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Canada’s financial system has taken a series of devastating blows in the wake of the global equity market collapse. These shocks were precipitated by the spread of the coronavirus and the inability to contain the health crisis that threatened normal life and economic growth. Like the virus, a lack of confidence has quickly spread to all financial-asset markets.

These financial-system shocks have grown progressively precarious during the four weeks of March, with the damage ranging from four to seven standard-deviation drops below normal levels of financial accommodation. To put this in context, stress in the financial system has not been this strained since the days prior to the September 2008 meltdown of the global financial system.

As such, the Bank of Canada responded with: (1) a series of three 50 basis-point rate cuts to 0.25 per cent, which is the effective zero lower bound for short-term securities; (2) injections of liquidity into the money markets in order to maintain short-term funding; and (3) purchases of government securities to pressure long-term interest rates lower and facilitate investment.

Central banks have come to realize that stable and accommodative financial conditions are necessary in order to maintain full employment and full output within reasonable levels of inflation. And in fact, the monetary authorities of the G-7 economies pledged to maintain financial stability and functioning in response to the equity market collapse.

The RSM Canada Financial Conditions Index is a composite measure of the risk being priced into financial assets and therefore, the level of accommodation in the financial system. We estimate the overall stress in financial markets by observing the level and volatility of asset prices in the equity market, money market, bond market and commodity market, all relative to noncrisis norms.

One would expect that risk to normally fluctuate within two standard deviations above or below normal levels of stress. So a four-standard-deviation move below normal conditions suggests disturbing circumstances, requiring extraordinary responses by both the monetary and fiscal authorities. A seven standard deviation shock is telling us that—without redress—we are on the verge of a financial crisis that could rival the global financial crisis of 2007–09.

Recognition that the spread of the coronavirus would threaten the well-being of households and shut down normal life did not become apparent in the asset markets until the last weeks of February. By then, it was too late. Not only did the equity market collapse in the first week of March, but the money and bond markets showed significant signs of a lack of liquidity necessary for short-term transactions and longer-term investment. As of this writing, the equity market is more than 9.7 standard deviations below normal levels of noncrisis stress, the money market is 2.1 below normal, and the bond market is 4.2 standard deviations below normal levels of stress.
The performance of the commodity market is also negative (−1.8 standard deviations), but not to the extent of the security markets. That’s because we measure commodity market performance relative to the past five years. That range now includes residual pricing from the 2014–15 commodity price collapse. We expect that to change in the weeks ahead, as consumer demand for durable goods and energy shrinks in response to the health crisis and then as business begins cutting back on energy use and production in response to that lack of demand.

**Shocks to the real economy**

All of this paints a bleak picture for the economic outlook. Shocks to the financial system are transmitted to the real economy via a loss in income and a decline in investment. The propensity to borrow and to lend collapses, with lenders demanding higher compensation for increased credit risk, and with borrowers unwilling to take on the risk of the lack of demand.

In turn, existing policies by the monetary authorities to counter supply and demand shocks—such as the coronavirus outbreak—are transmitted to the real economy via the financial sector. For example, the Bank of Canada’s lowering short-term interest rates increases the ability to meet business transaction demand for liquidity as well as facilitating investment by pressuring interest rates lower out along the yield curve.

As the figure below illustrates, the degree of accommodation in the financial sector—as measured by financial conditions—tends to coincide with bank lending conditions. Positive levels of the financial conditions index suggest a more accommodative environment for lending. Conversely, negative levels of the Financial Conditions Index imply a restrictive environment for lending.

**RSM Canada Financial Conditions Index and bank lending conditions**

And as the figure below indicates, that degree of financial accommodation tends to lead the trend in overall economic growth by six months. The current shock to the financial system could be catastrophic for the economy if events were allowed to follow the 2008 freeze-up of the global financial system.

**RSM Canada Financial Conditions Index (with six-mo lead) and Canada real GDP growth**

Though this shock has the potential to be devastating for the economy, the monetary authorities have developed tools to respond to shocks based on the experience of the 2007–09 global financial crisis. The Bank of Canada and the other G–7 central banks have thankfully and quickly implemented those tools. But without further legislative initiative, the banks will soon exhaust the range of those tools.

