In The Vortex Of A Perfect Storm

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The oldest and strongest emotion of mankind is fear, and the oldest and strongest kind of fear is fear of the unknown."
H.P. Lovecraft (1890 - 1937), American writer of weird and horror fiction

It had been a while that financial markets have been treading on thin ice, and after one of the longest bull market streaks in recent memory, the day of reckoning was just a question of time, waiting for that "perfect storm" confluence of fear inducing events to manifest itself. In terms of calamities, this one certainly did not disappoint, causing widespread panic strong enough to trigger the infamous market circuit breakers[1], as it sucked share prices through the vortex of what at some point may have appeared like a bottomless pit. What we are living through is unprecedented, like a modern-day Carrington Event[2] with its potential for widespread economic destruction and social strife comparable to the Great Depression.

Even though the warning signs were many (high multiples, protracted bull markets, record borrowings, ongoing trade spats, de-globalization drive) and with an almost constant lingering sensation that something bad might be brewing on the horizon, the final triggering event crept onto us out of nowhere, and in a classic "black swan" kind of way, caught even the most seasoned of pundits by surprise along its destructive wake[3]. The market response was understandably extreme, not only because of the shock effect from a sudden realization that radical containment measures would be necessary to contain the pandemic, forcing the global economic engine to an almost complete shutdown, but also because unlike with other major events such as the 9/11 attacks, where we had a rough idea of the size of the damage soon after it occurred, the offending cause of the crisis in this case is likely to remain active for some time to come, making it difficult to get an accurate reading of its final financial impact.

From the moment the iron curtain came down and through the decades that followed, the world went into a hyper-globalization frenzy, as competing regimes found common ground in free markets, loosening huge swaths of untapped labor pools into a world economy in demand for cheap labor. Through the improved interconnectedness of better infrastructure, cheaper and more efficient means of transportation, and as new technologies helped shrink the cost of high bandwidth communications over long distances, it didn't take long to realize the economic attractiveness of outsourcing the various segments of a business. Manufacturing and other competencies began to dislocate to far flung regions across the globe, where they would be put to their most efficient use.

[1] https://en.wikipedia.org/wiki/Trading_curb
[2] https://en.wikipedia.org/wiki/Solar_storm_of_1859
[3] This is not a "black swan" event in the strict sense of the word given that such events are defined primarily by their rarity. Devastating pandemics have occurred throughout history, and we fully know they could happen again. Despite this knowledge, we have decided to remain only partially prepared because the cost of maintaining full preparedness over the long term appears to be prohibitively high.

Now as we fast forward into the present, it is remarkable to note the degree to which this "globalization drive" has transformed the world we inhabit. Whether it is the instant gratification of "one-click shopping", the conveniences brought about by the gig economy[4] or the ability to conduct business from almost anywhere and with a minimum of resources, the sheer benefits of globalization cannot be overemphasized. But all these changes that have led to an almost singular betterment in the lives of a broad and diverse swath of humanity comes at a price, whether it be through its destructive effects on the environment or in other, more discrete ways that show themselves when major events like the current one strike.

Just as viruses require living hosts to survive and propagate, globalization, through its tight integration, has created a sort of "super organism" through which it can spread[5]. A "perfect storm" of conditions appear to be amplifying the potential damage from such threats, and in more ways than we may imagine. Porous borders (US, EU, Schengen, Russian Federation and China come to mind), the ease with which people can travel almost anywhere, anytime means that actual host infections can very rapidly jump from being local to becoming an epidemic and from there morphing into a pandemic. There is also the role played by highly integrated factory supply chains and just in time inventories to consider. Right now, as world infection cases rise exponentially, extreme measures such as shutting down factories create another form of "contagion" by, for example, disrupting output from all industries that depend on the global supply chains and which can sometimes have devastating consequences[6].

Add to this the effects of just in time inventory management where technology advances have made it possible to keep inventories to a bare minimum for cost purposes, and it quickly becomes clear how a localized case of the flu in some far flung place can suddenly morph into a financial and economic calamity of epic proportions[7]. We are in unchartered waters in the sense that the world is experiencing an unprecedented shock in both demand and supply, grinding the global economy into an almost complete stop[8]. The abruptness of these changes — and the near-lockdown of major cities— is unheard of, more akin to wartime privation than the downturn that accompanied the last financial crisis. A large swath of businesses are being simultaneously starved of oxygen for an undetermined period. This will be feeding a negative feedback loop that needs to be broken to avert far graver consequences down the road.

What happens when both demand and supply falter at the same time across many industries? When revenues dry up just as borrowing is at its highest? Or just when things could not get any worse, the Saudis engage into an all-out oil price war with the Russians? And what happens when most major polluting sources come to an almost complete stop, long enough to make it noticeable? Does that raise our awareness on the huge amounts of waste that our economies are generating sufficiently that it irreversibly emboldens the drive against climate change?

