

# Long-term impact of Covid-19 policy response

The Covid-19 outbreak and the responses put in place to slow its progress have caused extensive disruption to society since December 2019. In an attempt to soften the negative economic impacts of these disruptions, central banks and governments around the world have provided support on an unprecedented scale. They have given a clear message, they are willing to do “whatever it takes” to get through these testing times.

There has been a wealth of press focused on the short-term impact on financial markets and investors. However, it's important not to get bogged down in the day-to-day headlines. Looking beyond these headlines, we believe that there are three key messages that investors should keep in mind:

**1. We expect the initial recovery to be much quicker than after the global financial crisis:** The policies put in place around the globe in response to the outbreak are of a level never seen before both in terms of size and speed of deployment. Their objective is, once the pandemic has passed, to allow global economies and markets to recover very quickly. Although economies are harder to start up than they are to shut down and

the success of the policies is dependent on the path of the pandemic, at the present time we expect the recovery, when it comes, to be much quicker than after the global financial crisis (at least initially).

**2. There is an unprecedented level of uncertainty surrounding investing:** The unprecedented policy response, reflects the unprecedented nature of the situation we find ourselves in, and with this comes unprecedented levels of uncertainty. This means it is impossible to gauge the risks associated with many investments at the current time. This should be borne in mind when making investment decisions at the moment.

**3. Looking beyond the next 12 months, there are going to be lasting impacts from this crisis, regardless of how it plays out:** It is too early to say exactly what those will be but we expect that focussing on inflation, global trade and debt levels will look very different in the future, all of which have significant implications for investors. As such, we suggest investors watch developments in these areas closely.

The remainder of this note provides further details on our views around each of the three points above.

## Unprecedented response. Accelerated recovery?

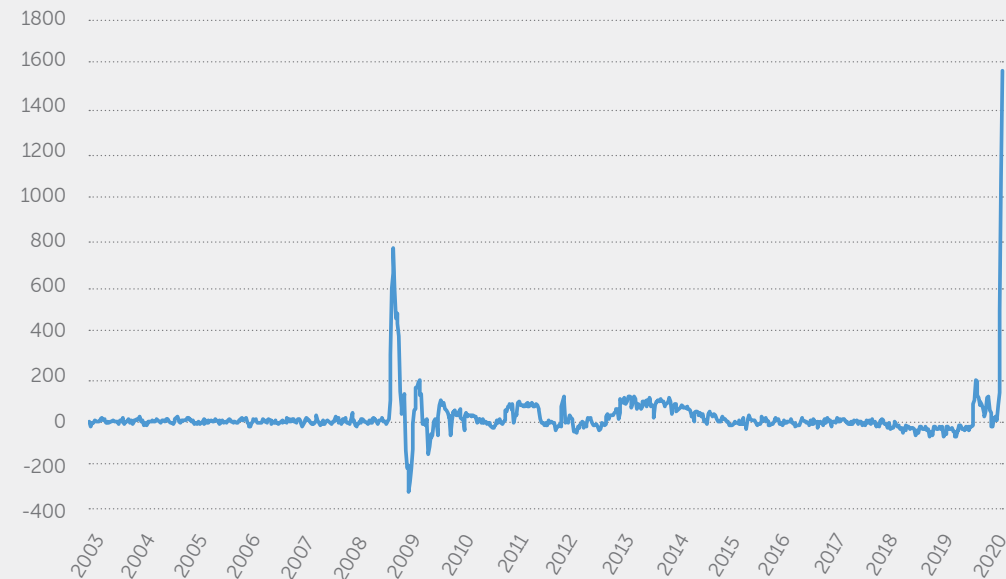
### Central bank response

Once it became clear that the pandemic would result in large-scale outbreaks in Europe and the United States, central banks acted incredibly quickly. Their immediate response was to cut interest rates. By 19 March, the US Federal Reserve and the Bank of England (BoE) had cut rates by 1.5% and 0.65% respectively, to almost zero. Whilst this response is, in our view, likely to have limited economic impact given the nature of the crisis, the speed and size of the cuts had a symbolic impact and reassured markets that central banks would do what they could to keep the economy functioning.

