

Where to Invest in a Post-Lockdown World

29 April 2020 | Roger Montgomery, Montgomery Investment Management

Now that governments are talking about re-opening the economy, investors can start thinking about the businesses that might provide the best returns as we emerge from economic hibernation. Here, I give a quick appraisal of the investment landscape, and identify the key attributes of businesses that I think will rebound the hardest.

Many are comparing the Australian economy's current predicament to the Great Depression. During the Great Depression however unemployment in Australia rose to 30 per cent. Nobody is currently predicting such a crisis – unemployment is forecast to rise to between 7.5 per cent and 10 per cent. And as each state gains control over the spread of the virus, relaxes social distancing rules and reopens commerce, the unemployment rate will likely lean towards the lower end of that range or, if it spikes higher, is unlikely to remain at the peak level for long. That is even more likely if lockdowns are unlocked sooner.

Wages however have plunged as those that remain employed are forced to take pay cuts. Meanwhile, the official response has been enormous. Government stimulus of \$220 billion represents 11 per cent of GDP, which is much greater than the average globally and the RBA has been buying bonds, supporting banks and ensuring rates on business and household lending remain low.

While economic conditions are rapidly evolving and highly uncertain, the economic outlook has deteriorated. The questions for many investors is how deep will the recession be, what sectors are expected to see the largest declines, and what are the key data points to monitor?

As 'bottom-up' equity investors however, we are interested in the experience of individual companies, as well as an understanding of the dynamics in each sector, which can vary greatly. While we expect earnings and dividends to fall by as much as a third in aggregate, it's not all bad. A friend of mine, Peter, owns a large bike shop and his revenue is up more than a third year-on-year. Bike stores across the country are reporting a huge spike in sales and servicing as families ride together to escape boredom and get fit.

Not everyone is using home isolation to get fit though. Another friend owns a boutique wine distribution business and he tells me volumes are double to triple what they were this time last year. Another bonus for him is that with restaurants shuttered he's suddenly a wine grower's best friend. Labels that might not have spoken to him previously are now clamouring for him to buy their stock and he can help in their crisis, establishing enduring relationships.

Collating our own and sell-side analyst thinking we note the following.

Market overall

After rallying slightly more than 25 per cent from the low on March 23, market valuations appear stretched again, which could limit further upside. Putting the rally in perspective, the ASX 200's PE ratio is more than one standard deviation above its recent average. Ex materials, property and banks the market appears to

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be on a FY20 PE of over 25 times. Obviously the market is looking beyond the short term impacts of COVID-19.

Mining

Lower global demand for raw materials and steel. China accounts for 70 per cent of seaborne iron ore demand and economic activity there is reviving. Lower production to date due to disruptions but production from South America, South Africa and South East Asia is coming back too.

Banks

We have been negative on banks for a few years now, believing credit growth would moderate and net interest margins would come under pressure. Our significant underweight position reflects those views. And while credit conditions have now collapsed, we mustn't forget the banks are high quality oligopolists. Several banks are now trading below book value for the first time in many years and therefore offer much better value. Capital raisings below book however are dilutionary and impact adversely on valuation per share. On balance a more neutral (rather than negative) perspective is required.

During the bank reporting season which has commenced this week, investors will probably focus on outlook statements and the extent to which expected cuts in dividends are realised. Earning reports will be from the past, with late March and April likely to better reflect the downturn and therefore immediate future conditions. But it will still take some time for arrears to flow through, so bad debt provisions will help us to understand how a bank's management is balancing actual first half conditions versus expectations for the full year.

In terms of valuation, they are cheaper than they have been for some time, but we believe better value is necessary given the substantial erosion of profitability over many years and more recently.

REITs

Difficult to summarise all in one paragraph as they have different exposures. There will be negative impacts from short term rental abatements and from retailers negotiating with greater legislated power. Deferrals and incentives will ensure landlords share some of the burden of the economic lockdowns. In turn, there will be an impact on loan to value ratios, which may result in capital raisings. In the residential space, turnover has collapsed. The extent to which job losses extend beyond part-time and casual staff will pressure volumes as will the rapidly rising level of rental stock.

Infrastructure

Lockdowns have significantly restricted mobility, which in turn has impacted cash flows and dividends for the major players in this hitherto reliable sector. Essential infrastructure status (airports and roads – Transurban, ALX, Sydney Airport) however will ensure the long-term investment merits of the sector, and even a gradual or staged return to economic activity may limit the downside from here for investors. Dividend cuts/suspensions may remain for 12 months ensuring there are no questions relating to liquidity or credit market access. Sell side analysts are anticipating traffic to return to pre-COVID19 levels by 2021 –

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not too long to wait for investors with a longer-term horizon. Essentially, near-term volume impacts are being seen by professional investors as having a limited impact on longer term valuation.

Retail

Probably the most challenging to correctly anticipate. Revenue impact from declining foot traffic partially offset by staff reductions, store closures and rental negotiations. Revenue has been hit much harder than the cost of doing business. For some, a surge in online sales has increased the number of 'members' who will stick to the brand. This is particularly true for supermarket owner Woolworths, which has picked up almost a million Rewards members and online customers. We note, grocery (Woolworths, Coles, Metcash), electronics (Kogan, Harvey Norman, JB Hi-Fi) and hardware sales (Wesfarmers, Metcash) have been very strong – never seen so many people buying "essential" items at hardware stores during the lockdown. Analysts are assuming discretionary earnings return to past levels in FY22.

Prior to the sell-off, the key was to be in defensive, large cap, high quality businesses to reduce risk. Investors now need to think about leverage to the recovery. Another wave of price weakness is possible as markets re-calibrate their recent optimism, in light of the depth and length of the economic fallout. The possibility of another sell-off should be seen as a positive for long term investors. Being prepared will ensure the lower the price paid, the higher the return.

The best businesses will be those with sound balance sheets but whose share prices have not recovered. One way to assess this might be to think about which companies have done a good job of their online offerings, are leveraged to a recovery because they sell categories that respond quickly (think fashion, homewares, fastfood for example), while comparing current price multiples to historical averages. Investors need to also ask whether strong recent sales have brought forward demand from later in the calendar year.

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