Legislative policymakers should also note that this shock did not originate in the financial system. It is the result of unprecedented supply shock that disrupted the global supply chain and then quickly became a demand shock as the virus spread. At this point—and now that the monetary authorities have done all that could be expected—this crisis needs to be addressed by the fiscal authorities.

The governments need to first fight the spread of the virus by restricting normal levels of human interaction and provide the tools necessary for treating its victims, protecting the caregivers and supporting vaccine research. They can facilitate the shutdown of social interaction by safely providing the food, energy, shelter and household income.
Once the health crisis is solved and we can safely return to a “new normal” state of life, the fiscal authorities can facilitate the means for preventing further illnesses while increasing the availability of health care and crisis care. The government can then support the ability of businesses to recover, and for employees to work online by expanding broadband to all citizens.

That leaves one horrible question unanswered: Who will risk their health to deliver groceries to our front door? For all our advances, why is there always someone who gets left behind?

The financial crisis in pictures

A financial crisis tends to spillover into other economies.

**Canada and U.S. Financial Conditions Indices**

Equity market returns were accelerating in the post-USMCA era. The trend in TSX returns has become a bellwether of Canadian growth.

**Canada’s equity market yearly return and real GDP growth**

Money markets tend to signal the lack of liquidity during periods of financial market stress. This episode is concerning because of the rarity of a two-standard deviation move.

**Canada’s money market performance and real GDP growth**

**Canada’s bond market performance and real GDP growth**

To the degree that Canada’s economy is resource dependent, trends in commodity prices would be expected to anticipate trends in GDP growth.

**Canada’s commodity market performance and real GDP growth**
Forecasting economic growth is always challenging, but particularly so in the current environment. Measures being taken to limit the spread of COVID-19 in Canada, the United States, and around the world have ravaged and will continue to ravage Canada’s economy through 2020. Jobless claims numbers in Canada and the United States have literally skyrocketed since the beginning of March. There were 16.8 million jobless claims in March and early April that are attributable to the coronavirus, shattering previous records.

As of March 31, there is limited evidence to suggest that the rate of infection has decelerated in Canada, the United States, and Europe indicating that social distancing measures including the closure of the U.S.–Canada border will stay in place for the next month at least. As a result, we could see more job losses in the immediate future.

V, U or L?

Eventually and hopefully soon, the rate of infection will decline and the Canadian, U.S. and global economy will start to rebound. Given the uncertainty associated with how long social distancing measures will be in place, it is difficult to forecast when and how the recovery will take shape in Canada: will we see a V-, U- or L-shaped recovery?

An L-shaped recovery, like the one the U.S. economy went through after the Great Recession, seems unlikely at this point given that the crisis has not set off a broader financial and banking crisis. Thanks, in part, to activist and globally coordinated monetary policy, which includes a number of quantitative easing measures that have provided several hundreds of billions of dollars of liquidity in Canada alone (and trillions globally).

Real GDP growth, YOY

Source: StatCan; RSM Canada
Relative to the U.S., Canada’s economy could follow more of a U– than V– pattern for the following reasons:

1. Canada’s economy was already showing weaknesses before the onset of COVID–19. GDP growth in 2019 was underwhelming and slowing down. Our Financial Conditions Index, a leading indicator of economic growth, was also showing increased signs that financial conditions were tightening.

2. The U.S–China trade war, which disproportionately affected Canada given the degree of integration between the U.S and Canadian economies, resulted in an uncertainty tax that affected business investment levels. Indeed, business investment, not including residential structures in Canada, decreased significantly over the past couple of years.

3. Energy products including crude petroleum, refined petroleum and petroleum gas accounted for nearly 21 per cent of Canada’s exports or $124 billion in 2019. Automobiles and automobile parts account for another $86 billion or 14 per cent of Canada’s exports. Canada’s exports are expected to decline significantly in both these sectors as a result of COVID–19. Oil and gas sector, in particular, is also being affected by the Saudi–Russian oil price war, which may persist after the impact of COVID–19 dissipates. The price of the Canadian benchmark for oil—Western Canada Select — is currently trading at under $5 per barrel and a number of producers are looking to cut and curtail production. WCS has fallen by almost 90 per cent since the beginning of March.

