

## LOW ON RESERVES

The global economy already had a weakened immune system when the coronavirus struck. Nonetheless, the chances are good that it will stage a timely recovery. Times of great uncertainty call for diversification, discipline, patience – and a dose of courage.

“Modern Times” is a classic film from the 1930s starring Charlie Chaplin. It parodies a world that is focused on technology and efficiency, in which every detail of the manufacturing process is controlled by a medley of levers, buttons, and gears. Chaplin is stationed at a conveyor belt, tasked with turning two screws simultaneously, at high speed, with a wrench in each hand. Right next to him are two fellow line-men with hammers. Minor annoyances, such as a buzzing fly in Charlie’s face or a sudden sneeze, have an enormous and immediate effect, resulting in chaos on the production line. The line is part of a gigantic machine, created for the sole purpose of maximising production output – and animated by the conviction that everything and everyone can be controlled by machines, technology, and planning. It is a system in which every element is connected to everything else. There is no room for the unforeseen; reserves are superfluous and unproductive.

Similarly, there is chaos on the production line of our economy today. A small, seemingly

innocuous annoyance, the coronavirus, first knocked out the supply of production components from China, and many finely differentiated global supply chains were severed. The sudden disappearance of key suppliers impacts companies that have spent decades striving to minimise inventories and deploy just-in-time and lean production methods. Now that the virus has spread around the world, the chaos affecting industrial supply chains has also risen exponentially. Economists are calling it an unprecedented supply shock.

### Alphabet soup

It is not only the supply side of the economy that is reeling from the drastic measures now enacted globally to reduce interpersonal contact. The emergency brake on our system has also dramatically reduced the consumption of goods and services. Seldom in history has the global economy decelerated this sharply and this synchronously on both the supply and demand sides in such a brief time. At the same time, it is worth noting that so far not a single production facility has been destroyed. Transport routes, supplier and customer relationships, and networks all continue to exist and can be ramped up as soon as warranted by the health situation.

Against this backdrop, economists and forecasters are running wild with speculations about the further course of the economic curve. Models in letter form are particularly popular. Specifically, we hear about a “V” shock (“everything will

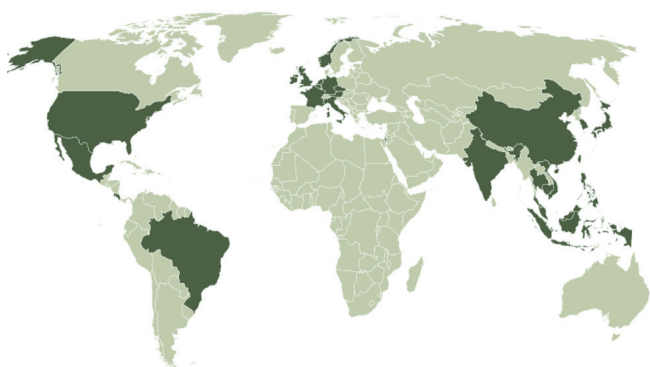


quickly return to normal”), a “U” (“everything will return to normal, but not so quickly”), or an “L” (“nothing will be the same again”). We’re just waiting for a “J” and a “W”. Most observers favour the “V” and “U” models, as do we. At the end of the day, however, this alphabet soup reveals one thing above all: no one knows, and no one can know, because the system is too complex. But history teaches that even after an “L” shock, at some point everything is fine again – although the road there may be long and painful. Those who have time will have the advantage. Reserves of time also have value, especially in times like these.

countries. If the corporate sphere were to start re-thinking on a broad front, security – i.e. maintaining storage capacities, introducing redundancies in production and data storage, etc. – could move more prominently into the foreground. Companies would probably pass on the ensuing costs to consumers. In a world where safety takes greater precedence over efficiency, prices would tend to rise again. After years of no inflation, this would be a novelty. Provided that the global economy’s respiratory failure is not long-lasting, and that the subsequent build-up of reserves in the real economy is only gradual, this process could likely unfold in a relatively orderly fashion without major friction.

