COVID-19 and the Evolution of American Capitalism, Policy, and Asset Allocation

As of April 30, 2020

The United States faces an unprecedented crisis with COVID-19. There are significantly more casualties than many previous catastrophes and an increasingly complex enemy. This has the potential for long-lasting impacts on our society that outlive the current crisis, which we consider as we look at the future of the US economy, capital markets and asset allocation. As we think about the future, we would be well-served by reviewing the lessons of the past. The Spanish Flu of 1918, the San Francisco Earthquake of 1906, Sputnik, World War II all contain clues to the likely continued governmental response and the longer-term impact on society and markets.

Jonathan Lewis
Chief Investment Officer

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Pearl Harbor, 1941

The potential impacts

As the federal government response is currently unfolding and will likely continue to grow in scope, we consider the following as longer-term potential outcomes of the response:

- **Change in the regional and global balance of power.** We believe the regions and nations who emerge from this crisis first, strong and safe, will have longer-term strategic and competitive advantages.
- **Increased investment in scientific research and development.** Whether it be for vaccines, testing or treatment, the pandemic has prioritized the need for research and development. This is not just a moral imperative, but an economic one. Societies and economies cannot properly function when under the continuous threat of diseases. Adequate treatment and prevention for this disease is a requirement.
- **Permanent shifts favoring some lifestyles and regions over others.** Starting in March 2020, one third of the world's population went on some sort of lockdown. Once restrictions are lifted, many may choose to leave their current homes and flock to areas that offer a refuge from these events. In the US this has been called the "Great American Migration of 2020."[1] This ranges from city dwellers leaving Coronavirus hotspots to college students forced to childhood homes with closure of universities and dorms. This could be temporary or result in permanent relocations similar to patterns seen after Hurricane Katrina. Additionally, a large portion of the workforce has now been acclimated to remote work, which may impact the need for proximity to offices and economic hubs. Prior to the current crisis there was already evidence that remote workers were making the decision to relocate to more affordable and smaller cities. This trend could be accelerated as more companies have been pushed by the crisis to embrace remote work.
- **Further retrenchment of the US commitment to globalization.** As supply chain management becomes a national security issue and we decrease our reliance on overseas suppliers, the US will likely continue to move away from global integration.
- **Higher inflation.** Overtime, after the deflationary impact of the crisis passes, we can expect a higher trend of inflation to emerge.

- **Changes in consideration of supply chain management and reliance on oversees providers.** At the government level, this will become an essential focus of US national security and the Department of Commerce will likely receive new resources/powers. Companies will also be under greater pressure to properly identify and manage supply chain risks. During the upcoming proxy seasons they will likely face ballot initiatives from activist investors to focus management attention on these issues. Shareholders, especially large pension funds, will likely engage. Additionally, there could be a new industrial policy to reduce reliance on overseas providers of essential pharmaceuticals and medical equipment.
- **The Federal Reserve (Fed) intervention in markets will continue.** This will likely exceed its involvement during the Great Recession. It will act to control interest rates so that the federal government can fund its response to COVID-19 at continued low rates. We saw this during World War II. The level of debt needed to finance the war was unprecedented and in order to keep interest payments on the debt affordable, the Fed set a ceiling for interest rates by fiat. From 1942 to 1951, longer-term interest rates were not allowed to rise above 2.5%.[2]
- **Amplified support to entrepreneurs and small businesses.** The Department of the Treasury, working with the Department of Commerce and the Small Business Administration, is likely to increase funding for innovative programs to support entrepreneurs and small business. This could support longer-term outperformance of small cap companies vs. large cap companies.
- **Change in the balance of power between labor and capital.** We expect union membership to rise and push companies to embrace worker safeguards, and improved benefits and wages. ESG and Impact investing will likely reinforce this, and large pension funds and endowments will likely engage on these issues as well. Markets could then be expected to reward companies who manage their worker relations well and penalize those who do not.
- Equal access to educational technology will become central to governments' education expenditures and policies. Education has been moving more and more online. Not all communities and families have equal access to technology, or bandwidth. For example, the pandemic forced elementary and high schools to quickly shift to and become more reliant on delivering instruction virtually. This has highlighted the digital divide that exists between communities and schools. Building more robust virtual education resources will become an important initiative of state and Federal departments of education. Investment in public education as a percentage of GDP will likely increase sharply in the years ahead as addressing digital inequities becomes an important theme in education policy.

