Quarterly Update Autumn 2020

The COVID-19 pandemic will delineate investment eras. We will talk about the COVID-19 crisis in the same way we now talk about the Dot-Com boom and GFC. Like crises before it, we will get through it and markets will recover. How long that recovery takes, and the costs involved, remain unknowns.

This quarterly update will cover:

1. Economic Update
2. Investment Update
    a. Asset class overview
    b. Portfolio position / industry commentary
3. What next?

Economic Update

The COVID-19 pandemic is a 'black swan' event that acts as a catalyst for creating and exposing economic frailties. The pandemic has coincided and contributed to a crash in oil prices associated with a breakdown in output agreement between Saudi Arabia and Russia.

1st order impacts

- **EU has gone into recession. US is moving into recession**. **Australia to slide into recession mid-year**.
- **Emerging markets,** due to less developed health care systems and a greater reliance on interpersonal commerce, will be truly devastated.
- **The 12% AUD crash** has acted as an automatic stabiliser for Australian investors and businesses.
- The **US FED** has now promised unconstrained purchasing of bonds (quantitative easing). **US FED cash rate has dropped to 0.25%**.
- **RBA cash rate dropped to 0.25%** and begun quantitative easing.
- All central banks "**will do whatever it takes"** and have left absolutely nothing in the tank.
- The Australian government, supported by central banks, has pumped in approximately **$320B of stimulus** (approx. 15% of GDP). State Governments are providing land tax offsets.
- **US fiscal stimulus is USD$2T (trillion)**. There are rumours of further stimulus.
- UBS are forecasting an **unemployment** peak of 10.5% and Goldman Sachs forecasting a rise to 8.5% in Australia.
- Meanwhile, unemployment data in the US looks diabolical.

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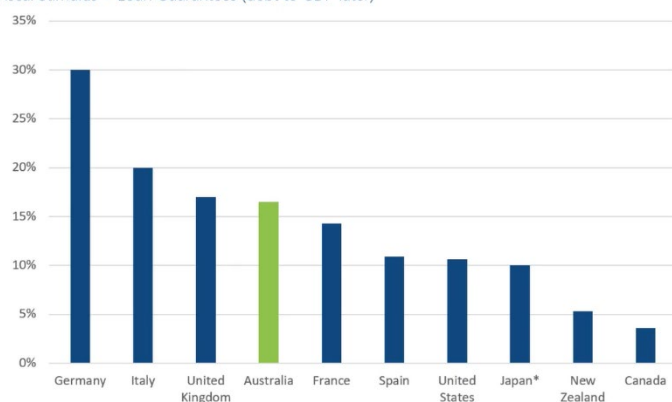
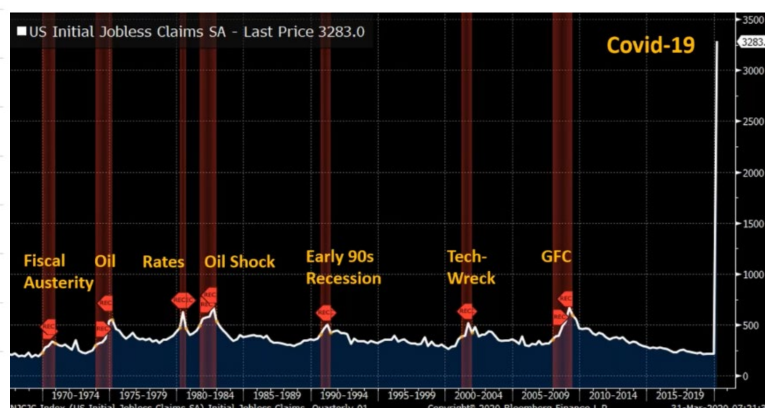
Fiscal Response is Significant

Fiscal Stimulus + Loan Guarantees (debt to GDP later)





* Likely to be announced

Source: Bentham, Macquarie, Goldman Sachs, HSBC, CBA, RBC

2nd order impacts (flow on effects)