That reassurance lasted perhaps a week. The central banks' second response was quantitative easing (QE). Many readers will be familiar with QE but, for those that aren't, QE involves the central bank buying government bonds and other assets. In comparison to previous rounds of QE the scale of the asset purchases this time have been enormous, as shown in the chart on the right for the US.

Whilst the majority of the new quantitative easing programmes will be used to purchase government bonds, central banks will also purchase large amounts of corporate bonds. This is a major step for the Federal Reserve, who did not do this as part of their response to the 2008 Global Financial Crisis. Over the course of March, the introduction of QE provided liquidity that was critical to the smooth functioning of markets and ensured markets continued to operate on some level of normality.

FEDERAL RESERVE 4-WEEK NET ASSET PURCHASES (\$ BILLIONS)



## Government response

It is the size, speed and scale of the fiscal stimulus provided by governments that marked the biggest change relative to past practice, and is likely to have the biggest impact on our short-term recovery.

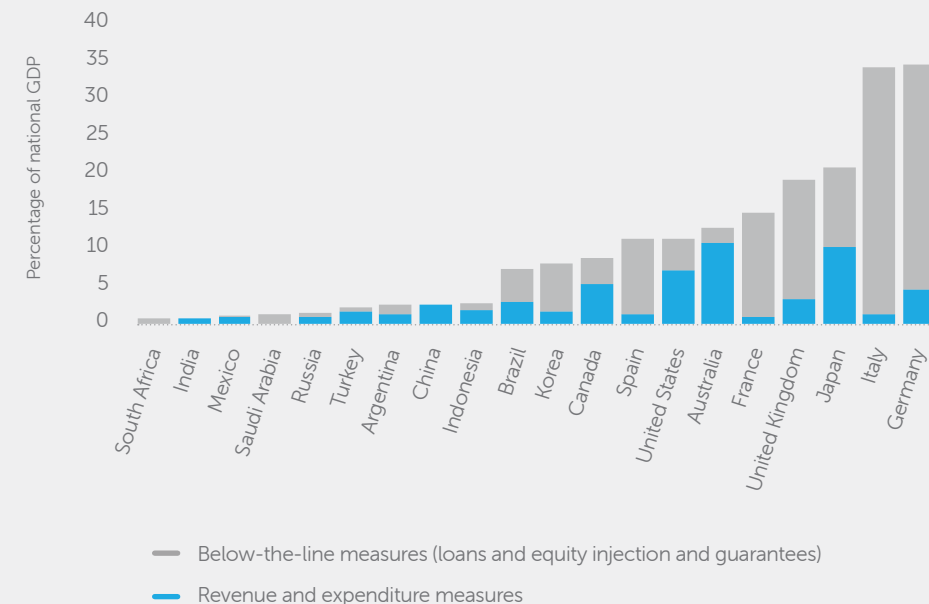
In the recent past, monetary policy has been the dominant tool for managing economies. However, central banks had little firepower left as they faced the impact of Covid-19 – rates were already low and balance sheets large relative to their starting points going into the Global Financial Crisis (Table 1 below shows the UK position, although the global picture is very similar). Furthermore, this time support was needed in areas that monetary policy simply cannot reach. It quickly became clear that monetary policy alone would not suffice and governments worldwide launched far-reaching, and expensive, stimulus packages.

### STARTING POSITION VERSUS GLOBAL FINANCIAL CRISES

UK	2007	End 2019	April 2020
Base rate	5.5%	0.75%	0.1%
GDP growth	2.8%	1.1%	-4.2 (Q1 forecast)
Government debt vs GDP	33.4%	80.8%	95% (end 2020 forecast)
Central Bank balance sheet	£92bn	£581bn	£608bn (end Q1 forecast)

Source: Bank of England, TradingEconomics.com

### THE GLOBAL FISCAL RESPONSE



Source: IMF, Fiscal Monitor, April 2020

## Impact on recovery

The collective objectives of policy action are to:

1. Preserve functioning markets – this is largely performed by the actions taken by the central banks; and
2. Avoid destruction of supply and demand – this is the objective of fiscal stimulus and, in our view, will have the most important economic impact.

For now, the fiscal stimulus mentioned above is providing the liquidity needed for fundamentally sound businesses to remain solvent throughout the crisis and therefore have a chance at resuming normal trading once the outbreak has passed; without this stimulus the destruction of supply chains would have been absolute and any recovery would be very slow to start. Whilst it may have long-term implications – see Section 3 - this unprecedented fiscal response gives a chance for a rapid initial recovery to markets and economies once uncertainty surrounding the course of the virus has been reduced and lockdowns relaxed.

