Creative Destruction: Will the Pain Justify the Gain?

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"Creative destruction" is a term that often surfaces during an economic crisis. The term, coined by Austrian economist Joseph Schumpeter over 50 years ago refers to the "process of industrial mutation that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one." The current economic crisis, with the extreme measures taken by Congress and the Federal Reserve, shows evidence of creative destruction, but it's too soon to tell if the positive results will outweigh the negative.

The positive side of creative destruction comes from the creation of new jobs, products and businesses. The other half of the equation, unfortunately, is a necessary evil: Jobs, products, businesses etc. that are no longer viable or desirable must be discarded. Evidence of past episodes of creative destruction can be found in the lists of now-defunct companies and industries, replaced by more efficient, more innovative or more desirable ventures.

Successful creative destruction can be described in four words: no pain, no gain. Attempts to soften the impact of the changes brought by creative destruction, such as artificially preserving jobs in declining industries or propping up unhealthy businesses, can lead to economic stagnation and decline.

Almost six months into the COVID-19 crisis, we have seen both creation and destruction. People have created new ways of doing business, new technologies that bring individuals together remotely, new methods of educating our children and new products to help protect our health. Unfortunately, we have also experienced the loss of jobs, homes, livelihoods and businesses. The government stimulus and the Fed's quantitative easing policies were intended to reduce the uncertainty that COVID-19 thrust upon the nation. But are these actions helping? Or are they limiting the flow of resources to new opportunities, thus postponing our inevitable adaptation to a changing economic reality?

US Economy: Record Unemployment and Unprecedented Policies

Record Unemployment. At least temporarily, unemployment has risen to heights not seen since the Great Depression, as measured by initial and continued unemployment claims. The June Bureau of Labor Statistics report included 4.8 million new unemployment claims, although the unemployment rate declined to 11.1% from 14.7% in April. The week of July 2 marked the fifteenth consecutive week that unemployment claims surpassed 1 million. By July 9, another 1.3 million Americans had filed for initial unemployment, bringing the total number of people receiving some form of jobless aid to more than 32 million—20% of the US workforce. But this may not be the end of the story. As COVID-19's second wave forms, the likelihood of additional furloughs and layoffs looms.

Much must be done to fix this situation. Compensating laid off and furloughed workers through unemployment and government-funded relief checks is like putting a Band-Aid on a broken limb. Some jobs may be lost forever as a result of this pandemic, replaced by new positions in the industries and companies that are prospering now. Providing short-term financial assistance to those workers is important, but so is job retraining, education and other services to enable those workers to find jobs in the post-COVID economy.

GDP plummeted, but will start to recover. The initial report on first-quarter real gross domestic product (GDP), released at the end of April, estimated a decline of 4.8% for the 12 months ended March 31, 2020. All of that decline came in the first quarter, which suffered a 5% decline in real GDP, according to numbers issued on June 28. The Conference Board[i] expected second-quarter GDP to decline by almost 40%, due to an almost 50% drop in consumer spending. The other two components of GDP—capital spending and exports—were expected to decline by more than 20% and 35%, respectively. The actual second-quarter GDP decline may be a slightly better -32.9%, according to a July 30 Commerce Department estimate.

After a bad second quarter, the Conference Board's economists expect real GDP to increase 20.6% in the third quarter, but to grow a mere 0.8% during the fourth quarter, yielding an overall decline of 7.0% for the entire year 2020.

Government debt balloons amid new policy initiatives, but outcome is uncertain. Unprecedented steps have become official policy during the pandemic. Government borrowing surged in response to the $2 trillion CARES Act relief package, which essentially replaced a few months of American economic activity with a flood of new government debt. Another $1 trillion in relief is being considered to help keep the economy afloat.

Not to be outdone, the Fed kept interest rates near zero and rolled out new lending programs to keep money flowing throughout the financial system. The Fed is also purchasing trillions of dollars in government, mortgage and corporate debt. The funding of these programs could add an estimated $6 trillion to the Fed's $4 trillion balance sheet—more than doubling the balance sheet. Chairman Powell has rejected the idea that the Fed is playing politics in implementing these programs, claiming the goal is to make the steep economic downturn as short as possible. But is this spending wise?