NUMBER OF APPLE SUPPLIERS PER COUNTRY, 2018

## PRECARIOUS SUPPLY CHAINS



China	Japan	USA	Taiwan	Korea	Other Asia	Europe	Latin America	Others
380	128	65	55	41	96	34	8	1

Source: Apple.

Even if things were to normalise after a few months, as many continue to expect despite all the turbulence, the corona crisis could have a longer-term legacy. Given their recent experiences, companies might reincorporate greater reserves into their supply chains, necessitating major (and costly) conversions. Global giants such as Apple, for example, have trimmed their supplier systems for maximum efficiency, following the lead of Apple’s long-serving CEO Tim Cook, who has long described the provision of storage capacity as a “fundamental evil”. As the chart above indicates, Apple currently has more than 800 suppliers in 28

## Risk of contagion

The picture would be quite different if the world were to be confronted by many months, or even numerous waves, of drastic measures to combat the pandemic. The chaos on the production line would spread further, eventually resulting in new, sweeping shortages. As a result, prices would shoot up. The situation we currently observe with protective masks would then crop up in other sectors of the economy. Such a cocktail, spiked with a surge of liquidity from governments determined to maintain or stimulate sputtering demand, could become quite unappetising. Our entire system has adapted over decades to the absence of inflation and – by association – falling interest rates and a generous supply of liquidity, and no one expects the trend to be reversed. However, should such a reversal emerge, the focus would quickly shift to the solvency of companies and governments and thus to the question of the stability of the financial system and of money itself. This would be “the big one” that we discussed in our last “Letter”.

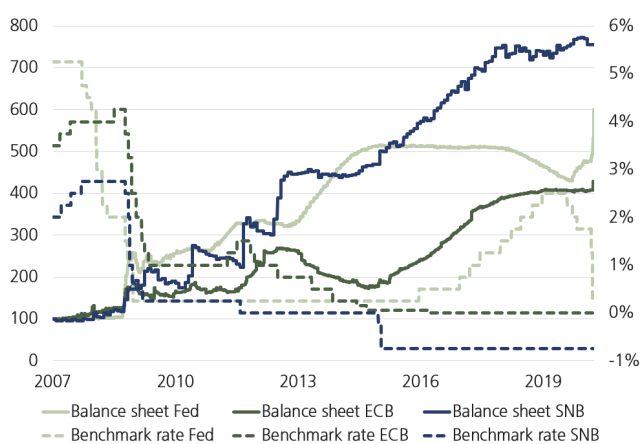
Another special factor in the current situation is that problems on the conveyor belt cannot be solved with cheap money. Over the past 20 years, the central banks have always been able to combat crises in the financial sector and in demand with interest rate cuts and liquidity programmes.



This time, however, a large part of the problem is on the supply side, for one thing, and for another, central bank resources are pushed to their limits. As our chart shows, it would be virtually impossible to lower interest rates further. Moreover, balance sheets are already heavily distended and no one knows whether further expansion might have undesirable side effects at some point, especially if it were to coincide with supply shortages.

BENCHMARK RATES AND CENTRAL BANK BALANCE SHEETS 2007-2020

## CENTRAL BANKS AT THE LIMIT



Source: Bloomberg. The left scale indicates central bank balance sheets indexed at 2007 (solid lines). The right scale indicates the level of benchmark interest rates (dashed lines).

However, this is not yet the case. In the aftermath of the financial crisis, the capitalisation of the banking system was reinforced in many areas, particularly in Switzerland. Countries such as Germany and Switzerland are in a relatively comfortable situation due to their budgetary policies, which until recently were often criticised as needlessly frugal, and can now release funds in good conscience. It is nonetheless clear that due to the record levels of global debt and the limited scope for action by central banks, reserves are not particularly abundant. The global economy already had a weakened immune system when the coronavirus struck; the risk of infection is real.