## Impact of QE on assets

A knock-on effect of low interest rates and QE is that asset prices are increased, potentially artificially. This typically starts with the assets that central banks are buying and then spreads to other assets as investors are forced to look elsewhere for returns (and so demand for those assets increases).

During the 2008 Global Financial Crisis, the European Central Bank purchased corporate bonds as part of their QE programme, whereas the Federal Reserve (“Fed”) focussed on US government bonds. This time, as well as government bonds, all of the major central banks will be buying vast amounts of investment grade corporate bonds and, in some cases, even higher risk assets under their QE programmes. Whilst we do have some reservations about, for example, the Fed buying high-yield credit and the Bank of Japan buying equities, we believe governments purchasing investment grade corporate bonds as part of their programmes will help support that market and provide a level of reassurance to bond investors.

## Uncertainty, uncertainty, uncertainty

We would love to be able to give investors some clear guidelines as to how the recovery will play out. However, the issue we currently face is that – because the nature of the virus is still unknown and the policy reaction is so unprecedented – there are a lot of “unknown unknowns” (see box to the right). This makes it impossible to accurately assess how much risk you are taking and the likelihood that risk will pay off.

At the most fundamental level, there is still very little known about the path the virus will take. For example, to pick a day from the outbreak, on 7 April:

- Austria announced that it would be seeking to ease lockdown restrictions, an unexpected outcome given the rest of Europe was at the height of the current outbreak; and
- Singapore and Japan, widely praised for controlling the disease early on, announced surging numbers of cases, and a possible second wave, forcing greater lockdowns.

Further outbreaks can crop up anywhere at any time, even in the places that seem the most prepared, while countries that border hotspots can escape relatively unscathed. As well as the path of the virus, there are unknowns surrounding the reactions of governments and the economic implications of those reactions. Those decisions will have very wide ranging and varying impacts on different parts of the economy.

	Known Outcomes	Unknown Outcomes
Known Probabilities	RISK	UNCERTAINTY
Unknown Probabilities	UNCERTAINTY	UNCERTAINTY

Finally, even if we could identify the possible outcomes, we do not have enough data to assign any probabilities to those outcomes, leaving us with unknown outcomes and unknown probabilities.

To illustrate how this differs to normal market events, take the example of the recent falls in oil prices. We knew there was a risk of falls in oil prices – i.e. it was a known outcome – but who would have predicted that Saudi Arabia would have used the middle of the pandemic to start an oil-price war? This was therefore a known outcome with an unknown probability and as such falls into the bottom left box on the table. The difference in the case of the Covid pandemic is that there are so many unknown outcomes, and the size and far reaching nature of those possible outcomes. This places us, for now, firmly in the bottom right of the table shown above.

That is not to say we think investors should be paralysed and avoid taking investment decisions because of the unknowns. Far from it. But we do think investors should remain cautious and have that uncertainty in mind. We feel, in general, not straying too far from their long-run strategic objectives and aims that they have already set is a sensible course of action. Be cautious about adding extra uncertainty into the portfolio at this stage and aim for diversification and certainty where you can find it.

## Beyond recovery

Assuming we see some sort of economic recovery within the next 18 months, are there any lasting financial impacts of the crisis and the policy response?

We think the global nature of the crisis and scale of the response mean there is no question that there will be lasting impacts. It is impossible to know at this early stage exactly what they will be and how they will play out, but our view is that the following three areas could look significantly different post-Covid-19: corporate profitability, debt and inflation.

### 1. Corporate profitability

Over the past decade, a large part of the corporate profitability (and thereby earnings growth) has been achieved by compression of costs. This has provided handsome returns to equity holders. We believe that this model is under fundamental threat.

Supply chains cannot be restarted as quickly as they can be shut down and the longer the shut-down, the harder it will be to restart. Regardless of the re-start point, we believe that the effects of the Covid-19 response are likely to combine with existing tensions to result in a longer-lasting reduction in global trade. Throughout most of the 2010s, the total value of world trade remained relatively stagnant, having expanded over previous decades. There were signs it had already started falling slowly in 2018 and 2019, before the pandemic took hold. In the aftermath of the pandemic, we do not expect global trade to recover to its previous heights. Instead, we expect geopolitical tensions will continue, trade wars will resume and the approach of companies to supply chain management will fundamentally alter. Japan has already launched a \$2.2bn fund to encourage its manufacturers to move their supply chains out of China.

