Antares Insights – April 2020

Adjusting to the coronavirus effect

Extreme volatility, uncertainty and negative returns across numerous asset classes and geographies have quickly torpedoed our relatively optimistic outlook for equity markets.

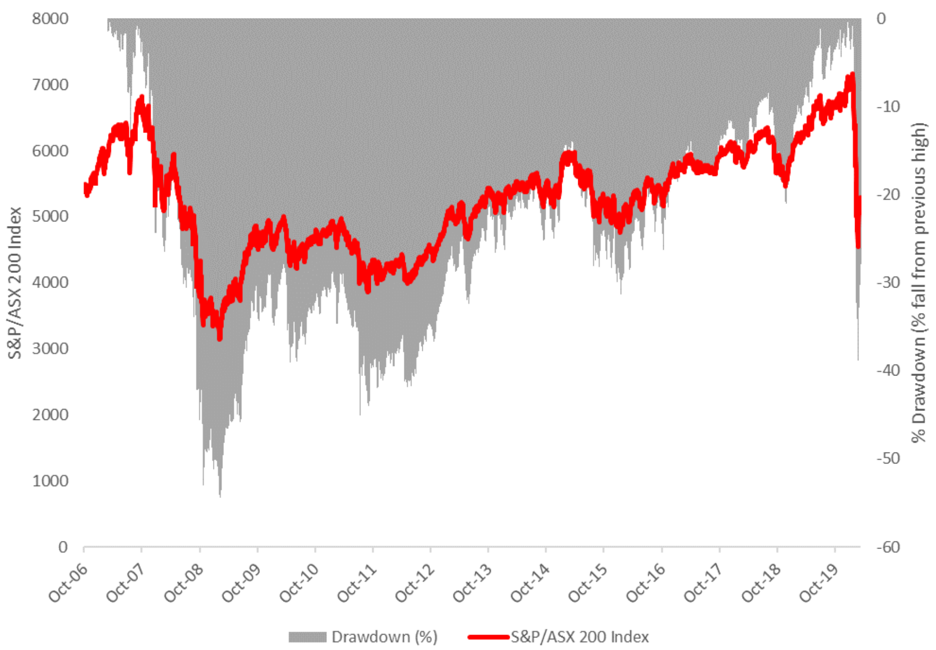
Catastrophic rises in unemployment have been accompanied by global falls in equity markets and bond markets in particular high yield bonds, industrial commodities, oil and the listed property sector. Unlisted markets have no doubt fallen but the asset values are less transparent.

Our previous view was that the global economy would accelerate into the back end of 2020 as Global PMI's turned around, the trade war had subsided and the peak of the Brexit uncertainty had passed. In the wake of the coronavirus pandemic, we have had to re-think our base case strategy.

March quarter performance, like that of the market, was disappointing. Stock performance was largely dictated by macro influences for which we were poorly positioned given our more optimistic expectations for the global economy (eg cyclical stocks and those with exposure to discretionary spending). Consumer staples and sectors with defensive earnings fared best.

For the Australian equity market, the fall has been both large in magnitude and stunning in its speed. At its worst, the market was down almost 40% from its previous highs. Only the global financial crisis (GFC) over a decade ago comes close to the magnitude of the fall, but unlike the current sell off, during the GFC the market took more than 12 months to fall by just over 50%.

Chart 1: S&P/ASX 200 Index and % Drawdown



Source: Antares, Bloomberg, 7 April 2020

Also, unlike the GFC, the coronavirus pandemic is not just a financial crisis – it is a health crisis which has already had far reaching impacts on economies and financial markets. There is no consensus on how it will play out and what, if any, will be the longer-term consequences.

Using our experience from the GFC, we have acted decisively on news of the coronavirus outbreak and have moved away from companies we believe will be impacted more severely by the coronavirus pandemic and its effects.

These have included companies with operational leverage to a slowing economic environment and companies that are financially leveraged that may experience a liquidity squeeze.

We have generally added to portfolio diversity with stocks in different sectors with different attributes as we are investing in a period of uncertainty. We have also tactically introduced some companies, that in a relative sense, may benefit from the crisis. In some strategies this includes a slight tilt towards Chinese end-demand – be it consumer goods or raw materials. China was the first country to experience the virus impact, and so we expect its economy to normalise faster and we also expect it to commit substantial stimulus to its economy.

To summarise, our focus is on:

- balance sheet strength;
- operational and financial leverage;
- those companies that can emerge from the crisis in a better relative position; and
- those that have demonstrated robust operating performance that may command a higher multiple once the crisis has passed.

We have also participated in some of the recapitalisations that are now occurring on a regular basis at discounted prices.

Particularly in our dividend builder strategy we have changed some stock positions where we thought companies may

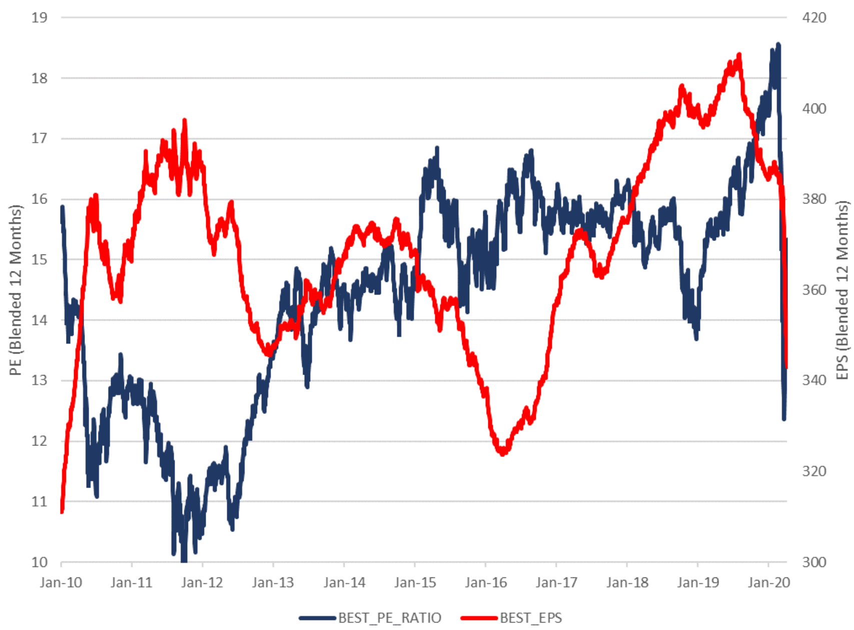
- reduce the dividend permanently; and / or
- have a balance sheet that was no longer appropriate for the environment, meaning that it was unlikely when the economy reopens that their dividends would reach previous expectations.

Having experienced market shocks before, we have learned that the second leg, the recovery, is just as important as the fall. This means that we maintain our focus on the numbers - pandemic, economic and corporate - and look for a turning point to invest in those companies that have been harshly sold-off.

And while Australian equities valuations look more reasonable can we be confident about the accuracy of the current earnings estimates?

To date, consensus earnings expectations for the Australian market have fallen around 16% from the peak achieved in the middle of 2019. At this stage, given the speed of the downturn, we feel that a trough in earnings is yet to be reached as analysts are often slow and reactionary when updating numbers. However, if the current earnings are accurate, our market trades on 12.5 x blended 12-month forward earnings; making equities attractive if history is a guide.

Chart 2: S&P/ASX 200 Earnings and PE Ratio (x)



Source: Antares, Bloomberg, 7 April 2020

This is why, as active managers, we meet twice daily, via teleconference, and continue to discuss, contest and refine our views on stocks and markets as an integral part of our portfolio management.

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