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Written by James Macpherson

> *"The coronavirus pandemic is a public health emergency. But it is also an economic emergency… This national effort will be underpinned by government interventions in the economy on a scale unimaginable only a few weeks ago. This is not a time for ideology and orthodoxy… We will support jobs, we will support incomes, we will support businesses, and we will help you protect your loved ones. We will do whatever it takes."*
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> UK Chancellor of the Exchequer Rishi Sunak 18/3/2020

The first quarter felt biblical. There were fires in Australia, floods in the UK, and even a plague of locusts in Africa and Asia. Overwhelming all these though was the Covid-19 virus that started in Wuhan in China, and has since swept through the world in a remarkably short time. It led to entire economies being shut down with billions of people in lockdown, causing an enormous shock to both supply and demand. In effect a serious recession has been mandated to control the disease. The ferocity of this shock sent stock markets crashing, corporate bonds tumbling, credit markets seizing up, in contrast to Sovereign bond markets which soared as investors fled to them for their safe haven status. As an indication of the turmoil, in three days the Dow Jones experienced two of its ten largest ever daily declines. Governments struggled to respond to the most severe healthcare crisis since the Spanish flu a hundred years ago, and have enacted emergency measures to try and support their economies. Stimulus packages that dwarfed those made in response to the 2008 financial crisis were announced in a stampede of decision making, which will cost trillions. Effectively governments in the short term have nationalised the payrolls of large sections of the economy. Adding further confusion was the collapse in March of the negotiations between OPEC and Russia which led to the oil price collapsing. The short term effects of the virus are dramatic, but the longer term effects may be equally profound.

A pandemic creates an unusual economic shock because it hits supply first. A closed factory or quarantined workforce cannot make products no matter how many people want to buy them. Lower interest rates do nothing to free up halted supply chains or top up the income of the idled worker. Fiscal packages do nothing to help a closed restaurant. With everyone in isolation consumer spending stops, so the crisis becomes a demand shock. The virus creates the bizarre circumstance where governments need to suppress economic activity to protect public health. The uncertainty that this engenders kills investment and spending, which is the life blood of commercial activity. Covid-19 has been compared to the SARS crisis of 2003 but that was confined mostly to China and HK, and China was then smaller and less integrated into the world economy. In future one can see that the eruption and rapid spread of new diseases, with the accompanying panic and economic dislocation, will raise fears over complex multinational supply chains, and so will add to President Trump's calls for more industrial activity to be returned to the West for security reasons. Nonetheless the extreme measures that governments have taken mean that the virus will be brought under control. China's draconian restrictions have achieved that already, and in Italy the number of new cases is decelerating. The one place where we can pin down accurate data is the cruise ship Diamond Princess because it was a closed environment. The salient facts are that 80% of those on board were not infected; 75% of those infected have recovered; 0.2% of the total on board have died, and they were all elderly. One mercy of this virus is that generally it spares the young. The key risk going forward will be whether a second wave of cases occur as activity restarts. Almost certainly the economic recovery will be slow because the return to normal activity will have to start gently, as that is the only way to minimise the risk of a second outbreak. Meanwhile besides the human cost of this disaster, markets will be left to appraise the economic damage.

How much is permanent and how much can be salvaged? Restaurants, the entertainment industry, most small businesses and highly indebted companies will suffer a terrible toll, though government packages are trying to offset this. Much depends on how quickly economic activity can fully resume, and that depends on how quickly the virus can be contained. At that point attention will turn to government balance sheets which are having to support this relief effort. In many cases these balance sheets were already stretched from the policies dating from the 2008 Financial Crisis.

