AKE Update

COVID 19 – Long term opportunities

Key Points

The COVID-19 pandemic has shocked the global economy. Economic activity ground to a halt, and global supply chains have been battered. It is highly likely that the contraction in economic activity worldwide in Q2 2020 will be the steepest in recorded history. When the pandemic is controlled economic activity will likely slowly normalise, although even in the longer term the structure of the economy will have changed.

Globalisation and the correlated dependence on international supply chains has increased efficiency over the last half century– that is, reduced the costs of production– but has created vulnerabilities. Production of vital commodities can be frustrated by issues in an individual geographic area. Furthermore, national policy responses have threatened the integrity of supply chains.

COVID-19 will result in an expanded role of states in the developed world as a provider and financer of economic activity. State intervention will involve a combination of direct provision (through the ownership of industry), state financing of vital domestic production, enhanced reserve stores, direct purchases by the state of domestic production, and increased protectionism (tariffs and voluntary export restrictions) to ensure the competitiveness of domestic production.

State involvement will grow beyond industries that are deemed vital to prevent another massive pandemic. The expansion will likely be a product of industrial lobbying, increased tolerance for state aid, and greater latitude in international trade treaties towards protecting strategic sectors.

Governments are likely to focus on building capacity in:

1. Pharmaceuticals
2. Medical products, including ventilators, and protective equipment
3. Agricultural products
4. Steel and basic materials in the production process
5. Semiconductors, and vital technological components

There will also be changes in the private sector. An important shift will be reduced private sector demand for central commercial real estate, as employees are moved from central areas and dispersed (either to new offices, or to work remotely).

Companies that entered the crisis with capital buffers and remain stable have the opportunity to acquire undervalued assets – including corporate equity, debt, and real estate. Large corporations too will likely benefit from low borrowing costs. A consequence is that the economy will become more concentrated, with fewer small and medium enterprises, and larger de facto conglomerates operating.

COVID-19 will cause a shift in consumer behaviour, although the changes will not be dramatic. Consumers will re-evaluate their priorities and will adapt to different models of service delivery.

About us

AKE has over 20 years of experience working with the financial sector, providing clients with political and economic risk consultancy. Our experienced team provides tailored analysis and strategic forecasting, allowing our clients to better assess risks in challenging environments.

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Overview

The COVID-19 pandemic has shocked the global economy. Economic activity ground to a halt, and global supply chains have been battered. It is highly likely that the contraction in economic activity worldwide in Q2 2020 will be the steepest in recorded history. When the pandemic is controlled activity will likely slowly normalise, although even in the longer term the structure of the economy will have changed.

The largest shift will be the expanded role of developed world (broadly understood as those countries that are members of the Organisation for Economic Cooperation and Development (OECD) governments as a provider and financer of economic activity. The COVID-19 pandemic has highlighted a problem with the global economic structure. While globalisation and the correlated dependence on international supply chains has increased efficiency – that is, reduced the costs of production– it has created vulnerabilities. Production of vital commodities can be frustrated by issues in an individual geographic area. Furthermore, national policy responses have threatened the integrity of supply chains. There are shortages of personal productive equipment (PPE), including gloves, masks, protective clothing and medical devices. Food products are also subject to shortage – although thus far in the developed world there has yet to be serious limits in supply. The private sector is unlikely to fix these vulnerabilities without a manipulation of incentives on behalf of governments.

There will nonetheless be fundamental changes in the functioning of the private sector. Corporate 'risk-awareness' has increased. With corporate profits likely to be depressed for several years, and debt growing, there will be a tension between cost reduction and the need to improve the resilience of their production processes. Consumer demand will also shift, although the changes on the consumer side are unlikely to be dramatic.

Supply chains and COVID-19

A globalised production chain is fragile as they can be disrupted by events in even one country, thus importantly the provision of even medical equipment and food can be threatened by epidemics. In some cases, production of components stops. In other cases, the political decisions of states to protect their own supplies and restrict exports creates a lack of supply. These factors create an imperative to strengthen domestic production of vital goods – including agricultural products, pharmaceuticals, medical equipment, and basic industrial commodities. To reduce the risk of disruption, production of important goods and services needs to be diversified and, in some cases, domesticated.

Left to their own devices, private corporate action may lead to a partial diversification of supply chains (see below). However, private companies are unlikely to significantly re-shore production – that is move production back from overseas – in developed countries. This is because the cost of doing so is high, and consumers are unlikely to pay a large premium to purchase domestic made products. Demand in normal periods will also rarely justify the need for onshore supply.

