MARCH 2020

GEOPOLITICS

COVID-19 CRISIS

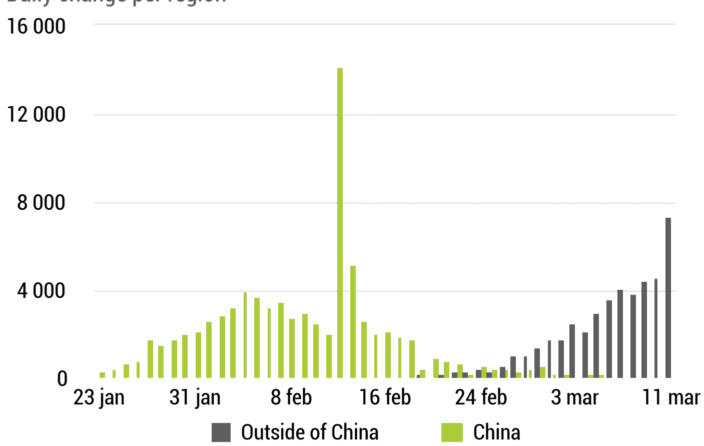
WILL IT FORCE A NEW WORLD ECONOMIC ORDER?

The COVID-19 crisis is still developing and the effects on the population are terrible. Initially concentrated in China, the virus is spreading to all countries, including Italy, South Korea and the United States, where infections have exploded rapidly. Several economies are nearly paralyzed, schools are closed in several countries and in extreme cases public gatherings are banned. These confinements are having an impact on global economic growth and financial markets have adjusted accordingly.

The hope that hot weather will solve the problem is, for the time being, merely a hypothesis that is pleasant and reassuring, but is not based on scientific evidence. It is possible that after a lull this summer, the virus may strike again this fall, in a second wave.

Some governments are trying to reassure and minimize the problem, starting with the United States and China. In Washington, the U.S. president is underestimating the mortality rates of the virus. In Beijing, the Chinese government is said to have asked factories to run machines to give the illusion that the economy is recovering. The government claims that more than 70% of Chinese industrial activity has resumed, but in reality the figure is close to 40%.

Number of Infected People
Daily change per region



Source: WHO, US Centers for Disease Control and Prevention, Chinese Center for Disease and Prevention

The development of the coronavirus outbreak in Italy caused the stock markets to plummet because Western investors suddenly realised that the West was in danger of an pandemic. The appointment of Mike Pence as head coordinator to fight against the epidemic in the United States accelerated the downward movement. A further decline occurred after Trump announced new measures against travellers from Europe.

Confidence Problem

One of the biggest problems of this epidemic is the absence of a vaccine and the lack of confidence inspired by the majority of leaders in industrialized countries vis-à-vis their general population. This confidence is not likely to be easily restored if contagion figures increase exponentially. The leaders are trying to strike a balance between limiting the spread of the virus without harming economic activity and people's freedom.

Under the circumstances, the government of various countries that have not yet been hit hard by the new coronavirus epidemic have a choice of three models for dealing with the situation:

1. The Chinese Model

The Chinese model is a confinement solution. In quarantined areas, citizens are not allowed to visit each other. Movement and contact between people is strictly limited. Businesses and factories are closed, with some exceptions. To compensate for the loss of income, the Chinese government is offering debt refinancing for banks and merchants. It has also planned a massive investment program in infrastructure when the epidemic ends. Employees who were technically unemployed received compensation. But protests broke out for the government to do more, especially for small businesses.

2. The Taiwan Model

In Taiwan, where the epidemic is still relatively limited, the government plans to pay 50% of salaries to those who were unemployed due to the virus. The government authorities even plan to increase this ceiling to 70% if the epidemic continues.

3. The South Korean Model

In South Korea, people who have been in contact with infected people are systematically tracked down and tested and, if necessary, quarantined in their homes. Because the savings rate is very high, the government has decided to release nearly US$10 billion in various measures such as vouchers for the poorest and the elderly, loans to support small businesses and 10% rebates on energy-efficient appliances. The Central Bank has also lowered its policy rate.

