

Clarity & Opportunity in a COVID-19 World

13 July 2020 | Anton Lawrence (Chief Strategist), Collins St Asset Management

- A world awash with COVID-19 points to global economic contraction in the 2nd half of 2020 being worse than many investors have internalised.
- Central bank activism is leading investment markets by the nose and may cause unintended consequences in the medium term.
- The geo-political climate has worsened considerably, and the Australian corporate sector is moving quickly to take account of shifting trade and investment relationships.
- The Collins St Value Fund has successfully pivoted its exposure to sectors to benefit from the Australian economic recovery while retaining flexibility for the recovery beyond those sectors to not take hold until the second half of Financial Year 2022.
- We retain our conviction on gold and uranium, continue to invest selectively in pharmaceutical companies that show real promise on a 2-3 year timeframe, and are investing at attractive price points in companies that will benefit from Government expenditure on infrastructure, changing commuting patterns and the evolution of white collar employment.

“We are in a time when the smart money lacks all conviction, while the dumb money is filled with a passionate intensity”

Paul Krugman, Economist, New York Times, 17 May 2020

Introduction

How have you been feeling over the past four months with the gyrations in both global and local stock markets? Throughout the COVID-19 event we at Collins St Asset Management have retained our normal high conviction approach in relation to both our investment world view and our actions on the ground.

Far from lacking conviction, we have been actively placing funds with specific companies and specific sectors. Sectors where the upside from both global markets and Government intervention are going to be most pronounced. Companies where we have been able to gain exposure at prices which provide real upside over the next two years.

We have been all been witness to a lot of strange things since April.

Mum and Dad investors have been pushing up stock prices, here and the United States but also in Asia and Europe, to levels that make little sense on normal valuation metrics. In the United States, the best manifestation of this was the rising share price of global hire car company Hertz – a company that filed for bankruptcy on 22 May! Shares were only finally suspended by the authorities on 17 June. To cap it off, the S&P 500 finished the quarter up 20 per cent at 3,100, its biggest percentage gain since the fourth quarter of 1998.

There have been the worldwide protests against racial discrimination, an admirable cause but complex in the face of a pandemic. Putting aside the cause itself, it provides us with an insight into the psychology of a segment of the consumer in western democracies (after all, western democracies are the only place where these protests are tolerated).

Europe has started to open its economy as COVID-19 infection rates have declined. We wait to see whether this results in a crushing second wave of infection there. Quite aside from the racial issues described above, the social condition of the United States is going from bad to worse with everything, and I mean everything, split upon a pro-Trump and anti-Trump fault line that will be difficult for anyone to heal for many years. As investment professionals with our primary concern being producing positive returns for our investors (after all, we do not get paid unless we do), it is vitally important that we stay above any ideological subjectivity and stick to the facts.

The ground rules we established for adjusting our portfolio settings have served us well as evidenced in our investment returns being well above market on an after-fee basis since the advent of COVID-19. We retain a laser like focus on the economic consequences of the primary drivers.

Government Economic Stimulus

It is getting close to witching hour for Job Keeper. States other than Victoria are opening fast now but things could go sour at any time and all Government's know it. The Federal Government has made it clear that there will be no geographic distinction within Job Keeper or for that matter Job Seeker and other than the impracticality of delivering assistance on that basis, it would almost certainly trigger a political landmine for the Federal Government.

We suspect that there will be a continuation of support at both the business and individual level until the end of March 2021 although there will be considerable tapering of that support, most likely by industry with the tourist and airline sectors the most likely to be left standing holding the loot at that date.

Government Intervention in Private Markets

The pressure put on debt providers (both bank and non-bank lenders) to provide companies with a 6-month interest payment holiday to help their customers 'reach the other side of the crisis' to quote the Prime Minister has now extended in many cases to, in the words of the Australian Banking Association president Anna Bligh 'up to an additional four months'. We remind all that the interest on these loans will still need to be paid.

One of the key issues for the Government will be whether to retain the directive for ASIC to allow companies to continue to trade in the current environment, when in reality many of them without many or any customers are technically insolvent, what are now being called 'zombie companies'.

The Government needs to find a nexus here between giving false hope to these zombie companies and forcing tens of thousands of small businesses, and a few big ones into administration.