What can we learn from history?

While these long-term impacts will continue to evolve as the crisis unfolds, we can glean some insights by viewing the US responses to previous national disasters through a historical lens.

The Spanish Flu of 1918

There has been a lot of comparison to the effects of the Spanish Flu of 1918 - death rates, the government response, and the overall tragedy. However, moving beyond these common talking points and looking at how that pandemic transformed American society could shed light on what we may see in the future.

Red Cross Volunteers, Boston, 1918

It is estimated that at least 675,000 Americans died during this historical pandemic, a number that greatly exceeds the 53,402 who died in World War I itself. It transformed America in ways that are now forgotten. The impact it had on women's role in the workforce is informative when we think about the America that is likely to emerge from the COVID-19 pandemic.

During the 1918 pandemic there was a shortage of doctors, a field that was dominated by men. This required female nurses and attendants to take charge of the day to day care of most patients – work which was dangerous and deadly.[3] This was an important catalyst in raising the profile of women in the workplace and increased respect for women in American society.

The male death rate was also meaningfully higher than the female death rate. It is estimated that 175,000 more men died than women due to the flu. This, combined with the loss of life from World War I, created a labor shortage that women stepped in to fill. The participation rate of women in the workforce jumped sharply and played a direct role in the ratification of the 19th Amendment to the US Constitution in 1920, which granted women the right to vote in the United States.[4]

Just as the 1918 flu "helped elevate women in American society socially and financially, providing them more independence and a louder voice in the political arena,"[5] we may see sustained changes in the balance of power between labor and capital. These changes are likely to favor labor.

Red Cross Volunteers, Detroit, 1918

The San Francisco Earthquake and Fire of 1906

The San Francisco Earthquake of 1906 leveled one of the largest cities in the US and displaced its population. Approximately 3,000 people perished and 250,000 out of a population of about 400,000 were made homeless.[6] The images of destruction dominate history books but overlook the series of financial disturbances and the wave of reform the earthquake sparked. Whether the act of nature is an earthquake or a virus, financial markets and the economy eventually become casualties of the consequences.

San Francisco, 1906

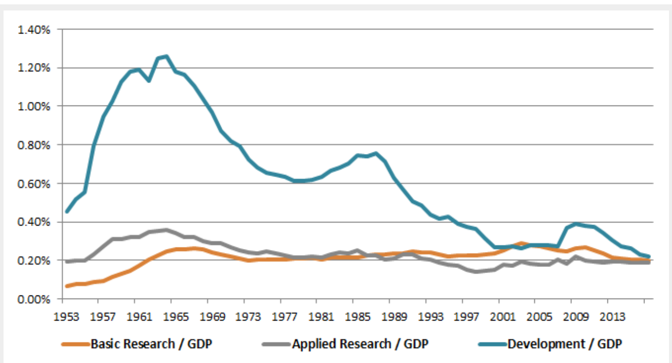
In 1906, the buildings in San Francisco were largely insured by British insurance companies and the international monetary system operated on the Gold Standard. When money left British insurance companies to pay for the claims in San Francisco, gold left the money supply of Great Britain and its money supply contracted. Interest rates went up, the economy slowed, and a financial panic developed. A bank in New York - the Knickerbocker Trust - failed and the Panic of 1907 deepened, making it clear that institutions were needed to manage these sorts of financial crises. Enter the Federal Reserve, born as a result of the Federal Reserve Act of 1913.[7] We may see new institutions appear as a result of the current pandemic.