A Crisis During the Election Period

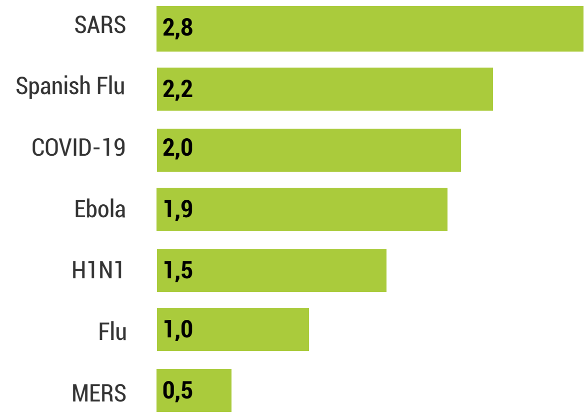
In addition, the coronavirus epidemic could highlight infrastructure and policy weaknesses in several countries. In the U.S., the outbreak is shining a spotlight on the poor state of the U.S. health care system. If the stock market slide continues, Trump could lose its two main pillars of electoral propaganda. The presidential election could also turn into a referendum on the Trump administration's crisis management. Crises can quickly tarnish a president's image. When George W. Bush continued his summer vacation despite the devastation caused by Hurricane Katrina, his approval rating dropped. Angela Merkel said she expected a contagion rate of between 60% and 70% in Germany. Assuming a rate of similar contagion, the number of deaths is expected to skyrocket in the United States.

Supply Chains Affected

This crisis has profoundly disrupted global supply chains and illustrates the flaws in the current global economic system. Supply chains have become highly integrated over the past 20 years. Globalization means that it is becoming increasingly difficult to identify where a good comes from. An iPhone is assembled in China, but its components come from more than 40 different countries. Moreover, the multiplication of monopolies

Contagion Index

Average number of people a contagious person can infect



Source: WHO, US Centers for Disease Control and Prevention, Chinese Center for Disease and Prevention

and oligopolies has concentrated the production of many essential goods in a limited number of places.

The COVID-19 crisis is a good illustration of the problem of these integrated chains. It has raised awareness of the dependence of the global pharmaceutical industry on China and India. It has prompted governments to create new drug manufacturing hubs in these countries.

The pharmaceutical industry is only the tip of the iceberg. Faced with the danger of shortage in supply chains, many governments are considering how to keep or build up production of strategic goods within their borders.

There is an old adage that investment is often driven by greed or fear. However, an even more powerful force drives investors to act: need. When a production chain is disrupted or at risk, business leaders may need to modify it to make it safer and bring it closer to their market.

Repatriating production chains implies diversifying the places where certain goods are produced, which is both a good and a bad thing. This could have a beneficial effect on employment where the chains will be moved, but such a strategy could also generate inflation that would be difficult for the less fortunate to bear. A more equitable redistribution of wealth would certainly be a sine qua non condition for the success of a safe relocation of production sites.

Towards New Debt

The reflex of the governments of industrialized countries, under pressure from the people, will probably be to invest more in their economies.

These measures are certainly sound in the short term, depending on how the investments are made. They also imply inflation and a sharp increase in the debt burden.

The crisis will also accelerate the strengthening of production chains by making them more resistant to crises like the new coronavirus. Production is therefore expected to enter a new phase of de-globalization around the world.

Effects on Financial Markets

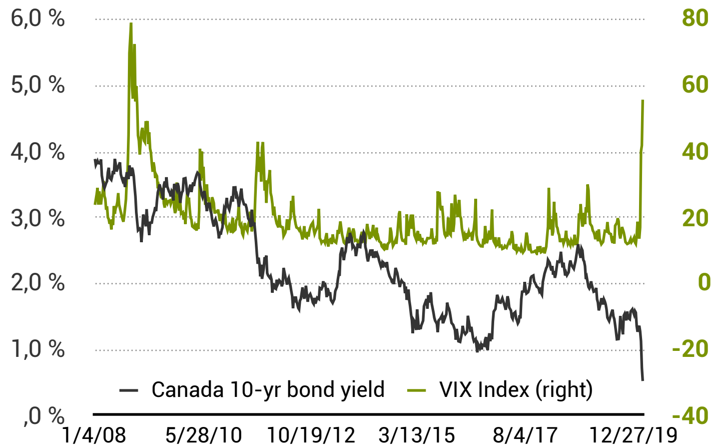
Investors' risk perception has changed significantly as a result of the outbreak of cases outside China's borders. Investors have shifted from risky assets to the safety of bonds. In an effort to mitigate the economic disruption and support household and business confidence, the Federal Reserve and the Bank of Canada reduced their policy rates by 0.50% each. Instead of calming investors, the Fed's decision created a panic in the markets. Does the Fed have information about the economy that investors don't know about?

The drop in bond yields have been drastic and historic. Some investors are drawing a parallel with European and Japanese rates and are starting to talk about negative rates. Is this the right solution? Central bank interventions during the 2008 financial crisis and the sovereign debt crisis in 2012 were effective since the problems were financial as well as the tools used. On the other hand, the coronavirus crisis is a public health problem that disrupted global production chains by forcing workers to isolate themselves in order to restrict the spread of the virus. Monetary policy can be used when it's time to support demand or to offer liquidity in the banking system. Low rates do not provide an incentive for households to consume if they are in quarantines or are afraid of being infected in public.

