Strategic Essay for SMEs – May 2020 Edition

The objective of this essay is to provide in 3 pages (10 min read) a clear and actionable strategic summary for CEOs of SMEs.

The essay is organized in the following 5 sections:

1. **Economic Update** - GDP, Unemployment, Inflation
2. **Financial Markets Update** - Stock, Bonds, Commodities, Derivatives, Currencies
3. **Policies Update** - Governments, Central Banks
4. **Scenarios and Probability** - V, U, W, L-Shaped Recovery
5. **CEO Strategic Tool** - One Simple Actionable Instrument for this period

1. Economic Update

These are the three main macro-economic indicators:

- GDP: a measure of the value of products and services produced in a given country
- Unemployment: a measure of how many unemployed are actively looking for jobs
- Inflation: a measure of whether average prices are increasing or decreasing

GDP: we are expecting a 5-10% annual GDP drop in 2020 on average in all the major developed countries. As a comparison, in Italy a 10% Real GDP drop since 1861 has only been seen in the period 1942-1945. In US the only historical precedent is the 1945-1946 period. In the historical precedents, steep declines have been followed by economic booms. None of these cases though was linked to a global widespread virus, therefore there is uncertainty on when and how fast that recovery will be.

Unemployment: the current estimate for June is to reach 20-30% unemployment in US before gradual recovery. This compares with an historical high of 25% during the Great Depression, and of 12,5% in the last 80 years (1982). The difference with the Great Depression is that it took 4 years to reach the 25% peak from 1929-1933, while this time it will take just 3-4 months. This also means that a strong rebound is likely, how fast depends mostly on how much capital disruption we will see in the coming weeks.

Inflation: we have entered a very unstable pricing situation with both pockets of deflation and pockets of inflation/hyperinflation. Deflation is seen in real estate prices, hotel/airbnb prices, non-essential service industry and in general in any industrial supply that has been overproduced vs demand in this period (some food, some automotive, some airline in particular). Inflation is seen in products with complex supply chains (PCs, Phones, Pharma), as well as in specific segments where demand has far surpassed supply (some groceries, PPEs). While deflation is currently prevalent, wave of bankruptcies and disruptions to global supply chains are likely to accelerate inflation very fast in the coming months.

2. Financial Update

These are the six main financial markets:

- Stock market: trading public shares of companies
- Corporate debt market: trading public debts/bonds of companies
- Public debt market: trading debt of countries
- Commodities market: trading raw materials such as oil, gold, minerals

- Derivatives market: trading products based on another financial asset, index or security
- Forex market: trading foreign country currencies

Stock market: after a 37% crash in 3 weeks (one of the fastest crashes in history) the market has now recovered primarily due to the fact that risk free assets such as public bonds are almost entirely purchased by central banks and have very low premium. In addition, there is a strong belief that no matter how bad the situation will get, the potential damage is so extended that the downside risks will be minimal due to intervention from central banks.

Corporate debt market: this has gone under huge pressure in US, junks bonds have increased their cost from 300 to 1000 points above risk-free. Many investment grade bonds that was considered solvent became junk (so called Fallen Angels). Heavy intervention by the Fed to stabilize the markets. Several companies already declaring bankruptcy (in shale oil and retail), others under heavy pressure (car rentals, airlines).

Public debt: for solvent countries both central bank's intervention and market demand for safe assets are pushing public debt to zero and occasionally negative interest rates. This means people are paying money in order to keep them in what is the safest asset at the moment. Countries that had solvency issues such as Argentina have already gone through a new default in the last months. Countries that are borderline such as Italy have gone under intense pressure, but are now back to a safe area thanks to ECB intervention.

Commodities market: Oil has undergone a double pressure due to shock in demand (less purchase due to factories closed) and also price war at OPEC (increased production). This brought prices at WTI at -37 USD and led to bankruptcy of major US oil producers. Now the situation is stabilizing with prices rising due to increasing demand and decreasing production. Gold, also considered safe asset, is now at a 12 year high. Some minerals and food-related commodities have been trading up to 20% lower due to less demand but are now recovering.

