LONG-TERM CONSEQUENCES OF THE COVID-19 PANDEMIC

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Summary and Major Conclusions:

The US economy will likely witness another wave of industry consolidation over the next several years as a result of large-scale business failures and bankruptcies among small and mid-sized firms. The implication is that the biggest firms will become even bigger: The three or four largest survivors in various key industries should gain significant market share at the expense of weaker firms. Various academic studies have demonstrated a strong correlation between market share and profit margins of business firms. A new wave of mergers and acquisitions could accentuate this trend toward industry consolidation.

- The COVID-19 pandemic has had a devastating impact on the world economy with significant residual consequences that could persist for many years. There will be durable structural changes that will alter the future course of the economy.
- Major shifts in consumer, business, and government behavior were already in place prior to the pandemic. As a generalization, history reveals that exogenous shocks often accelerate structural changes already underway.
- Notable examples of this principle include increased utilization of online shopping; an increased tendency toward remote work; migration from urban centers to suburbs; declining fertility rates and slower population growth; consolidation of major domestic industries; and a secular decline in free trade.
- It seems intuitively clear that the pandemic is ushering in a new era of big government — a more activist role of the federal government in economic affairs. The economic and investment implications of this political trend could be a less dynamic private sector and a less favorable investment environment.
- Inflationary pressures could emerge during 2022 and beyond. The Federal Reserve is on track to implement the most expansionary policy in 50 years, while the amount of fiscal stimulus is the largest since World War II. A rising trend in inflation would be a major headwind for financial markets, most notably for fixed-income investors.
- The potential for much higher inflation in coming years has significant implications for long-term interest rates. I expect interest rates to trend higher over the next five years, with negative implications for returns on all asset classes.
- The pandemic has directly altered the outlook for fiscal policy over the next five years. Congress will ultimately need to adopt a more restrictive fiscal policy by raising taxes and cutting spending once the economy returns to a firm footing.
- Treasury borrowings will remain elevated for many years, reinforcing the upward trend in long-term interest rates. Fiscal policy will constitute both a direct and indirect headwind to economic growth over the next five years, at a minimum.
- It seems reasonable to assume that the pandemic could be the spark for a boom in technological innovation. History is very clear in revealing how national crises and emergencies spur large-scale entrepreneurship and technological innovation.
- It also seems plausible that the current multi-billion-dollar global project to develop a vaccine for COVID-19 could result in widespread scientific breakthroughs in a wide range of medicines. History has clearly shown that intense scientific research in a specific field often yields astonishing advances in treating diseases in unrelated fields.

- Evidence of a migration from metropolitan centers to suburbs and exurbs first became apparent around 2015. The coronavirus has turbocharged this shift, with families seeking more spacious and lower-density living arrangements in the context of a spreading pandemic.

- The relationship between labor and capital could change radically over the next five years, as the percentage of national income earned by the business sector increases at the expense of labor. The critical investment implication is that company profit margins could widen as the return to labor is suppressed.

- The US economy will likely witness another wave of consolidation over the next several years as a result of large-scale business failures and bankruptcies among small and mid-sized firms. The implication is that dominant firms in a number of key industries could enjoy widening profit margins.

- COVID-19 has dealt a severe blow to the property market, as major changes in behavioral and lifestyle patterns have undermined the demand for commercial space. All property types have been negatively impacted. Property prices could decline by 10% to 20% over the next several years, with the largest declines for retail.

- Regrettably, the shift away from globalization that began with the Trump administration is likely to become more pronounced in future years, with profound implications. Spreading trade protectionism and restrictions on immigration would almost certainly be manifested in slower growth in world living standards.

The COVID-19 pandemic has had a devastating impact on the world economy and financial markets, with numerous significant residual consequences that could persist for many years. It seems virtually assured that the world will be entering a new normal involving radical changes in consumer, business, and government behavior.

Structural change in some sectors of the economy could be permanent. And although some of these pandemic-induced changes are positive for economic growth, most are negative. This week's *Economic Perspective* attempts to identify some of the most important structural changes that could have a major impact on financial markets in coming years.

Acceleration of Existing Trends: Major shifts in consumer, business, and government behavior were already in place prior to the coronavirus pandemic. As a generalization, history reveals that ***exogenous shocks often accelerate structural changes already underway***. The following are examples of socioeconomic trends that have been supercharged by the pandemic:

- Increased use of online shopping
- An increased tendency toward remote work
- Migration from urban centers to suburbs
- Declining fertility rates and slower population growth
- Consolidation of major domestic industries
- Reduced globalization and a secular decline in free trade
- A long-term structural decline in the US dollar

Each of these structural shifts in behavior was already evident in recent years and is likely to be accentuated in the aftermath of the pandemic. The following is an in-depth discussion of what I perceive to be the most notable repercussions of the coronavirus pandemic.

