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Daily Observations
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# The Two Big Forces at Work and Their Differential Impacts over Time

We regularly get the question, "Are we in a secular bear market?" That question is impossible to answer with any degree of confidence. However, we also see it as a question that reflects more upon the world we've been in than the world we are now in. In this new world, we see two giant forces at work operating against one another, having disparate impacts across companies and countries. One is the massive global collapse of income and spending. The other is the countervailing reflationary production of liquidity via fiscal and monetary policies.

In this world, the *level* of economic activity will be the biggest influence (i.e., not growth rates). This may or may not be offset by the liquidity. The *accumulated* impacts of these two countervailing forces on balance sheets and wealth will have big, long-lasting effects. And *differences* in outcomes across countries and companies will be far more significant than how the average turns out. These differences will unfold gradually as the level effects accumulate, perhaps too gradually to notice until you look back on them.

**The Range of Uncertainties Is Too Wide to Make Reliable Estimates of the Future**

With respect to the collapse of income and spending, it will be driven by a) the virus and b) society's response to it. There is a wide range of outcomes pertaining to each of these. The natural course of the virus and the speed and effectiveness of the medical response remain unknowable. And as the virus lingers, the choices that societies will make between economic activity and mortality are now also unknowable.

With respect to the production of liquidity and the fiscal response, governments are by and large sending money to the rescue through various channels hoping that it finds its way to the intended destination, which is spending and income. Whether that money gets to its intended destination is another big unknown, and as one looks further into the future, the uncertainty compounds exponentially. For example, as the impact of the virus continues, will governments run out of borrowing capacity to offset it, will governments stop their support as they see positive growth from very low levels of output, will the elevated levels of borrowing and printing lead to currency declines and inflation that require tightenings, and so forth? For each government the answers will differ. At the same time, the longer and the deeper the level of income remains depressed, the greater the accumulated effects.

The probability of accurately forecasting any one of these sub-scenarios is inherently low. Multiplying the probabilities together, the combined probability of getting any one holistic scenario right is close to zero, i.e., not a smart bet.

**The Environment Will Create Numerous Sources of Differentiation**

Each country has had and will continue to have widely varying medical and societal responses to the virus and will experience widely varying outcomes. To deal with that, they have widely varying capacities for fiscal and monetary stimulation. And they will make widely varying choices between these things.

Some markets are directly supported by government actions, such as the direct buying of bonds by the central bank. Other markets rely on second- and third-order impacts that are a function of how much of that liquidity flows through the system to them. And each central bank buys a different set of assets.

Companies have different "durations" with respect to their income and balance sheets. Companies that have little cash and higher debts have less staying power and are effectively "shorter-duration" assets. Companies that have lots of cash and lower debts have more staying power and are effectively "longer-duration" assets.

Some markets are shorter-duration than others. Oil is a very short-duration asset because it can only be stored above ground for a limited number of days. This amplifies the downward pressure on prices from oversupply. On the other hand, a big technology company with little debt, lots of cash, and wide profit margins is a much longer-duration asset, so a near-term decline in sales and profits has very little impact on the present value of that long-duration income stream (assuming they aren't destroyed by another tech company, of course).

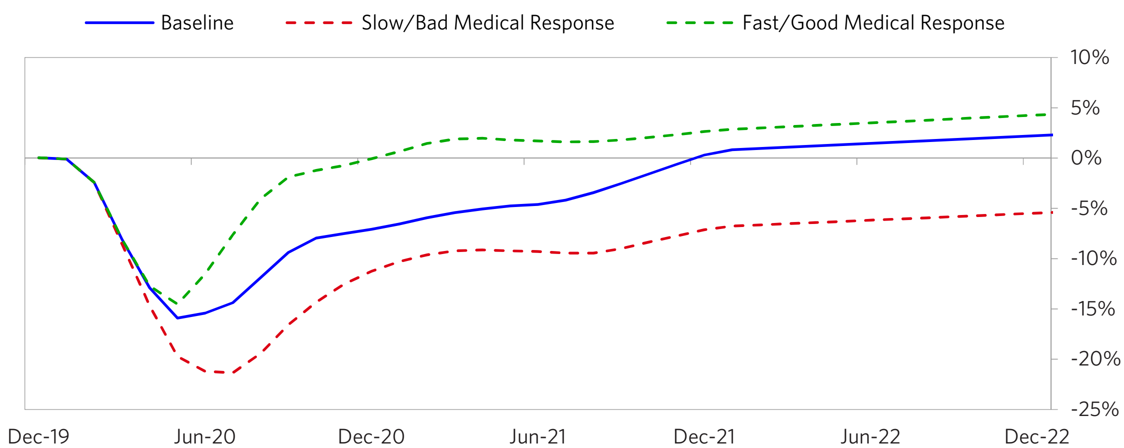
**"Duration" Mismatches Will Be a Driving Force of Differentiation**

Given these conditions, understanding the duration mismatches and how the passage of time will impact them is of primary importance. We can't know how long the virus impact will last, but we can know that the longer it lasts, the bigger its impacts will be on one company or country relative to another, and that these differential impacts will rise gradually and exponentially over time. In addition, while the passage of time will gradually increase balance sheet and cash flow pressures, at the same time there is likely to be an increased difficulty in addressing them with fiscal and monetary policy. A quick end to the virus impact would reduce these differential pressures, and an extended process would widen them exponentially.

