The Absolute Return Letter

June 2020

Five Lessons from History

Lesson #5: Wounds heal, scars last.

"There are decades where nothing happens, and then there are weeks where decades happen."
Vladimir Ilyich Ulyanov Lenin

Lessons from history

"More than thirty million people -- about the population of California -- died over four years on the Eastern Front during World War II. The dozen or so territories that made up the Soviet Republic represented about 10% of the world's population in 1940. By 1945, 13.7% of that group was dead. Forty thousand villages were completely destroyed. But most of the physical damage was cleared away and rebuilt by 1960. There are stories of people still finding bones, bullets, and bombs today. But the physical damage of the war was cleaned up. Industries rebuilt. People reorganized. Total population surpassed its pre-war level less than a decade after the war ended."

With those words, Morgan Housel starts his commentary on the fifth and final lesson in his paper, Five Lessons from History, which he calls "Wounds heal, scars last" – in fact quite aptly named in the context of the current pandemic.

Although this is indeed a massive crisis, at least in the world of economics, I cannot think of many incidents that have left bigger scars than the combination if hyperinflation and depression did in Germany in the 1920s. To this day, Germans are amongst the biggest savers in the world and German central bankers are truly paranoid of inflation.

Before digging in, let me finish these opening comments with another quote from Morgan Housel. As he wraps up his paper, he finishes with the following lines on lesson #5:

"It is too easy to examine history and say, "Look, if you just held on and took a long-term view, things recovered and life went on," without realizing that mindsets are harder to repair than buildings and cash flows. We can see and measure just about everything in the world except people's moods, fears, hopes, grudges, goals, triggers, and expectations. That's partly why history is such a continuous chain of baffling events, and always will be."

Let me give you a simple example. I sit on three investment committees (ICs), all of which are quite conservative in nature, meaning that we rarely take a massive amount of equity beta risk. Usually, during more benign times, the IC may decide that next time there is a set-back, we *must* add to our equity beta risk. Guess what happens when the buying opportunity actually materialises, as it did recently. Suddenly, the appetite for equity beta vanishes faster than you can count to ten, and I am not pointing fingers at anyone. I am as bad, if not worse, than anybody else.

It goes back to Morgan Housel's last point – we can see and measure just about everything in the world except people's moods. As investors, we are very much under the control of our emotions, even if logic tells us to be rational. In my experience, the best investors are those who can control their emotions. Warren Buffett is a great example of that.

The concept of recency

Scars most definitely last, and some of them for generations, but the concept of recency can tweak behavioural patterns. Allow me to explain. Recency is the tendency to remember information obtained more recently better than information that was obtained a while back. In other words, the human mindset often assigns more importance to recent events than it does to events that happened years ago.

The COVID-19 pandemic is a good example. When asked the question, "which events have had a major impact on your worldviews?", a sample of American youngsters (Generation Z and Millennials) marked the ongoing pandemic as a very clear #1. I am not saying it doesn't deserve to be #1 (we don't know yet) but, if you glance over the list of incidents in Exhibit 1 below, you can see that, in general, incidents of a more recent date get a higher score.

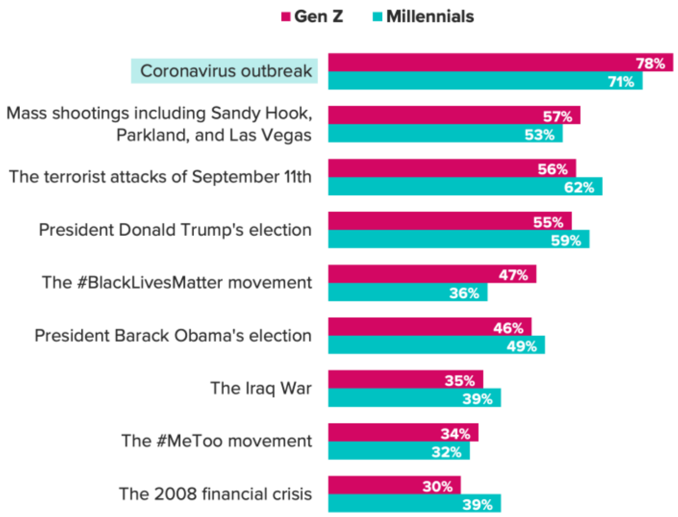

Exhibit 1: Which Events Have Had a Major Impact on Your Worldviews?
Source: Morning Consult

For an incident to leave scars for generations like the case of hyperinflation in Germany in the 1920s, it has to be life-changing for millions of people. Otherwise, the wound will not only heal, but the scars will fade over time and behavioural patterns from the past will gradually resume, which is why the so-called Fed Put is so dangerous.

