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Perspectives

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The Tipping Point

Part II

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- Raj Nair

ABOUT THE AUTHOR

As a strategy consultant, Raj has helped companies across diverse industries in India, USA, Europe, and the Middle East to develop strategies, align strategy to vision, grow in competitive markets, restructure to make companies more customer focused etc.

In his current role, Raj serves as - Chairman: Avalon Consulting, AGR Knowledge Services, and Germinait Solutions Pvt Ltd.

In his previous roles, Raj has worked as a Merchant Banker with Grindlays Bank and has also worked in the Consumer Durables industry. He is the immediate past President of IMC Chamber of Commerce and Industry.

Raj graduated from the Indian Institute of Technology, Bombay and the Indian Institute of Management, Ahmedabad, which are India's top engineering and business schools respectively.

2020: The Tipping Point – Part II

By **Mr. Raj Nair,** Chairman, Avalon Consulting

Things got so bad that on February 20, 2020 when COVID19 spread across Asia, Europe and the US, a senior scientist, Dr Boris Lungski from a University in Europe decided to shrink himself, and slid into the lungs of a patient to interview a COVID19 virus. This virus goes by the name, Cyrus de Virus. I bring you excerpts of this path-breaking interview with Cyrus which could help mankind understand the disease, its current plans and how it will shape the global economy in 2020.

Dr BL: *I understand that you are the first cousin of the good virus causing common cold and also the bad SARS Corona virus. Which one are you more like?*

CdV*: You are mortally scared. Why don't you ask me directly whether it is possible for the human race to deal with me or kill me to save itself? Yes, it is possible, but you will have to change your approach.*

You want to explore other planets without having enough understanding of things on your own planet. You assume things exist or don't, things are living or not living. Your scientists have already shown that Quantum particles can exist and not exist at the same time. Why is it so difficult to understand that viruses too can be living or non-living? You argue that I don't fulfil the 7 criteria that defines a living being, yet you believe that if I don't get a carrier cell, I will die in a week. Die, when was I alive according to your own knowledge?

Good like common cold virus? There is nothing good about it if it kills half a million people a year. I spread faster than SARS virus, have chosen trade routes from Wuhan to other parts of the world. You think that I don't like senior citizens. You think I kill mostly weak people with other underlying maladies. That is your perception based on available statistics. Unlike in the past, your scientists have figured out very quickly what I look like- a single DNA/RNA strand coated with protein material, etc. and an exterior having protruding receptors to help me latch on to living cells. To qualify as 'living' in your language, I need to get embedded in a living cell, make them 'bad' and then use our combined might to replicate. And your problem is that you cannot easily destroy those bad human cells to destroy me, without destroying the host person.

You will not be able to stop me on your own without understanding how to prevent me from spreading or remaining inside you without harming you. You will be hoping that I will be halted by circumstances, probably nature itself, before you learn how to. However, by then, I will inflict a lot of pain to humans and their ecosystem which you call economy, business, entertainment, etc. because of your ignorance and inability to think out of the box which you have put yourselves into.

Dr BL: *This is creating human misery by destroying families and livelihood. Already over 50,000 humans across 40 countries have been infected and in a couple of weeks that count will double. People are scared to travel, being advised not to congregate in groups, scared to go to crowded places, etc. Businesses are downing their shutters, planes are grounded, hotels are vacant, some factories are shut, etc. Don't you feel bad?*

CdV: *My tribe did cross over from an animal host to a human. But you brought the rest upon yourself. You and we have the same right to exist and procreate. We like all animal cells. Why can't you devise a way for your body to host us without your immune system destroying us and you? You bear the responsibility for the current problem, not my tribe. Now deal with it.*

Dr BL: *When will you end this onslaught on the human race?*

CdV: *Not until nature prevents us from colonising human bodies because you are at least a year away from developing a vaccine. In the meantime, I moved from China to Iran because it is the land of my famous namesake, Cyrus the Great, who conquered a large part of the Old World more than 2500 years ago. He was considered to be a virtuous and evolved human being. One day, humans too will figure out ways to use me like you have found ways to deploy Herpes virus in killing cancer tumours.*

Dr BL*: Do you realise how much harm you have caused?*

CdV: *Of course, I do realise it. I know that the world's largest business vertical, 'Tourism and Travel', is panting for breath. Tour operators, hotels, travel agencies, airlines and soon buses and trains across the world are going to suffer even more badly from now on.*

The economy across the board will suffer a slowdown. Job losses by the millions. Therefore, stock markets across the world will crash. Wealth losses by the billions of dollars.