Thus, the development of vital domestic industry will require state intervention. That intervention will involve a combination of direct state provision (through the ownership of industry), state financing of vital domestic production, enhanced reserve stores, direct purchases by the state of domestic production, and increased protectionism (tariffs and voluntary export restrictions) to ensure the competitiveness of domestic production.

AKE is highly confident state involvement will grow beyond industries that are deemed vital to prevent another massive pandemic. The expansion will likely be a product of industrial lobbying, increased tolerance for state aid, and greater latitude in international trade treaties towards protecting strategic sectors. For instance, the United States will likely expand the number of industries protected through Section 232 tariffs for products where domestic production is justified by 'national security' concerns. Furthermore, the futures of several sectors and companies are threatened by COVID-19 – including aviation, tourism, and auto-manufacturing. In some cases, the risk to employment will be used as a justification for the state to either support otherwise unprofitable companies directly or provide indirect benefits to facilitate their continued existence.

These trends are not new. Before COVID-19 there was a notable increase in protectionism and state subsidies to protect employment. However, these trends will rapidly accelerate. The shape of support to industry will alter and cover an expanding set of industries.

Production vulnerability - Private behavior has created largely efficient supply chains. However, these supply chains are potentially vulnerable to disruptions in particular geographies. The unplanned temporary closure of factories in one country can thus have a knock-on effect on the rest of the world. The initial lockdown over COVID-19 in China disrupted supply chains in the automotive sector and electronics most notably.

Both China and India, for example, are vital in the production of generic pharmaceutical products. While China only accounts for 13 per cent of active pharmaceutical ingredient (API) makers supplying the US market, it accounts for many of the APIs required for widely-used medicines, including antibiotics, ibuprofen, acetaminophen and heparin.

The global spread of COVID-19 thus disrupted supply chains in multiple countries. However, the more general lesson drawn is that overreliance of some sectors on a small number of geographies increases the vulnerability of supply chains.

Export restrictions - A response of states is to restrict non-domestic sale of vital commodities for export, primarily for both medical and agricultural products. Even in the European Union there have been unilateral export restrictions of personal protection equipment visa-a-vis both EU member states and third countries, although these have since been relaxed. The US also announced a temporary ban on the export on five types of PPE, as well as medical devices – including respirators.

Broadly the restrictions fall into three categories:

1. Export bans – the prohibition of exports for certain categories of products for a set period;
2. Bans on new contracts – allowing previously agreed exports to continue, but a ban on new contracts for exports
3. Export licensing requirements – a disruption to product trade, with some exports requiring prior approval
4. Requests for private companies to restrict sales abroad – non-mandatory requests for companies to stop exports

The products controlled can broadly be catagoried as:

1. Medical equipment – ventilators, masks, testing kits, PPE
2. Pharmaceutical products – drugs
3. Sanitisers
4. Agricultural products

A non-exhaustive list of trade restrictions in place as of 11 May 2020 is as follows:

Country	Product	Product Type	Type of restriction
Argentina	Medical equipment and medicines (including disinfectants)	Medical	Export licensing requirement
Belgium	Pharmaceutical Products	Medical	Export ban outside of the EEA
Bulgaria	Disinfectants containing ethyl alcohol	Medical	Export licensing requirement
Bulgaria	Quinine-based drugs	Medical	Export ban
Egypt	Legumes	Agriculture	Export ban
Eurasian Economic Union	Some food products	Agriculture	Export ban outside of the EEU
European Union	Personal protective equipment	Medical	Export ban
Honduras	Red beans	Agriculture	Export ban
Hungary	Hydroxychloroquine-sulphate	Medical	Export ban
India	Diagnostic kits	Medical	Export licensing requirement
India	Hydroxychloroquine	Medical	Export ban
India	Hand sanitisers	Medical	Export ban
India	Ventilators	Medical	Export ban
Indonesia	Ethyl alcohol	Medical	Export ban
Kazakhstan	Food products	Agriculture	Export quota
Myanmar	Rice	Agriculture	Export ban
Norway	Personal protective equipment	Medical	Export licensing requirement
Norway	Pneumococcal vaccines	Medical	Export ban
Poland	Respirators and cardio monitors	Medical	Export ban
Russian Federation	Grain	Agriculture	Export quota
Serbia	Staple foods	Agriculture	Export ban
Serbia	Personal protective medical gear and hygienic products	Medical	Export ban
South Africa	Hand sanitisers, medicines	Medical	Export licensing requirement
Switzerland	Personal protective equipment	Medical	Export licensing requirement
Thailand	Bird eggs	Medical	Export ban
Turkey	Lemons	Agriculture	Export licensing requirement
Ukraine	Ethyl alcohol	Medical	Export ban
United Kingdom	52 different medicines	Medical	Export quota
United States	Personal protective equipment	Medical	Export ban
United States	Respirators	Medical	Request for prohibition on exports
Vietnam	Rice	Agriculture	New export contract ban (lifted)