Sputnik

In 1957, the Soviet Union shocked the US by beating our nation into space with the launch of the Sputnik Satellite. Alan Waterman, the first director of the National Science Foundation, called Sputnik a "Scientific Pearl Harbor" and immediately issued a report to President Eisenhower tying the well-being of the nation to its leadership in science and research. Eisenhower responded positively and led a transformation in the role of the federal government in science and education, increasing financial expenditures and the scope of resources devoted to these ends.[8]

Eisenhower's policies ushered in an era of unprecedented federal investment in research and development, which drove a scientific and technological revolution in the US. In the years immediately following Eisenhower's new R&D agenda, federal investment in this area rose to 2.5% of GDP by the mid 1960s (it previously hovered around 0.5%). However, since the 1990s the federal investment in research has retreated, while China has increased its efforts to be on the forefront. From 2011 to 2016, China increased government investment in R&D by over 60%, while our federal government cut its investment by over 10%.[9]

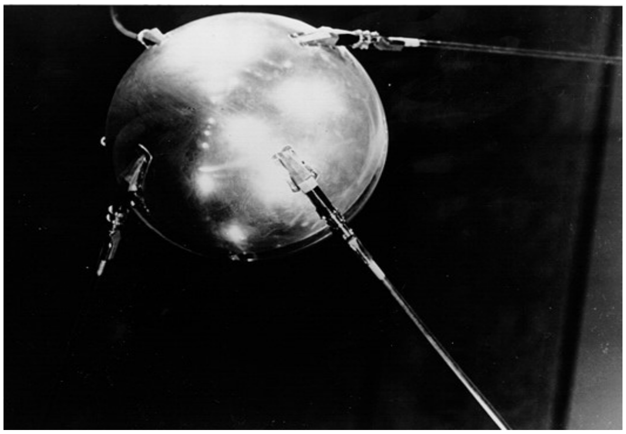
Government R&D as a Share of GDP by Type



Source: National Science Foundation, National Patterns of R&D Resources, 2019[10]

In the US, private industry has replaced the fall-off in federal investment. However, the private sector is driven by a different motive in its priorities for research and development.

As a result, it has not filled the void left by the federal government in the funding for pure science that strengthens and enhances national security and the ability to respond effectively to a pandemic. If past is prologue, the nation's response to COVID-19, like Sputnik, should unleash another renaissance in federal investment in research and development.[11] This could support the longer-term outperformance and competitive advantages of major US research universities, technology, pharmaceutical and biotechnology companies.



Sputnik, 1957

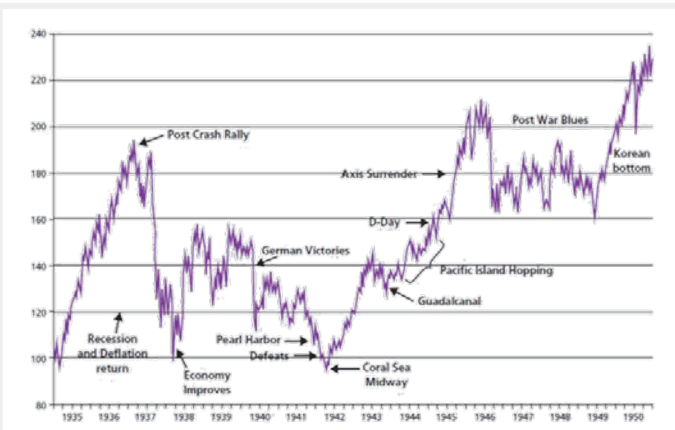
Not only did Sputnik lead to a massive federal intervention and investment in science, including the creation of NASA in 1958,[12] but it also led to more federal involvement in education. The government wanted to ensure that America did not fall behind the Soviets in the production of missiles, satellites, and, most importantly, scientists. The creation of the National Defense Education Act in 1958 is another example of legislation resulting from a crisis that shaped American history. The bill provided funds for scholarship and aid to students pursuing an education in science and technology and provided funds to help schools build new teaching facilities and support for media to play a role in education as well.[13] If the federal government follows the precedent it set after Sputnik, then we can expect more funding on education and technology to equip younger generations to excel outside of the traditional classroom environment. This could support a revolution in how we deliver K-12 education in US public schools.

