Disease and Debt Now: Dispersion Later?

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by K2 Advisor Team

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Deficits are rising across the developed world as governments aggressively loosen their purse strings in response to the COVID-19 pandemic. But what are the ramifications of all this debt? Our K2 Advisors team weighs in on the longer-term unintended consequences for governments that maintain massively leveraged balance sheets for an extended period.

It is estimated global government debt will reach US$66 trillion by year end, and debt to gross domestic product (GDP) will rise from 105% to 122%, a bigger increase than any seen during the global financial crisis (GFC).[1] In the United States, for example, the government borrowed a record US$3 trillion just in the second quarter of 2020, more than five times as much as it did in 2008 during the GFC.[2] The US deficit could balloon even higher in the months ahead, as legislators seek to pass additional spending bills aimed at supporting state and local municipality budgets.

Debt levels create long-term uncertainty related to if or how countries will unwind their borrowing.

However, we believe the current environment presents opportunities for hedged strategies, such as long/short equity.[3] Coming out of this crisis, we believe there will be clear winners and losers across almost every sector. In our view, this will create opportunities for idiosyncratic stock selection, long and short trading, and alpha capture.

A Necessary Evil?

Few would argue, including the most conservative economists, whether the massive government stimulus in the wake of the COVID-19 pandemic was the prudent choice. For all intents and purposes, these deficits are (at least according to modern economic theory) a necessary evil.

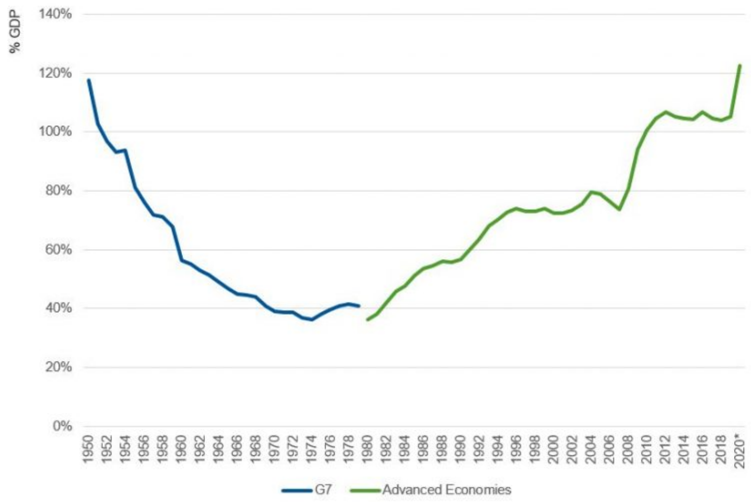
Without significant bank easing and fiscal support, a global depression of historic proportions is all but assured. Lawmakers, the US Federal Reserve (Fed), the European Central Bank (ECB), the Bank of England (BOE) and the Bank of Japan (BOJ) have little choice but to act aggressively.

Necessity notwithstanding, the fact remains the world is now left with a massive fiscal burden. This is on top of the already significant pile of debt left behind from the GFC, as seen in the chart below. Managing such colossal debts will burden advanced economies for years, if not decades, to come. To navigate the legacy of COVID-19, the world will have to strike a delicate balance between necessary stimulus and conservative fiscal policy. A daunting challenge on many levels—as we will discuss.

Uncharted Deficit Waters

General Government Debt as Percent of GDP: G7 and Advanced Economies

1950–2020 (Projected)



Sources: IMF, Franklin Templeton Capital Markets Insights Group. 1950–2011 data from IMF World Economic Outlook, "Hopes, Realities, Risks," April 2013. 2012–2020 (Projected) data from IMF, Fiscal Monitor, April 2020. The Group of Seven (G7) comprises Canada, France, Germany, Italy, Japan, United Kingdom and the United States. There is no assurance that any estimate, forecast or projection will be realized.

A Volatile Future

So, where do we go from here? What impact will the highly levered global economy have on future growth prospects? Inflation? Sector and asset class rotation? Volatility? While the initial shock of COVID-19 is painful, including the requisite spending of trillions of dollars of public money to mitigate depression, could the secondary shock of unwinding the massive wall of debt be worse?

In the prescient words of economist Ludwig Von Mises, did we "attempt to remedy a present ill by sowing the seeds of a much greater ill for the future?" Only time will tell of course, and we presume that central banks around the world are fully aware of the potential for negative outcomes associated with aggressive interventionist policy.