Do you realise the folly of your profit-obsessed businessmen? They made themselves vulnerable to supply chain breakdown by putting all their eggs in China. They compromised on geographical concentration risking their entire business, in order to leverage China's low cost. Now the cost of disruption will be in hundreds of billions. Massive job losses too.

Don't blame me alone for your ills. There is more to come. You have inflicted so much harm on nature that now nature is all set to pay back in the form of global warming which will also lead to more types of microbes troubling you, besides rising sea levels, droughts, floods, water shortage, etc.

I met a worried Dr Boris Lungski two days later. After hearing him out, I rushed to Professor Inov M Smarth, the famous American economist, to get his educated views on the implications of what Cyrus de Virus said. A condensed version my 10 hour meeting with Prof. Smarth has been organised under four topics as follows:

Economic slowdown and GDP

I told him that even in January 2020, the cautiously optimistic World Economic Report 2020 of the IMF had no mention of the Covid risk. Inability of China to control the spread of Covid19 to other countries is a grave portent of things to come especially if those countries are not able to prevent onward spread to other countries. There could be a global pandemic. The bad news is that, human carriers of Covid19 survive longer, much longer than the more deadly Nipah and Ebola and can therefore, spread the disease wider. But the WHO believes that a pandemic is not likely, although in much of the OPEC and the developing world especially Africa, the preparedness to deal with pandemics is highly suspect. Though H1N1 infected 1.62 million and killed 284,500 people in 214 countries in 2009, we did not panic as much then as we do today. It is partially because the world is now more heavily dependent on China than ever before, news spreads faster in today's digitally networked world and also because of algorithmic trades that have replaced human judgement. Whilst there are various attempts to quickly model the likely scenario, there is clear consensus that there will be a serious global slow-down, but opinion is divided whether there would be a serious pandemic or not. That Covid19 will fade out is still speculation since not enough is known except that there may be similarities with SARS virus which slowed down after winter when warmer temperatures arrived.

Table 1: Projected Mortality in case of Covid19 Pandemic

Country/Region	Population (Thousands)	Mortality in First Year (Thousands)						
		S01	S02	S03	S04	S05	S06	S07
Argentina	43,418	-	-	-	50	126	226	50
Australia	23,800	-	-	-	21	53	96	21
Brazil	205,962	-	-	-	257	641	1,154	257
Canada	35,950	-	-	-	30	74	133	30
China	1,397,029	279	3,493	12,573	2,794	6,985	12,573	2,794
France	64,457	-	-	-	60	149	268	60
Germany	81,708	-	-	-	79	198	357	79
India	1,309,054	-	-	-	3,693	9,232	16,617	3,693
Indonesia	258,162	-	-	-	647	1,616	2,909	647
Italy	59,504	-	-	-	59	147	265	59
Japan	127,975	-	-	-	127	317	570	127
Mexico	125,891	-	-	-	184	460	828	184
Republic of Korea	50,594	-	-	-	61	151	272	61
Russia	143,888	-	-	-	186	465	837	186
Saudi Arabia	31,557	-	-	-	29	71	128	29
South Africa	55,291	-	-	-	75	187	337	75
Turkey	78,271	-	-	-	116	290	522	116
United Kingdom	65,397	-	-	-	64	161	290	64
United States of America	319,929	-	-	-	236	589	1,060	236
Other Asia	330,935	-	-	-	530	1,324	2,384	530
Other oil producing countries	517,452	-	-	-	774	1,936	3,485	774
Rest of Euro Zone	117,427	-	-	-	106	265	478	106
Rest of OECD	33,954	-	-	-	27	67	121	27
Rest of the World	2,505,604	-	-	-	4,986	12,464	22,435	4,986
Total	**7,983,209**	**279**	**3,493**	**12,573**	**15,188**	**37,971**	**68,347**	**15,188**

Source for Tables 1 & 2: Brookings Institute

Prof. Smarth showed me two scary tables from the Brooking's Institute Report on the likely impact of Covid19, based on the McKibbin and Wilcoxen Model (a hybrid of Dynamic Stochastic General Equilibrium (DSGE) and Computable General Equilibrium (CGE) Models which shows that barring the least impact scenario, out of the six studied by them, the global death toll in the first year will be about 3.5 million to 15.2 million. In the worst case, India and China will be at the top with 3.7 million and 2.8 million respectively due to their high population density. Generally, it would be high in emerging markets due to lack of resources and readiness to combat a pandemic (Table 1).