What does a post COVID-19 America look like and how does the federal response impact the markets?

There is still much uncertainty regarding what America will look like in the next eighteen months. If history is a guide, the only thing that is certain is there will be changes in the American way of life driven largely by the federal response. This has the potential to significantly impact markets and the future of asset allocation.

After the surprise attack on Pearl Harbor in December 1941, stocks fell sharply. They bottomed in April 1942 and then began a rally that continued, albeit with periodic corrections, for the remainder of the war. The turning point for markets coincided with three important events of the war: the Doolittle Raid; the Battle of the Coral Sea; and The Battle of Midway. These battles, which took place during April and May of 1942, demonstrated the US's ability to win and sparked hope that the US would lead its allies to victory. Markets responded favorably.

Dow Jones Industrial Average, 1935-1950



Source: Wealth, War and Wisdom, Barton Biggs, Wiley Inc., 2008

The US is now fighting a different battle against COVID-19. We can expect markets to react when we begin to show success. Clear signs of success will be when large scale testing is widely available, vaccines or treatments are discovered and the death curve nationwide begins to flatten. As these victories manifest, we will likely experience a continued and sustained rally driven by massive government spending.

Supply Chain Management Could Become a National Security Issue and Reinforce the Trend Away from Globalization

The pandemic has exposed weakness in US supply chains, highlighting the importance of our supply chain management and national security. We should expect these likely conclusions:

- Acceleration of Trump Administration's Tariff Wars. From a national security perspective, supply chain management may mean a further move away from globalization.
- Efforts to ease the nation's dependence on foreign sources for pharmaceuticals. In January of 2020 about 80% of pharmaceuticals purchased in the US were manufactured in China and, in many cases, they were the only supplier of life saving drugs. China is also a major supplier and manufacturer of medical equipment (data reported as of February 2020).[14]
- Increased focus on the risk of outsourcing manufacturing. Over 40% of Global Fortune 500 firms had a supply source in Wuhan, China (as of April 2020). Research by Deloitte found many firms were unaware of how vulnerable their supply chain was to global shocks. These firms may rethink their supply chain and seek greater supply chain visibility to understand not only their Tier 1 suppliers (direct) but their Tier 2 suppliers (secondary).[15]
- Possible changes in inventory management. We may have witnessed the end of "just in time" supply management. After COVID-19, businesses will likely want to maintain a cushion in their inventories.
- Shifts in procurement policies There will likely be less emphasis on cost savings and more on suppliers' dependability. Companies will need assistance to better track their supply chains and sources of disruptions.[16]
- Rapidly rising risks to the global food supply chain. Factories are closing, shipping facilities are disrupted, and, in certain cases, food is being destroyed because of transportation disruptions.[17]

Risk markets appear to have succeeded in making a bottom for the time being. Given all the uncertainties about the future, it is unclear that it will be sustained. Market bottoms are often retested after a major sell-off; this has yet to occur.

While a strong case can be made for stocks longer-term, the outlook for the bond market is more uncertain. We should expect the Fed's intervention in bond markets to remain at elevated levels and to even expand. As previously discussed, the Fed's intervention in the bond market during World War II established an interest rate ceiling that stayed in place for nearly 10 years. This was enforced to make it more affordable for the government to borrow money to fund the war effort.

If this historical example proves informative, the Fed could react in the same way and keep interest rates low. In this scenario, fixed income markets are not likely to generate the income needed by savers and retirees to sustain their lifestyles or meet their financial objectives. This may impact asset allocation and financial planning.

As a result, we believe investors will need to focus on fixed income proxies in the alternative private markets as well as traditional substitutes like preferred stocks and high dividend stocks. Furthermore, if the Fed were to impose an interest rate ceiling, investors will likely have to consider alternative forms of risk-off diversification. The role of fixed income in an asset allocation framework and as a diversifier will likely become more limited.

END NOTES

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