**Real business investment growth ex–residential structures growth, YOY**

![Graph](Source: StatCan; RSM Canada)

**Western Canada Select, USD**

![Graph](Source: Bloomberg; RSM Canada)
4. Household debt levels in Canada have increased substantially over the past several years. As of the third quarter of 2019, household debt as a proportion of GDP was 102 per cent in Canada far exceeding that of the United States (76 per cent) and the highest in the G-7. Back in December, the Bank of Canada decided against cutting rates due in part to concerns about growing household debt levels. While the decrease in interest rates since the onset of COVID-19 will improve debt service ratios, Canadian households may be adding to their overall debt load during this period of economic uncertainty. Household spending, which accounts for approximately half of GDP, may not rebound as quickly as we hope.

Household debt-to-GDP ratio (1=100)

5. The fiscal policy response in Canada to date has been rather conservative particularly in comparison to that in the United States, which is roughly 10 per cent of U.S. GDP. In Canada, the initial economic stimulus package plus the enhanced Canada Emergency Wage Subsidy amounts to approximately 3 per cent of GDP not including tax deferrals despite Canada having the lowest net government debt to GDP ratios in the G-7. Fiscal policy to date has assumed a V-shaped recovery, yet there are a number of signs that suggest the economic recovery may be more tepid.

Looking forward
Over the next several weeks, we will see to what extent the measures put in place in Canada and around the world help decrease the spread of COVID-19. We will also be looking at the economic calendar to better understand how COVID-19 has affected Canada’s economy and for additional fiscal policy measures in Canada and the United States.
In general, business interruption policies require that direct physical damage be the underlying trigger for various available coverages. Debate and legal disputes over what constitutes physical damage and whether COVID-19 falls into the definition of physical damage are likely to ensue. However, in this evolving situation, there is currently no clear guidance from insurers or courts on coverage interpretation.

Based on the nature of losses a policyholder incurs, certain coverages may exist, and depending on the policy wording, they may extend to COVID-19-related losses. Manuscript policies, which have customized wording drafted for an insured to fit the business’s unique risks, are more likely to have COVID-19 coverage; traditional policies with one-size-fits-all wording are more likely to exclude atypical events.

Business interruption coverages may include:

1. Event cancellation insurance
2. Interruption by civil authority / Prevention of ingress/egress
3. Infectious disease and other nonphysical damage endorsements
4. Contingent business interruption

Event cancellation insurance

Event cancellation insurance insures against the cancellation, postponement, abandonment, etc. of a scheduled event such as a concert, conference or sporting event. These policies are often all-risk policies that have exclusions for specific causes or threats, including communicable diseases. However, policy wordings vary greatly, and we expect to see claims arise related to COVID-19 for this type of coverage. The coverage will be similar to business interruption insurance in that it covers loss of net profit and extra expenses related to the event cancellation or postponement. Given the uncertainty over how long the COVID-19 pandemic will continue to affect events, we expect that the majority of events will be cancellations with little prospect of being rescheduled within a reasonable timeframe.
Interruption by civil authority / Prevention of ingress/egress

Interruption by civil authority covers the insured when denied access to the premises where they operate their business as a result of an order made by a government or civil authority. The order must be a result of physical damage of the type for which the policyholder is insured. Further, the indemnity period (period losses can be claimed) on this coverage is often limited from two to eight weeks. Although widespread government orders have shut down businesses globally and would appear to trigger this coverage, having the underlying cause related to physical damage may be a barrier that prevents many policyholders from making successful claims.

Prevention of ingress/egress is very similar, but with somewhat wider application. It includes the inability to access the business premises for reasons other than an order by civil authority. It also often includes cases when physical damage has not yet occurred, but a threat of physical damage exists.

Again, the particulars of the policy wording is key, which may provide some policyholders the ability to make claims under one of these coverages.