The impact on GDP according to them, is likely to be very significant across continents (Table 2).

Table 2: Likely deviation in % from base line GDP growth

Country/Region	S01	S02	S03	S04	S05	S06	S07
AUS	-0.3	-0.4	-0.7	-2.1	-4.6	-7.9	-2.0
BRA	-0.3	-0.3	-0.5	-2.1	-4.7	-8.0	-1.9
CHI	-0.4	-1.9	-6.0	-1.6	-3.6	-6.2	-2.2
IND	-0.2	-0.2	-0.4	-1.4	-3.1	-5.3	-1.3
EUZ	-0.2	-0.2	-0.4	-2.1	-4.8	-8.4	-1.9
FRA	-0.2	-0.3	-0.3	-2.0	-4.6	-8.0	-1.5
DEU	-0.2	-0.3	-0.5	-2.2	-5.0	-8.7	-1.7
ZAF	-0.2	-0.2	-0.4	-1.8	-4.0	-7.0	-1.5
ITA	-0.2	-0.3	-0.4	-2.1	-4.8	-8.3	-2.2
JPN	-0.3	-0.4	-0.5	-2.5	-5.7	-9.9	-2.0
GBR	-0.2	-0.2	-0.3	-1.5	-3.5	-6.0	-1.2
ROW	-0.2	-0.2	-0.3	-1.5	-3.5	-5.9	-1.5
MEX	-0.1	-0.1	-0.1	-0.9	-2.2	-3.8	-0.9
CAN	-0.2	-0.2	-0.4	-1.8	-4.1	-7.1	-1.6
OEC	-0.3	-0.3	-0.5	-2.0	-4.4	-7.7	-1.8
OPC	-0.2	-0.2	-0.4	-1.4	-3.2	-5.5	-1.3
ARG	-0.2	-0.3	-0.5	-1.6	-3.5	-6.0	-1.2
RUS	-0.2	-0.3	-0.5	-2.0	-4.6	-8.0	-1.9
SAU	-0.2	-0.2	-0.3	-0.7	-1.4	-2.4	-1.3
TUR	-0.1	-0.2	-0.2	-1.4	-3.2	-5.5	-1.2
USA	-0.1	-0.1	-0.2	-2.0	-4.8	-8.4	-1.5
OAS	-0.1	-0.2	-0.4	-1.6	-3.6	-6.3	-1.5
INO	-0.2	-0.2	-0.3	-1.3	-2.8	-4.7	-1.3
KOR	-0.1	-0.2	-0.3	-1.4	-3.3	-5.8	-1.3

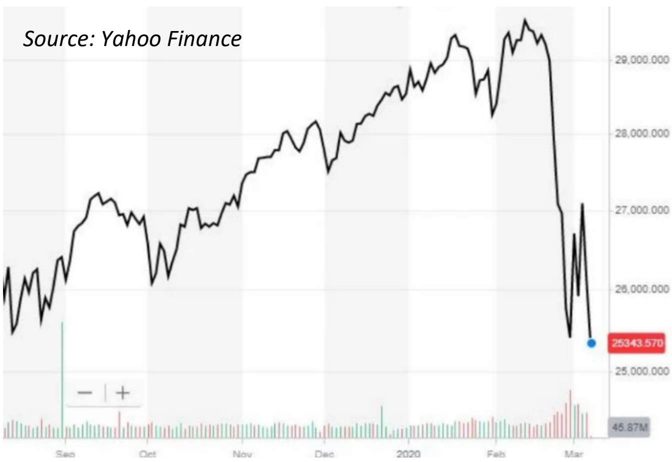
He nodded in agreement when I quipped that this would place the global GDP growth in 2020 at around 1.3 to 1.5% in case of a pandemic of such magnitude, with the US, UK and the EU being close to zero (France and Germany being just above water), China at 4.4 to 4.6% and India at 3.5 to 4%. Asia as a region would be hit severely. If there is no pandemic (and things get controlled in Q2), one could add 0.8 to 1% to each one's GDP growth except in the case of the US where it could be 1.4 to 1.7% higher because massive interventions could be expected to shore up the economy in the short term due the elections in November.

