Investment Insights

The coronavirus is proving to be a black swan event – unpredictable and with massive consequences

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Justin Leverenz examines the long-term impact the virus outbreak could have on economies, sectors, and companies.

After a decade of reasonable tranquillity - and disappointment - global equity markets have hit another "black swan," and trust me I use that word with fearful caution. The coronavirus is truly a black swan in the sense of being both unpredictable and an event of massive consequence. I believe it is also likely going to significantly change behaviour and approaches at fractal levels across society and culture, including demand for greater state capacity and governance. As Nassim Taleb explained to us in his book *The Black Swan*, history is seemingly smooth and linear, until it is not. And when it is not - black swans are responsible for much of what we call in history those large disconnects where big change happens.

Healthy stressors are vital for developing less fragility (or anti-fragility). The suppression of these stresses has been occurring for decades, since the tenure of "The Greenspan Put,"1 by trying to avoid healthy recession. This has been further amplified in the aftermath of the Global Financial Crisis (GFC), with central banks around the world suppressing natural interest rates levels along with other fiscal stimulus in the big economies such as the US and China. This has created fragility by constraining volatility against nature, depriving markets and corporations of the ability to be stronger and more vigilant. It also has encouraged complacency, buybacks by professional CEOs and leverage. One can easily find the analogue in public health care - where efficiency has trumped preparation for pandemics and now, we are witnessing the dire consequences.

Although I am an investor, I can also be a speculator about the broader world. Beyond elections and markets, I imagine that many, many things may change in response to this black swan event. At the level of global relations, we can hope for greater collaboration and understanding. Perhaps a renewal of the Pax-Americana era, which followed the demise of the Soviet Empire, an era of globalisation and liberalisation, with more equitable and tolerant leadership in an increasingly multi-polar world. My bet, however, would be the opposite, and that the endogenous forces of national chauvinism and parochial interest we have witnessed over the past decade will get further reinforced. But outside of obvious triage improvements in public health, I suspect the most profound changes at the abstract level are likely going to be about a big shift in the orientation of capitalism. I see a few potential developments:

1. **The pursuit of shareholder capitalism will come under greater attack**
   A milder form of capitalism, with less pronounced focus on meritocracy (a "winner take-all" approach), and a greater focus on fairness: re-establishing an ethos of equality of opportunity (which is not the same thing as equality of outcome). After the second massive economic crisis in a decade, the pendulum will shift in the ongoing balance between the state and the market. I also suspect that social demands for greater accountability of governance will grow as state capacity expands. I believe we are moving towards a better world, where redundancy will be more appreciated vs the MBA-orientation of efficiency at all costs.

2. **Oligopolies will be under pressure**
   This implies not just technology, which has some level of meritocracy associated with it, but also politically prominent oligopolies which under-deliver innovation and unfairly tax society.

3. **Corporate empires will face internal pressures to find focus**
   The behemoths will struggle to overcome the inevitable diseconomies of scale that lodge in as corporate complexity overwhelms efficiency gains. Bureaucracy and process at extreme scale overwhelm competitiveness as these behemoths get disrupted. Leverage is often a catalyst and a bane amongst such companies.

Beyond speculation about the world, I have some thoughts on likely proximate consequences for emerging market (EM) equity investors.

1. **Contrary to convention wisdom, Russia may just be one of the great places to invest now**
   Russia is the strongest of any major oil economies with a fortress balance sheet, strong fiscal position and a flexible currency (and cost structure).

Figure 1
Russia is better positioned to cope with US$30/bbl oil price (%)

	2017	2018	2019	At US$30 oil
Current account/GDP	2.1	7.0	4.4	0.6
Budget/GDP	-1.7	2.5	1.5	-1.7
Government debt/GDP	12.6	11.7	12.5	12.5

Source: Central Bank of Russia, Ministry of Finance, Sberbank, CEIC.

While oil at US$30 will be uncomfortable for Russia, where inflation is estimated to rise to around 4% resulting in lower real incomes, it will be devastating for the Gulf economies. Saudi in particularly could run double-digit deficits and see its net debt to GDP soaring to 53% in 3 years.