A NEW ERA OF BIG GOVERNMENT

It seems intuitively clear that the coronavirus pandemic is ushering in a new era of big government — a more activist role of the federal government in economic affairs. This megatrend would be consistent with history, wherein major crises — such as the Great Depression, World War II, and the 2008 world financial crisis — have acted as catalysts for a shift in American governance, whereby citizens have placed more reliance on the federal government to provide solutions to social and economic problems.

COVID-19 has created a greater sense of vulnerability and insecurity, reinforcing policies that will enhance the social safety net. Americans have become more accepting of increased government intervention because of the perception of diminished economic and physical security. *The economic and investment implications of this political trend could be a less dynamic private sector and a less favorable investment environment*.

LONG-TERM INFLATION

As I have discussed on numerous occasions, inflation is likely to remain under good control over the next one to two years. A rise in the rate of inflation is unlikely to emerge until the economy returns to normal and spare capacity in labor and resource markets is absorbed. In principle, inflation is a lagging indicator and tends to trail the recovery in aggregate spending by one to two years.

However, investors should be mindful of the potential for a decisive change in trend that could become evident within the next two years, resulting from unprecedented government stimulus to counteract the pandemic. The Federal Reserve is on track to implement the most accommodative policy in 50 years, while the amount of fiscal stimulus is the largest since World War II. Fed officials are visibly fearful of a deflationary bust emanating from the pandemic, and are desperately trying to create more inflation.

A rising trend in interest rates and inflation would be a major headwind for financial markets, most notably fixed-income markets. The equity market is also vulnerable, as higher inflation and a rising trend in bond yields would result in lower market valuations for common stocks. While the absolute values of company earnings and assets would rise with inflation, shrinking valuations could be a significant offsetting factor.

LONG-TERM INTEREST RATES

The potential for much higher inflation in coming years has significant implications for long-term interest rates. In principle, there are two independent factors that determine the level of long-term interest rates:

- An inflation-adjusted (real) yield based upon real economic growth and productivity
- An inflation premium to compensate investors for the risk of rising consumer prices

The market yield on the ten-year US Treasury has averaged 1.75% over the past two years. Since the COVID-19 outbreak, yields have fluctuated within a range of 0.5% and 0.9%, with an average of 0.65%. *I expect interest rates to trend higher over the next five years because of both rising inflation and rising real rates*. The latter could come about because of higher productivity stemming from increased investment in digital technologies and automation (see below). Market yields on ten-year government bonds could climb above 3.5% by the middle of this decade.

US FISCAL POLICY

The pandemic has directly altered the outlook for fiscal policy over the next five years. The unprecedented level of federal government spending earlier in the year associated with the CARES Act was absolutely necessary to cushion the economy from a potential depression. However, the combination of escalating federal spending and plunging tax revenues has resulted in an unprecedented explosion in the budget deficit and national debt.

- The budget deficit could remain above $2.5 trillion in each of the next five years.
- The national debt will continue to trend higher during the remainder of the decade.
- Congress will need to adopt a more restrictive fiscal policy — involving higher taxes and reduced spending — as the economy returns to a firm footing.

- Treasury borrowings will remain elevated for many years, reinforcing the upward trend in long-term interest rates as the private economy returns to normal.

The key point is that fiscal policy will constitute both a direct and indirect headwind to economic growth over the next five years, at a minimum.

THE ROLE OF TECHNOLOGY

It seems reasonable to assume that the pandemic could be the catalyst for a boom in technological innovation. History is very clear in demonstrating how national crises and emergencies — such as wars, geopolitical conflicts, natural disasters, and pandemics — spur large-scale entrepreneurship and technological innovation. World Wars I and II were followed by bursts of technological innovation, as was the Civil War (please see my *Economic Perspective* dated March 9).

Consistent with this pattern, it would not be surprising to see a steadily rising increase in technology spending and investment as a share of GDP, as scientists provide new solutions and innovations for a wide range of applications.

- In response to a sharp increase in remote work, companies are adopting digital technologies to achieve greater interaction and connectivity among employees.

- In a comprehensive survey conducted by McKinsey & Company, nearly one-half of firms implemented enhanced digitization of customer channels with the use of e-commerce and mobile applications.

- Many companies have improved their management of supply chains by linking their suppliers with the use of digital platforms.

- In addition to digitization, companies have accelerated their implementation of automation technologies, including robotics, autonomous vehicles, and artificial intelligence.

