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The KWR International Advisor Macro-Outlook , Vol. 2, No. 12

June 2, 2020

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A Long Hot Summer Ahead – Riots, Food and Debt

Summary: Angry mobs, tear gas and burning police vehicles is never a good sign. In the last weekend in May and early days of June this was America. The caught-on-phone camera murder of George Floyd, an African-American, by a white Minneapolis police officer, triggered a pent-up explosion over longstanding racial inequities, especially concerning the abuse of police authority. Contributing to this was the brutal economic downturn, skyrocketing unemployment and coronavirus pandemic, all of which fell disproportionately on the country's black and brown

populations. To many Americans the situation was made worse by a seeming lack of national leadership. When it finally came from President Trump it was a call for law and order and a willingness to deploy "thousands of heavily armed soldiers" to deal with what he called as angry mobs and lacked any recognition of the root causes. The situation has not been helped by looting in major cities and the existence of an organized minority seeking to provoke violence. The post-pandemic period looms as one defined by more social upheaval and a greater bifurcation between haves and have-nots. This is going to play out through the summer and into the November 2020 elections. It is going to be a long, hot summer in America.

But 2020 is not only being shaped by race riots in America; we are still dealing with the coronavirus pandemic (a second wave in some countries), a massive global economic plunge (the worst since the 1930s), and the deterioration of Chinese-Western relations. The last took a major downward shift in late May when the Chinese Communist Party decided to impose a new security law in Hong Kong. This effectively ends the "one country, two systems" idea that made the city work as an international business and financial hub. China's sending of troops into a disputed border area with India only added to a bubbling geopolitical pot. Concerns have also risen over food security, pushed along by the impact of COVID-19 on distribution, transportation, and the potential for new restrictive measures on grain exports by some governments. Perhaps the words of American photographer David Bayles are the most apt for the times, "Tolerance for uncertainty is the prerequisite to succeeding."

The Shape of Things: While the world follows a path marked by a 1930s playbook (an intentional lack for international cooperation, a preference of national interests over multilateral approaches and the view of the global political economy as a zero-sum game of winners and losers), *global markets remain buoyant*. Why? The forward-looking nature of markets discounts the economic pain (which it expects to be short-term in nature), is placing a heavy reliance on finding a vaccine to mitigate future waves of COVID-19, and harbor a belief that the Federal Reserve will continue to introduce massive liquidity, buy securities and keep rates low for longer. Moreover, the U.S. is done with the shutdown (at least that appears to be a growing sentiment among the population) and the idea of reopening businesses adds to the positive momentum.

The U.S. economic recovery will come back, but only after a 30-40% contraction of real GDP in Q2, coupled with a peak in unemployment of somewhere over 20 percent. At the end of May the Labor Department reported that Americans filed another 2.1 million jobless claims, raising the 10-week total to more than 40 million. The bullish market outlook also ignores the view that there is a coming spike in small and medium-sized business bankruptcies. The U.S. economy will probably resume growth in Q3 and Q4, but unemployment is likely to remain high through 2021. Part of the problem is that the work landscape has changed; many of those sectors hardest hit by the pandemic and economic shutdown are not coming back in the same fashion, especially retail, but the verdict is also out on autos (see table below), entertainment and airlines. The bottom line is that the economic recovery is going to take longer than what markets are expecting. There will be a let-down.

We think that markets will continue to push ahead through the summer, but caution that as the perceived risk from COVID-19 fades (at least until the fall) geopolitical risks could dampen bullish sentiment. These include U.S. political and social tensions; the potential for social unrest in Europe (France, Italy, the United Kingdom and Spain are probably the most at risk); and there could be deeper-than-expected economic problems in the Caribbean and Latin America as these economies grapple with ongoing pandemic-related problems, severe economic downturns and debt repayment problems. Things to watch include who the likely Democratic Party candidate Joe Biden picks as a running mate; if the U.S. launches another stimulus package (which is questionable); and access to credit markets (will the ocean of U.S. Treasury bond issuance crowd out other issuers?).