Figure 2
Budget Surplus/Deficit at US$30/bbl

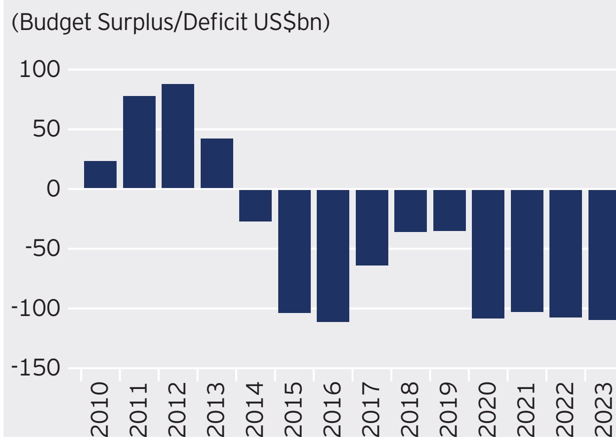
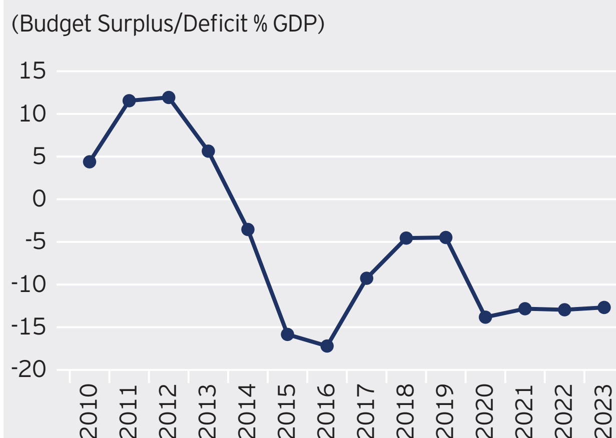
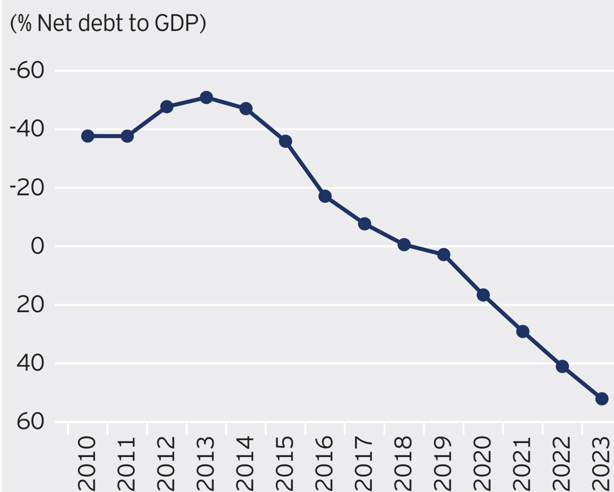


Figure 3
Budget Surplus/Deficit at US$30/bbl as % GDP



Please see figure 4 for source.

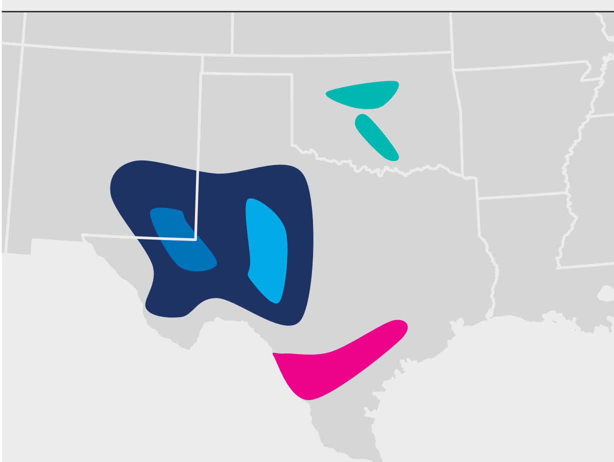
Figure 4
% Net debt to GDP at US$30/bbl



Past performance is no guarantee of future results.
Source: IMF, Kingdom of Saudi Arabia Ministry of Finance, as of 31 December 2019. Bernstein Estimates for 2019-2023). Estimates may not come to pass. Subject to change.