The Fed Put is a term that goes back to the days Alan Greenspan chaired the Federal Reserve Bank, as he is believed to be the first Fed chairman to practise it. Quite simply, the Fed Put is the belief (rightly or wrongly) that the Federal Reserve Bank will always do its utmost to rescue the economy and thus, by implication, the stock market. My point is that the widespread belief that such a put exists has allowed certain scars to fade – scars that control human behaviour and which protect them against greed. Hence those scars should never be allowed to fade, but the Fed Put has allowed that to happen.

How many scars will COVID-19 leave?

Here in Europe, COVID-19 has been on everybody's lips since early March when Europeans were first hit in large numbers. The skiing season in the Alps was still very much alive, and I have friends who returned from either Italy or Austria in late February only to find out a week or two later that they had been infected.

In the early days of the outbreak, in most countries, the number of dead were still within a range that could be expected at that time of year (many die from influenza every winter), but that is no longer the case. Since late March, the number of dead has been much higher than normal (Exhibit 2). The data in Exhibit 2 is based on US statistics, but the picture in Europe is not much different apart from timing. Most of Europe remain at least a couple of weeks ahead of the US in the disease cycle.

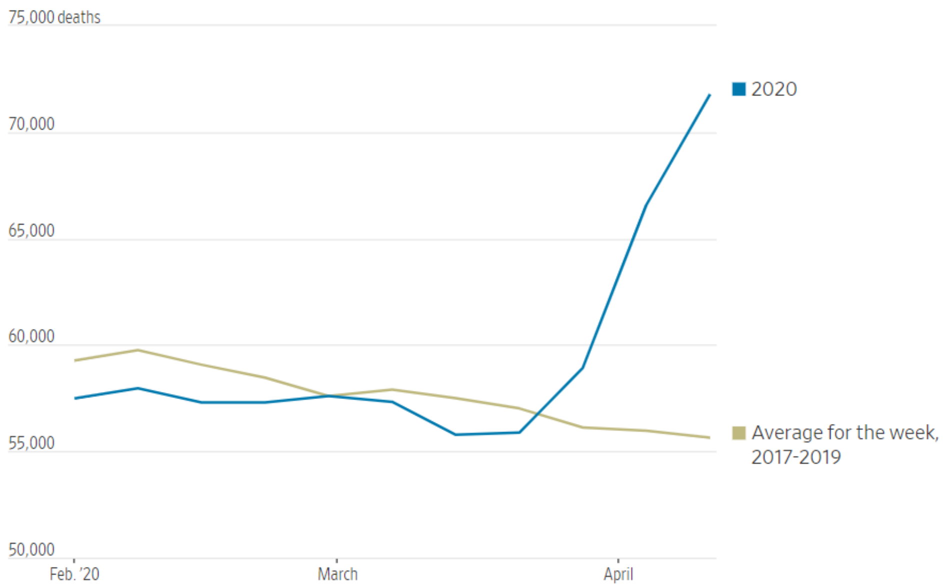

Exhibit 2: Weekly number of US deaths
Sources: PEW Research Center, National Center for Health Statistics

Although young and otherwise healthy people are very unlikely to die from COVID-19, not everybody is. When a family member or a good friend succumbs to the disease, the numbers on websites like Johns Hopkins University suddenly become more than a mere statistic, and that is precisely why the scars left by COVID-19 will be quite severe.

The fear of dying is in a league of its own in terms of how it impacts human behaviour. Nothing else comes even close. If you don't believe me, I suggest you google "How does fear of dying affect human behaviour?". The reason this observation is important to a financial newsletter, is the impact that fear will have on behavioural patterns for a long time to come.

Re-opening the economy

As we learned back in March, the economy can be closed pretty much overnight. You close your business one evening and don't open it the next morning. Quite simple, really. Re-opening is not nearly as simple, though. Staff, who have been laid off, must be re-employed, and some of those people may no longer be available; i.e. training of new staff must take place.

Furthermore, the supply chain is often affected so, even if you are ready to fire on all cylinders again, your suppliers may not be able to deliver what is required. And supply chain problems is not just an issue for manufacturing companies but can be a major problem for service companies as well.

Reduced purchasing power amongst consumers is another factor that shouldn't be underestimated. The US has pursued a fundamentally different COVID-19 strategy from most European countries. Whereas employees on this side of the Atlantic have been offered ample protection, US employees have not, and that could lead to serious socioeconomic problems over there.

