BLOG POST
Trickle Down Economics
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Trickle Down Economics was a much-debated economic construct in the 1980's and the driving force behind Reagan's Supply Side Economics. The theory states that high income earners receiving tax incentives will put more capital to work and the benefits trickle down to middle- and lower-income earners in employment opportunities. This debate is still prevalent in economic discussions today, but we are currently experiencing a different type of "trickle down economics" as a result of COVID-19 or the coronavirus.

While the spread of the deadly virus outside of China has remained mostly contained, notwithstanding the sudden outbreak in N. Italy and South Korea in late February, the impact is going to be felt globally. The trickle-down impact of the virus is likely to reduce global growth significantly. The financial markets oddly ignored the impact of COVID-19 for nearly 2 weeks before deciding to price in elevated risk starting February 24th when the Dow lost more than 1,000 points in a day and the market suffered back-to-back 3% down days.

The question astute investors are asking themselves today is "will the coronavirus result in a global recession?" How you answer that question determines the appropriate portfolio allocation. I believe the impact on supply chains will force the Fed, BOJ, and ECB to cut rates (likely 50 basis points) and initiate QE4. When announced, I expect a V-shaped recovery from initial market losses making this a non-event for investors if a recession is avoided. No posturing from Central Banks, however, will prohibit a steep sell-off if we experience a global recession.

The spread to Italy and resulting cancellation of public events like Carnival is distressing and will lower growth. The most concerning article I read was from the World Health Organization (WHO) that stated that there are cases with no known epidemiological link. If true, this would differentiate COVID-19 from SARS and make a devastating spread more likely.

The closest comparison we have is the SARS outbreak in 2002-2003 that also originated in China. The difference today is that China only represented 4% of the global economy in 2002 but represents 18% today. When factoring supply chain disruption, China directly influences roughly 30% of global economic activity according to some measures.

Context for COVID-19 is difficult. "Official" numbers on the virus are 80,000 cases and 3,000 deaths (WHO, at the time this was written). Any loss of life is tragic, but according to

WHO figures, in the 2019-2020 flu season in the United States there were 15 million cases of the flu, 140,000 hospitalizations, and 82,000 deaths (U.S. only figures). We also live in a very different world than in 2002 when SARS occurred. It took 20 months to get a vaccine in phase I trials for SARS but it has taken only 3 months to achieve the same benchmark with COVID-19. It is likely a vaccine will be available this summer for coronavirus.

The velocity of money has dropped dramatically. Germany and Japan are likely already in recession given their negative growth in Q4. 18% of German auto exports are to China and the Chinese are not going to be buying as many cars in 2020 (UBS). The SME sector is the largest in China and most firms have reduced workforce by 20% and forced a 30% pay cut to the remaining employees (WSJ). China's economy could slip to below 3% growth, or less than half of previous forecasts.

Growth in the U.S. appears to be far more resilient. I was forecasting 2% growth for Q1 and it looks like it will only be necessary to drop that forecast to 1.8%. I expect Q2 to be hit the hardest, where growth could drop to below 1% before recovering in the second half of 2020.

There is a "silver lining" for the U.S. economy, at the risk of sounding callous given the suffering around the world. The Trump tariffs were already causing many companies to re-think supply chains and manufacturing and bring more of that economic activity back to the U.S. This outbreak will almost certainly result in an acceleration of plans to move jobs back to the U.S., resulting in higher domestic economic growth in the future.

The current flight to safety has been unprecedented, even if it began later than expected. The 10-year Treasury hit all-time lows just 10 days after the S&P 500 hit an all-time high, a feat that that most portfolio managers, me included, could not have imagined. This has made Treasuries a great hedge against equity risk. We are vigilant in controlling volatility and will continue to do so in our portfolios.