

What Comes Next?

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“Unprecedented” is a word that has slipped into our collective vocabulary largely unnoticed these last few weeks, but with good reason: much of what has played out in markets and in our day-to-day lives over the last month has no directly comparable equivalent without going back many decades.

While it is tempting to present a series of metrics or charts to explain just *how* volatile the last six weeks have been, it likely doesn’t add much to the discussion on what happens next. At this stage, I cannot imagine any readers are not aware of what has happened in markets.

Instead, I believe having a framework on how to approach the next few weeks and months in equity markets may prove helpful.

How To Think Through What Happens Next

There is a huge amount of uncertainty involved in making forecasts and predictions at present. It is a time to be long humility and common sense, and short on pride.

While it can be tempting to make predictions regarding the progression of the spread of COVID-19 based on available research, there are definite risks to claiming domain knowledge in a very technical field far outside of one’s normal areas of expertise. I would wager that an in-depth understanding of epidemiology certainly falls into that category for most; it certainly does for me.

Additionally, I do not believe there is much to be gained in debating the correct actions policymakers *should* be taking, either from a monetary, fiscal or health care policy perspective. That is outside of the control of investors.

As a hugely experienced investor once told me early in my career, don’t confuse with what you *want* to happen, or what you think *should* happen, with what actually can or will happen.

In my opinion, understanding the potential trajectories of the spread of COVID-19, the broad policy implications on public health and economic activity of each trajectory, the potential impact on portfolio holdings, and having pre-determined flags or triggers that would prompt action as events unfold will add more value than trying to time the bottom.

Much of what transpires next will depend on the robustness of the combined fiscal, monetary and public health response to contain the crisis and ensure there is no irreparable economic harm. As such, it is worth discussing each in a bit more detail.

A Very Different Recession

In a 'normal' recession, consumers and businesses reduce discretionary spending as unemployment increases due to a tightening of financial conditions. Almost all businesses face revenue pressure. Deeply cyclical businesses – mostly those in the commodity, financial, industrial and consumer discretionary sectors – tend to experience an above-average negative impact to their revenues.

The key takeaway is that this recessionary scenario still assumes some base level of activity to continue across the whole economy, with the percentage decline in revenues range somewhere between low- or mid-single digits for less cyclical businesses to potentially somewhere in the 30s for deeply cyclical businesses. Astute management teams, private business owners and even households make financial decisions based on worst case scenarios within this 'normal' range, based on prior experience.

What makes the coming recession very different is that there will be entire sectors of the economy essentially shut down to combat the spread of COVID-19, meaning the assumed base level of activity and demand for many companies will simply evaporate.

To state this in more practical terms, the owner of a well-managed, successful local coffee shop might assume a decline in sales of 5% to 15% during a 'normal' recession and be in the financial position to withstand such a period. However, no-one plans for revenues to suddenly decline by 50% to 90% due to customers being unable to even access your product or service.

It will hit economies with large service components very hard – and given that service industries employ a huge number of people, the resultant spike in unemployment will be enormous, feeding a collapse in demand.

On the other side of this equation, there is a substantial disruption to supply chains. This applies equally to physical goods and labour. Even if workers are at factories and able to produce, the globalised nature of just-in-time supply chains mean that a break somewhere along the chain essentially renders the capacity to produce moot. Additionally, if labour is unavailable due to the lockdown measures imposed by governments to contain coronavirus, an up-and-running-again supply chain counts for very little.

The global nature of the cause of this recession – a pandemic – means that all economies will experience this disruption simultaneously – there is no true 'safe haven' of demand, though Chinese demand will likely recover first.

Taken together, these factors mean this recession will be very different in scope and shape to anything that has occurred in the post-World War 2 global economy. Practically, it means using the financial performance of businesses during previous recessions to forecast performance going forward will be of little use. The playbook is well and truly different.

As an investor, the focus needs to be on cash flow, liquidity, and the ability of an investee company to stay solvent. Having a three- or five-year investment horizon counts for very little if a business runs out of cash in the 3rd quarter of 2020.

The Monetary and Fiscal Policy Response

To address the current policy response implemented by governments and central banks around the world, it is worth understanding how the coronavirus impact can be transmitted to the economy.

To assess the economic outlook, I find it useful to apply a structure to think through the issues: real economy risk, policy error risk, and financial system risk.

