One Hundred Years of Solitude? (A follow up to 'Love in the time of COVID-19')

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With a bit of luck, continued good behaviour, and the arrival of more medical equipment, we can see an end to isolation. From here-on, it might not be 100 days, let alone 100 years. People will be glad to be out and about and back to work. While human interaction may change for the better for a little while, there will be long term significant persistent changes in attitudes, behaviour and policy, by companies, individuals and governments as a result of this pandemic. Some beneficial for investors, some not so much.

This last week saw the best weekly return for the USA equity market since 1974. If you are needing to sell, now is a decent opportunity. We don't think long term returns have been seriously impaired so if you don't need to sell, don't. We may have had the 'V' shaped bounce we suggested recently? As ever the stock market can be as punishing as it is rewarding.

However, if you agree with the new trends we foresee below, you may need to think about what stocks you wish to buy and hold for the next few years?

Also, don't forget the key aspects of managing your portfolio – Love in the Time of COVID-19.

Briefly we anticipate the following to be enacted, adopted, or mooted. All may change the relative merits of stocks and countries.

1. **Government interaction with, and intervention in, corporations**

i. Financial assistance to companies will be most likely be conditional upon equity dilution or capital controls (dividends and/or buy backs suspended). European and UK banks have already been told by their regulators they cannot pay a dividend – even after it has been declared and passed the necessary resolutions. Insurance companies are under similar pressure. Cyclical companies such as airlines, luxury goods retailers (Tod's, LVMH), and hotels will also suspend payment. Dividend payments from the UK and Europe will fall perhaps 50% from last year. The USA is not immune either.

ii. Japan on the other hand is in a far better position with respect to balance sheet strength. With Y6 trillion in cash on the balance sheet you can look to Japan for consistent dividends. This will mean a re-appraisal of the Japan Inc business model, for the better.

iii. Taxation 'playing field' in focus. The fiscal programmes will cost a lot of money and while the poor consumer (aka the taxpayer and the provider of savings capital) will get slugged, so ought companies which hitherto have paid no tax and/or avoided regulation. Companies which have avoided tax and

regulation will come under popular and maybe legal scrutiny? Hard to argue with a government that cries "more tax for all to pay for healthcare"? https://itep.org/amazon-in-its-prime-doubles-profits-pays-0-in-federal-income-taxes/

iv. Governments will be more engaged with MNEs headquartered in their country, regarding "conflicts of interest". President Trump invoked legislation from the 1950s (Defense Production Act) to prevent 3M from exporting face masks made in the USA to Ontario, Canada. He has also ordered GM in Detroit to produce ventilators under the same legislation. This use of the DPA will pass as the virus subsides but it has exposed the 'conflict of interest' between what the governments think they need from companies for which they provide legal protection and which they regulate and tax, and what the companies wish to do in 'their own best interest'. This has been simmering for a while and originated in the (justified) objections of President Trump to technology theft by the Chinese and their freely used importation of American technology. President Trump prevented export of certain USA technology. Governments are also likely to use this opportunity to prevent technology transfers and hostile or foreign company take-overs citing 'temporary vulnerability'.

v. That "global opportunity" may not be so global anymore? Qualcomm, Micron and Broadcom all sell over 40% of their stuff in China. Supply and sourcing chains will become more robust or duplicated, and dependence on Asia reduced. On the other hand, Asian supply to Europe is likely to increase in other areas such as medical equipment given the failure of the EU to unite effectively. This will be positive for capital investment in the USA and Asia.

All of the above reduce the returns to shareholders and the efficiency of capital deployment; and raise inflationary pressure.

2. **Changes in individual behaviour**

i. Travelling and Leisure

Public space hygiene practice will now look more like Asia than the West – this is a wider change than at first appears. We don't just mean more face masks and hand sanitizer. Think about airport and shopping centre checks on individuals' temperature, no free movement without a 'bio certificate', or at least mandatory tracking, willingness to travel and shop in confined spaces, budgets for corporate travel when Zoom, Skype etc may have held up. Beneficiaries are likely to be companies like Quest diagnostics, Thermo-Fisher Scientific which provide diagnostic and maybe on-line testing.