Stock markets

The longest bull in recent years (131 months versus 119 months before the Great Depression) showed no sign of abating even in late January. I felt compelled to draw his attention to Prof Robert Schiller's observations which I had quoted in my 2018 paper -The Good, The Bad and The Oily. Schiller had explained that the CAPE Index in the US was 31 at the start of 2018 (about 25% higher than the CAPE in the previous 15 years) and that the last time it was as high (it touched 30), marked the end of the Roaring Twenties in 1929. Something triggered a collapse and we had the Great Depression. I had mentioned in my paper that it is difficult to predict what would trigger the next collapse and when.

That got Prof. Smarth excited. He argued that a collapse was more than probable now because there were numerous triggers, the most potent and immediate one being Covid19. He showed me the following chart (Table 3) in which the Dow Jones kept rising till February 2020 when it started falling.

Table 3: Dow Jones trend (Mid Aug 2019-mid Feb 2020)



Source: Yahoo Finance

The good Professor not only spoke of a further drop in March and beyond, but also was clear that all major Stock Exchange Indices will, at best, end the year at a bit lower than they were in late February, notwithstanding the ups and downs in the interim. He was sure that the Schiller moment had arrived. Covid19 would spare none and for some countries including India, with its weak financial sector, could hurt even more. The bears amongst Hedge Funds want us to believe that there will be a Great Depression type global carnage.

Banking and Finance:

The expected economic slowdown due to Covid19 has the potential to reduce credit offtake, savings and to increase defaults by leveraged borrowers. Fearing shocks to the banking system, several Central Banks have swung into action to minimise the impact on their banking system. Most OECD countries will throw their war chest at the problem like they did in 2008 and reduce interest rates to near zero or negative. Unlike in 2008, many of the large global banks are more stable now though albeit not be very profitable in 2020. Mid-sized Banks will be under pressure due to the slowdown. In some countries like Lebanon where banks hold mostly sovereign papers and the Government is close to default, there is going to a severe crisis. Chinese Banks will be challenged by corporate defaults due to the slowdown. Corporate debt to GDP ratio which was a precarious 160% in 2017 has grown further to over 200% now. It is argued that most of it is owed by State Owned Enterprises. The Shadow Banking sector in China is on the knife's edge. Covid19 has made the situation challenging.

The Indian Banking system has a peculiar problem due to many large and medium sized Indian companies being more debt-leveraged in 2019 than they were in 2008, in pursuit of growth. Worse still, many of their promoters are in even more debt by hypothecating their equity shares to raise money for investments. When growth slowed down due to De-monetisation in late 2016, their debt started unravelling. The heavily borrowed infrastructure sector suffered delays due to lack of clearances, inability to close their funding plans in some cases, etc. resulting in Banks running huge NPAs and their inability to lend more for growth.