Financial Regulator Intervention

The directive for APRA to lower Tier 1 capital requirements for banks so that they can lend more has waxed and waned recently. The possibility is that this would expose lenders to greater stress in the event of a protracted property downturn, which as mentioned earlier is part of our macro investment proposition. As also mentioned above, regulator intervention may have some unfortunate consequences in relation to lending to businesses that look, speak and smell like zombie companies. All of this does not add any confidence to our outlook for bank share prices through the next few months.

National Quarantine Measures

It is now clear that there will be no business, leisure or VFR (visiting friends and relatives) international travel in 2020, with the increasingly unlikely exception of New Zealand. Despite the best efforts of some State Premiers to suggest otherwise, domestic tourism remains highly constrained and this is having a deep effect, both economically and psychologically, on communities in regional Australia.

Recent speculation from municipal leaders in the far north Queensland tourist mecca of Cairns that the unemployment rate there could be 30% by late this year puts an exclamation mark on a tourism sector awash with woe. We are not seeing the real effects yet because the tourist sector, whilst it employs (or did employ) 5.2% of the Australian workforce, contributes just 3.1% of GDP - directly.

I say 'directly' because the financial stress felt those one in twenty Australian consumers will flow through to the other sectors of the economy dependent on domestic consumption. We will not see it manifest directly in the share market though because tourism companies make up just 0.2% of the market capitalisation of the S&P ASX200.

We need to look under the cover of listed companies in the consumer staples and related sectors to see just where the pain is. We also know that where there is pain, there is opportunity to invest in good businesses that the market is likely to undervalue over the coming months.

Social Distancing

There is no debate that Australia's social distancing discipline broke down in late May and early June. That, at the time of writing, the resultant outbreak of COVID-19 is limited to metropolitan Melbourne is likely due to a concurrent breakdown of Victorian Government department bureaucratic discipline as well. Despite the wishful thinking of many, as with investing, luck plays little part in medicine or health. We expect that September consumer patterns will show increased caution in the rest of Australia and that the psyche of Australians will remain poles apart from that in New Zealand – the only country in the world with a population of more than 2 million people that in mid-July can genuinely point to COVID-19 suppression.

The Global Interface

A major feature of international politics is the ever-increasing schism between China and much of the rest of the world, Turkey, Pakistan, Iran and North Korea excepted. While back in April, the thought of a de-coupling from China on a business plane by much of western Europe, North America and Australasia remained more theoretical than practical, at times it seems as if this is China's wish. In the past three months we have seen a ratcheting up of threats from a raft of Chinese officials to a conga-line of western trade partners, followed by the imposition of trade barriers, some subtle, some explicit, for those said countries critical exports.

Together with a doubling down of anti-global trade actions by the United States administration, this is forcing many countries that, like Australia, prosper on the back of free trade to place new free trade agreements with the European Union and Britain as a top priority. A long-term pivot in trade from Europe and the United States to Asia, especially China, is over. It is now a bi-partisan position in Australia and the view of the overwhelming majority of the Australian population that the sovereign risk to Australia from foreign ownership of the core means of production and core infrastructure, whether that is telecommunications or hard assets is a clear and present danger to our economic and physical security.

That is unlikely to change in the next generation. The recent announcement that defence spending will increase to 2% of GDP overlays this thesis but an important by-product is the permanent employment opportunities in that sector. While Singapore may be the biggest beneficiary of the displacement of many of Hong Kong's investment banks and other property and finance companies due to China's intervention there, as this plays out in the next few months we will be looking closely at what proportion of Hong Kong's finance companies, if any, may choose to relocate to Australia.

We reiterate that the Covid-19 event will change the global business and political map permanently. The most powerful manifestation of this will be seen in the aftermath of the health component of this crisis where the economic fallout will linger for several years. It will come in the form of a from-the-ground-up societal shift from an ever-decreasing emphasis on the nation-state to a demand for Governments to assume a 'my country first' approach to economic activity.

Investor Psychology

In our last paper, we discussed how the investor, as a global entity, is now moving from a state of shock to one of denial. The disbelief at what has unfolded since the beginning of 2020 - infection, death, job destruction, long lines of the newly jobless and the inability to hug one's parents and grandparents, is real and persistent and has now turned to a rising sense of anger. This anger only increased further due to the renewed disease outbreak in Victoria from mid-June. We continue to emphasise that this is a normal human reaction to distressing events and no one is completely emotionally detached from those feelings.