- The most substantial risk that prevents a longer-term economic recovery is this **'destructuring' of the economy.** Should otherwise healthy businesses become insolvent and productive employees be laid off, there will be a permanent contraction in the economy's productive human capital and industrial capacity. When we emerge from the COVID-19 crisis, the loss of businesses reduces the capacity to absorb employment demand. This means temporary GDP declines are baked in. Governments desperately want to avoid this and have demonstrated their resolve through the substantial stimulus packages they have announced.
- **A bankrupt Italy** is a bigger problem than a bankrupt Greece. This may induce **geopolitical tension, challenging the continuity of the EU**.
- **Australian property prices will go down.** With the second highest level of household debt in the world (after Switzerland), a rise in unemployment must impact property. 37% of Australians struggle to pay their mortgage (source). Should unemployment substantially increase over the short to medium term, many Australians will default on loan obligations.
- **Will there be a depression?** There are key differences between the conditions prior to the great depression of 1929 and now. Globally we are much wealthier, meaning that individuals and business have greater resources to fall back on (large institutions, landlords and governments are all stepping in to provide financial relief). Commerce is more agile, automated and resilient. Improvements in agricultural productivity should insulate us from the shortfalls and food rationing that was a feature of the Great Depression. Most importantly, in the Great Depression government stimulus arrived three years too late. Whereas in a matter of days, Governments the world over have announced and passed the largest stimulus measures of any peace time period in modern history.
- Long term, **interest rates will now certainly remain lower**. Debt is spiking, consumer spending weakening and employment is fragile. In short, inflation will be weaker than ever. We may even see **deflation**.

Final Economic Comments

The timely and substantial stimulatory support from all levels of government and policy setters should provide some optimism for Australians. Businesses with healthy balance sheets have been quick to offer financial hardship support, like payment holidays to debtors and support for employees. Australia has the balance sheet strength, political cohesion and world leading health care system to

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fall back on. Countries like the US are certain to fair much worse than most developed nations due to their poorly equipped health care sector and early mismanagement. We are early in the pandemic crisis and things are certain to get much worse before they improve. However, economies will recover, how quickly and after how much pain is unknown.

Developing nations will end up suffering the greatest human and economic cost and yet, little attention has been paid to meeting that challenge.

Investment Update

Asset class discussion

"In the real world, things generally fluctuate between 'pretty good' and 'not so hot'. But in the world of investing, perception often swings between 'flawless' to 'hopeless'" – Howard Marks.

All asset classes contracted in March (apart from cash).

As central banks rapidly lowered interest rates, we expect **bonds** to provide capital protection for investors. This hasn't happened.

Bonds have two primary financial risks for investors.

1. Duration risk – The risk of a loss in relative value of a bond's income stream if cash rate settings change.
2. Credit risk – The risk that a bond issuer (borrower) defaults on their repayment obligations.

With interest rates already low, they didn't have much further to fall. Credit risk however deteriorated dramatically. The blowout in credit spreads[1] sent bond values backwards. **In a new 'low rate world', the conventional inversely correlated diversification benefits of fixed interest have nearly vanished**.

Domestic equity fared poorly as an asset class, reflecting the heavy weighting of Australian industry towards materials, mining and financials. Investors with **international equity** exposure saw more modest reductions, benefiting from a 12% drop in the Aussie dollar (year to date).

Industry & portfolio positions

The **travel, hospitality, discretionary retail and consumer credit** industries have been hit with regulatory impasse, i.e. forced closures. Although not permanent, many businesses in these industries are small and lack balance sheet scale. Some will not be able to hibernate, and even large businesses are being tested.

In the 'larger cap investable universe', the above industry exposures do not feature in client portfolios (except for an indirect exposure to US airlines via Berkshire Hathaway). Investors with capital allocated to these industries need to assess the balance sheet strength (or in Qantas' case, fiscal support) to decide to whether they can ride out this period of dislocation. **Cash is king**.

