 e.g. enabling a more efficient use of infrastructure. More significantly, however, cities are also characterized by super linear scaling: socioeconomic quantities involving human interaction, such as wages, patents, diseases and violent crime all scale with a common exponent around 1.15. Thus, on a per capita basis, human interaction metrics (which encompass innovation and wealth creation) systematically increase with city size while, to the same degree, infrastructural metrics manifest increasing savings.

In other words, with every doubling of city size, socioeconomic quantities – the good, the bad, and the ugly – increase by approximately 15% per person with a concomitant 15% savings on all city infrastructure-related costs.



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While much of the focus on the growing number of megacities has focused on the overall net positive effects of ever larger cities, a global pandemic event like COVID-19 also highlights the rising fragility of our economies as cities scale. At time of writing, COVID-19 has already spread within a short period of time from one megacity, namely Wuhan, to other megacities around the world, both in Asia, Europe and also the US, where New York City is the current city epicentre. Despite this we think the human race will continue to seek the wealth and the opportunities of the city and the trend towards megacities should remain intact.

The digital society

At the time of writing, although we are still in the midst of the pandemic, it seems clear that digital business models are much more capable of coping with the



challenges of the COVID-19 disruption. Quarantine and self-containment obviously have a huge effect on supply and end-demand, and COVID-19 looks like yet another nail in the coffin of traditional retail. However, digital services and products are not so susceptible to the disruption. Case in point, although sport stadiums and concert venues across the globe are closed, people still need their “bread and circuses” as was said in ancient Rome. Amazon and Netflix and similar businesses are probably taking significant market share – and mind-share in the current environment.

Furthermore, in China nowadays, banknotes and coins are considered to be virus transmitting objects. Therefore, COVID-19 will be an accelerator towards the cashless society.

Digitized economies are probably also more robust in situations like this, including highly digitalized societies like the Nordic countries, where the public sector seems to continue operating as smoothly as can be expected in these circumstances. Post this pandemic, digitization

of businesses as well as societies will likely unfold at an accelerated pace due to COVID-19.

Commercial real estate is at risk of a longer-term impact as employees and employers harvest and react to the experiences learned during the COVID-19 induced lockdowns, and as traditional retail never really recovers fully after COVID-19 as mentioned above. As more and more digitized companies find that working from home can be efficient and functional, the longer-term consequences could be an added impetus to a shift down in the structural demand for commercial real estate space.

Similarly, workforces are getting used to new workplace experiences and set-ups as they adjust to the COVID-19 disruptions. For example, holding video conference calls instead of physical meetings could clearly have lasting effects on business travel and attendance at conferences as virtual meetings are both less costly and time-consuming.



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The healthcare system

No matter what happens to supply chains going forward, it will not change the fact that we will continue to live in a highly connected world and that the current pandemic will not be the last. There will be consequences for the way our healthcare systems are organized, based on how they cope with the current challenges. There will probably be a tendency for further centralization of healthcare systems, because they are better capable of coordinating across geographies, as well as a need for greater investment in healthcare. The big question regarding this issue is probably how the decentralized and private US healthcare system copes with the challenge. This will be a political battlefield through the 2020s and much will depend on the COVID-19 outcome in the US.

Other shorter-term aspects - Chinese tourism and food safety

The most important driver of tourism and general travel in recent years has been the explosion in outbound

Chinese tourists. At least in the medium-term, this will go into decline as the Chinese population will be more hesitant to travel abroad due to fear of health issues. However, domestic Chinese tourism will as a result see a boom once the pandemic is behind us, though global luxury goods spending will likely take some time to rebound.

There will be a need for renewed discussions on food safety and food culture. The SARS coronavirus (SARS-CoV) epidemic in 2003 was linked to civet cats kept for food in a Chinese food market in Guangzhou. The consensus among researchers studying the spread of COVID-19 pinpoints the likely origin to a “wet market” or live animal market, in Wuhan, China. High-quality, branded processed and frozen food bought in supermarkets will see a significant boost, while in the longer-term local markets will probably be reduced very significantly for food safety reasons. With a population of almost 1.4 bn people, a shift in food preferences in China will have global ramifications.

Summary

Whilst it is speculative to assume a virus outbreak like COVID-19 will have a lasting impact on the growth of cities, it is more likely that the described effects on economic policy choice and structure of our entrepreneurial system will play out. The reason being that the virus is reinforcing an existing trend towards more political interference in economic matters as well as less efficient but also more resilient supply chains. The trend towards more digitized societies will be reinforced by the COVID-19 outbreak leading to a further digitization of payments and an acceleration in the movement towards the cashless society. Work routines are radically being readjusted because of COVID-19 and in the longer-term will probably lead to people adjusting to more flexible and efficient work practices. Health-care systems are being put to the test and will likely see both significant investments and an ongoing discussion whether radical change to the design of the system needs to happen based on the experiences and lessons learned of COVID-19.

The battle to eradicate the virus can be done in several ways. One way is for the governments to mass monitor populations by application of technology and punish those who break the rules. A successful application of

suppressive mass surveillance would be a watershed moment for a more general application of population control and go completely against liberal democratic principles. Modern technology can help us tremendously in this battle, but must be done by empowering a self-motivated and well-informed population with trust in its institutions to do the right thing in order to combat the virus. Otherwise, the price to our democracies will be too steep.

The virus calls for politicians to act, and since politicians are elected locally, the preferred solutions will most likely be local ones. Unfortunately, global challenges call for a global response. The world today faces many challenges of global dimensions. Besides pandemics like COVID-19, global warming and migration pressures are but a few issues, which cannot be dealt with except by acting in unison.

Like all global challenges, coronaviruses do not discriminate based on nationality or religion. They touch on our most basic human condition and human fears. Understanding the disease, slowing its spread and developing a vaccine, will require intense international cooperation. We are all in this together

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C WORLDWIDE ASSET MANAGEMENT FONDSMAEGLERSELSKAB A/S

Dampfaergevej 26 · DK-2100 Copenhagen

Tel: +45 35 46 35 00 · VAT 78 42 05 10 · cworldwide.com · info@cworldwide.com

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