Today, households need a vaccine, not lower rates, which only reinforces the idea that financial markets control monetary policy and not central bankers. Instead of reducing the cost of money, economic authorities should explore more targeted solutions. In order to control the spread of the disease, the government could pay the costs of testing and hospitalization for low-income people who become infected. Tax holidays and loans to affected businesses as long as they retain their staff would limit layoffs. For employees who are laid off, there could be an employment insurance bonus or paid sick leave.

This public health crisis also demonstrates the shortcomings of the current world economic order. After the trade tensions between the United States and China in the last year, COVID this year and SARS in 2003, companies should reconsider their dependence on China in their chain production. Deglobalization would make it possible to secure and control production near head office. This will mean more expensive inputs, the return of dormant inflation for several years now and the end of falling bond yields that started 30 years ago.

Violent Reactions on Financial Markets
The Speed of the Rate Cut is Historic



Source: Bloomberg

How do we Predict the End of the Crisis

Modern financial history does not have a lot of examples of viruses affecting financial markets to such an extent. The SARS episode in 2003 is the closest parallel that can be used to understand the violent reaction observed in financial markets.

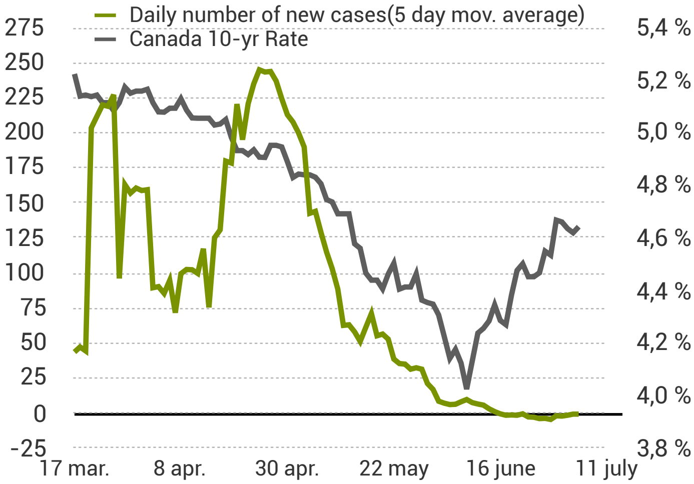
In the absence of a vaccine, investors were faced with the unknown and feared the progression of the virus. During the SARS episode in 2003, investors would rush to safe havens as long as the virus was spreading. Once the number of infected people reached a plateau, investors regained a taste for risk and moved away from the security of bonds.

Currently, COVID-19 appears to be under control in China, but is spreading rapidly to the rest of the world. As long as the number of infected people continues to rise, risky assets will remain under pressure.

In addition, central bankers have announced a series of measures in an effort to calm financial markets. In addition to rate cuts by the Federal Reserve, the Bank of Canada and the Bank of England, massive amounts of liquidity have been injected into the United States and Europe to ensure the proper functioning of financial markets. The Federal Reserve announced an injection of $1.5 trillion on reverse repurchase agreements and the European Central Bank (ECB) increased its asset repurchase program by €120 billion while launching a new program of discounted loans to banks and relaxing bank capital ratios. However, Christine Lagarde, the new ECB President, surprised many investors by keeping the key rate at -0.50% when several investors were expecting a cut. Her message to politicians is clear: the ECB will not be the only one to support the European economy as it did during the European debt crisis. Now it is time for fiscal policies to act.

SARS Example in 2003

Markets Stabilize When Number of Infected People Stops Growing



Despite these extraordinary monetary measures, investors did not feel reassured. Liquidity allows financial markets to function well, but the future of the economy depends more on fiscal measures. Authorities must put in place programs to allow companies to get through this crisis without laying off employees. Even if rates are low and markets are flooded with liquidity, consumers, the backbone of the modern economy, will cut back on spending if they are out of work. England, Italy and China have already announced higher government spending, while Germany is ready to abandon its balanced budget policy to contain the fallout from the coronavirus. It's now time for the United States to announce budget measures to reassure their population and investors.

The combination of monetary and fiscal stimulus will allow a rapid recovery of economic activity once the crisis is over. The explosion of deficits will worry bond investors, especially if production lines are to be brought back close to consumers. Once this crisis is over, the structure of the yield curve is likely to change with long-term rates well above short-term rates due to the explosion of deficits and inflation.

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