Investing for Roubini's Greater Depression

By Adrian Saville

8 Jun 2020

In September 2006, economics professor Nouriel Roubini warned an incredulous audience of fellow economists at the International Monetary Fund (IMF) that the US housing market was at risk of collapsing - an event that could ruin the global financial system. This was at a time when the global economy had recorded its fastest patch of growth in 30 years and, in the space of a decade, US house prices had doubled, making for the sturdiest gain in house prices in the post-war era.

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Unfortunately, Roubini was right. Soon after his address, the global financial crisis (GFC) struck, and the little-known scholar of emerging markets quickly became the Wall Street celebrity "Dr Doom".

The lessons learned from the GFC encouraged policymakers worldwide to work furiously to get economies back into shape through a series of fierce and coordinated policy responses to the impacts of Covid-19. In turn, this has encouraged a consensus view amongst economists that the recovery from the crisis will be V-shaped. Wall Street agrees, with the S&P500 and Nasdaq having rebounded sharply since March's meltdown. In fact, it seems that markets anticipate that the bold responses from the world's leading policymakers will produce an equally fierce rebound in economies and earnings.

Groundhog Day

Yet, as if trapped in the tragicomedy of Groundhog Day, Dr Doom again disagrees with this consensus, and suggests the economic trajectory is likely to be L-shaped. Admittedly, Roubini expects an economic rebound in the pandemic's immediate aftermath, but insists that this recovery will quickly collapse beneath the weight of the global economy's accumulated debts, giving rise to the prospect of an economic depression.

It’s tempting to dismiss Roubini as having been “spectacularly right” the first time because he was banging on the disaster drum for many years before the GFC struck. But there is more than enough evidence in the post-pandemic makeup to suggest that we should be paying close attention to a depression scenario.

Markers for concern include a collapse in vehicle sales; the imposition of trade barriers to protect domestic markets; falling commodity prices; a wave of consumer debt thanks to easy money; a dive in the federal funds rate; a surge in unemployment; sharp market swings; deepening fiscal deficits; and the risk of a deflationary price spiral.

The risk is that Roubini is right

This list bears eerie similarity to the features that characterised the Great Depression of the 1930s. So, in deliberating on Roubini’s diagnosis and the implications for policymakers and investors, the risk is not that he is wrong, but that he is right.

We ignore this risk at our peril. In depression scenarios, conventional economic policy stops working, and markets behave differently. For example, in terms of policy, economists Lawrence Summers and J Bradford DeLong have shown the importance of fiscal expansion – rather than fiscal prudence – in depressions.

Depressions also offer a good reason to seek and maintain some price inflation. Nominal interest rates of zero can’t be lowered much further. But the real rate of interest – the nominal interest rate minus expected inflation – can be taken far below zero by policies that push inflation rates higher.

Positioning portfolios for a depression scenario, then, means preparing for a world of higher rates of price inflation, government spending stimuli, nominal interest rates of zero, and negative real interest rates.

Diversify, diversify, diversify …

In this world, the first three rules of investing must be enforced with the strictest discipline: diversify, diversify, diversify. Portfolio diversification is a free lunch available to every investor, and the surest form of risk management.

We don’t know how or when the pandemic period will end – and we can’t be sure that Roubini is right. But diversifying your portfolio across asset classes, geographies, currencies and industries has a surer prospect of getting you to your investment destination than investment decisions that, in the absence of diversification, could be perfectly right or exactly wrong. This means gold and growth assets, not gold or growth assets; it means China and the US, not China or the US; and it means healthcare and resource stocks, not healthcare or resource stocks.

… and look for transformative assets

Additionally, investors should consider investing in transformative assets. If Roubini is right, it’s likely that even in an environment of hardship and misery, investments that are inclusive, co-operative, and collaborative will thrive. Covid-19 bonds could be one such asset, where issuers include the African Development Bank, or even the Bank of America, which has come to market with a $1bn four-year Covid-19 bond to fund lending to hospitals, nursing facilities and healthcare manufacturers.

Then there are transformative businesses that will do better in hard times by doing good business, taking the place of current portfolios winners. In March, Kenyan telecom operator Safaricom made all person-to-person transactions under 1,000 Kenyan shillings free on the mobile money service M-Pesa. Near term, this put one-quarter of Safaricom’s revenue at risk, but long term is likely to entrench the business’s position in the payments market. Likewise, British restaurant chain Leon has reinvented itself by converting 57 sites into shops selling groceries and takeaway meals, saving 1,500 jobs and looking after 70 suppliers.

In other words, depression times do not spell the end for businesses or investors. Rather, as Joseph Schumpeter implores, our task is to create out of the destruction, by redesigning, reinforcing and reinventing.

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