Non-discretionary industry sectors have held up better. Some positions are via:

1. Health care: CSL, Resmed (RMD.ASX), Sonic Health Care (SHL.ASX), Fischer and Paykel (FPH.ASX) via Bennelong Ex-20, Novo Nordisk via Stewart Investors

[1] A credit spread is the return margin above the risk-free rate required by an investor for lending (i.e. investing) their capital. A credit spread reflects the credit worthiness of the borrowing counterparty.

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2. Non-discretionary retail: Coles (COL.ASX), AIN Holdings & Nestle through Stewart Investors Fund

Even when shutdowns occur, these businesses will see little change to consumer demand. As such, many have held their value well.

Cochlear (COH.ASX) is one business that declined further than its health care compatriots, succumbing to its own 'flawless' valuation. Or perhaps, Cochlear products have more buyer elasticity than traditional health care. We all know a friend/relative that should have bought a hearing-aid years ago – so eventually they will, and the company should bounce back.

Some **Technology businesses** also succumbed to their flawless investor valuations, while others have been rewarded for their balance sheet strength. Some Australian technology businesses were flawlessly valued in January, with large declines in February/March. Established US technology players like Apple, Microsoft and Alphabet (Google) gave up 6 months of gains. For Australian investors the drop in the Australian dollar softened the decline in real terms. The sheer volume of cash held by Google, Apple and Microsoft (USD$358.4B* combined) is more than Denmark's GDP and provides incredible shareholder protection.

Commercial Property broadly traded near record high valuations earlier this year. With no valuation protection and the expectation landlords will shoulder the cost of rent abatement for disrupted tenants, property investments sail in troubled waters. Scentre Group (SCG.ASX) has dropped over 60%, reflecting their acute exposure to the discretionary retail sector. Goodman Group, with a logistics orientated property business, managed more modest falls. Neither are in our client portfolios. Upon market recovery, near zero interest rates will see investors chasing yield, with *tenanted/in demand* properties likely to recover more quickly.

The leverage that underpins **residential property** will hamper recovery. Pain felt now is more acute. Perhaps we are demonstrating a negative bias to property, but high leverage, low cashflows (even before the crisis) and forced sellers bode poorly.

Financial sectors. Banks generously stepped up to provide financial relief. The largest direct client exposure we have is via Macquarie Bank (MQG.ASX). Share prices dropped c.40%, in line with other major Australian banks.

This is not a financial-sector crisis (like the GFC before it) and the banks have vastly stronger balance sheets. The RBA has pledged support should it be needed. Banks will see a short-term loss in earnings, but interest owed to banks will have increased. Payment relief is a deferral/capitalisation of interest, not an absolution. Bank funding costs have lowered as well, improving margins. The main risk we foresee for banks will be in an increase in bad debts associated with mortgage stress. If balance sheet write downs coincide with a sharp downturn in property values, losses can amplify.

Challenger Financial Group (CGF.ASX) was a cyclic investment made when the internal return on equity hurdle was lowered in 2019. The resulting share price fall saw the company attractively valued. With fixed commitments to meet customer income payments, but market linked capital funding pools contracting, earning margins have reduced. Challenger's lowered return prospects are an extension of the broader market.

Raw Materials and Oil. Global supply chains have ground to a halt. The demand for raw materials and fuel has fallen sharply, and withit, commodity prices. Oil prices relying on OPEC output controls have plummeted with the souring in relations between Russia and Saudi Arabia. Woodside Petroleum (WPL.ASX) is our primary exposure, falling more than 50% in value. Woodside holds about USD$4B

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cash on hand. At current oil and LNG prices, we expect Woodside to be operating at a loss. Assuming no reduction in costs, and basing business revenue on current commodity prices, (*loose assumptions*), Woodside's balance sheet reserves may last longer than Saudi Arabia's. Woodside will recover when oil price rises. On the 31st of March, Trump and Putin discussed COVID-19 plans and oil market dynamics - watch this space.