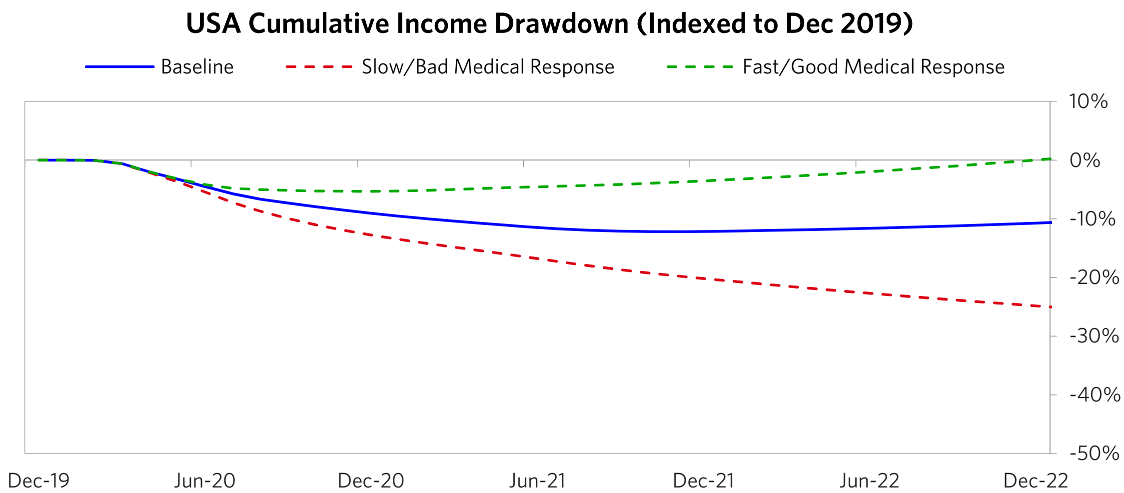
**The Accumulated Impacts of Low Levels of Income Will Be the Driving Force for These Outcomes**

The accumulated impacts of low levels of income will be the driving force of these differences in outcomes. It will be reflected in accumulated debt levels, bankruptcies, the strong buying the weak, dilutions due to recapitalizations, balance of payments crises, the relative returns of assets, secular changes in the global balance of power, and so forth. In previous *Observations*, we've shared our range of estimates of the future level of GDP across countries. As shown below for the US, there is inherently a wide range between our optimistic and pessimistic scenarios.

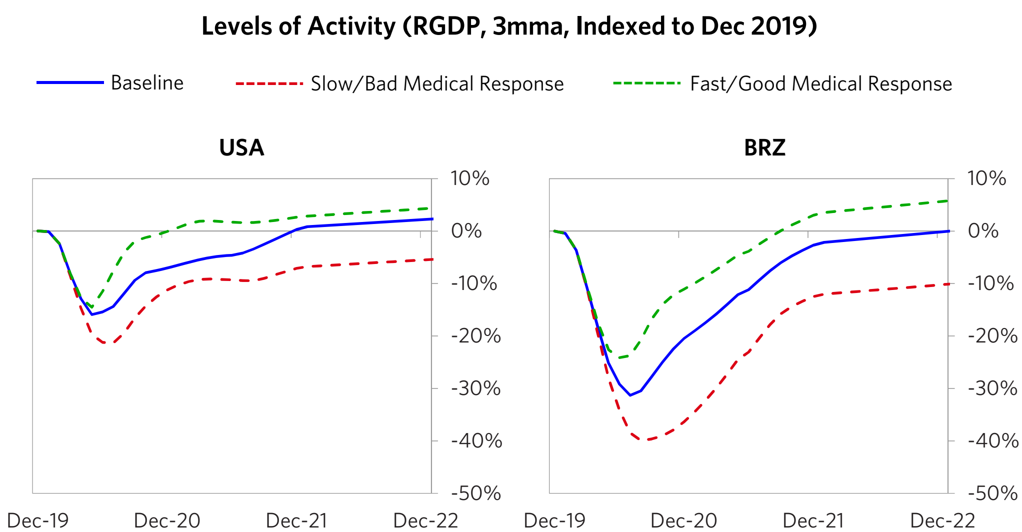
**USA Level of Activity (RGDP, 3mma, Indexed to Dec 2019)**



What is not evident in the chart above is how big the *cumulative* effects will be. In the above chart, the zero line is the level of GDP prior to the pandemic. The best way to see the accumulated impact is through the accumulated area below that zero line. That represents the cumulative shortfall of income, which requires the liquidation of cash balances, increases in debt, fiscal support, and so on. This is shown below for the US. As you can see, over the next few years the cumulative difference in income between the optimistic and pessimistic scenarios shown above has a very wide range, from a wash (zero net GDP growth) to a cumulative 25% reduction of national income in just a few years.




Such cumulative impacts will vary substantially across countries, widening over time. Below, we compare our estimated growth curves for the US, which as a reserve currency has a very high capacity for reflationary fiscal and monetary action, with those for Brazil, which has a far lower capacity.



The resulting cumulative effects on income differences would be substantial, with wide ranges unfolding gradually over time.

**Cumulative Income Drawdown (Indexed to Dec 2019)**