Morgan Stanley

INVESTMENT MANAGEMENT

Tales From the Emerging World

The Era After the Coronavirus

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When we hear forecasters talking about how the new coronavirus will "change everything," we look back at previous pandemics and ask what, if anything, did those crises change? The deadliest ever was the Spanish Flu, and it did nothing to slow the outpouring of relief after the end of World War I, or the pace of the "Roaring 20s" that followed. The Asian Flu of 1957 and the Hong Kong Flu of 1968, also much deadlier than the coronavirus so far, were largely forgotten, even by those who lived through them.

AUTHOR

RUCHIR SHARMA
Head of Emerging Markets and Chief Global Strategist

This pandemic is different, not so much for the nature of the virus but for the government effort to control it, with sweeping lockdowns and massive stimulus programs to keep economies alive. By coincidence, these unprecedented moves arrived at a time when the world was already shutting its doors to cross-border flows of people, money and goods, struggling to promote investment and raise productivity, and increasingly addicted to debt and bailouts as a tool to keep growth alive.

So while we don't see the coronavirus changing "everything," we do see it rapidly accelerating a worldwide turn inward that has been underway since the global financial crisis of 2008. Populists have an urgent new reason to close borders they wanted shut anyway. What we have called the Four Ds—deglobalization of trade and finance, depopulation including slowing immigrant flows, declining productivity and rising government debt—are all getting a huge push from the pandemic.

Deglobalization has been driven by the rise of populist leaders, who feel more emboldened than ever to bash foreigners and foreign trade, casting outsiders now as a threat to public health. Donald Trump has amped up his anti-global, anti-trade, anti-China rhetoric, and his advisers have cast the pandemic as proof that he was right all along about the need to bring manufacturing back to U.S. shores. Inspired by rising costs in China and a growing desire to protect supply lines from shocks like the pandemic, so far this year 75 companies have announced plans to move production to the United States, capped by a deal to build a $12 billion semiconductor plant in California.[1]

Anti-global, anti-China rhetoric is growing more strident in many nations, from India and Brazil to Britain and even France, which had been a last redoubt of globalism under President Emmanuel Macron. A recent survey covering 12 global industries found that companies in ten of them, including autos, semiconductors and medical equipment, are moving or planning to move their manufacturing operations, which in most cases will mean out of China.[2]

Growing twice as fast as the global economy before 2008, global trade has struggled to keep pace since, and is now in free fall. Global trade is projected to fall around 15 percent in 2020—at least three times the expected fall in economic output—and the extent of the post-virus recovery could be dampened by more divisive trade politics.[3] Trade fell as a share of global GDP from 60 percent in 2007 to 59 percent at the start of this year and is now headed toward 53 percent.[4]

The world's debts are heading in the opposite direction. After 1980, a combination of falling interest rates and financial deregulation set off a global explosion in lending which—by the eve of the 2008 crisis—had tripled the world's debt burden to more than three times global economic output.[5] Now, massive stimulus programs are driving up government debt in particular and central banks will have little choice but to monetize large parts of these unsustainable debt burdens.

In early May, when we pointed out how stimulus programs are bulling up the markets, the United States had announced new fiscal spending in response to the pandemic equal to 8 percent of GDP. Now that figure alone is 12 percent of GDP. Automatic stabilizers could add close to another 3 percent, and loan guarantees another 19 percent. For its part, the Fed's aggressive intervention to prop up the debt markets will likely add a sum equal to 17 percent of GDP to its balance sheet.[6]

There seems to be a consensus across political parties that somehow the debts these programs entail are necessary emergency measures, which is fair enough, and won't have long-term consequences, which is nonsense. In past Tales we have laid out the case for how, ever since inflation was whipped in the early 1980s, central banks have pursued easy money polices in good times and bad. This easy money culture has fueled the rise of monopolies and of a new class of "zombie" companies that survive by constantly taking on new debt.

Monopolies and zombies both tend to be relatively unproductive, and their rise helps explain why productivity growth has been slumping worldwide. In OECD (Organisation for Economic Co-operation and Development) countries, the average productivity growth rate fell to less than 1 percent after the global financial crisis, down from around 2 percent in the two previous decades.[7] Zombies were already surviving for longer and longer in their distressed condition before the pandemic hit and now, with all the new loans and loan guarantees, they may be on the verge of immortality.