At a minimum, we anticipate market volatility will remain highly elevated for the foreseeable future. Past experience and independent research show that volatility tends to have a "memory," in that it may stay elevated for a period of time after initial dislocations—as was the case in the 2009–2011 period, for example. The best trade over the last ten years had been to be short volatility, sell volatility spikes, and be short gamma.[4] Many prospered utilizing such strategies and methodologies in the past, but we believe those days are behind us. COVID-19 negated these in one fell swoop.

Increased Security Dispersion Ahead?

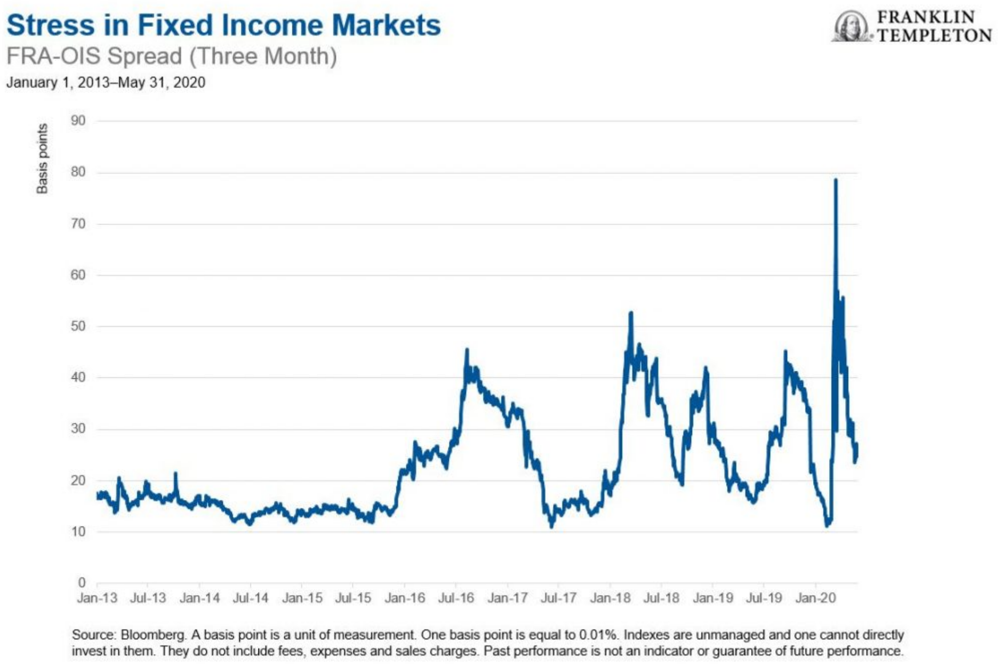
With heightened volatility has come heightened dispersion. In our view, this is a positive development. For more than a decade, global stock market dispersion[5] has generally been anemic. This has made it difficult for more active strategies, such as hedge strategies, to differentiate themselves and capture alpha. Since the onset of COVID-19, however, we have seen a distinct uptick in dispersion. As of March 20, global stock returns and diverging more than they have since the GFC.[6] For hedged strategies, such as long/short equity, increased dispersion is a good thing.

Coming out of this crisis, we believe there will be clear winners and losers across almost every sector. In our view, this will create opportunities for idiosyncratic stock selection, long and short trading, and alpha capture. COVID-19 will have a greater impact on certain sectors, such as technology and health care. This may result in potentially better relative value opportunities, both between and within sectors themselves.

In technology for instance, cloud computing services and software will likely benefit more from COVID-19 than hardware and on-premise services. In the health care space, we may see the virus response hamper the elective surgery business, while testing industries and home health agencies may grow. These are only a few examples of the many ways in which this "new normal" will impact industries differently, creating unique investment opportunities.

Importantly, the same factors that create dispersion in equities impact other markets and hedge strategies as well. Things like uneven interest-rate policies or excess leverage could result in volatility in currencies and fixed income. Various metrics of risk and volatility in traditional fixed income are showing historic levels of stress, propagating through to even the most liquid parts of the capital markets.

In the chart below, we see a widely followed measure of financial stress in the banking sector, the FRA-OIS spread—the difference in interest rates between forward rate agreements and overnight index spreads. The spread widened to a 10-year high in March, but remains well below the peaks seen in 2008, once again highlighting that the recent dislocation is not centered around financials (at least not yet).