In order to combat the virus governments globally had to undertake extreme measures. To offset the enforced idling of economic activity it is estimated that governments will need to provide 10-20% of GDP, on an annualised basis, in support of lost wages and packages for businesses. There will be an avalanche of debt issuance, and this extra debt comes on top of heavy debt burdens in most western countries. Already prior to the crisis there had been signs that bond yields had been creeping higher. In the second half of last year the US 10-year bond yield rose from 1.5% to 1.9%, but when the crisis erupted it plunged briefly to 0.3% before ending the quarter at 0.67%. This debt splurge is unlikely to be friendly to bond prices. At the end of 2019 US Government debt reached $23 trillion, with the latest trillion being racked up in just five months. This figure will surge again. In the short term interest rates will remain low given the deflationary effects of the shutdown, but the coronavirus questions the complacency of a bond market that buys bonds with a 20-, 30-, or 50-year maturity at such low yields. Some Sovereign bonds have been trading at negative yields, and many more at close to a zero return reflecting their safe haven status. In the US, for example, bonds of up to six months maturity offer a negative yield. But is a bond a low risk asset when it yields 0%, which by definition eliminates a return? The US runs a budget deficit and a current account deficit, so in the competition for foreign savings they may start to find that they have to pay higher prices to secure investors to buy their ballooning debt. This puts increasing pressure on the Federal Reserve to plug the gap, which may in turn put pressure on the dollar. No-one is concerned with inflation today but print and spend enough money and inflation will come through. Unlimited stimulus addressing a limited crisis can stoke inflation. There are some signs of rising concern about this in Europe. As the government rescue packages were announced bond markets in France, Italy and the UK sold off sharply. The sheer scale of the rescue and the pressure it will put on governments' balance sheets may finally put a line under investors' willingness to buy government debt at such low yields. As an extreme example, Greek debt yielded 35% in 2012 and briefly fell to a level where it was under 1% in February. It is hard to think that investors will feel comfortable continuing to buy at this level. Equally if there is more upward pressure on bond yields that in turn will make life more difficult for companies that have high debt levels. Before the coronavirus hit several trends were emerging that could put pressure on bond prices increasing. Among these were political pressure to curb globalisation, rising tariff barriers and reorganisation of supply chains, unfavourable demographics (a falling proportion of workers relative to retirees in the developed world), rising anti-trust activity against monopolies, more pro-active fiscal policies, and underinvestment in energy and some other basic materials. None of this is a concern in the next few months, but the trend is worrisome.

The dramatic falls in the stock market were a natural response to the crisis, though they were made worse as the crisis struck at a point when investors were raising their risk levels given that figures from the US were better than expected, and as the Presidential election cycle was ramping up, there was good reason to think that plenty of stimulus would be provided to keep the economy brimming till November.

However the S&P was already richly valued, ending 2019 trading at a record high valuation relative to sales. This measure is useful as it avoids the distortions in reported earnings due to the long standing American addiction to leveraged financial engineering. The extent of this can be seen in S&P 500 total operating earnings rising 13.1 per year in the last three years, whereas corporate profits after tax are up only 2.4% per year. The economic shutdown will affect the market in a number of ways. First there is the obvious effect on this year's activity. Second it will undermine share buybacks which have been one of the largest supports to the market in recent years. It will also reduce the yield support. Any company that needs a bailout from the government will lose its dividend. Governments won't be in the business of giving welfare to the wealthy. However the stock market crash did discriminate between sectors. Companies selling staple products (like Colgate and Nestle), and some technology companies that benefit from the need for people to live and work remotely have held up much better. Generally, therefore, growth sectors have performed far better than value. Although the ratio of valuations of growth companies to value companies were already at extreme levels this sudden economic shock devastated value names, usually because they are far more dependent on the economic cycle, and they carry the most debt. By contrast the value of companies with durable franchises and long term growth prospects became even more attractive with the plummet in bond yields. When the US 10-year bond has fallen from about 2% to 0.8% since November the long term value of a stock that grows in perpetuity above these rates becomes far greater, and the rating accorded to that stock expands. In theory a 1% earnings yield equates to a PE ratio of 100 times. If growth and inflation remain at current levels then companies that produce growth above the level of Sovereign bonds could see their PE multiples rise dramatically, even if this year's earnings are disrupted. Ultimately equities are valued not on current year's profits, but on the value of their earnings in the future. Strong companies also benefit from the elimination of competition in the recession, so many companies will emerge from the crisis stronger than before as industries are rationalised, the airline industry being an obvious example. The duration and full impact of the virus is hard to judge today, but when there is more certainty markets will 'see through' present difficulties, and start to price the recovery. Current levels of interest rates make equities extraordinarily attractive relative to bonds.

