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Kitchen Sinking

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The major consequence of the global financial crisis in 2008 was a decade of “austerity” where the excesses of global finance in the run up to the crisis were paid for in a decade of cuts to public budgets. In the famous formulation of the time, “profits were privatised but losses were socialised.”

Having lived through the GFC, many of us expected a reset in the relationship between government, business, finance and the public but it never really happened. Instead the rather inchoate sense of public dissatisfaction with the aftermath of the crisis expressed itself in the raw political populism that is now tearing up much of the settlement of the second half of the twentieth century.

In a sense the Coronavirus both accelerates and bookends many of the emergent trends that came out of the original crisis: deglobalisation, nationalism and immigration, whilst raising important questions over the movement of capital and labour.

These issues are relevant to investors since the free flow of international funds has a direct impact of the cost of capital and on the rate of return on investment. Restrictions on free movement of capital (and labour), including trade conflict, are likely to raise its cost thus threatening returns to shareholders.

The virtual cessation of economic activity, following Covid, has thrown all these issues into sharp relief. Economies are likely to shrink by a third in the second quarter whilst claims on the state have risen faster and by more than any time on record. In the UK, fully 1/3 of the working population is being paid by the government furlough scheme. In April, unemployment claims rose by 69% to 2.1m people.

Coronavirus has thus turned public policy on its head. If George Osborne’s instinct in the face of serious economic downturn was to cut, Rishi’s Sunak’s, the incumbent ingénue Chancellor, is to spend.

UK GDP going into the crisis was roughly £2.3 trillion but in 2020 that number is likely to be much closer to £2 trillion. The Office of Budgetary Responsibility (OBR) estimate that Mr Sunak will borrow between £300bn and £500bn. In effect, the Chancellor is replacing the lost national income caused by the Corona recession with borrowing, leaving net spending in the economy in 2020 – unchanged!

That is remarkable and it is a key reason why stockmarkets have rebounded from their March lows. It is also why it is important that the “lockdown” is brought to a close as quickly as possible since Mr Sunak cannot replace “lost national income” indefinitely.

Will things stay the same as they largely did following the GFC? We think not.

Governments will become more interventionist; tax rates will change and the on-line tax benefits accruing to internet retailers will be brought in-line with their bricks and mortar cousins.

Companies will focus on “resilience.” It is likely that equity issuance will rise and leveraging will fall. Just-in-time financing like just-in-time logistics will give way to capital and manufacturing structures that have more “slack.”

Companies will take the opportunity to “kitchen sink” their results. Covid is a good time to release bad news. Shareholder return expectations will be reset; dividends and share buybacks will reduce.

Above all, fiscal policy will take centre stage. Monetary policy has run out of steam and ammunition and is incapable of stimulating a recovery from the zero bound.

But, spending will be maintained and, as cloudy as the near-term outlook appears to be, that’s good news for shareholders and good reason to invest.

As someone once said, “We’re all Keynesians now!”