This Time IS Different, We Think

It is important to note: during the GFC, after an initial spike in market volatility in the first months after the onset of the crisis, the aggressive accommodative easing by the Fed and other central banks eventually settled markets globally. The persistent low interest rates bailed out many lower-quality companies, allowing them to borrow aggressively and continue to rollover debt.

Generally, there was very little differentiation in multiples across industries. Meaning, there was little dispersion in price-earnings multiples, so investors were not differentiating between good and bad or low- and high-quality companies. They were all trading at similar valuations. Investors learned “not to fight the Fed” (or ECB or BOJ or BOE), which translated into high correlation, low dispersion and cheap beta via indexes.

We think things could be different going forward for several reasons. Yes, low rates are again in place globally, and central banks are “all in.” However, this time around, debt levels are significantly higher than they were after the GFC. Secondly, demand trends are changing dramatically. COVID-19 has accelerated a move toward efficiency in many industries and sectors. We believe this will quickly lay bare the differences between winners and losers.

Therefore, we would argue that dispersion is here for the long term. Money is going to flow differently for an extended period. How long will video conferences replace face-to-face meetings? And, what percentage will be replaced forever? What happens long-term for airlines? Will global supply chain models across industries shrink? What does that do to global shipping channels? What happens to countries dependent on tourism? Will anything ever go to Vegas to stay there again? Will commuters return to mass transit? What does this do to the auto industry? Where will advertising dollars be spent when there are no live sports/events? Will education be rethought? Restaurants?

The bottom line: in our view, the future will demand active and nimble portfolio management, with an emphasis on allocations that seek idiosyncratic alpha opportunities. The pricing dislocations between industries, regions and asset classes due to COVID-19 offer abundant opportunities for select hedged strategies. Even before the pandemic we were expecting sector rotations, geographical movements and asset-class rebalancing.

Today, those rotations may be even more pronounced. We think skilled active managers with access to a full toolbox to express their views are best positioned to take advantage of a very dynamic marketplace going forward.

Yes, We Unwind. But How?

If policymakers desire to diminish the current glut of global public debt, we see three potential paths they could take. First, they could pay back the borrowing by raising taxes and applying budget austerity measures. Second, they could decide not to pay, or agree with creditors to pay less than they owe. While this may be forced onto emerging economies which may lack any other way out, it is not a realistic option for the developed nations. The result would be global financial disruption on a cataclysmic level. Third, they can wait it out, rolling over their debts while hoping they shrink relative to economic growth over time. This is where we imagine things are headed.

It will obviously be a very long slog. The secret will be ensuring an economy's combined level of real economic growth and inflation stays above the interest rate the government pays on its debt. That allows the debt-to-GDP ratio to shrink over time. Again, this is a daunting challenge. The good news is that we see opportunities to accelerate the process. There are many forces that may bring about large-scale and long-acting changes to economies. Perhaps the most significant of these, particularly since the Industrial Revolution of the late 18th and early 19th centuries, has been technology.

Technology represents more efficient ways of doing things, and once it is mastered it often creates lasting change, allowing economies to create more value with less input. In our view, it is here that we should focus our attention in terms of the potential for future prosperity—and the unwinding of debt. Emerging technologies could represent the path toward a sustainable budget in the future. We think that would be a blessing.

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1. Source: International Monetary Fund (IMF), Fiscal Monitor, April 2020. There is no assurance that any estimate, forecast or projection will be realized.

2. Source: Kiernan, P. "U.S. Budget Deficit Widened to $1.935 Trillion in 12 Months Through April," Wall Street Journal, May 4, 2020.

3. Long/short equity is an investing strategy that takes long positions in stocks that are expected to appreciate and short positions in stocks that are expected to decline. A long/short equity strategy seeks to minimize market exposure while profiting from stock gains in the long positions, along with price declines in the short positions. Although this may not always be the case, the strategy should be profitable on a net basis.

4. A short gamma trade (negative gamma), is a trade that bets option prices will decline, either puts or calls.

5. Dispersion can be measured as a standard deviation, that is how much the return of an individual security differs from the average return of a collection of those securities (such as an index). Put simply, the greater the dispersion the greater difference in prices.

6. Source: Goldman Sachs, "The Great Reset: A Framework for Investing After COVID-19," Goldman Sachs Research, May 28, 2020.