I believe there is zero chance of monetary or fiscal stimulus being withdrawn too soon; if anything, the risk is to the other side. The here-and-now requires substantial intervention by governments and central banks to get individuals and businesses – productive capital, essentially – to the other side of the crisis with as little damage as possible. Lower rates, materially higher government deficits and unprecedented quantitative easing will likely have inflationary consequences down the road, but I believe this is more of a medium-term risk than an immediate one.

This means the immediate transmission mechanism for the crisis lies in the real economy and in the financial system – and in this case, the two are interrelated.

Traditionally, financial crises affect an economy's supply side by disrupting new capital formation. When credit cannot be extended to projects where it can be deployed to create economic growth and profit, businesses cease to grow and look to cut costs. Workers exit the workforce, skills are lost, and productivity – a key input to GDP growth – declines. Finding and retraining new workers is a lengthier process laying people off, meaning the longer a crisis drags on, the slower the recovery is likely to be.

Policymakers have a playbook for dealing with crises like these. First and foremost, it is essential to improve liquidity conditions to ensure there is not a mass liquidation event, where many leveraged economic actors (including investors) become forced sellers of otherwise productive assets to meet payments to credit providers. Given how poorly the financial plumbing was working on some days in March, central banks stepping in with very meaningful measures to keep the financial system up and running was critical. (The risk of having a full-blown financial crisis on top of a real economy crisis of this scale would be almost too terrible to contemplate).

Secondly, if the issue becomes one of a capital nature, governments could effectively recapitalise businesses or even entire industries. These actions are always politically controversial and fraught with potential moral hazard. However, given the cause of the current crisis – a largely externally driven event, comparable to a global natural disaster – we believe it is likely that such action will be taken by fiscal policymakers if required. (The calculus essentially amounts to solving the immediate crisis and having to pick up the pieces afterwards, versus an outcome so dire as to not have any pieces left to pick up once the dust settles).

Where the policy playbook ends is in dealing with the impact to the real economy: the day to day 'business of business', consisting of millions of individual transactions between market participants offering goods or services, and being paid in exchange for those.

The current health care policy of social distancing required to slow down the spread of the disease has a hugely negative impact on economic activity, given that it effectively shuts down business activity that

occurs in close human proximity and cannot be done remotely. This effective shut-down will have the effect of placing otherwise healthy businesses and households in a massive liquidity crunch, with no income to meet fixed expenses in the absence of government support. Should this continue for an extended period of time, the liquidity crunch turns into a solvency event, driving up real economy bankruptcies and directly feeding into the financial system, which then becomes less inclined to extend credit into the real economy, starving it of capital.

This non-linear risk between the real economy grinding to a halt and its impact on the financial system was the greatest immediate threat in March, and central banks and governments responded apace.

While I believe policymakers will continue to do everything in their power to avoid a liquidation event, I do not believe they can effectively step in and subsidize all the lost economic activity for an extended period of time via stimulus. The reality is that there will be businesses and households forced into bankruptcy.

The Health Care Response

The missing element not yet discussed is the health care response. As is well understood, the policy of social distancing has substantial negative impacts on economic activity. As mentioned above, I claim no particular domain knowledge of epidemiology, but offer some observations on how the health care response will be critical to the resolution of the economic crisis.

The single most important factor to achieving some sort of near-term resolution will come down to a substantial increase in testing capability for COVID-19. Economies that have more successfully dealt with the outbreak of coronavirus have all been extremely aggressive in the application of testing. If done early enough, daily life and economic activity can continue with relatively few restrictions; left too late, much more severe social distancing is required to slow the spread and delay the impact on the health care system over a period of time.

This latter point is critical. The true risk of this outbreak is the non-linear increase in the mortality rate as soon as the health care system becomes overwhelmed.

Current data indicates that somewhere between 15% to 20% of individuals infected with COVID-19 require hospitalisation. A smaller subset of those hospitalised need intensive care, with some percentage – estimated to be somewhere between 1% to 2% of all infections, though with a wide margin of error – unfortunately pass away. However, the mortality rate increases dramatically if one exhausts the ability of the health care system to provide this level of intensive care.

Sufficient quantities of ventilators and protective equipment for frontline health care workers are critical. If one considers the lead times for training a new doctor or nurse, they are literally the most valuable resource to be protected during this pandemic, as losing a substantial portion of these trained professionals means not only will the health care system be overwhelmed sooner, but that other treatable conditions or emergencies will not be attended to – a recipe for much, much higher mortality rates.