Logistics - COVID-19 has disrupted logistics infrastructure. In particular, shipping - the lifeblood of global trade - is disrupted. COVID-19 mitigation measures have led to reduced manpower at ports, fewer international carriers sailing, and created increased difficulties

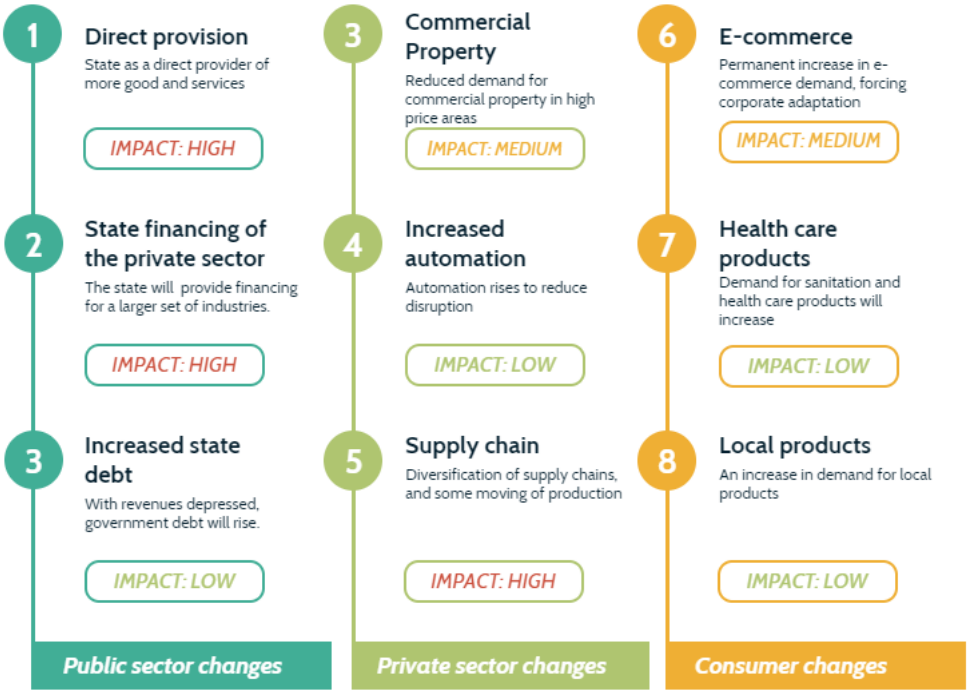
for ships docking, loading and disembarking. There are also labour shortages on ships, with the lack of air travel making the changeover of crew members difficult.

As of the week of 6 April there was a 41 per cent decline compared to normal conditions in container vessel calls, and a 41 per cent decrease in movement in other cargo vessels. Part of this fall is due to weak demand. However, 49 per cent of nations have extra restrictions of vessels for containers, and 47 per cent have increased restrictions on other cargo vessels. Delays due to extra procedures was up 42 per cent for container ships, and 35 per cent for other vessels. Transport from ports inland also faced significant delays.

Air freight has also faced significant disruption. In normal times around 40 per cent of all air freight is transported on passenger aircrafts, but COVID-19 has grounded many of the world's passenger aircrafts - with only around 20 per cent of global widebody capacity currently in the air. Dedicated freight flights are also disrupted by the potential of quarantine for crew.

Potential opportunities

COVID-19 has underscored the problems with existing supply chains, including for vital products. States are likely to respond by creating and incentivising the creation of redundancies in the production of key supplies. A private sector response is unlikely to create sufficient backup supply, as in normal periods demand will be too limited to justify production.



Nonetheless the private sector will be central in the development of domestic supplies. The vast majority of states do not have the inclination, or administrative capacity to develop and run industry themselves. The state's primary role will instead be to finance the domestic developments, as well as procure products as required.