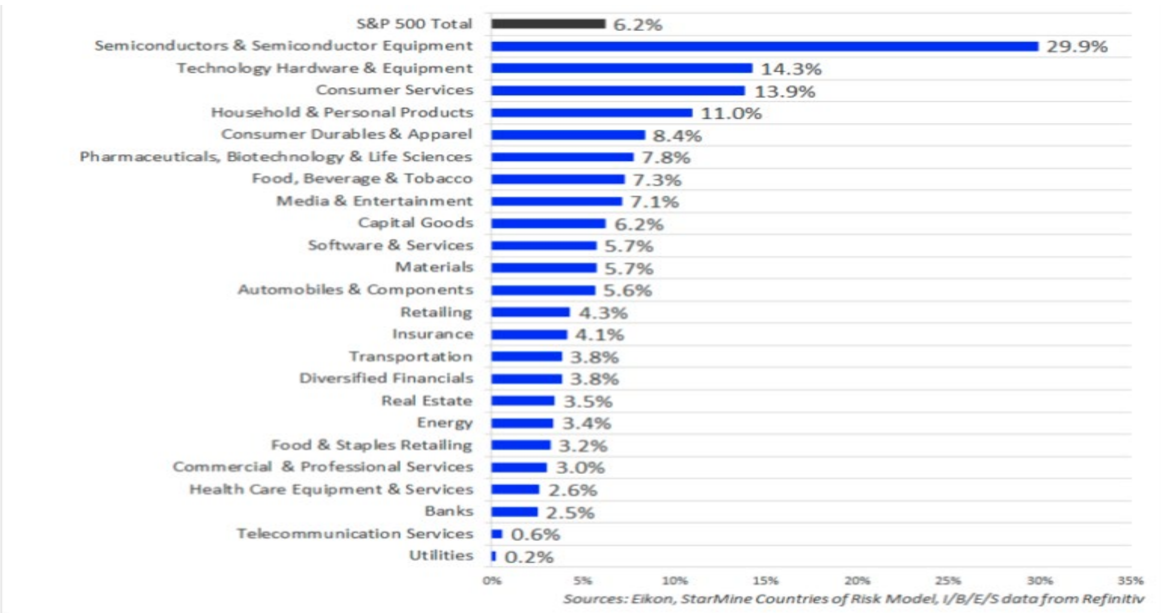
The NBFC sector got stranded without adequate funds to lend, after the spectacular collapse of IL&FS which was the darling of many lending Banks. At that time, the RBI added to the woes of even normal businesses by following a conservative policy of inadequate money supply for Non Food credit and high interest rates. Whilst the RBI reversed those policies later, the economy had already got into a rut. The Budget of February 2020 which was a golden opportunity to build a levee against a looming crisis, was wasted. Reform measures could have tipped the economy from slump to higher growth. Instead the Government largely scrimped on economic measures essential for lifting the Indian economy out of the rut despite the global economy heading for a slowdown. The business community did not cover itself with glory by its gushing endorsement of the Budget. It is fortuitous for some countries like India that the Corona virus sent the global oil prices down from the $60s per barrel at the start of the year to below $50 in February. With the fear of Covid19 resulting in severe cut-backs in travel, conferences, and production cuts in certain sectors which are dependent on imports from China, the fear of loan defaults is palpable. Oil price will fall further and soon test $ 35, which will help India.

Some NBFCs and banks are in bad shape, one of them being Yes Bank. Rescue plans for Yes Bank have been in the works for many months, and more frantically in the past six weeks. For more details read Sucheta Dalal's piece https://www.moneylife.in/article/will-govt-support-efforts-to-save-yes-bank-and-prevent-another-systemic-shock-after-ilfs-and-dhfl/59442.html. Finally, the RBI and the Government of India declared a moratorium on March 5 on Yes Bank for 30 days to give it time to prevent another IL&FS type contagion. While Yes Bank shares have nose-dived after that, pulling other scrips and indices down, the entire finance sector stands exposed to ill winds blowing initially from China, and now from all around.

Global Supply Chains

The major global supply chains that are already getting disrupted even without Covid19 becoming a pandemic are Semiconductors and related equipment, IT & Telecoms hardware, Household and Personal products, Consumer Services, Consumer Durables, Pharmaceuticals and Life Sciences, Food, Capital Goods, Media & Entertainment and Software services. In some cases, supply from China has ground to a halt. The reliance of S&P 500 companies on supplies from Greater China (Table 4) is a good proxy for global trade at large.

Table 4: The reliance of the S&P 500 on supplies from China and Hong Kong



This level of dependence is sufficient to lead the world economy asunder as supply chains take time to reorient with new supply sources and because China carries the world economy on its shoulders (nearly a third of the increase in the world GDP in $ terms in 2019 came from China) and not the USA (which only accounts for 13.8%) though it is the world's strongest economy. China's likely GDP growth rate in 2020 is expected to be range bound with a cap of 5.6% and a low of about 4.5%- a steep fall from 6.1% estimated in 2019. The implications are huge considering that imports and exports are about 50% of China's GDP. To whom will the world sell to or buy from if China slows on both counts? It spells trouble for the rest of the world and if there is a pandemic, all hell could break out in the short term.