A period of lockdown, combined with very aggressive testing to identify and isolate those infected, seems to be the consensus forming between government and the scientific community on how best to deal with the outbreak. This also seems the most sensible approach: slam the brakes as hard as possible on

community spread to maintain the integrity of the overall health care system, using the time afforded to aggressively test and isolate chains of transmission. Once the community transmission is under control, the strictness of the lockdown can likely be loosened using a tiered approach. This would allow less vulnerable populations to return to work, but with the understanding that aggressive public health interventions in public spaces will be in effect for an extended period to control potential further spread.

Based on interaction with subject matter experts and research, this type of outcome can likely be achieved over a six to twelve-week period – but it requires severe restrictions upfront. At present, the US has effectively implemented a social distancing policy of to 30 April 2020, whereas restrictions in Australia will last to the end of June. In other countries, shorter periods have been announced, with the provision that it may be extended based on local conditions.

A possibility one cannot discount is the potential for an effective preventative or therapeutic treatment to become available that dramatically reduces the risk of mortality. As of the 31st of March, there are several trials already underway around the world to test potential drugs that have anecdotally had some positive impact on patient outcomes. The trials are being conducted to test whether or not there is a clinical basis for rolling out these treatments to a wider patient population. In addition, the medical community is moving at record pace in developing a vaccine against COVID-19. Though the timeline for this vaccine is likely 12 to 18 months away, it is the endgame scenario for dealing with the virus.

Any progress made in defeating the outbreak will be a massive positive – both from a humanitarian point of view, but also for markets and economies, as it means activity will normalise sooner.

Implications for Portfolio Construction

To understand what all the above means from a portfolio standpoint, it's worth distilling it down to an operating thesis from which to work. These assumptions are presented with the knowledge that there is a substantial margin for error.

- Governments are most likely to implement a period – between six to twelve weeks – of social distancing policies of varying severity. In many countries, this period has already started.
- To counteract the inevitable economic impact from the abovementioned policy of social distancing, expect robust and ongoing fiscal and monetary interventions to get households and businesses to the other side in the best possible condition. This will likely continue over the remainder of 2020.
- The lockdown period will be used to aggressively ramp testing and contact tracing capability, with a view to identifying community spread and isolating it, driving down the reproduction number (the expected number of people one sick person is likely to infect, also known as R_0 or R-nought) as much as possible.
- Once the spread of the virus has been contained, lockdown restrictions will be slowly lifted in a tiered manner, with the view to avoid secondary infection clusters from occurring. Certain restrictions on public gatherings will remain in place, but economic activity will slowly start to normalise.
- Central bank policy will remain incredibly supportive until a recovery is well and truly underway, and even then, rates will only go modestly higher.
- Economic activity will slowly start to normalise by the fourth quarter of 2020, with a more robust pick-up in activity in early 2021.

- After the initial rebound, the long-term economic growth trajectory will likely be tepid for an extended period.

What does this mean from a practical standpoint?

Firstly, it means having a robust portfolio, focused on owning businesses with high quality balance sheets and substantial free cash flows that will survive this disruption relatively unscathed. If a business has the balance sheet to survive, assess whether this disruption will ultimately change the long-term prospects of the business once we emerge from the lockdown phase. If the answer to the second question is 'no', any weakness due to a short-term revenue disappointment is likely an opportunity to accumulate a larger holding.

Secondly, it means not selling businesses with high-quality balance sheets and an unimpaired long-term outlook in a panic, even if you believe there will be a near-term hit to revenue. There has already been a substantial correction in markets. I cannot profess to have the ability to call a bottom in markets, but unless the impact of COVID-19 stretches well into 2021 or beyond, I believe the outlook for equity on a 12 to 24-month basis is attractive. This is particularly true when compared to cash or government bonds, which at present levels are almost certain to deliver poor real returns over the same timeframe. Markets will bottom before the data does and trying to time the bottom is very likely to destroy more value than it adds to a portfolio.

Finally, have a plan to use further market weakness to selectively deploy cash. It helps to have identified several high-quality businesses that one would like to add to a portfolio.

The above playbook is the one we have deployed over the last six weeks, and it has served us well over the short term.

In Closing

The first quarter of the new decade proved to be one for the record book, though for reasons none would have wished for.

We fully expect the next few weeks and months to be tough. Volatility will remain elevated, and it is likely several weeks before news starts improving, barring a medical breakthrough that alleviates both the health care challenge and allows for an earlier resumption of economic activity.

I wish you and your loved ones safety and good health during these challenging times.

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