It is critical that investors channel their feelings to enhance their clarity of thinking. In May and June this focus meant we identified some great investment opportunities, which we were able to execute at prices well below what we considered to be fair value even on the most negative scenario of closed borders for the entire 2021 financial year. We invested with the house view that the Australian share market and global markets in no way represent what is happening economically on the street, or even reflects a reasonable view out 12 months from now.

The possibility of a renewed closure of a large part of the Australian economy (Melbourne houses 1 in 5 Australians and a similar share of GDP) was always in our range of scenarios and we have not discounted further outbreaks elsewhere.

Consumer Behaviour

With the above in mind, there will be no snap-back in household consumption or private sector investment to what existed in late 2019. In many sectors of the economy we will see permanent changes to the way goods and services are demanded and provided. Other sectors will see a gradual return to previous levels and behaviours, but the emphasis must be on gradual.

An example is the way we commute. As the Australian economy attempts to re-open, we may see a continuation of the decline in public transportation usage and a corresponding gridlock on our urban roads as people practice social distancing. Even once virus suppression is declared, perhaps late this year, will people be prepared to resume close proximity travel on the train, tram or bus or will they continue turn to their cars in droves, thus producing a windfall for toll operators (and causing massive congestion)? We think it will be the latter for quite a while, and so in May we increased our investment exposure to the effort of keeping cars on the road. We have been rewarded.

Similar questions continue to apply to many sectors of the economy including the hospitality and fast food sectors (when will you be happy to dine at your favourite restaurant?) and insurance (remember that moment when we realised pandemics weren't covered?). What does the demand profile really look like for air travel? Qantas thinks it knows. It has sent all 12 of its A380 super jumbos to California for storage for the next three years. None of these huge planes are more than 12 years old and yet some or all the fleet may never fly again. Right now, in mid-July, 25% of its Australian customers (Victoria) and all of its international customers are out of reach. Ditto Virgin.

Demographics

The numbers we adopted as a base case in March are now becoming a stark reality. We know all demand for goods and services is driven by demographics, and the complete cessation of overseas migration to Australia is now confirmed to be a feature until at early 2021. Together with new ABS data showing 32,000 people left Australia in March, April and May than arrived, when adding in births over deaths, this will have resulted in zero population growth over that short period. It points to a population growth rate of between 0.2% and 0.35% in the year to March 2021, no more than a fifth of that for the previous year. This will manifest itself in lower demand for new housing.

Do you want just 20 people at your wedding? I think not.

So, notwithstanding the propensity for many to live together prior to formalising the relationship, household creation will be lower, which in turn will see a decline in demand for whitegoods and furniture, construction materials, and lower employment in the construction and property sectors.

As in the past, this may create a vicious cycle of higher and persistent unemployment which results in declining housing and commercial property values, tenant demand and so on. Others have suggested a decline of 80,000 housing starts in the next 12 months, a huge decline in percentage and numerical terms and we think these numbers make sense. Property will be the last sector into the downturn and the last one to emerge. Do not believe the real estate agents.

But there is a new X-factor that needs to be built into our demographic scenario. Hong Kong will not be the same global financial centre following Chinese Government regulatory changes now in place. There are around 100,000 Australians in Hong Kong and many will choose to relocate back to Australia in the next two years. Australia is now adjusting its immigration rules to allow many Hong Kong citizens to migrate here should they wish.

The population of Hong Kong is 7 million. There is every prospect of 300,000 Hong Kong residents migrating here in the 2021-2025 period, equivalent to 19 months net migration prior to COVID-19. Such a highly motivated and productive immigration cohort, which would likely flow primarily to Sydney and Melbourne, would provide a material boost to our longer-term economic prospects.

Market Sector Prospects

As we continue to tweak our investment overlay at the global and Australian level on both economic and political terms, we can provide our updated sector specific investment strategy within our investment universe of ASX listed companies.