The market was caught by surprise by the dramatic collapse of the oil price when the agreement between OPEC and Russia imploded, with the result that there is no limit to what any of its members can supply to the market. Unbridled supply combined with a collapse of demand when the world was locked down led to the oil price halving in a few days. For oil producers this is painful, even catastrophic. However it is worth remembering that for consumers of oil it is a gigantic positive, acting as a massive tax cut. Unsurprisingly energy company share prices were decimated, but herein may lie an opportunity. While the renewable energy industry has made great strides, the world still relies on hydrocarbons to operate. When the economies settle down there may be an imbalance in the oil market because demand has been growing more than supply. Some oil wells are likely to be shut down altogether as a result of the crisis, and future supply is limited because there has been little investment in conventional new production in the last five years. The shale industry in the US which has filled the gap has been hammered by this latest collapse, though it was already finding life more challenging because of climate change concerns. When the virus lifts sentiment will lift and the oil market may be short of supply, with the result that prices may overact as much on the upside as they have recently on the downside.

What other opportunities are there? In the short term investors are likely to prefer the most solid and stable assets. However there is a danger that investors overcrowd these ideas. Bonds, for instance, offer almost no attraction unless a truly awful economic scenario prevails for the next ten years. Many stocks are being highly priced for their defensive characteristics though they exhibit little growth, but if the world recovers those qualities will be less highly valued. In the market crash some great values have been revealed. Asia has managed the crisis and is starting to recover. Having performed poorly since 2013 despite decent growth there are plenty of interesting situations. The Japanese market is trading at all time historic lows on valuation grounds, despite a decade of steady earnings improvement and substantial improvements in corporate governance for shareholders. Episodes like this also tend to generate exceptional innovation. Medical-related R&D and supply chains, where companies may have to choose between efficiency and security can prosper. This could result in higher paid manufacturing jobs being created. Gold has also sprung to life in the crisis, as it responded to the extreme policy announcements. Gold is a good hedge against Central Banks not being able to normalise the monetary policies undertaken in this emergency. Gold is an investment in monetary disorder; it is the reciprocal of the world's faith in Central Banks. If that faith is shaken, then gold benefits. Since the 2008 crisis emergency policies like QE that were intended as temporary have had a habit of becoming permanent. While easy to implement they have proved hard to exit in a benign manner. Ultimately there is a risk that these policies will discredit the Central Banks that pursue them, threatening the stability and integrity of the current fiat paper system. The main risk in holding gold is that as it nears its previous high of approximately $1900, Central Banks will not want it to break that as it would indicate that they are starting to lose control. Nonetheless that situation has moved one step closer.

Writing in the middle of a crisis is always precarious but investors can draw some conclusions. The virus has not destroyed infrastructure, so everything is in place to restart activity once it is deemed safe to do so. However such a dislocating event leads to a complicated series of aftershocks. Confidence has been badly shaken, and that always takes time to restore. The financial support measures help, but only a vaccine can truly lift the uncertainty. While the rapid and astounding scale of the authorities' intervention to replace the lost demand from the global shutdown has helped calm financial markets, the longer term consequences of these actions may come back to haunt them. In the short term the highest quality bonds and equities are safe havens. Some sectors will benefit due to the nature of the crisis helping their businesses like healthcare, supermarkets and some technology. The huge injections of liquidity, massive fiscal support, and much lower oil price are all positive for markets, and as the virus wanes confidence can return. The most important thing now is to watch for signs that the safety of public health is being restored, which would allow a resumption of normal activity. Once that is established investors will have to worry about a new set of problems, one of which may be inflation. For the time being the key remains the ability to hold on to companies that will emerge from this crisis, and avoid those companies that will be compromised by it.

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