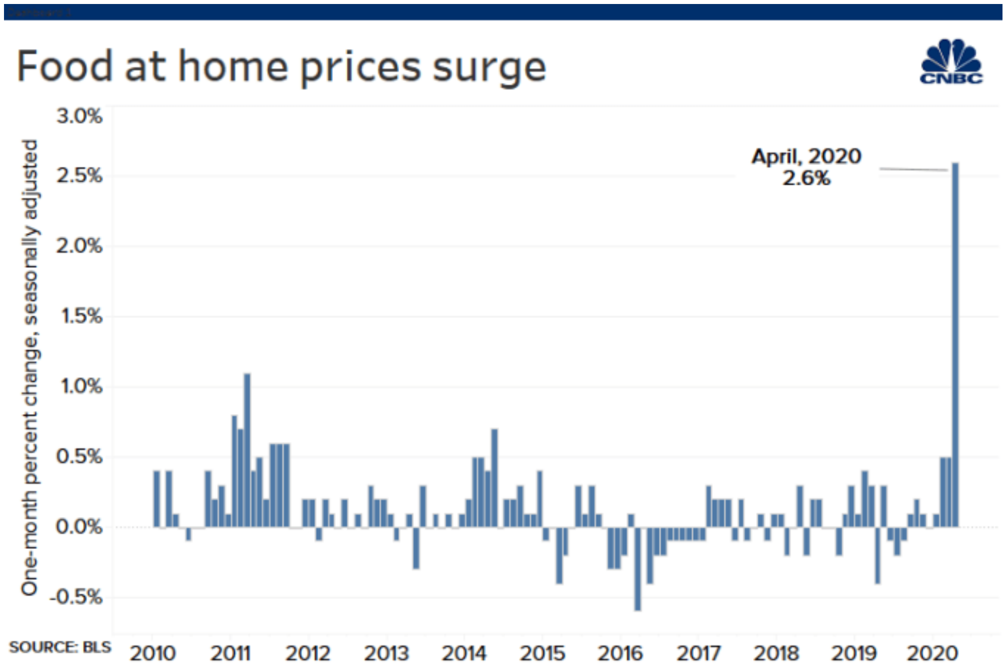
The New Cold War?: Another major geopolitical problem is a deepening of a new Cold War-like relationship between China and the United States. This will be pushed by the U.S. as 2020 is an election year and both political parties have already made China the villain of the international drama. The spat over Hong Kong is only one issue between China and the United States; the House of Representatives has authorized sanctions against Chinese officials for abuses against Muslim minorities. Other bills in Congress include measures to target Huawei Technologies, Chinese companies listed in the U.S., and banks that conduct business with Chinese officials who interfere in Hong Kong's affairs.

For its part, China has huge worries at home with its worst economic performance since the 1960s and early 1970s and its leadership has to be concerned that the recovery may be too slow to stave off some degree of social unrest. Consequently, it is easier to use foreign affairs to distract attention from home: clamping down on Hong Kong (which demonstrates that the Chinese Communist Party is still in charge), showing force in the South China Sea, backing Venezuela, and playing tough with India on its Kashmiri border.

The last has the potential to become a major geopolitical crisis. China has accused India of forcing its way into the Galwan Valley and a few other areas. To counter this “threat”, China sent in large numbers of troops into the disputed areas and built up heavy weapons to counter any countermove on the part of the Indian military. India has indeed built better roads and communications in areas where it feels at risk. However, India maintains this was a case of Chinese action. It is now sending more troops and heavy weapons. Reports indicate there have been initial skirmishes, but no fatalities – so far.

China and India have two of the world’s largest militaries and nuclear weapons as well as being led by strongly nationalistic leaders. Both countries are also seeking climb out of an economic hole left by the coronavirus pandemic. A major question for both leaders, therefore, is does either country need a war? The answer is no. Both leaders face major challenges in reviving their economies, which are likely to restrain more bellicose behavior. Nonetheless, India is now being draw in to the new Cold War.

