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FREEDOM IN A FRACTIONAL RESERVE SOCIETY
Long-Term Losers From the Pandemic

"Who knew a diversified portfolio now includes toilet paper?"
Strategas Colleague Pat Alwell

The question is as old as the Book of Genesis itself – what is the cost of free will? Of freedom? In any society, there is a continuum of tradeoffs between freedom and security. Depending on how much power we were willing or able to give to those in charge, we could choose, theoretically, to have near-perfect security without much freedom or have near-total freedom without a lot of security. In the West, the scales have decidedly been tilted in favor of liberty, although, it seems, little by little, we all have largely been willing to sacrifice our privacy and other rights in exchange for a greater sense, in spirit if not in fact, of safety. Before 9/11, there were few office buildings in the United States that required visitors to show identification before a visit. (Due to the first bombing attempt in 1993, the World Trade Center was one of the few notable exceptions.) One could also show up 15 minutes before just about any flight and have a reasonable shot of getting on the airplane. Such conventions seem almost quaint today. The system is the system and few are willing to take the time or trouble of questioning the wisdom of, let's say, completely disrobing and putting one's personal hygiene products in a clear plastic bag to get past TSA.*

So here we are in the middle of a global health crisis, the pandemic known as COVID-19, and we are faced with a new yet familiar set of choices – how much freedom are we willing to sacrifice in the name of public safety? In some quarters this has been posed as a false and vulgar choice between money and life itself. False, I believe, because the costs of a recession as deep as the one we are in will cause enormous and incalculable pain on the lives of everyday people, most especially on those least able to afford it. As a lifelong New Yorker, such tradeoffs are personal and ubiquitous. I have an elderly mother whom I have not been able to see for nearly a month. She is relatively content, nonetheless, because she feels safe. On the other end of the spectrum, my best friend from high school has been forced to shutter his four retail stores on Long Island. He was left with the painful decision to ask all of his employees to file for unemployment insurance

* *Quality control checks have routinely estimated that the TSA fails to detect weapons and explosives at least 70% of the time.*

two weeks ago. His father opened their first store in the late 1950s and what the future of the company may be is just about anyone's guess.

All of this has led me to conclude, once again, that we all have less control over our lives that we think we do - yes, even in the United States. We may be able to decide to watch just about any movie ever made at a moment's notice. A good portion of us are within a 20-minute drive from a dizzying array of retail chains and fast food restaurants that could satisfy every want and taste. And yet, it seems clear that, in the end, we know not the time nor the hour. Banks aren't the only companies that operate on a fractional reserve basis. The individual, the hospital, the local grocery store, and pharmacy all do. No company or individual could, or would, I believe, live their lives setting aside reserves for every conceivable misfortune that could befall them. Not only would that be costly and inefficient, it would also ruin the essence of what it means to be a human being – with all of its pain, its sorrows, and triumphs.

But in the same way life changed after 9/11 it seems clear that life will change after COVID-19. While we still hold out some vague hope for a V-shaped recovery later in the year, it would appear that a U-shaped recovery is the most likely outcome and perhaps the best one for which we can hope. The savings rate in the U.S. was uncharacteristically high at about 8% before the virus hit despite the fact that the unemployment rate was only 3.5%. It seems likely that the savings rate will be higher still once the dust settles from this tragedy. There will be some, especially among the young, that will proceed after this crisis has passed with the same sense of invincibility. But anyone in a position of leadership that must think about the lives of others is likely to err on the side of prudence. Businesses and societies themselves are likely to organize themselves differently and more cautiously. Higher reserves mean less leverage, lower growth and skinnier profit margins. To that end, we have identified a number of potential losers from the pandemic:

China: If a company didn't start thinking about the need to diversify their supply chains last year during the trade war, they are likely to start thinking about doing so now. While President Trump's views on the trading relationship between China and the U.S. were seen as well beyond the mainstream of popular and elite opinion three and half years ago, they are far closer to conventional wisdom today. Onshoring will undoubtedly become a major theme in some industries, especially pharmaceuticals and antibiotics. Once lost, trust is more difficult to reestablish. Once this episode ends, it will not be difficult to see a growing sense of anger and mistrust of China's place in the world. China appears to be trying to head this off by offering aid to other countries now but more and more people who were willing to look the other way with regard to China's political system will be unlikely to do so now.