Infectious disease and other nonphysical damage endorsements

Nonphysical damage endorsements that cover business interruption are not very common in traditional commercial policies. However, if included, they may trigger coverage for business interruption losses. When nonphysical damage endorsements are included in a policy, it is typically because the specific risk could have a high impact to the business operated by the policyholder; accordingly, it insures against that specified event.

Coverage for infectious disease is relevant to COVID-19. This coverage could take a variety of forms and may be related to the contamination or presence of a disease on the insured’s premises and, as a result, loss of access to the business premises by an order of civil authority. If the infectious disease endorsement identifies only specified diseases, COVID-19 is unlikely to be included due to its recent discovery. If the policy is an “all risks” or broad form infectious disease endorsement, then coronavirus would likely be included. These types of endorsements are highly dependent on the policy wording and should be reviewed in detail by a coverage expert to determine if a claim can be successfully advanced.

An interesting development in the United States is taking place in New Jersey, where the state Legislature is considering a bill to require insurers to pay COVID-19 business interruption claims expressly excluded by a policy “virus” exclusion. Although the intention is to help business owners recover their losses, we believe there are significant issues with the practical application of this type of legislation; there may be unintended far-reaching consequences beyond insurers’ financial exposure within the state of New Jersey. Consequences may include difficulty in handling an overwhelming number of claims with unknown processing times, a knock-on-effect in other states where similar legislation may be advanced and the financial ability of insurers to pay these claims without significant government funding.

Contingent business interruption

Contingent business interruption insurance provides coverage for loss of profit or extra expense to an insured when one of their customers or suppliers is shut down due to an insured loss (typically direct physical damage) which has a direct impact on the insured’s operations.

Since the business closures relating to COVID-19 are wide reaching, if an insured’s primary policy does not cover business interruption losses, it is not likely that the contingent business interruption would apply. However, if the insured’s business impacts are primarily due to a customer or supplier who is shut down, the policy wording should be reviewed in the event that coverage is broad enough to consider the current situation with COVID-19.

Summary

How business interruption insurance policies will respond to the COVID-19 pandemic is evolving. Although, at this time, there appears to be limited opportunity to submit claims, it is advisable to consult with a claims professional and understand the coverages your policy may afford and how the claims process works.

Our global insurance claims services practice at RSM has extensive experience with claims preparation and review for a wide variety of commercial policies. In the event you have a loss that is eligible to be claimed, professional fees coverage is often included, allowing you to hire a professional to prepare or review your claim at little to no cost.
The slowdown in West Coast port activity implies that the supply shock affecting the North American economy is broad and deep.

The data suggests a sharp decline in consumption and industrial activity as businesses struggle to acquire supplies needed to make finished goods and consumers pull back because of a lack of products on store shelves.

Imports at the Port of Los Angeles are down 22 per cent through February, compared to a year ago, the largest drop in six consecutive months of declining imports at the U.S. gateway for Asia-produced goods. Imports at the Port of Vancouver are down nearly 15 per cent during the same period.

Without a doubt, these declines translate to increased unemployment in the trade and transport sectors supported by trade and shipping.

L.A. and Vancouver are not alone: Import activity (measured by the decline in shipping containers loaded with imports and exports) at all West Coast seaports is in decline, initially as a result of the U.S.–China trade war, and now as COVID–19 shuts down production of Asian trading partners.

The drop in imports implies a continuation of the supply shock facing North American consumers once their panic buying subsides. The lack of imports from Asia will make it even more difficult to restock empty shelves once inventories are exhausted.

And with income streams threatened by business closings and consumers sheltering in place, we expect an eventual drop in consumer spending on nondurables, to be followed by decline in spending on durable goods.

Though not a perfect predictor of GDP growth, the decline in West Coast port activity since 2017 would suggest a further slowdown in overall economic growth on both sides of the Canadian border.
Business insights to bolster your response to COVID-19

As businesses like yours respond to the impact of the coronavirus pandemic, it’s important for you to stay on top of the evolving issues related to this crisis in order to mitigate risks and plan accordingly.

RSM can help you stay informed with the latest insights, ideas and countermeasures to minimize the outbreak’s negative effects, as well as prepare you for future emergency events.

Visit our Coronavirus Resource Centre to learn more.