Ironically, the ultimate losers of this price war will likely be the biggest recent growth producers - the US shale firms, whose breakeven price lies between US$48 and US$54, according to a Dallas Federal Energy survey. By taking advantage of all major OPEC price stabilisation while sitting on a mountain of debt, the shale oil industry has lost its ability to weather the black swan moment. As the capital market is turning off its tap on the US shale producers, the number of bankruptcies rose 50% to 42 in 2019, from 28 in 2018. At US$30 oil, there will likely be a lot more US shale producers going belly up this year.

Figure 5
Average breakeven prices in US range from US$48 to US$54 per barrel



Permian (other)	$54		
Permian (Delaware)	$49		
Permian (Midland)	$48		
SCOOP/STACK	$53	Other U.S. (nonshale)	$49
Eagle Ford	$51	Other U.S. (shale)	$49

Notes: In the March 2019 Dallas Fed Energy Survey, executives from 82 exploration and production firms answered the question, "In the top two areas in which your firm is active: What WTI oil price does your firm need to profitably drill a new well?" The survey collection period was March 13-21. WTI refers to West Texas Intermediate crude oil.

2. China will be reasonably fine
While the coronavirus has hammered China's economy, which grounded to a near standstill in February, it has a strong and pragmatic state that acted fast and decisively to contain the spread of the virus.

Figure 6
Active cases in China

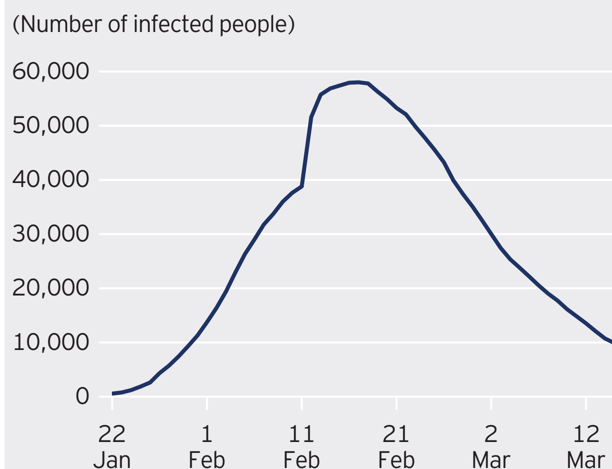
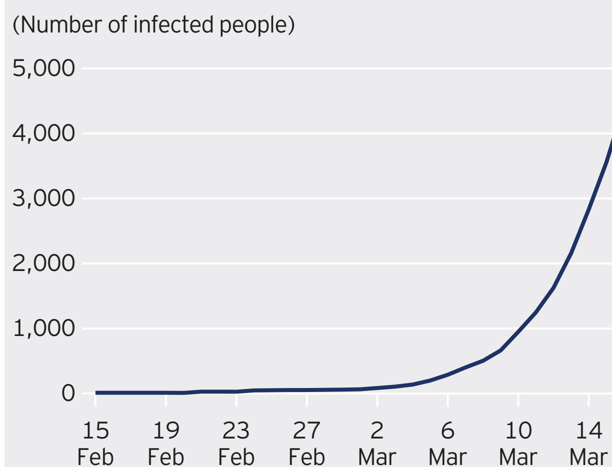


Figure 7
Active cases in US



Source: https://www.worldometers.info/coronavirus/country/us/

In response to the outbreak, China has spent roughly 1.2% of GDP (US$150 billion) - excluding infrastructure investment - on a myriad of targeted support, including granting waivers and reduction of social charges, lowering value-added taxes (VAT) for some enterprises, and electricity and gas fees for corporate users.