Globalization: When push comes to shove, all politics is local in the words of the inimitable former Speaker of the House Tip O'Neill. For a long time, the political and commercial elite were able to convince a lot of average folks that access to cheap foreign goods was an acceptable tradeoff for more limited occupational possibilities, especially for those without a college degree. So too, were we led to believe that other cultures possessed largely the same values as our own. The tidal wave of populism that started in 2016 over the benefits of globalization, like it or not, has only just begun.

The Euro: A more specific example of a well-intentioned idea designed by elites to save the rest of us from ourselves was the Euro. Certainly, anything that could be done to avoid another land war in Europe was worthwhile. The only problem of course is that the concept was never particularly popular among rank and file citizens. Those in the well-heeled circles of politics and business could see only the benefits of less national sovereignty. The simple shopkeeper, farmer, or manufacturer could see those benefits too but needed to balance them against another layer of government interference in their affairs. Italy, in my estimation, will be the most important country to watch when determining the long-term viability of the Euro. There were growing tensions between the country and Germany before the outbreak of the virus. And who could blame the Italians? Germany enjoyed both a budget and trade surplus with unemployment below 4%. Italy had to go hat in hand to run a budget deficit of much above 2% despite structural unemployment rates of over 9%. Christine Lagarde's observation that the "ECB didn't exist to narrow spreads" did little to heal the rift.

Illiquid Alternative Investments: It seems like ancient history now, but Harvard found itself in the unenviable position of needing to float bonds to meet its operating expenses during the Global Financial Crisis, so chock-a-bloc was the endowment in highly illiquid investment when the storm hit. Here we are now, a little more than 10 years later and it appears that many states may be in a similar position, such has been the love-affair with the high-returns of highly illiquid investments largely built on leverage. In a world of near-zero real interest rates, liquidity was a tertiary concern. No longer. The writedowns private equity funds will need to take during this period of a general shutdown of economic activity will be real and large. Although the industry is trying to move heaven and Earth to access SBA loans, capital calls on the $1.3 trillion in dry powder to meet operating expenses appear inevitable. IRRs will fall.

High-Priced College Education: With the industrial base of the country getting ever smaller, many parents and students alike believed they had no choice but to pay for high-priced private colleges to get an edge in the new world. Cheap money, an influx of foreign students willing to pay full tuition, and the snob appeal of these institutions all fed the frenzy. A deep recession along with a reconsideration of globalization and on-shoring some industries may change all that, especially after a period in which we have noticed that our kids can take advantage of new technologies to pursue their education. The top-100 colleges in the U.S. will likely thrive in any event. Many others will struggle. The likelihood of an institution of higher learning installing a lazy river to attract students, as LSU at Baton Rouge, Texas Tech, and the University of Iowa have done in recent years, is quite unlikely in a period in which state finances will be under extreme pressure.

Small Government: "We're all Keynesians now," said either Milton Friedman or Richard Nixon in the late 1960s. The more things change, the more things stay the same. Despite the desire of the current Administration to "drain the swamp," it seems very unlikely that a minimum of $2 trillion in additional government spending (or 10% of GDP) will not wind up being a step function higher in the government's involvement in the economy for a long time to come. This unhappy circumstance will have a lot to do with our ability to contain the virus and get back to work. The longer a general shutdown persists, the longer Uncle Sam will have a big seat at the table of private enterprise. Mercifully, some regulations are being eased now to help businesses – emissions standards, leverage ratios, drug approvals, and a deferral in the collection of import duties. The election in November will have a lot to say about whether this trend may continue.

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