COVID-19 and Food Insecurity: COVID-19 has left many governments wondering about food security. This has included dealing with issues as wide-ranging as the need to find enough workers to cultivate crops and man slaughterhouses to the ability to transport food and get it to the right consumer. Although there is growing fear of a food crisis, supplies remain adequate to feed most of the world’s population. Going into the COVID-19 pandemic, food supplies in some areas were at recent highs. The major risk is we talk ourselves into a new food crisis due to bad policies.



COVID-19 has been disruptive of the global food industry in a number of unexpected ways. In the pre-COVID-19 era, in advanced economies a large volume of food was sold to restaurants and large entertainment venues. As part of the coronavirus measures, restaurants were either shut down or limited to takeout and pickup. At the same time, entertainment venues, ranging from movie theaters to sports events and schools, were closed. The result was a radical reduction in demand from one part of the economy, which was replaced by a substantial uptick in demand from grocery stores and ecommerce food delivery companies as consumers were forced to deal more with preparing their own meals. This process was disruptive for many companies as well as putting food at home prices on an upward surge (see chart above).

Another impact of COVID-19 has been on transportation. During the pandemic a number of countries closed borders or limited transportation. While this was done to control the spread of the virus, it is a problem for the cross-border movement of food. For regions like the English-speaking Caribbean, this immediately raises concerns over food security, considering that 94 percent of all imports of cereals, 90 percent of edible fruits and nut imports, and 90 percent of imports of edible vegetables originate from the U.S.

Closed borders hurt the flow of migrant workers, who often constitute a key component of the work force, be it for the harvesting of fruits and vegetables by pickers from Bulgaria and Romania in Germany or the UK to transporting bees around to help the pollination of crops. In the U.S., honey bees gather pollen and nectar from plants including berries, melons, broccoli and almonds, pollinating an estimated $15 billion worth of crops every year, according to the U.S. Department of Agriculture. As *Financial Times'* Emiko Terazono and Benjamin Parkin noted (April 17, 2020): "Both the US and Canada, which need a large number of bees, import queen bees and other bees from Australia, New Zealand, Mexico and Chile. However, since many flights have been cancelled and airports closed, bee purchases have become impossible for some beekeepers." Enforced 14-day quarantines for bee movers also hindered pollination.

Another area hard hit by COVID-19 was in the protein protection sector. As the virus gained momentum it eventually reached slaughter houses, where working conditions proved conducive to transmission. This led to concerns about meat shortages throughout the U.S. Indeed, the menu of meat products shrank and some stores imposed restrictions on quantities on certain meats purchased by customers. In the U.S. the issue of meat supply resulted in President Trump signing an executive order under the Defense Production Act to compel meat processing plants to remain open amid the pandemic. The meat industry was also forced to redesign how it approaches the operation of meat processing facilities, resulting in the closure of many plants for deep cleaning and remaking working stations.

One positive development coming out of the COVID-19 pandemic is that food security is now a front and center issue. Although food insecurity remained a concern for the most food security vulnerable countries, like Afghanistan, East Timor and Central African Republic, it had faded as a risk factor in most advanced economies. Indeed, the debate over food in countries like the United States, Japan and Europe had moved from making affordable, plentiful and safe food to catering demand for "from farm to table" food. In his *Food Politics: What Everyone Needs to Know*, Robert Paarlberg noted in 2013: "Now consumers in these countries are beginning to demand other things as well, such as foods with greater freshness and nutritional value, foods grown with fewer synthetic chemicals, foods grown with smaller carbon footprints, foods that are locally grown, and foods produced without harm to farm animals."

The post-COVID-19 food security narrative is going to be different. While food supplies are adequate in most advanced economies, the main issues are going to be affordability and access. In the U.S. COVID-19 has resulted in 40 million unemployed or over 17 percent of the total workforce. As the U.S. moves deeper into depression-like territory, the expectation is that unemployment will head upward toward the 30-35 percent range. This has disproportionally hit those in lower-income jobs, stretching many family budgets to the breakpoint. Considering the social unrest in late May and early June in most major U.S. cities, questions over food security could exacerbate the situation further. Food may exist in stores, but people could lack the means to purchase it.