Derivatives market: VIX, an index of volatility, has reached historical high of 82 at the peak of the crisis in March beating the 2008-2009 record of 79, showing extreme uncertainty in the market. There are great risks currently rising especially on products exposed to real estate and consumer credit which is traded in packages with CLOs and ATSs. As rents and consumer credits don't get paid these can and are in turn going under great pressure.

Forex market: mostly stable, except for Mexico and Brazil currencies which have lost 25% in the last months. US has entered heavily the currency market, providing liquidity to other central banks that were seeing a massive outflow from their currency into US dollars. Swiss franc as in any crisis, tends to increase in value, which creates risks for the Swiss economy becoming too costly for exports. Therefore, massive intervention of the Swiss central bank to stabilize his currency value.

3. Policy Update

Fiscal (Governments): All regional governments are injecting well over 1 trillion dollars in the main regional economies (US and EU) with unemployment insurance, business grants, emergency income. Average intervention per EU Country around 200 Billion €.

Monetary (Central banks): FED and ECB have deployed all the unconventional monetary policies that were used in 2008-2011 but in just 3 months: Zero Interest Rate, Lending Operations, Asset Purchase, Forward Guidance. They can technically print money endlessly, but they need to operate within inflationary and political boundaries.

4. Scenarios and Probability

Following are the 4 main scenarios for GDP recovery and their probability as of today:

- **V-Shaped Recovery:** 5 %. Almost certainly not going to happen (except in stock markets) due to the prolonged disruption in the economy that has already caused major damage in terms of bankruptcies and unemployment, both unlikely to recover quickly.
- **U-Shaped Recovery:** 50%. Currently the most likely scenario, with an expectation for growth gaining momentum around 2020 Q4 and into 2021, if we see gradual containment of the virus.
- **W-shaped recovery:** 25 %. For many health experts this is a very likely scenario, as winter returns, measures prove to be insufficient. Especially possible if emerging market economies don't manage to contain the virus. We do have 3 possible hopes: herd immunity, development of cures, mild social distancing proving effective.
- **L-Shaped recovery:** 20%. Still possible outcome if capital disruption persists for prolonged periods of time and if it combines with persistence of the virus and/or major political instability, making it very complicated to restart the global economy.

For perspective, it is very important to keep in mind that all major crises display their consequences in the period going from 2 to 24 months since the crisis starts. We are now in month 3-4 so very much at the beginning of this cycle. It is also important to understand that while we are going through a massive Wave 1, this situation will have several Tier 2, 3, 4 Waves linked to shocks in demand, bankruptcies, disruption in supply chains, inflationary consequences, security concerns.

5. CEO Strategic Tool – What should a CEO do?

Given this context, CEOs should set-up a very lean Crisis Management Team with these goals:

1. **Map** all the possible **risks and opportunities** of the current crisis across all functions
2. **Rank** these risks and opportunities **by priority and by impact** on company bottom-line
3. **Analyze** each of these and evaluate the **best action plans**
4. Create a **Crisis Business Plan** – defining an **overarching direction** for the business
5. **Launch the plan** with a Crisis Management Team using **PM tools** (Trello)
6. **Execute the plan** and schedule meetings for the team every 1/2/4 weeks depending on needs, to **update the plan** and resolve all the main obstacles encountered.

Having an external strategic consultant can be helpful for 3 reasons:

1. **Competence -** specific expertise on vision-planning-execution can make a great difference
2. **Cross-industry exposure -** can rapidly transfer new ideas from other industries
3. **Outside view – fresh perspective** being able to see the business from the outside

Currently 65% off: 4-week Crisis Turnaround Package for ~~6000 USD~~ 2000 USD:

- Implementation of the 6-step Crisis Management Plan
- Daily Phone and Email support for Emergency Handling
- Free monthly copy of the Strategic Essay for SMEs

For more information please get in touch by email at **Giovanni.spaliviero@simpleconsulting.it**

May 21, 2020