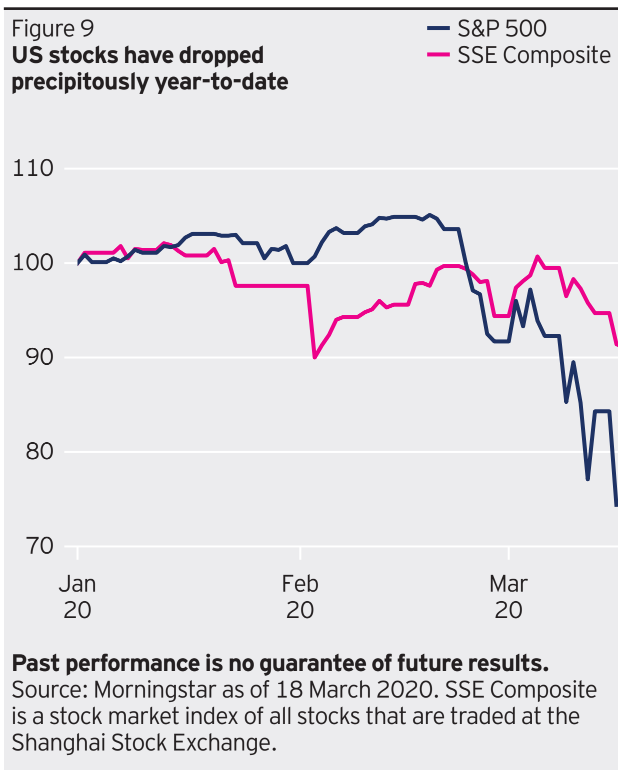
Structurally, China has a lot more ammunition in its monetary policy. It has developed its anti-fragility out of a host of inherent stressors in the system - including its skimpy pensions and health insurance system - which have reinforced its high levels of domestic savings. The culturally rooted fiscal conservatism has harnessed China for it to emerge stronger from crisis.

Figure 8
Interest rates - China in no rush to follow aggressive global interest rate cuts (%)

	China	US
3-month rate	2.6	0.9
2-year rate	2.3	0.5
10-year	2.8	0.9

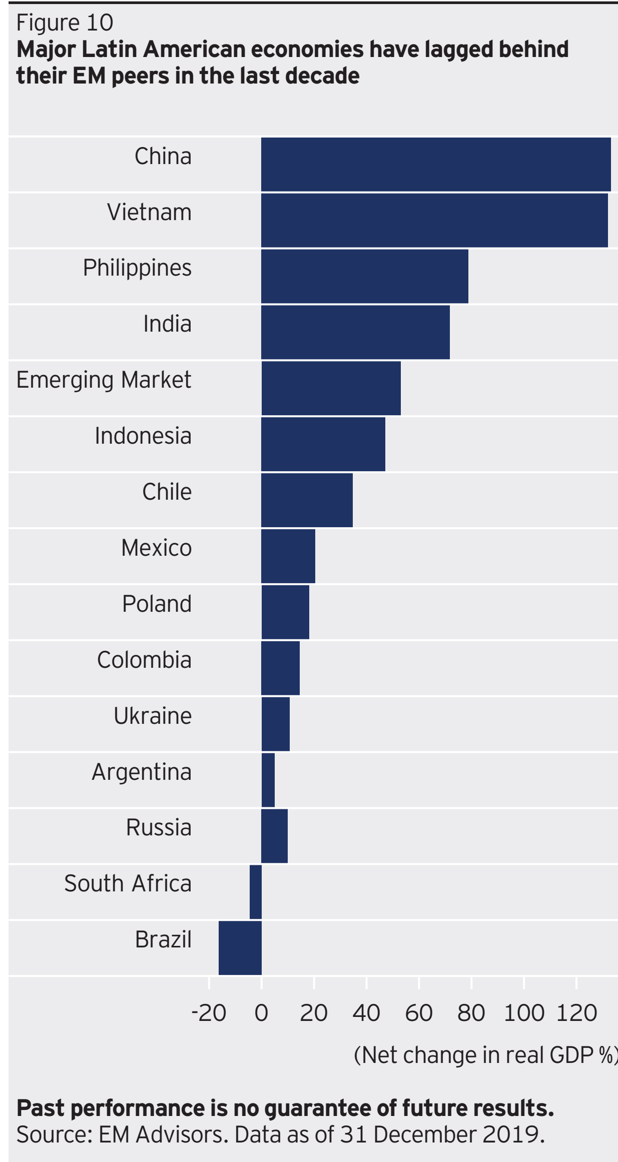
Past performance is no guarantee of future results.
Source: Bloomberg, as of 17 March 2020.

Figure 9
US stocks have dropped precipitously year-to-date



Past performance is no guarantee of future results.
Source: Morningstar as of 18 March 2020. SSE Composite is a stock market index of all stocks that are traded at the Shanghai Stock Exchange.

Figure 10
Major Latin American economies have lagged behind their EM peers in the last decade



Past performance is no guarantee of future results.
Source: EM Advisors. Data as of 31 December 2019.

