Catapult Insights | Global Macro Perspective

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GDP – Possible massive negative surprise: We could end up down 30% of the year easily

Why and for whom?

For those entrepreneurs and businesses that are interested and/or impacted by changes in the global/macro environment, I am going to try to give a monthly summary of my personal perspectives on current situation/events. Although it is not my specialty, I do have a personal interest in this subject matter and have noticed that we at Catapult enjoy discussing these matters amongst ourselves greatly. I believe that having a Marco perspective/framework is a necessary precondition to making sound investment and business decisions. Hence, we would like to share with you in these newsletters the fruits of my deliberations and our internal discussions, for what they are worth.

Having called the overleveraged, overbought and overvalued nature of markets and global supply chains in late 2019, and seen COVID as possible catalyst for (overdue) correction early in 2020, I was surprised that the equity market correction stopped at minus 35% at the level at which I was only just starting to get interested in getting back into the stock market (which I did not).

I have spent the past month in disbelief looking at equity market rebound to the extent of feeling some doubt, as to my judgement and a healthy dose of FOMO (Fear Of Missing Out) creeping in. Thus the need to double down on research of different perspectives and facts to determine whether I needed to change my bearish short to medium term outlook.

Let's start with a Macro Perspective

- Even though the Corona crisis is far from over, the range of possible outcomes is slowly starting to narrow and thus the consensus on impact thereof should start to emerge over the coming months
- "Re-opening" has commenced in China and will commence in Europe and US shortly. Although nobody knows how economies will re-engage any concept of V- or U-shaped recovery - whereby we end up where we started two months ago in short order - is now discounted by most given unprecedented unemployment data, the collective mind-shift as a consequence of the COVID shock and corresponding deleveraging and restructuring required in the private and corporate sector
- The US showed the sharpest and clearest employment impact of COVID - given US labor-market structure. Although the rate of increase of US unemployment data is starting to slow already, we are currently around 20% and peak will be around 25-30% by May/June. These are unprecedented numbers by any measure
- Q1 GDP numbers for the US, EU and the rest of the world where a massive negative surprise with QoQ declines of between 4-6% for Q1 which means that Q2 could be down 15-20% and we could end up down 30% of the year easily. Forget the 90% economy, try 70%!
- The percentage of unemployed that will be able to go back to work upon re-opening and the GDP that can be recovered reasonably quickly, is pegged by most at around of one-third and/or less than half, suffice to say that most realize life after the shutdown will be substantially different
- In Europe many countries have dampened lay-offs with temporary part-time work subsidies but when these end, necessary restructuring will result in substantial unemployment impact

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Necessary deleveraging and restructuring in the global economy is likely to result in significant deflation

- Global supply chains have been disrupted and labor-market impact in emerging markets - although less well documented - is even more grave than in developed countries. The global labor market is thus likely to be in oversupply for some time to come
- Corporates and supply chains globally will face utilization and margin pressures which combined with inventory cycle and deleveraging will result in deflationary pressure and the need to ultimately restructure to face the new reality. No amount of money printing and/or stimulus by the FED or the ECB will be able to change that
- What the stimulus has done is solved the very real liquidity issues in the capital market and allowed all those caught "off-guard" by COVID to refinance/term-out financing with record issuance in the past month. But one must not be mistaken in thinking that it has "solved" the fundamental problems: The central banks' liquidity knife cannot win the solvency gunfight of an over-levered corporate universe in contractionary global environment!
- The good news is: we don't have to worry about inflation in the short term, but the less well understood consequence is that the necessary deleveraging and restructuring in the global economy is likely to result in significant deflation of financial assets - i.e. what has started in the oil market, will spread to real estate, equity markets, other commodities and other financial assets; these markets should correct in order to accommodate demand/supply rebalancing before we can start sustainable ascent again (re-flation)

So, what does that mean for Markets?

- Given US/FED pro-activeness in responses versus EU/ECB more complicated debate and decision making, I expect US Dollar to outperform the Euro in the short/medium term. The FED SWAP "lifelines"[1)] have alleviated the pressures temporarily, but downward pressure on Euro will emerge upon re-opening of economy/trade
- EU is in a precarious position whereby it must choose to "support" those that have historically not shown the greatest fiscal and other discipline in order to remain a player of relevance in what can only be described as a global currency war to stay competitive. I can see the argument for doing so, but given the complexity and the actors on the stage I have limited faith in the ability to execute expediently, and therefore see large risks to European Banking sector and indeed the Euro in that regard
- Emerging Markets - especially those with large dollar denominated debt and/or commodity-based economies - will likely struggle in the short term. Those that have not been thrown SWAP lifelines by the FED will be extra vulnerable
- Equity markets in my mind must correct. I expect that to materialize as the COVID impact becomes clearer over the coming months. The next leg down will likely be more gradual as the central bank provided liquidity, which gives all parties the ability to gradually reposition and separate the wheat from the chaff in the investment universe
- Expect fixed income rates/curve to decrease/flatten and to stay close to zero bound for the near term, with risk of real rates staying negative