**Diversification, discipline, patience, courage**

The question of reserves is also important for investors – not only in the higher realms of business and politics, but also at a very personal level. Only those with reserves – time, financial resources, nerves, knowledge, prospects, options, networks, inventory – are capable of acting even in extreme situations. The ability to act is not only vital in the short term; experience teaches that it also pays off in the long run. And we all know that extraordinary times present not only risks, but also specific opportunities. Ultimately, the question of reserves involves an analysis of one's own ability and willingness to take risks, as we have repeatedly emphasised.

Despite the serious risk of contagion described above, our view is that while the corona crisis will have a tangible impact, the picture will brighten in the second half of 2020 at latest. We also believe that a smart investment strategy must be able to function regardless of this forecast – forecasts are even more subject to error in extraordinary times than otherwise. In addition to a well-founded analysis of one's own situation, this includes:

- *Diversification*, because investments that seem safe or high-yielding today may be unsafe and loss-generating tomorrow.
  - *Discipline*, because reactions based on fear, greed, and the herd instinct are rarely good advisors.
  - *Patience*, because time is a decisive factor in successful investing.
  - *Courage*, because there is no return without risk and otherwise wealth may simply melt away over the long term.
- The present crisis is a reminder to us all that not everything can be managed, planned, and foreseen. However, for the experienced, long-term-oriented investor, this is nothing new.

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IA, 31.03.2020



## THERE IS A TOMORROW

In the feuilleton of my favourite newspaper – the "Neue Zürcher Zeitung" – when times were still halfway normal, there was once some speculation about whether our universe might be an object created by higher artificial intelligence. In this case, we humans would be digitally functioning creatures, highly complex assembled things, equipped with a little autonomous (also artificial) intelligence, trapped in a huge hamster wheel spinning frantically. In the background of this universe would be computers of unimaginable size. These ultra-powerful machines would occasionally find ordinary human activity too monotonous, so they would send the busy little humans a surprise or two and then watch with interest and amusement how the earthlings would come to terms with them.

People, and the economy, are more resilient than is generally assumed and more than the well-meaning regents believe.

Now I personally am sceptical about such a mechanistic idea of metaphysics. And certainly in the case of the corona crisis, the word "amusement" is inappropriate in view of the number of victims and the extensive economic damage. Nevertheless, the question of the arrangement, that is, what the post-corona world will look like, is the crucial one. It is of course still too early to assess the extent and nature of the fall-out. But one thing already appears clear: it will be some time before the global economy is back in sync again. The main problem is not the immediately apparent effects such as closed restaurants and shops – after all, these qualify for the not insignificant fiscal aid measures. More threatening are the countless

secondary effects that will follow the imposed respiratory failure. Here a build-up of goods, there shortages, in many places production by government decree, and everywhere demand for state funds, since regaining the pre-crisis level will not be a rapid process.

But where lies the greatest danger? We have suddenly been caught up in a regime of directives. We must obey – and rightly so. This is a world of black and white. Right and wrong, good and evil, are sharply delineated. Real life, though, is colourful, the transitions between the shades are blurred, the good always contains a hint of evil – and vice versa. We must return to that life-affirming state as quickly as possible! And we must put this proxy regime, driven by virologists, behind us again, depose the well-meaning regents. The planned economy, enthusiastically applauded by certain media, is already gazing around the corner. The road to servitude is paved with gifts and promises for which no one has paid.

There is no question that we have just slipped into a recession. There is equally no doubt that the world has suddenly become poorer, that we have to pick ourselves up again from a lower speed. But people, and the economy, are more resilient than is generally assumed and more than the well-meaning regents believe. Let us produce once more, when the process no longer makes us ill! And let each of us who can bring fuel to the economic cycle, with our creative power or our capital, search with a free spirit for ways and means to be useful. Stagnation is a question of mind. So is an upswing. A free spirit is not controlled by a superior artificial intelligence, but neither does it serve a dirigiste authority.

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KH, 31.03.2020