It is in such times of upheaval, when the road ahead appears to be taking a turn for the worse, that extreme measures like those used during war times are needed to turn the tides. It is also in such times, when we attain inflection points, that revolutionary changes tend to occur[9]. Ultimately, how we come out of this conundrum is going to depend very much on how a more fractured and divisive world, lacking both unity and leadership, that has emerged in the last couple of years, handles the challenges ahead. Stark differences in policy effectiveness between the different forms of governance

[4] https://en.wikipedia.org/wiki/Gig_worker
[5] Unlike HIV; SARS or Ebola, one of the hallmarks of Covid-19 appears to be the relative ease with which it spreads, which is also why more drastic measures of containment need to be implemented in order to stop it.
[6] https://www.wsj.com/articles/it-may-not-be-the-virus-that-kills-me-11584048964
[7] By keeping inventory to a minimum, a firm runs less of a risk of ending up with unsold goods in the event of a sudden and sharp drop of demand. If there is a sharp and unanticipated pickup in demand, it will require a ramping up of production, creating a lag and the risk of losing customers to competitors that may have stock. The major drawback is when production shuts down unexpectedly, leaving customers out in the cold.
[8] You might think that the world during the World Wars experienced something similar, but the economies did not come to an almost grinding halt because they continued to operate, but for different purposes.
[9] The Spanish flu of 1918 that lasted 3 years, may have been more lethal in its effect, killing a larger proportion of the infected, but also appears to have been less easily transmitted than Covid-19. The world was also at war during part of the Spanish flu, leading to a less "controllable" spread of the disease than is possible currently.

(democracies vs. autocracies and dictatorships) are already showing their effects, suggesting that Europe and the US are going to be having a tougher time combating the pandemic than both China and South Korea did.

It appears like a paradox that the more forcefully we deal with the crisis now, confronting it head on, the greater will be the near-term economic repercussions from it, but also the quicker we are likely to recover from it. Time appears to be of essence here, the decisions and actions taken in coming weeks are going to substantially determine the shape of the recovery and its aftermath. This is not going to be an easy ride, it never is when facing something so overwhelming, so suddenly and unexpectedly.

Where Do We Go From Here?

The sudden and steep correction in global shares set off multiple circuit breakers and dragged markets deep into bear market territory, whilst volatility rates went through the roof. Generalized fear led to a panic hoarding of “defensive” instruments including treasuries, precious metals and refuge currencies[10]. It was the abrupt realization of the type of measures that would be necessary to reverse the course of the pandemic, its crippling effects on a wide range of sectors, but more importantly, the uncertainty on how long these conditions would remain that led to a sharp reversal in sentiment from measured optimism to extreme bearishness.

It is becoming increasingly evident that stopping the tide is going to require more than just textbook macroeconomic theory, it will necessitate actions on the scale of those that were taken during the previous crisis and possibly much more. The authorities are going to have to put on their creative thinking caps, strike preemptively wherever they can and do some fine-tuning adjustments to keep the world economy from sliding into another great depression. The major central banks of the world (Fed, ECB, BOJ) entered this crisis with their traditional recession fighting monetary tools almost completely exhausted. The central banks of Europe and Japan are already in negative interest rate territory and the Fed has just spent its remaining reserves when it recently slashed its target rate to almost zero.

What all this invariably means is that going forward, we will be seeing more of the type of measures such as quantitative easing or TARP, that were enacted during the previous crisis. The authorities are slowly realizing that what they are facing is a catastrophic event of potentially monumental proportions, and that the combined efforts of central banks and their use of a broader set of tools may not suffice to avert the next phase: widespread bankruptcies of businesses across a whole range of sectors that have been sitting on piles of debt over an extended period of cheap loans. The situation is like a systemic time bomb in which the longer the conditions of “oxygen deprivation” (collapsed revenues, no free cashflow) drag on, the more it will feed into a negative feedback loop[11] [12].

What happens if widespread bankruptcies trigger losses in the banking system, causing a tightening of credit across the economy? In such a situation, healthy firms that would be normally expected to ride out a crisis will find themselves unable to continue because of a cash crunch. This pandemic threatens to set off financial contagion in a world economy with very different vulnerabilities than those of previous downturns. That is why governments across the globe are implementing aggressive measures, to stave off a deeper recession before it becomes too late. Monetary measures are going to be increasingly bolstered by fiscal stimulus through the printing of money. The two trillion dollar announcement

[10] The volatility index surged above 80 from 13 over the past month, the S&P 500 and other major indexes plunged and even the Treasury market, usually a stalwart in market turmoil, faced disruptions so severe that the Federal Reserve intervened to prevent further chaos.
[11] Just the potential initial effects from all those restaurant meals not eaten, hotel rooms sitting empty and aircraft temporarily mothballed are potentially huge. And that’s before accounting for the ways those could ripple into second- and third-order effects.
[12] As businesses deal with the prospect of a sudden stop in their cash flows, the most exposed are a relatively new generation of companies that already struggle to pay their loans. This class includes companies that earn too little even to make interest payments on their debt and survive only by issuing new debt.

by the US is a case in point. Restoring confidence to the markets is going to be crucial to reversing the economic drag, by notably re-inflating the markets which should help reduce the negative “wealth effect”.

The world economy fell right into a trap and is now facing very powerful headwinds, and whilst like all things in life, these conditions will also eventually fade away, it is the decisions and actions that are taken now that are going to determine how things unfold. The world will come out of this undoubtedly stronger and better prepared to face such threats, but that may not matter if the next crisis comes out of nowhere, from a source that we never gave much thought about or didn’t spend enough time planning against. Much is still unknown about how we recover from this one, whether its effects will dissipate abruptly or drag along. What is more certain, however, is that with devastating human and economic tolls, the world is going to emerge much changed from before.

Altug Ulkumen, CFA

Independent Contributor
aulkumen@gmail.com