The bottom 90% of the US workforce (income-wise) have experienced negative savings rates for the past 30 years (Exhibit 3), and the COVID-19 outbreak can only prolong that trend. As of a couple of weeks ago, 50% of all American households had either already started to withdraw money from their retirement account or planned to do so, simply to survive (source: MagnifyMoney). This can only spell even bigger problems down the road in a sector that is seriously underfunded already.

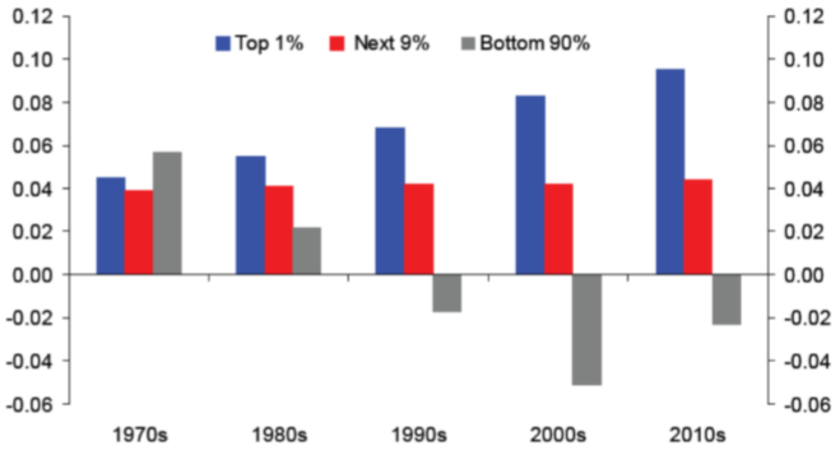

Exhibit 3: Net savings rates across the income distribution (%)
Sources: Deutsche Bank Research

Having said that, the biggest issue on the horizon could very well be the fear factor – i.e. the scar tissue left by the pandemic. Many will be afraid to visit restaurants or hotels any time soon, and the appetite for sitting on a stranger's lap in a packed Airbus 320 will also be limited. In that regard, the empirical evidence from China is quite overwhelming. Now, 2-3 months after re-opening the Chinese economy, Chinese manufacturing has largely recovered, whereas the Chinese service sector is nowhere near back to normal.

How will we pay for it all?

When all this is over, the total cost of COVID-19 – both past, present and future costs – will be mind-blowingly high. The chart below (Exhibit 4) landed in my inbox a few days ago, and it illustrates very well how massively above the norm COVID-19 related expenditures have been so far. Please be aware that the chart only depicts the UK, but more on the rest of the world later.

Exhibit 4 is also a healthy reminder that much higher expenditures is not the only problem tax payers will be facing. It is as much about government revenues falling well short of expectations. As you can see, UK government expenditure are running almost 60% ahead of year-ago levels, whereas receipts are almost 30% below the revenue coming in last year.

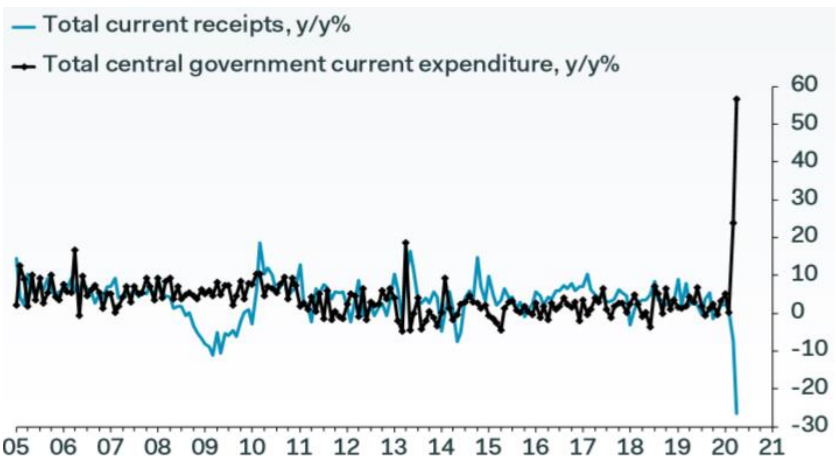

Exhibit 4: UK government revenues & expenditures (%, year-on-year)
Sources: Pantheon Macroeconomics

According to the researchers at Pantheon Macroeconomics, by the end of the current fiscal year, UK net debt-to-GDP will have risen to 120% (Exhibit 5). That estimate is based on a 9%

fall in GDP in 2020 vs. 2019 and public borrowings of £300Bn (15% of GDP). My guesstimate is that actual borrowings will end up being higher than that.