Successful creative destruction depends on the demise of unhealthy business ventures. When unhealthy businesses aren't allowed to fail, it stunts economic growth. During the 1990s, many large Japanese banks would have failed had regulators not stepped in. Government intervention meant the banks kept a number of zombie[ii] firms alive by rolling over their uncollectible loans, a practice known as "evergreening."[iii] This thwarted the necessary destruction, forcing healthy, productive companies to

	2018		2019				2020						2018	2019	2020	2021
	1st half	2nd half	1st half	III Q*	IV Q*	2nd half	1 Q*	II Q	1st half	III Q	IV Q	2nd half				
Real GDP	3.0	2.0	2.6	2.1	2.1	2.1	-5.0	-38.9	-22.0	20.6	0.8	10.7	2.9	2.3	-7.0	1.0

THE CONFERENCE BOARD ECONOMIC OUTLOOK, 2018-2019-2020, Updated July 8, 2020 compete with less productive zombie companies for scarce resources, such as personnel, buildings and capital. The result? Years of Japanese economic stagnation.

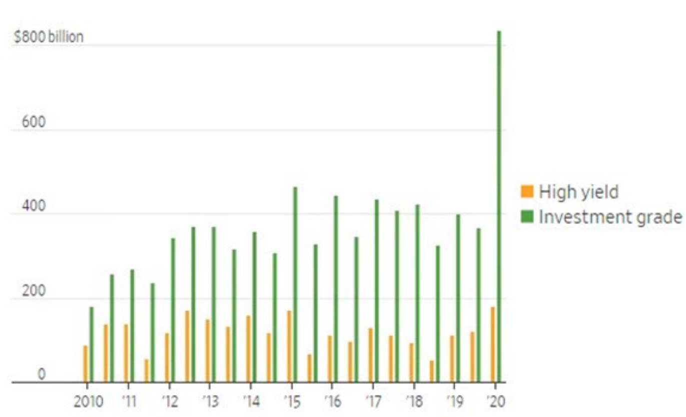
As long as the Fed keeps the federal funds rate at or near zero, US zombie companies can keep borrowing to stay in business, resulting in inefficient deployment of capital and labor.

US Bond Markets See Increased Issuance, but More Defaults Likely

US corporate bond issuance is up dramatically, with a high percentage of the issuance below investment grade. That's thanks to record-low interest rates along with the Fed's announcement that it will backstop all but the riskiest high yield bonds. Investors are continuing to buy even as defaults and credit rating downgrades increase.

A whopping 324 corporate bonds were downgraded from January 1 through March 31, 2020, compared to 365 downgrades in all of 2019, according to S&P Global analysts in their recently released US Default Rate Forecast for the 12 months ended March 31, 2021. They also stated that the proportion of new US issuer credit ratings at B- and lower reached a multidecade high of 49%.

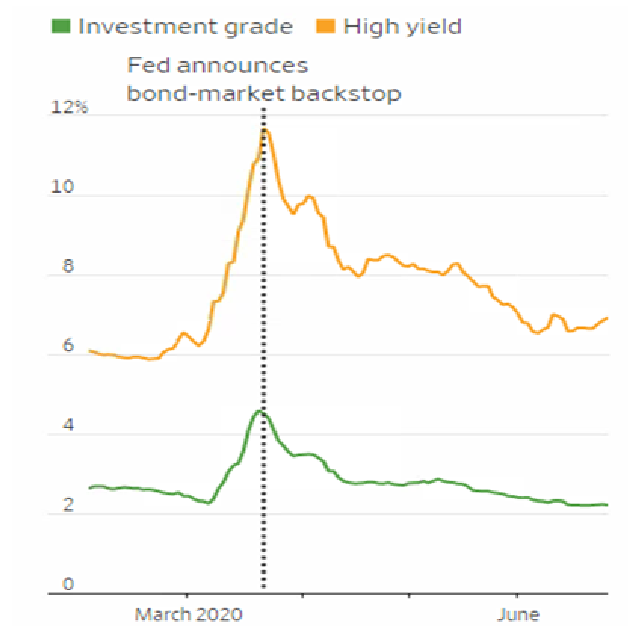
Corporate bond issuance*



*Deal value, half-year data
Source: Dealogic

The S&P Global analysts' forecast points to economic factors—such as unemployment and industrial production, as well as market conditions, such as equity market volatility and high yield spreads—to support their prediction that more corporate bond defaults lie ahead. They also noted that historically when the proportion of new issues with the lowest ratings (among newly rated issuers) rose quickly, double-digit default rates followed.[iv] If the S&P Global analysts' forecast is correct, high yield bond investors may be in for a rough ride.