There's a role for the WHO here to supervise food preparation globally.

ii. Food etc

There is already a trend to more 'wholesome' food which can be seen in the relative valuations of Australian producers and companies which are effectively chemical companies, such as Heinz and General Mills (which we own). Provenance of food and the willingness to pay up for 'quality' means we may see a shift back from generic or own brand to trusted branded 'organic' food? The large shopping centres may lose foot traffic to the high street and internet-based transactions become the norm even for old people? Retailers or real estate owners will accelerate disposals and merger plans. Expensive office space in city centres may be less desirable and/or necessary?

iii. Investing

Individuals have now been hit twice in 15 years with a big shift in market volatility and large 'losses'. With interest rates massaged to virtually zero in nominal terms, let alone real terms, retirees who should be invested safely in lower risk government and high grade corporate debt paying a reasonable positive rate of return, now have to bear equity risk to get income in retirement.

We cannot stress enough our distaste for endless rounds of QE in an effort to reflate the asset price souffle and its impact on moral hazard, investment choices and its bastardization of capitalism where risk capital should be at risk and past capital allocation mistakes get penalised. After this pandemic induced sell-off (and many probably and sadly either sold out in late March or have opted for high exposure to private equity or illiquid risk premiums in their super choices) there will be a serious examination of the quality of fund managers, financial advisers, and central bank / government policy.

Since governments won't like/can't afford higher interest rates on their larger debts, we can presume rates are massaged lower for longer. Consequently, to get an income, investors will seek safer stocks which are liquid. This looks like a return to 'Quality Value' to us.

3. Changes in company strategy

More investment, onshoring, less financial engineering, lower margins, less profit growth but 'happier' companies?

i. Given the dislocation to supply chains, companies may sacrifice "lean and flexible" for "robust"; meaning more investment to duplicate supply and logistical chains, and perhaps a re-onshoring back to the USA or Europe?

ii. Corporate travel is unlikely to return rapidly to previous levels. Video conferencing remains a key component, again reinforcing a trend toward high speed internet build out, data storage and the need for up to date hardware.

iii. What price should investors now pay for CBD or 'downtown' office space when working at home has been possible? Notice also how clear the air has become with a reduction in commuters and commuting.

iv. The 'S' in ESG comes into focus?

More generally, the balancing act that companies perform between employees, shareholders and management may be seen to have gone too far to shareholders and management? There is plenty of evidence for this notably in the figures of 'profit share in the economy' which show companies in aggregate having more of the economic pie.

From the St Louis Fed:- https://fred.stlouisfed.org/series/W273RE1A156NBEA

As we return to work, we may see a 'populist' demand for a swing back toward employees? The 'S' in ESG will become more relevant and companies may have to sacrifice the mantra of shareholder focus for 'stakeholder' focus? It has clearly been a shock to many just how rapidly USA unemployment has risen; how little job security there is and how the 'gig economy' has made many people financially precarious. The Federal Reserve Board estimated that 40% of Americans couldn't cover a $400 emergency expense. https://www.federalreserve.gov/publications/2019-economic-well-being-of-us-households-in-2018-dealing-with-unexpected-expenses.htm

We know there are substantial fiscal transfers in the USA that make income inequality less alarming, but pictures of food bank queues and the statistics that will come out on illness AND poverty being intertwined, make us believe we will swing leftwards.

4. Thus, quite alarmingly, we are going to experiment with Modern Monetary Theory

This is a theory with origins in Australia but is now adopted by the left leaning Democrats in the USA. http://bilbo.economicoutlook.net/blog/

Essentially it posits that governments can and should be creating as much money as they need to ensure full employment. We think we have been here before with this one and think it dangerous, but since there is already a rapid increase in the availability of liquidity from central banks and politicians can claim there is no attendant inflation risk, we think we career towards it. In other words, liquidity will be cheap and plentiful for as long as can be maintained. For politicians it's nirvana – free stuff? What's not to like? Keep printing!

Of all the things that can cause a stock market to enter a serious prolonged bear market, it is inflation and debasement of money. Bad money drives out good. We will all have to watch this MMT development.

For now, this means you need a hedge against the expectation of gently rising prices. This is equities. If this expectation shifts to rapidly rising prices, be worried.

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