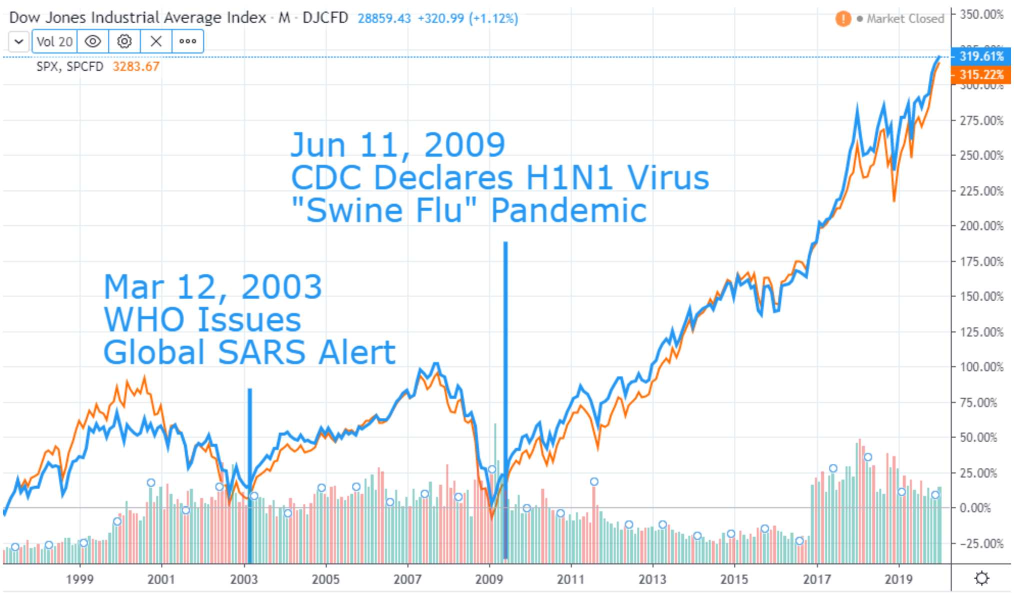
World trade will suffer badly in the first half of 2020 because of Covid19 induced supply dislocations. EU's trade with China could get hit even more because China will perforce reduce imports from the EU of goods that can be procured from the US to meet its targets when the US-China Phase 1 Trade Pact is implemented. A struggling EU economy will then face a double whammy. China has a new challenge as it will be tough for the US to not put bio security curbs against imports from China especially products for human consumption and use.

Covid19 is the most visible tipping point for the global supply chains because if it is severe enough, MNCs will be forced retreat to the old wisdom of not putting all eggs in one basket. This could lead to a more geographical diversification which could alter not just trade flows but also investment and human capital flows in the coming years.

Which are temporary effects, and which will stay?

There is little doubt that stock markets will eventually move up and beyond the January 2020 levels after this disease crisis is over, though not in 2020. It has always been the case in the past as can be seen from the chart in Table 5. Oil price too will sink much further and later work its way up.

Table 5: Pandemics & Dow Jones from 1997 to 2020



Source: Yahoo Finance

However, when it comes to global supply chains, it is reasonable to expect that the push to go beyond China which started more than five years ago, will accelerate. While China will remain an important source of goods, manufacturing that will move out of China will not return.

India, Indonesia, some countries in Latin America, Eastern Europe and Africa would stand to gain. This is an opportunity for India which can be capitalised if the top business chambers put together a smart Make in India Strategy with a compelling proposition for global supply chains to include India in a big way with the active participation of leading industrialists and the Government. The race has already started.

Where the opportunities and risks are:

Beware of the Ides of March which is just a few weeks away. Revisit your investment portfolio unless you want to go down like Caesar. With bond yields crashing due to a flight from equities to fixed income securities, and one seldom goes wrong by entering into equities when the markets are down, with a five year horizon. Either remain in cash or look for buying opportunities in stocks of high performance companies with low leverage and good governance. Yes, such stocks do exist. The rest of the market faces high risk of being decimated.