The knock-on effect of a reduction in global trade volumes is that companies will be less able to reduce costs through manufacturing goods wherever in the world is the most cost effective. This will act as a drag on profit growth. This is of interest to investors as lower earnings growth and corporate profitability means lower returns to investors. We would repeat the comments about uncertainty in the last section but, on balance, we think it is more likely than not that long-term returns will be lower (in absolute terms) in the post-Covid-19 world.

### 2. Debt

Governments will need to look at radical new ways to finance their spending and service their debt. Most developed economies, with the notable exception of Germany, were already running fiscal deficits and current actions will widen deficits even further. The International Monetary Fund estimates that advanced economies will run an average deficit this year of 11% of GDP and that the public debt of these economies could run to \$66trn by the end of 2020 (c.122% of GDP).

At some point this debt will need to be paid down. This usually comes in the form of spending cuts, tax rises or economic policies that help liquidate government debt; all of these options act as a drag on the economy and will keep growth sluggish over the long term. In particular, the latter may involve low interest rates and high (but manageable) inflation. The current crisis may result in governments taking stakes in companies which would compound the corporate profitability issues discussed above.

### DEBT-TO-GDP (ADVANCED ECONOMIES)



Source: IMF, Fiscal Monitor, April 2020

The approach governments take to dealing with their debt will have repercussions across economies and thereby investment returns. Different approaches may mean some economies grow quicker than others and it is therefore worth keeping a close eye on governments' responses. For the UK at least, our view is that interest rates are unlikely to increase any time soon. This is, sadly, not a new story for pension schemes, but this means rises in gilt yields are not likely to rescue pension scheme deficits in the near future. The approach to debt may also have implications for inflation (see next section).

### 3. Inflation

There is some debate about how Covid-19 and the policies launched in response will affect long-term inflation. Over the next few years we expect inflation to fall, perhaps even seeing outright deflation. However, the longer-term picture is more nuanced.

On the one hand, the large-scale fiscal stimulus, the supply chain shocks and the need to keep rates low to manage debt burdens are likely to stoke inflation. On the other hand, the global reduction in personal spending as a result of national lock-downs may last much longer than the pandemic, as consumers try to save more. Added to that, companies may try to protect against future supply shocks by building up their inventories; both of these would work to drive inflation down.

### UK INFLATION (CPIH)



Source: Office for National Statistics

Overall, we think something akin to the financial repression of the last decade – where inflation regularly exceeds interest rates – remains a risk in UK. Whilst we do not yet see permanent, very high inflation as the most likely outcome, we are watching this closely.

We wrote in 2014 about how investors should not necessarily be worried by inflation or deflation in isolation, but by unstable inflation ([see here](#) for the original article). The same is true today and we think there is a real risk that we are entering such a period of instability and that managing this risk should be high up on investors' agendas.

We therefore recommend all investors consider the impact of inflation on achieving their long-term targets and protect accordingly. For many investors, this will mean increasing your focus on long-term real assets. For pension schemes this may mean increasing how closely you match the inflation in your liabilities.

It is too early to say where global economies, or even the UK economy, will end up on the issues of inflation, debt and corporate profitability but, we think they will be key to the long-term economic and financial market recovery. As such, we think they are important to watch closely. We do expect a fall in long-term profit margins and returns on capital and we are worried about inflation and so would suggest that this should be factored into investment decision making.

## Conclusion

Monetary and fiscal policy action over the past month is already so transformative that it will have vast, long-term implications on the economy and asset returns. There is a strong chance that further fiscal policy support will be necessary in the coming months. Proposals that seemed radical a matter of weeks ago, such as "helicopter money", are already in place and further innovation is likely.

Looking past the short-term volatility, there will be long-term impacts of this large-scale intervention that remain to be seen. We have set out our thoughts on what these may be in this note but the key takeaway for clients is that, whilst the recovery may turn out to be much faster than following the Global Financial Crisis, there is much more uncertainty.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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