MEDICAL ADVANCEMENTS

More specific to human health, it seems plausible to assume that the current multi-billion-dollar global project to develop vaccines, therapeutics, and testing equipment for COVID-19 could result in scientific breakthroughs in a wide range of medicines. History has clearly shown that intense scientific research in a specific field often yields astonishing breakthroughs in treating diseases in unrelated fields.

Potential treatments for Alzheimer's disease, diabetes, heart disease, lower respiratory disease, and certain types of cancers could result from the current worldwide quest to develop a safe and effective vaccine for COVID-19. An increased pipeline of new medications in future years could benefit the pharmaceutical and biotech industries, while enhancing living standards and life expectancies.

URBAN VERSUS SUBURBAN LIVING

Evidence of a migration from metropolitan centers to suburbs and exurbs first became apparent around 2015; the coronavirus has turbocharged this shift, with families seeking more spacious and lower-density living arrangements in the context of a spreading pandemic. Listings in cities such as New York and San Francisco have plummeted, while sales of single-family homes in the suburbs and small cities have increased exponentially.

How permanent is this demographic shift? While it is impossible to know for certain, it appears plausible to assume that the current stampede to the suburbs will unwind once there is a scientific solution to COVID-19. *But it is also plausible to assume that a significant portion of the migration away from large cities will be permanent*. The most obvious implication would be reduced demand for high-rise luxury apartments and office space in central cities, and increased demand for single-family homes in suburbs and rural areas.

LABOR VERSUS CAPITAL

The relationship between labor and capital could change radically over the next five years. The US economy appears to be on track toward a jobless recovery, which means that a larger share of GDP growth in coming years will be derived from growth in labor productivity, as opposed to growth in aggregate hours worked. This conclusion is consistent with the outlook for widespread business investment in digitization and automation. It is also consistent with the focus of businesses on cost containment and hesitancy in adding to payrolls.

In a broad macroeconomic context, *the percentage share of gross national income earned by the business sector should increase, while the share earned by labor should decrease*. The critical investment implication is that business profit margins could widen at the expense of employment and wages.

COMMERCIAL REAL ESTATE

COVID-19 has dealt a severe blow to the property market, as major structural changes in behavioral and lifestyle patterns have undermined the demand for commercial space. All property types have been negatively impacted. Retail demand has been devastated by the surge in e-commerce; and empowered by Zoom and other video service providers, work-from-home has accelerated, reducing the demand for office space.

The collapse in business travel and tourism has resulted in a slump in hotel occupancy rates, while high-end apartments and condos in major urban centers have suffered from the surging demand for single-family homes in the suburbs. Property prices nationwide could decline by 10% to 20% over the next several years, with the largest declines for retail.

US INDUSTRY CONSOLIDATION

The US economy will likely witness another wave of consolidation over the next several years as a result of large-scale business failures and bankruptcies among small and mid-sized firms. *The implication is that the biggest firms will become even bigger*: The three or four largest survivors in various key industries should gain significant market share at the expense of weaker firms. *Various academic studies have demonstrated a strong correlation between market share and profit margins of business firms*. A new wave of mergers and acquisitions could accentuate this trend toward industry consolidation.

GLOBALIZATION AND PROTECTIONISM

Globalization is defined as the integration of the world economy through trade, immigration, travel, capital flows, and foreign direct investment. *It is not an exaggeration to argue that the spread of globalization since 1975 was the most important force in raising living standards throughout the world*, especially within the developing economies of Asia, Latin America, Africa, and Eastern Europe. *Regrettably, the shift away from globalization that began with the Trump administration is likely to intensify in future years*.

Many countries including the US have experienced shortages of critical materials and components sourced from foreign producers. Most countries have responded to the COVID-19 pandemic with an increased emphasis on *internal self-sufficiency and secure access to necessary materials and finished goods*, especially with respect to vital medical supplies.

The implications could be profound. *Both immigration and free trade will likely be less vibrant than during the past several decades*. Spreading trade protectionism and restrictions on immigration would almost certainly be manifested in slower growth in world GDP, income, wealth, and living standards.

SUPPLY CHAINS AND RESHORING

A prime manifestation of globalization in recent decades has been a diffusion of manufacturing supply chains around the world. In particular, multinational companies have taken advantage of low-cost labor in developing economies — most notably China — to locate factories in places that minimize production costs.

The COVID-19 pandemic has demonstrated in a glaring way the pitfalls and risks of this strategy, as some countries have experienced a dangerous shortfall in sourcing of vital materials and components. Consequently, many countries have responded to the pandemic by emphasizing internal self-sufficiency and secure access to necessary materials and finished goods, especially with respect to vital medical supplies and components.

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