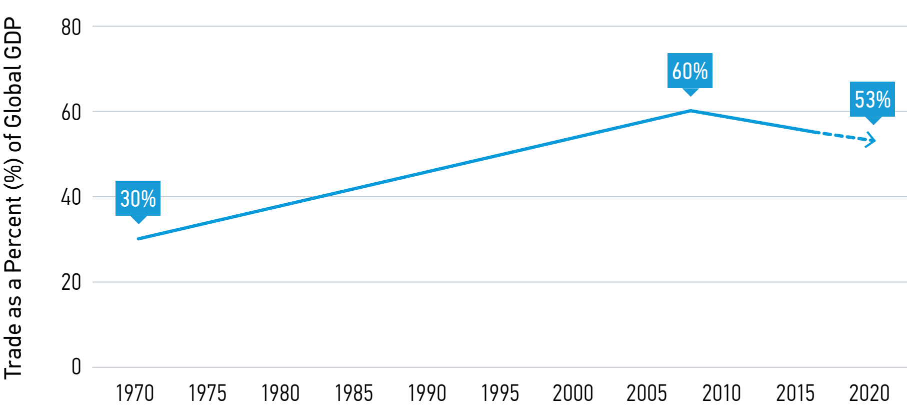
Historically, productivity has accounted for about half of economic growth, population the other half. And population growth has also been slumping since just before the 2008 crisis, driven down mainly by the lagged effect of falling birth rates, but also by growing hostility to immigration.[8] Though many populist presidents and prime ministers have been particularly quick to shut out foreigners during the pandemic, it is likely that opposition to open borders will remain popular for some time after the virus passes.

The accelerating turn inward has broad implications for investors, including

DISPLAY 1

Deglobalization

After Booming for Decades, Trade Flows Peaked in 2008



Source: MSIM, World Bank, Haver Analytics. Data as of December 31, 2018. Forecast calculation based on IMF forecasts. Forecasts are based on current market conditions, subject to change, and may not necessarily come to pass.

1 Cornerstone Macro as of May 2020.

2 Bank of America as of February 2020.

3 CLSA and JP Morgan as of April 2020.

4 MSIM, World Bank, Haver Analytics. Forecast calculation based on IMF forecasts April 2020.

5 Michael Roscoe, U.S. Fed, BIS, Economist. Last data point as of Q2 2018, sourced via IIF Research. Note: Includes debt at all levels including household, corporate and government.

6 Goldman Sachs as of May 2020.

7 OECD, "Labor productivity growth of OECD countries." As of December 2019.

8 World Bank, United Nations as of 2018. Productivity measured as residual of Labor Force Growth vs. GDP Growth.

the likely return of inflation. For many decades, inflation has been held in check by heightened global competition, growing labor forces, and the rise of the internet, which wiped out the middleman in one industry after another. These checks were so powerful, even the flood of liquidity unleashed by central banks in response to the crisis of 2008 did not reignite inflation—at least not in consumer prices, which is what central bankers focus on. There was massive asset price inflation.

Now, not only is deglobalization picking up speed, but central banks assume that because unleashing a wave of liquidity did not trigger consumer price inflation after 2008, they can unleash a far larger wave without serious inflation risk. Even as the longstanding checks on inflation erode. But deglobalization means less competition. Falling birth and immigration rates foretell labor shortages.[9] Declining productivity points to higher production costs. And rising government debt levels raise the risk of central banks printing more money to finance the deficits.

Of course, the pandemic is also accelerating the tech boom, which is still disinflationary in nature. With the lockdowns forcing people to work, study, shop and play at home, the traffic on a leading business conference app is up thirtyfold, a leading food delivery app is up sevenfold, digital classrooms and telemedicine sites up fourfold. Digital games makers, which see themselves as platform companies—creators of 3D digital environments that combine entertainment and commerce—have by some measures grown fastest of all.

But the quickening tech surge is the last surviving check on consumer prices, and probably not strong enough to counter the forces that portend the return of classical inflation. The markets, by various measures including inflation-indexed bonds, are priced for zero inflation. We think inflation is just playing dead, ready to reemerge under the right circumstances.

Its return in the post-coronavirus era would bring a market surprise with dramatic implications, portending the end of easy money, which could finally force many zombies into bankruptcy and dampen investment in healthy corporations, while boding well for traditional inflation plays like commodities and gold. This return won't unfold until the pandemic is truly behind us, but it is not too early to think about positioning for it.

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[9] United Nations as of December 31, 2018.

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