3. Latin America will continue the funk

The economic history of Latin America involved cycles of high expectations followed by disappointment. The region's volatile and uninspiring growth path has been marked by financial crises and contractions caused by repeated debt defaults and hyperinflation. While Latin America rode out the previous black swan crisis of 2008 with only a brief economic dip and little damage to its banks, the region has been in low-growth doldrums since 2013, with GDP growth averaging 0.8%.

The epidemic is casting fresh light on the region divided by cruel inequalities of wealth and political clout. But beyond aspirations for overarching reforms, Latin American countries like Brazil have never moved upstream to tackle the structural vulnerabilities perpetuating the cycle - including low levels of savings, clumsy states and the prohibitive cost of capital that has been crowding out private investment for years. At 38% of GDP, Brazil's fiscal expenditures topped all major EM countries in 2019, while its private capital investment has been steadily falling in the last decade - now hovering around 15% of GDP.[1]

4. The strong (not the oligopolies) will survive and thrive

The unprecedented non-wartime economic disruption of social distancing this virus has thrust on us will be painful to all competitors in multiple industries, and not all will survive. Many marginal players will face bankruptcy. Others will have to make fateful decisions to reduce investment in capacity, product development, brands, and talent. Either way, the strong will emerge even more competitive, gathering market share and likely gaining higher profitability against more anaemic competition.

The old adage "cash is king" is more applicable now than ever. Companies that have been relying on cheap funding - consequences of central banks' excessive monetary interventions - to expand their balance sheets will likely crumble under liquidity pressure. And a few privileged companies with strong balance sheets will be able to capitalise on real non-organic opportunities, which occur when prices are cheap.

[1] World Bank; https://www.theglobaleconomy.com/Brazil/Capital_investment/

5. Irrational competition, particularly in "disruptive' technology," will likely become far more rational
Cheap capital and unbounded ambitions have created unsustainable business models within the technology sector. If the WeWork debacle was a warning sign, the upcoming displacement in the real economy, as well as in financial markets, should end the technology world's obsession with often spurious numbers (such as Total Addressable Market, or TAM), many of which are used to justify ever higher valuations. Of late, we have seen the unique spectacle of businesses in the "sharing economy," where growth is clearly slowing, but profitability remains stubbornly out of reach. Such excesses are likely to face a reckoning, as will reckless capital allocators, who have been harbingers of capital and governance related malfeasance, in our view.

Our investment philosophy is driven by a long-term orientation and focus on differentiated research. We are deliberately not tactical as we attempt to restrain the team from decision fatigue, and hopefully poor decision making. In times like this we are reassured by our North Star compass, which guides us in an environment as turbulent and devastating as markets are today. We have been through a fair number of black swan events over the decades investing in EM and we trust that our focus on high quality companies with low capital intensity, resilient balance sheets and sustainable advantage will lead us in navigating this one successfully.

Despite the near-team challenges that all of us are facing, we remain excited about the opportunity that EM equities can provide for investors. We believe the most compelling opportunity for investors is to avoid short-term tactical positions and macroeconomic calls and instead focus on companies that have the potential to deliver strong, long-term financial performance. Investors should focus on sustainable competitive advantages and real options that can manifest over time. We look for companies that have innovative products or unique assets that capture demand domestically and/or outside their home economies and real options that can manifest over time. We look to avoid mean reversion/pattern recognition; capital-intensive, cyclical industries; companies without sustainable advantages; firms whose fortunes depend on product cycles or gadgets; state-owned businesses or companies with other governance conflicts. We believe these types of opportunities offer investors the greatest potential for compelling results over time.

1. The **Greenspan put** was a trading strategy popular during the 1990s and 2000s as a result of certain policies implemented by US Federal Reserve Chairman Alan Greenspan during that time. Greenspan was chairman from 1987 to 2006. Throughout his reign he attempted to help support the US economy by actively using the federal funds rate as a lever for change which many believed encouraged excessive risk taking that led to profitability in put options.

2. **Total addressable market**, also called total available market, is a term that is typically used to reference the revenue opportunity available for a product or service. TAM helps to prioritise business opportunities by serving as a quick metric of the underlying potential of a given opportunity.

3. **Mean reversion**, sometimes referenced as reversion to the mean, is a finance theory that states asset prices and historical returns eventually will revert to the long-run mean or average level of the entire dataset or population.

Investment risks

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