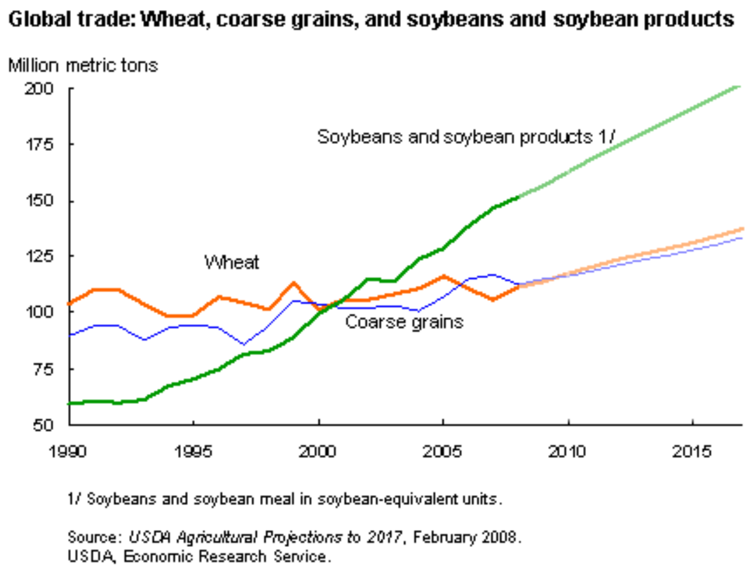
Similar problems exist among developing economies. When international transport fell off in January, February and March, the dependence on food imports became evident in a number of regions around the world, including large swaths of sub-Saharan Africa and the Caribbean. The concern over this issue was caught by Wayne Ganpat, Dean of the Faculty of Food and Agriculture at the University of the West Indies (UWI), St. Augustine in late April: "…COVID-19 has added a whole new dimension to this. Just look at how some developed countries have seized ventilators destined for other vulnerable countries. Consider for one moment, if this crisis extends over a long period and food becomes a very scarce commodity that the same behavior will not happen in the region?"

In Africa, the impact of the pandemic was bad enough, but has been compounded by an outbreak of locust swarms. Locusts bred unchecked in Yemen and were able to migrate to East Africa as well as to Pakistan (where they have already devoured crops) and India. Both regions have already been hit by the coronavirus pandemic; now locusts loom large on food crops.

According to the United Nations' World Food Programme (WFP), the number of people who are the verge of starvation had already risen to 135 million due to the destruction of crops by locusts; now COVID-19 is adding to the misery and threatens the flow of supplies due to curfews, long delays for truck drivers at border crossings, and mandatory quarantines affecting pilots. The starkness of the situation was captured by the head of the WFP, David Beasley, in June 2020, who stated: "Quite frankly, we've had 350,000 people around the world die from COVID over five months. If the supply chain breaks down like we're looking at, along with the economic deterioration, we could have 300,000 people die per day. Per day. It can't be COVID versus hunger, we've got to thread the needle and balance both."

Another major issue is how countries respond to food security issues. Of particular importance is how food exporters respond; do they fear not meeting the food demands of their own citizens and suspend exports or do they work through multilateral forums to ensure there is enough food to go around, especially for those countries that are the most vulnerable to food price and supply shocks?

The last round of food shocks in the international system was not necessarily caused by food scarcity, but by the fear factor. In 2007-2008, food prices rose, helped along by rising Chinese demand, the diversion of corn to produce ethanol and a greater role of financial institutions trading in agricultural commodities. However, the main cause was food exporting countries moving to protect their consumers from price inflation at home by taking measures to restrict food exports. This included Argentina, Cambodia, China, India, Indonesia, Russia and Vietnam. With supply thus squeezed, international prices quickly pushed upwards, which led importers to panic and start purchasing as much as they could before prices moved higher. In some countries higher food prices were met by social unrest.