We reiterate that there will be a large difference in the timing and shape of recovery across different sectors of the economy and this must be considered in the context of our pricing of investments. For example, any company exposed to international tourism, whether it is an airline, travel agency, tourist operator or an exposure to the international student market needs to be considered in the context of a five year timeline to the resumption of the previous volume of business, if at all.

Oil and Gas

We retain the view that Oil and Gas, rather than losing their entire customer base are likely to see only a gradual recovery in demand and prices that reflect that reality. We see little attraction in the oil sector but have maintained our small exposure to gas resource exploration by participating in the issue of new equity in the past few weeks.

Gold

Gold is now benefitting from a move to safety by some investors and we expect the attractiveness of gold to be maintained or even enhanced for some years. Several of our gold related investments have made significant price gains in the time since we made further investments to maintain our weighting in the sector.

We will make further investments as necessary to maintain the current weighting.

Uranium

We retain our positive view on Uranium. All the objective reporting on the demand and supply drivers for the sector point to the looming undersupply of uranium. Nuclear power, as a clean power resource that is always available to households and industry day and night and in any weather continues to be a sought-after commodity to power the world's five largest economies and many others.

We have retained our weighting to the uranium sector, participated in some institutional placements in recent weeks, and intend to maintain our weighting at current levels.

Retail

Retail remains in deep distress but there will be opportunities in that sector that will emerge as new consumption patterns establish themselves. We continue to watch closely but have not yet identified any opportunities to engage in a deep dive due diligence. The hurdles now are the continuing spiral of forward-looking profitability for most retail companies and the lack of realistic adjustment to pricing of those opportunities.

We suspect it will be some time until the real opportunities arise, but we will remain vigilant.

Information Technology

We are not getting swept up in the IT sector and certainly not in the 'buy now, pay later' companies that are witnessing an inexorable explosion in their share prices. From our perspective, this 'buy now, pay later' form of payment, which has always existed in smaller scale arrangements, will just add more and more debt onto households. Aside from the likely higher levels of financial distress and other issues it will cause at the consumer level, we believe there is every chance of a repeat of the dotcom boom and bust of 1998-2001.

We have not seen a realistically priced tech company on the Australian share market for some time.

Construction, Infrastructure & Property

Construction and property, two of the largest employers alongside retail, are also in a state of flux. As we said earlier, we expect the worst conditions in these sectors to be some time away yet. We are yet to be enamored by what looks on face value to be more attractive pricing in the REIT sector. But there are some interesting opportunities emerging.

Two key themes that we have already moved to participate in are Government fiscal stimulus in the form of physical infrastructure investment (road, rail and utilities) and the changing relationship between white collar employees and the workspace they utilise.

Infrastructure investment will be huge, and we believe that investing in infrastructure delivery businesses that target small to medium size projects (<\$2 billion) is the best approach rather than the enormous ones that often end up with massive cost overruns and disputes with Government.

We are focussed on companies that have industry certification with a high hurdle for approval and management prepared to inject new blood to refine company culture and thinking to the post COVID environment when it comes.

In respect of workspace, a new white-collar workplace ecosystem is starting to emerge from COVID-19 that includes the traditional office, albeit with a higher workspace ratio (m2 per employee), the home office, and what some are calling third spaces. We expect these third spaces will emerge and that they will be an improved outgrowth of the serviced office model but not in the way that the big global co-working companies envisaged.

Flexibility and adaptability will be key and in some respects the options will look like a restaurant menu with the ability to 'hold the onions' or have the proverbial steak rare, medium or well done. Temporary shutdowns such as that occurring in Melbourne at the time of writing or that may occur in other locations from time to time do not detract from our investment thesis over the next three years.

Banking & Finance

Banking and Finance will provide great opportunity at the right time. We were getting closer to pulling the trigger on an investment during the June quarter, but the price did not reach our required threshold. The downside has only increased now given the ramp up in sector share prices in May and June. The opportunities are yet to come but come they will.

Health & Biomedical

The final sector with our attention currently is health and biomedical companies. We continue to invest selectively in opportunities. However, many companies remain overvalued, Government intervention rewards some and damages others and we are concerned about unrealistic timelines for the development of new drugs.

In a new development, we are seeing some healthcare companies providing guidance on future prospects based on demographic and social scenarios that reflect the pre-COVID world, rather than the new paradigm.

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