Yields of U.S. corporate bond indexes



Source: Bloomberg Barclays Indices

US Stock Market Detaches From Fundamentals

Fundamental analysis used to be essential in selecting successful long-term equity investments. Today, stock prices seem to be driven more by mass sentiment and quantitative hedge funds than fundamentals. The Fed's "do whatever it takes" policies have ignited positive investor sentiment and willingness to take on greater risk based solely on investors' feelings about the future. The extremes of this new environment are exemplified by online investment platform Robinhood, which has successfully courted millennial investors by offering commission-free trades, free stock when you open an account and fractional share trading.

The typical Robinhood investor is a short-term trader chasing today's hottest stocks or, in some cases, stocks that baffle veteran analysts. For example, consider Hertz, the rental car company that declared bankruptcy on May 22. Since then, the number of

Robinhood accounts holding Hertz stock exploded from 44,000 to almost 148,000. From May 26 to June 8, Hertz's stock price rose more than tenfold from $0.40 to $5.53, before losing 75% to finish the second quarter at $1.41.

The high demand for Hertz stock since its bankruptcy filing is puzzling because stock holders often receive nothing for their shares when the issuer goes bankrupt. Even so, professional short sellers were forced to cover or lose their positions, which kept the share price up. Hertz tried to take advantage of the price surge by initiating a $500 million secondary offering of admittedly worthless stock, but put the move on hold when the SEC announced it would review the offering.

Historically, the stock market is considered a leading indicator of economic health and corporate earnings. But it's questionable if it's still a reliable indicator now that fundamentals no longer support stock prices. As one Wall Street insider said, "Having worked for many listed companies and being an insider to confidential information, I have sometimes struggled to understand the correlation between business results and the share price."[v]

Too Soon to Tell if Creative Destruction Will Succeed

Joseph Schumpeter said, "Capitalism, then, is by nature a form or method of economic change and not only never is but never can be stationary. ... The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates."[vi] Schumpeter considered creative destruction to be an integral part of economic growth. However, it's too soon to tell whether the economic destruction caused by the pandemic, our crippling government debt and the Fed's interference in our free market system is worth the creative benefit.

Strategic Asset Allocation Thoughts from Towneley

In anticipation of changing economic and market conditions, we are making the following strategic moves in client portfolios:

- In the equity portion of client portfolios, we are trimming growth exposure and enhancing value exposure. We continue to monitor active managers that we feel can enhance our equity strategy.

- We expect international equity performance to improve as it reverts to the mean after the past decade of underperformance, so we are returning client portfolios to their international equity targets.

- In expectation of declining credit quality, we are increasing the overall credit quality of high yield exposure in client portfolios, while maintaining the same allocation. We are also increasing the weighted average duration of the fixed income portion of client portfolios, as we now expect interest rates to remain low for the foreseeable future.

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[i] The Conference Board Economic Forecast for the US Economy - June 2020, https://conference-board.org/research/us-forecast, accessed 7/29/2020.

[ii] Zombie businesses are companies that have to borrow to survive and don't make enough profit to cover debt-service costs. The number of such companies has been increasing steadily in developed nations during the past 20 years. The reason is low interest rates, which allow zombies to sustain themselves on borrowed money rather than exit the market.

[iii] Matt Nesvisky, "The Misallocation of Credit in Japan," the National Bureau of Economic Research, https://www.nber.org/digest/oct03/w9643.html, accessed 7/29/2020.

[iv] Default, Transition, and Recovery: The U.S. Speculative-Grade Corporate Default Rate Is Likely To Reach 12.5% By March 2021, S&P Global Ratings, https://www.spglobal.com/ratings/en/research/articles/200528-default-transition-and-recovery-the-u-s-speculative-grade-corporate-default-rate-is-likely-to-reach-12-5-11509206, Accessed 7/29/2020.

[v] Quoted by Avi Gilburt in his commentary: "Stop believing the 'economy' is the same as the stock market", https://www.kitco.com/commentaries/2020-07-08/Stop-believing-the-economy-is-the-same-as-the-stock-market.html, accessed 7/29/2020.

[vi] Schumpeter, J., Capitalism, Socialism and Democracy, Harper & Brothers, 1942, pp. 82-83.