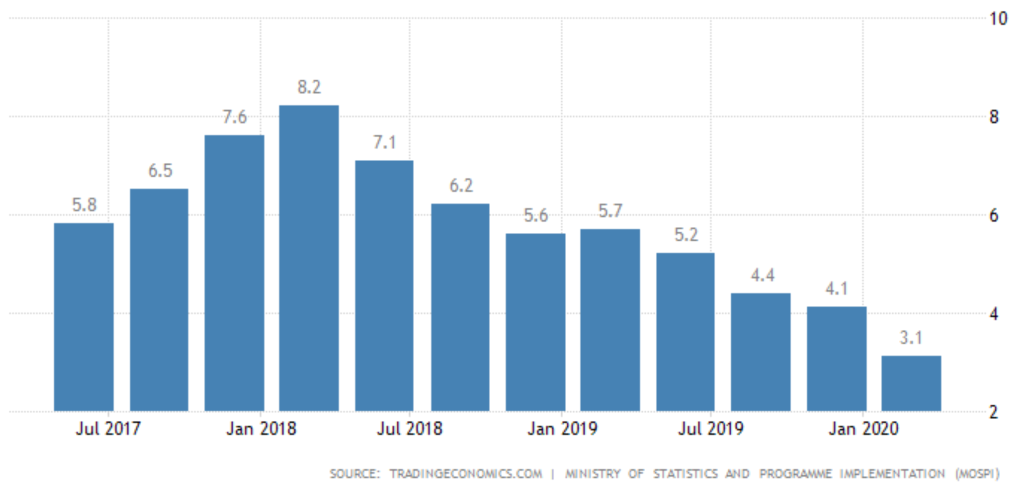


Food prices rose again in 2010-2011, partially caused by a drought in Russia and Ukraine, which once again stimulated importers to accelerate their usual buying in anticipation of an export ban. International food prices remained high, again pushed up by a drought in the U.S. in 2012. Although a number of factors were involved in the Arab Spring that swept through North Africa and the Middle East in the next several years, higher food prices and fear for food security played their part.

COVID-19 has clearly had an impact on food security around the world. We are walking on thin ice in terms of food supply and demand. Between trade war tensions, rising geopolitical tensions between a number of countries, and mother nature (ranging from locusts and African Swine fever to hurricanes and cyclones), we are a few policy steps away from a real food security crisis in parts of the developing world, which could have ripple effects on advanced economies in the form of refugees and tighter food supplies. The World Bank has consistently warned against a repeat of restrictive trade policies in regard to food. Greater efforts are needed to keep food insecurity from becoming a bigger problem, which means a return to a renewed sense of common good if that is possible. If not, the world is set to become a darker place and famine can return to the geopolitical landscape.

India Gets Downgraded by Moody's: At the end of May, Moody's downgraded India's sovereign rating from Baa2 to Baa3 and maintained a negative outlook. The rating agency's decision was due to the view that the country's policymaking institutions will be challenged in enacting and implementing policies which effectively mitigate the risks of a sustained period of relatively low growth, a significant further deterioration in the general government fiscal position and stress in the financial sector.

India's Real GDP Growth Rate (%)



Moody's also noted that the slowdown in reforms and constrained policy effectiveness have contributed to an extended period of slow growth, compared to India's potential. Real GDP expansion fell from a high of 8.3 percent in fiscal 2016 (ending March 2017) to 4.2 percent in fiscal 2019. It expects India's real GDP to contract by 4.0 percent in fiscal 2020 because of the coronavirus pandemic and related lockdown measures. Moody's sees a rebound in fiscal 2021, with 8.7 percent growth. The other issue worth watching is the rise in debt. Prior to the pandemic, India's general government debt-to-GDP ratio was estimated at 72 percent for 2019-2020. According to Moody's this is now expected to rise to 84 percent of GDP, where it is likely to stabilize, but unlikely to fall materially thereafter. The rating agency noted, "Although large private debt sector savings and long government debt maturities provide some stability and resilience to shocks to the cost of debt, interest payments comprised about 23 percent of general government revenue, the highest interest burden among Baa-rated peers and around three times the Baa medium."

Both S&P and Fitch (stable) rate India BBB-, the lowest investment grade level. We expect that the outlooks for these ratings are likely to change to negative and unless some corrective measures are taken, there is a risk of being taken down to non-investment grade, especially since the last reviews by both agencies came before the pandemic hit India.