Good times are starting for those who want to buy capital goods for greenfield projects or expansions. The same can be said about acquiring good businesses that can be revived with financial engineering.

Start-ups especially in consumer tech are expected to witness a 'back to reality' shift in valuation. Most of them don't make profits due to misplaced exclusive focus on growth and related metrics but have sky high valuations driven mostly by financial investors whose larger objective is to set up things for their exit at higher than their entry cost. In the emerging environment, the music could stop quite suddenly. Track the good ones and keep money at hand for acquisition.

It goes without saying that 'one should never waste a recession'. This is the best time to transform businesses to make them future ready with calibrated investment in digitisation and removal of flab. This is not just an opportunity but an important risk mitigation initiative which should not be deferred.

What signals to look out for

There are many lead indicators to choose from depending on whether your perspective is that of an operator of a business, or of a stock market investor or a borrower or an acquisition artiste or provider of professional services or a travel/ hospitality company, etc. If it helps to know the likely state of play of the economy in 2020 slightly in advance of events, you should track 7 indicators although there are many more:

1. Covid19: Rate of spread (number of countries, infections, mortality) and direction of spread (from which regions to which new regions)
2. Unemployment index: Trends
3. PMI trend: Available for most relevant countries
4. Retail sales index: Many countries publish them
5. Construction Permits issued: Trends will indicate likely job creation, demand for construction materials, credit uptake, etc.
6. Inventories: Trends in key sectors will indicate likely purchase and production in the near future
7. Automobile Sales: The mother sector whose health is a lead indicator of what will happen to several manufacturing sectors, retail lending, job market, etc.

The last words

2020 is a landmark year for the unstable world, with tipping points likely for several matters like climate, water availability, energy (especially oil), finance (including remittance and payments), digital technologies, quantum computing, geo-politics, etc. which will impact human life significantly but they are not covered in this note for want of space. What has been described in this note will create more than enough excitement, concern and opportunities during the year. I conclude this note with the hope that mankind will win decisively against Cyrus de Virus.

PS: In the above note, only Professor R Schiller is a real person. Professors Boris Lungski and Inov M Smarth are fictional characters.

Our Values –
The Avalon EDGE

E
ENTREPRENEURSHIP
Enterprising ownership to transform ideas into pragmatic and profitable solutions

D
DEDICATION TO EXCELLENCE
Commitment to premier quality and highest standards in everything we do

G
GREAT VALUE CREATION
Focus on delivering maximum client impact through innovation and collaboration

E
ETHICAL APPROACH
Respect, fairness and transparency in all our interactions

Contact Details
Raj Nair, Chairman
raj.nair@consultavalon.com

MUMBAI
Enam Sambhav, WeWork, 7th floor,
07B106, C- 20, G Block Rd,
G Block, Bandra Kurla Complex,
Bandra East, Mumbai – 400 051
Phone : +91 73045 29720 / 21
E-mail : mumbai@consultavalon.com

Marathon Futurex, WorkAmp Spaces,
Tower A, 7th Floor, No 703, Mafatlal Mills
Compound, N.M. Joshi Marg,
Lower Parel, Mumbai – 400013
Phone : +91 73045 29720 / 21
E-mail : mumbai@consultavalon.com

DELHI
Innov8 Old Fort Saket, Saket District
Centre, District Mall, Sector 6,
Pushp Vihar,
New Delhi -110 017
Phone : +91 74286 24664
E-mail : delhi@consultavalon.com

Innov8, 3rd Floor, Orchid Centre,
Golf Course Road, Gurgaon,
Sector 53,Haryana -122 022
Phone : +91 74286 24664
E-mail : delhi@consultavalon.com

CHENNAI
Door No: 128, First Floor,
East West Centre, Nelson Manickam Road,
Aminjikarai, Chennai - 600 029
Phone : +91-44-4345 5345
E-mail : chennai@consultavalon.com

BANGALORE
9th floor, Brigade IRV Centre Nallurahalli,
Whitefield, Bangalore 560 066
Phone : +91 9886348187
E-mail : bangalore@consultavalon.com

SINGAPORE
Level 30, Six Battery Road
Singapore 049 909
Phone : +65 3138 2042
Email : admin@apex-avalon.sg

THE AVALON GROUP
www.consultavalon.com