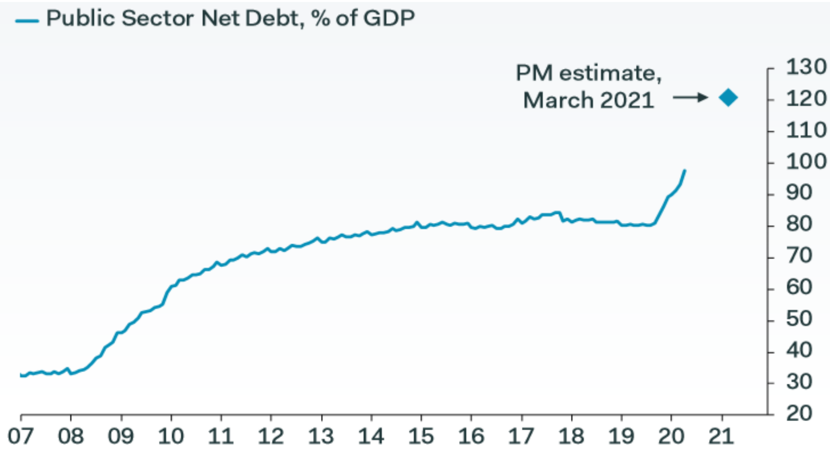

Exhibit 5: UK government net debt as a % of GDP
Sources: Pantheon Macroeconomics

Most other countries are not in a noticeably different situation. All over the world will you see debt-to-GDP ratios explode as the year unfolds. As you can see in Exhibit 6 below, according to Oxford Economics, Japan will remain the most indebted country in the world. By 2021, debt-to-GDP there will be no less than 247%, but several other countries are doing their best to sow the seeds for another sovereign solvency crisis down the road.

	2019	5yr change	2021F
Japan	225	10	247
Italy	149	-4	168
US	135	-1	157
France	133	9	145
Spain	114	-1	131
Canada	95	3	112
UK	85	-2	98
Netherlands	64	-18	67
Germany	56	-14	62
Sweden	49	-7	54
Australia	45	8	62
Korea	44	1	51
Switzerland	26	-4	28

Exhibit 6: Debt-to-GDP ratio by country, %
Sources: Oxford Economics

This raises the obvious question: How will we pay for it all? Various models have been suggested by economists around the world, but it will take many years before most of those models suggested can bring debt-to-GDP back to reasonable levels. The one that appeals most to me – and the one that all law-abiding citizens should embrace – is an immediate conversion to a cashless society.

Going cashless will eliminate a significant part of the shadow economy, which will bring in much needed tax revenue to the government without raising tax rates a penny. All countries have a shadow economy. In the OECD, it is estimated to account for 10-15% of GDP on average (Exhibit 7), so the incremental tax revenue would be meaningful. Even better, it is not a one-off. It will come back year after year.

Paying without cash is becoming increasingly popular, not only in the richest countries but also across emerging markets. As you can see in Exhibit 8 below, some of the largest EM countries – China, India and Russia (I don't have any data on Brazil) – are all increasingly going cashless, but that presents another problem which I will come back to in a moment.

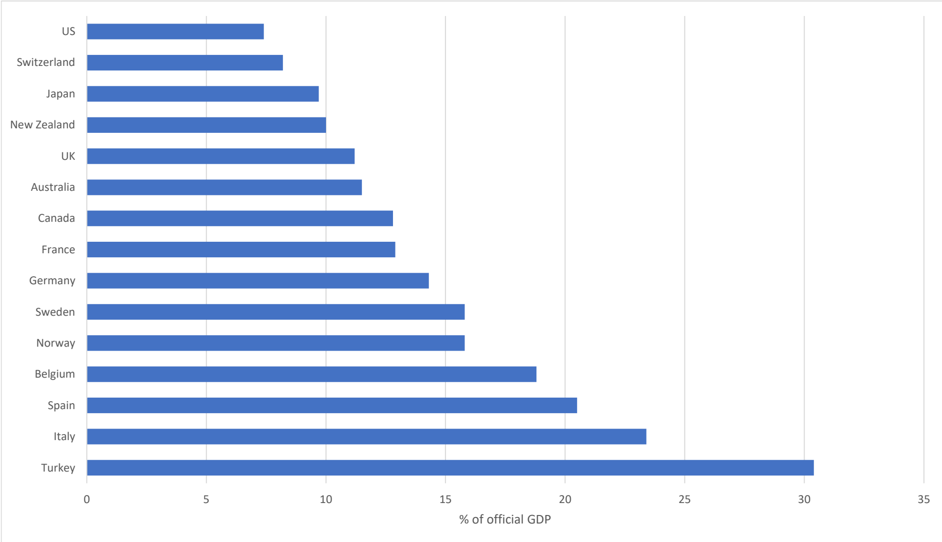

Exhibit 7: The shadow economy in % of GDP (2003-18 average)
Sources: [IZA World of Labor]