[1)] The dollar liquidity swap lines are designed to help maintain the flow of credit to US households and businesses by reducing risks to US financial markets caused by financial stresses abroad. They improve liquidity conditions in US and foreign financial markets by providing foreign central banks with the capacity to deliver US Dollar funding to institutions in their jurisdictions during times of market stress. By helping to stabilize foreign dollar markets, these swap lines also play a role in supporting foreign economic conditions, which also positively benefit the US economy through many channels, including confidence and trade. (source: FED – www.federalreserve.gov)

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THE 'PURGE' OF NON-VIABLE COMPANIES AND BUSINESS PRACTICES WILL TAKE A LOT LONGER THAN PEOPLE THINK / HOPE

Hence, what does that mean for SME's?

- Central bank and other governmental support measures are stop gaps to dampen the blow from Corona, but many seem to be misreading them as "solutions" and waiting/hoping that things will go back to "normal"
- I think this is a mistake much like the proverbial frog that does not jump out of the pot of water that is slowly being brought to a boil
- As turnaround professionals, we know that an ounce of prevention is better than a ton of cure. Entrepreneurs should prepare proactively for a future less dependent on leverage and with higher required resilience (lower costs, higher capital adequacy and more inventory and working capital) and in time also with higher margins as the weaker players are slowly forced out and the economy re-flates
- This "purge" of non-viable companies and business practices will take a lot longer than people think/hope, and thus people should prepare for a longer period of economic weakness/low growth during which only the fittest will survive. Cash conservation and buying time will be key to survival
- In a way the virus is not causing change but merely acting as a catalyst for and/or accelerating trends/transitions that where already predestined to materialize

Other points of interest, risks and asset allocation perspectives

- Escalation of tensions between China and US over the origin of the virus and/or the US Dollar's global reserve currency status and the divide that is currently being created by those that do and don't have access to US FED SWAP lines is something that keeps me awake at night
- Facebook launch of Libra digital currency this week - which can only be bought with Bitcoin or Ether and is equal in value to 1 USD - is interesting in this regard
- Equity markets remain uninvestable for retail investors with volatility (VIX) still north of 30 points and valuations even more ludicrous than before the COVID crisis
- My current asset allocation is 1/3 USD cash, 1/3 USD treasuries, 1/3 Gold and a bitcoin for every family member, just in case

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About Catapult

Catapult is a professional services firm that delivers Corporate Finance, Business Improvement and Turnaround & Restructuring services to business leaders facing exceptional challenges and opportunities. The firm is known for its entrepreneurial heritage, hands-on approach and relentless focus on execution and results.

Corporate Finance

Specialist guidance in acquisitions, sales and financing: because each transaction is unique.

Business Improvement

Practical advice and measurable improvements to your business operations leading to increased scope and value.

Turnaround & Restructuring

Hands-on support when times are hard: for when conventional solutions do not work and specific expertise is needed.

Catapult Services B.V.
Van Twickelostraat 13
7411 SC Deventer
The Netherlands

+31 (0) 570 572 250
www.catapulting.com

Chiel Ruiter

+31 (0) 6 57 88 49 20
chiel.ruiter@catapulting.com

Chiel Ruiter graduated from the University of Twente as a Master of Science in Mechanical Engineering. He started his career as a nuclear engineer at Stork where he worked on projects in The Netherlands and Germany. After he obtained an MBA from INSEAD, Chiel joined Goldman Sachs to work in London, South Africa and the Middle East.

Multidisciplinary

In 2009 he moved back to the Netherlands to head consecutively Credit Suisse's, BNP's and UBS' respective local investment banking businesses. He left banking to pursue a career as turnaround specialist, which started with a SME buy-out/turnaround. Since then he has been involved in a range of turnaround situations with Catapult.

Director in critical situations

Chiel is a seasoned professional with over twenty years of international experience in assisting corporates and their stakeholders as an adviser and in later years as interim manager. He combines his experience in finance with a passion for managerial, organizational, operational and commercial challenges. Chiel spends the majority of his time providing hands-on turnaround services as Chief Restructuring Officer (CRO) or Interim Director (CEO/COO).

Chiel is a member of the European Association of Certified Turnaround Professionals (EACTP).

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Van Twickelostraat 13
7411 SC Deventer
The Netherlands

+31 (0) 570 572 250
office@catapulting.com
www.catapulting.com