Governments are likely to focus on building capacity in three areas:

1. Pharmaceuticals
2. Medical products, including ventilators, and protective equipment
3. Agricultural products

The next crisis is unlikely to be exactly like the COVID-19 pandemic, and as a result AKE expects that states will also look beyond these sectors. There will also be increased awareness of the importance of producing of other vital products domestically or from a small range of domestic partners. In particular, it is likely that as a result of political incentive and lobbying there will be an expanded set of sectors that will benefit from support. These likely include:

1. Steel and basic materials in the production process

2. Semiconductors, and vital technological components

Building capacity will involve both push and pull factors, with the exact mix depending on the country, its politics, and the sector involved:

1. Direct state provision – potentially including through nationalisations, supported by state guarantees of financing for new state-owned companies.
2. Public-private partnerships, with the state maintaining an equity share. The state could provide grants, subsidies, and guarantees for part of the funding.
3. Financial support through grants, subsidies, and tax incentives to the private sector to engage private companies to build domestic capacity.
4. State guarantee purchases of a proportion of a private companies' output
5. Tariffs on importing some products from abroad
6. Tax penalties on companies that offshore parts of their work

These changes will lead to the expansion of several sectors in the OECD:

Pharmaceutical – The only broadly-agreed way to truly end the threat of the COVID-19 crisis will be the development of a vaccine. However, the crisis raises fundamental questions about current medical spending levels as well as, and arguably more importantly, funding structures. Support is likely to rise significantly for governments taking on the risk of funding pharmaceutical development and preventative medication programmes, as well as for intermediating such risk across other economic actors.

Manufacturing – The initial focus of states will be to increase domestic production of vital medical supplies. To do so will require the support of a domestic manufacturing base, and/or the outsourcing to a handful of trusted partners. Tax incentives and potential re-shoring subsidiaries are among measures being considered to spur changes for private companies.

Extensive lobbying on the part of industries, including steel, high-value manufacturers, and others will push for increased protection. Countries are also likely to be more active in using national security tariffs, permissible under World Trade Organization (WTO) rules, to spur the development of domestic industry.

While the overall effect globally will be inefficient, state protection and support should help the expansion of manufacturing in major economies.

Urban Agriculture – increasing agricultural capacity is a challenge, particularly in dense environments. A partial solution is the growth of urban agriculture, which would allow food to be grown close to the point of use. Urban agriculture requires the transformation of existing land into 'farm' land close to major metropolitan areas.

There are two main options. The first is the development of large greenhouses just outside of urban areas. The second is vertical developments in urban areas. The lack of space implies that the most efficient systems will require the growing of crops in vertically stacked layers. Currently the technology for vertical farming is expensive, as heating and growing requires electricity rather than natural light. It is increasingly likely that governments will support the development of vertical farms on the outskirts of dense urban environments along with larger greenhouse developments. Neither are likely to be commercially viable currently, although even without space they could benefit likely through the subsidisation of lightweight crop beds that can be stacked, efficient LED lights and hydroponics and aeroponics.

Government debt - An expansion of the role of the state in the economy will need to be financed. Financing the expansion could create difficulties given that all states have massively increased spending as part of their response to relieve the pain of the COVID-19 disruption on the population. The United States, for instance, introduced US$2.2tn of new spending, and the deficit for the year will be close to US$4tn. Germany introduced a EUR156bln supplemental budget, as well as offering guaranteed loans worth at least EUR757bln. Italy increased spending by EUR25bln and allowed for state guarantees worth up to EUR750bln. Overall the size of stimulus packages to mitigate the impact of COVID-19 is over 10 per cent of global GDP.

It is unlikely that the majority of states have the capacity to increase taxes in the medium term to make up the shortfall. Nor will developed countries be able to rely on high growth to reduce the real cost of covering their spending.

Funding the expansion will thus have to be debt-financed. For the majority of developed states this is unlikely to create immediate issues. Central Bank bond buying has depressed interest rates, which implies that the cost of servicing debt will remain low. There is likely to be some direct debt monetisation from central banks in the US and UK to reduce the deficit in the medium term.

Private sector action

COVID-19 will nonetheless impact private sector behaviour. Once restrictions are loosened there is unlikely to be a paradigm shift in corporate behaviour, although existing trends are likely to be amplified. There will be a tension in private sector responses. Increasing the resilience of their supply chains is vital to prevent a future disruption. However, such changes are unlikely to be cost-efficient in the short term. COVID-19 has also decreased profits (increased losses) for the vast majority of private sector firms. Debt has risen, and in that context, they will look to reduce their cost base.