Quality Value Equities (QVE.ASX) is a listed investment company with investment management provided by Investors Mutual Limited. Share price is presently at $0.69 (initial raising price was at $1.00). Underlying Net Tangible Asset (NTA) value of shares is $1.03 (as at 29 March 2020). So, for an investor to exit their position, they must accept a c.30% discount to their beneficial entitlement of capital. This is a heavy exit price… and a cautionary tale to the challenges of investing in all but the best managed listed investment companies. Written another way, shareholders would be 30% better off if QVE wound-up and returned shareholder capital, rather than exiting QVE shares in the open market. When we report values, we quote the ASX price.

Investment Summary

There are some commentators who are saying everything has now changed and things will never be the same again. Frankly, that is unlikely to be true. Researchers are familiar with Coronavirus strain and a vaccine is highly likely to be developed.

People are highly adaptable, and society will adjust, just like it did to influenza and other major world events. Markets will recover and business conditions will return to normal. From this point out, we still have no idea how bad things might get and whether the recent recovery was premature (most likely was). Every forecaster has an opposing view, reflecting more about their own personal behavioural bias than some insight into reality.

Being optimistic (my bias), when COVID-19 is bought under control, the zero-interest world we now operate in will see capital held on the side-lines rush back into markets in search of returns. This will make for a strong recovery. The only uncertainty is when.

What Next

Four questions come to mind:

1. How should investors react at this time?
2. Where should they look to invest?
3. When should they invest?
4. How do we know when markets have reached the bottom (financially)?

How should investors react at this time?

If comfortable with your underlying businesses' abilities to weather challenges ahead, disposing of investments is counterproductive in the long term.

Investors should consider what resources are available to pursue further investment opportunities.

Where should investors look to invest?

One of the biggest drops in value was the Australian Dollar. This makes it relatively unattractive for Australian investors to venture offshore. Concurrently, the Australian market, with its link to Chinese supply chains, has seen significant declines. With stimulatory support expected in China, and our low valued dollar, Australia is an attractive place for investment capital.

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Some possible opportunities:

- Woodside Petroleum (WPL.ASX) – Positive investment case. Balance sheet strength with exposure to oil price recovery.
- Macquarie Bank (MQG.ASX) – Positive investment case. Balance sheet strength, diversified income stream with large component of offshore earnings, not overly exposed to residential mortgage market.
    - Other major banks also look attractively valued, but have larger mortgage exposures.
- QANTAS (QAN.ASX) Demand for travel will not disappear long term, but unknown in the short to medium term. If staff reskill elsewhere, recovery may be hampered. Although there is about AUD$2B of cash on the balance sheet, net debt appears at about AUD$4.7B. We won't wade into this space, but braver soles may be lured by the discounted red kangaroo.
- Fixed Interest – Active managers are finding some of the most attractive investment opportunities they've seen in years.
- Hybrids – there appears to be upside here, with investors compensated for the risk of having their fixed income stream converted to equity.
- Goodman Group (GMG.ASX) – Key tenants are resilient to disruption. Some short term drop in the underlying property valuation is likely. Strong operating profit and a logistics focus provide a tail wind for longer term growth, modest gearing (<10%).
- Large technology and health care businesses have held up well through the crisis to date. Although a pleasing result for investors, they do not represent the most compelling investment case for new allocations.

When should you invest?

We reflect upon the comments made by Howard Marks in his recent memo.

"No one can argue that you should spend all your money today… but equally, no one can argue that you shouldn't spend any"…

We would like to see some *control* of the COVID-19 pandemic before taking new investment positions. However, waiting for a *cure*, i.e. vaccine announcement or anti-viral treatment, is likely leaving your run too late.

How do we know when markets have reached the bottom (financially)?

"'The bottom' is the day before the recovery begins" – Howard Marks

It can be instructive to see how markets react to earnings downgrades in the coming months and quarters. Little reaction signals negative business conditions are priced in.

Truth be told, nobody can tell you when the bottom is. If you are comfortable with the price you are paying for a long-term investment, the timing shouldn't matter so much.

Regards,

Matt Vickers
Snowgum Financial Services

Level 8, 99 Elizabeth St, Sydney 2000, Australia Tel: 612 9057 9091 www.snowgumfs.com

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