Going cashless is not entirely unproblematic. I can immediately think of three issues – (i) the impact on consumer spending, (ii) the illegitimate use of other (cash) currencies, and (iii) the impact on the poor and the elderly in society.

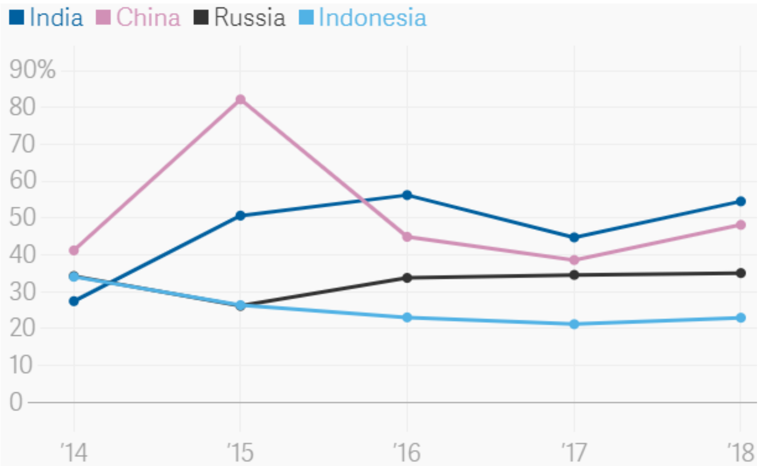

Exhibit 8: Annual growth in cashless payments (%)
Sources: [QZ.com]

As far as the impact on consumer spending is concerned, I have seen many research analysts argue that consumer spending will increase, as many will over-spend if there is no empty wallet to warn the consumer that now is time to stop. I am not so sure, though. If all transactions were above-table, less disposable income would be available for consumer spending as the tax man would take a bigger share. Only time can tell what the net effect will be.

The second issue is a tricky one. If, say, Europe goes cashless, but the Americans stick with their dollar, what will prevent Mr. Jones in Cardiff paying his plumber in US dollars? Some sort of exchange control could therefore be necessary unless everybody were to convert simultaneously.

As far as the elderly go, I am not sure how the Swedes plan to deal with that, but I am sure there is a plan. As far as the poor are concerned, it is well known that they rely far more on cash, and on the shadow economy in general, than the better-off do. Taking out cash could potentially create insurmountable problems for many and may restrict all but the richest countries from going cashless any time soon. It is no coincidence that Sweden will be the first country to go cashless early next year. I suggest you read this article if you want to learn more about this particular issue.

My own scars

I am about to finish this month's Absolute Return Letter but, before doing so, I will openly admit to having a few scars myself. The most notorious of them all dates back to 2009, when all the skeletons from the Global Financial Crisis started to pop out of the cupboards. The investment strategy I lost the most on – both in hard dollar terms and in pride/reputation – was private lending.

At first, most private lending funds did reasonably well, but what none of us had taken into account was that the more liquid private lending funds turned into ATMs when cash-starved investors used them to raise much-needed cash. And the follow-on effect of that was that even very modest asset/liability mismatches turned into career-ending mismatches. Investment managers learned a lot from that episode, though, and have subsequently changed investment terms in their funds in a number of ways, but those scars are still with me.

That's it for this month. I have now completed my mini-series on Morgan Housel's five lessons, which I hope you have enjoyed. As it happens, only yesterday (1 June) did I present my thoughts on COVID-19 to ARP+ subscribers under the title:

Will the world ever be the same again post COVID-19?

I provided guidance on COVID-related investment opportunities which regulators won't allow me to do in this letter. If you are not an ARP+ subscriber, it still isn't too late, as you can find a recorded version of yesterday's webinar here.

With Morgan Housel's paper now behind me, it is time to move on, but I have no idea what to write about in July. Strangely enough, it wouldn't surprise me if the word "COVID-19" will be mentioned at least once. Until then, stay safe!

Niels C. Jensen
2 June

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