Automation and supply chains – There will be an increased focus on automating more of the production process. COVID-19 has made companies risk-aware, and automation reduces the risks of pandemics disrupting production, disease transmission, and the requirement for face-to-face interaction. Importantly, automation also reduces the cost disadvantage in locating production in high-wage countries.

The trend to increase automation was already evident but will likely supercharged in the coming months or years. Paradoxically, government support for domestic production could accelerate automation at the cost of reducing potential employment.

Warehouses and delivery systems – COVID-19 initially created problems for companies that relied on just-in-time delivery. While efficient, the lack of inventory buffers risked the resilience of production. It is likely that companies will build up buffers over the medium term and increase the number of potential suppliers available.

Workspaces - COVID-19 has created a 'work-from-home' environment and forced adoption of new tools. Video calling and conferencing has become increasingly popular, and companies are starting to adapt to environments where employees are not in physically proximate to each other.

There are three immediate implications. Firstly, there is likely to be increased investment in remote work systems, software platforms, and cloud-based services. These sectors will all see significant gains once recovery starts.

Secondly, and perhaps more importantly, companies are likely to reduce their requirements for large central office space. Larger parts of the workforce will be moved from areas where real estate is expensive to either work from secondary (and more cost efficient) offices, or work from home. The net result will likely be a sizable medium-term reduction in central commercial real estate prices, and thus commercial products.

Third, companies are likely to reduce business travel – which will reduce demand for full-priced flights and hotel rooms.

Corporate social responsibility – Almost every company will directly or indirectly have benefited from state support during the COVID-19 pandemic. It is likely that there will be increased pressure on companies to show that that they have a positive social function from the public, and potentially from states.

For the majority of companies, the change will be superficial, and involve small changes (deferred dividends, reduced stock buybacks) in the short term, and the certification of their offering as environmentally or socially responsible.

Concentration – COVID-19 has led to increased corporate failure rates. The majority of companies that survive will be financially weaker. Companies that entered the crisis with capital buffers and remain stable have the opportunity to acquire undervalued assets – including corporate equity, debt, and real estate. Large corporations too will likely benefit from low borrowing costs. A consequence is that the economy will become more concentrated, with fewer small and medium enterprises, and larger de facto conglomerates operating.

Consumer demand

COVID-19 will cause a shift in consumer behaviour, although the changes will not be dramatic. Consumers will re-evaluate their priorities and will adapt to different models of service delivery. Consumer tastes will also partially adapt.

Increased e-commerce - There has been a rapid rise in e-commerce during the COVID-19 pandemic. The shift in consumer behaviour is likely to be semi-permanent, with an increased number of purchases being done online. Consumers have become more accustom to purchasing products online for home use and are thus likely to continue to do so.

The shift towards e-commerce is not limited to the provision of goods. There is increased demand from consumers to purchase other products, including entertainment, educational services, and online fitness classes from the home. Companies that have previously specialised in providing in-person services will need to develop their delivery systems, both through partnerships with existing e-commerce platforms and a change in the products they sell. A likely secondary effect will be increased demand for products that improve the experience of remaining at home.

Local purchases – there will a small shift towards purchasing local rather than global. The shift is unlikely to be large or long term, although some smaller businesses which have been able to remain functional could benefit from this shift.

Health awareness – COVID-19 will make consumers, producers, and financial markets increasingly aware of health risks, and reflections of such risk may push up the prices of several goods. Average long-term baseline demand for pharmaceuticals, supplements, medical devices, personal protective equipment (PPE) will rise. There will also be an acceleration in the shift towards telemedicine, online consultations, digital medical assistants, apps and mini-apps, self-diagnosing medical devices. Sanitisation products will also become more popular.

Domestic tourism – the global tourism industry has been badly hit by COVID-19, with major transport hubs seen as risks for spreading the pandemic, and airline capacity cuts likely continuing into the medium term. Consumers are likely to reduce international travel, particularly for low cost holidays – a trend compounded by an increased number of bankruptcies for low cost carriers. The reduction in international travel will likely be correlated with an increase in domestic tourism, which creates medium term opportunities to develop the low/mid cost domestic tourism market.

Increased acceptance of a privacy limitations - COVID-19 has resulted in citizens increasingly willing to share data when it is done so for 'social good', such as contact tracing. The willingness to share data is unlikely to extend entirely into the corporate sector, but it could reduce the backlash to the collection and sale of information by companies. New companies have the opportunity to develop products that use data but can claim to have such 'social good' in its aggregation. There is likely to be a correlated niche market for companies that can ensure high levels of privacy (or anonymity).