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Creating Value through Innovative Financial Solutions

LC Monthly Investment Memo : April 2020

"There are decades where nothing happens, and there are weeks where decades happen" – Lenin.

Such has been the experience of "The Great Lockdown" – a period which has seen many firsts:

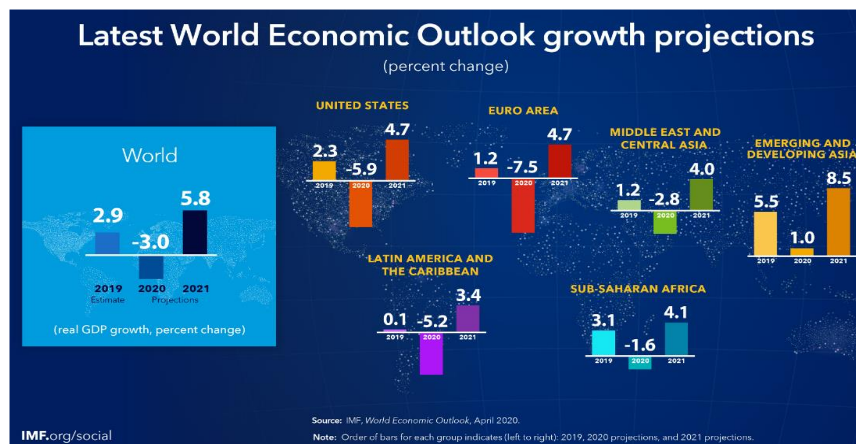
1) Over a billion people placed on lockdown in their houses
2) Work-From-Home (WFH) practices and accelerated digitalization
3) Schools replacing traditional learning in classrooms with virtual classrooms
4) Oil trading in negative territory

Increasing Unemployment Claims

The global economy is set for its worst decline since World War II. As shown on Chart 1 below, the International Monetary Fund (IMF) forecasts that the global economy will contract by 3.0% (real GDP growth) in 2020, which is a downgrade of 6.3% from its previous outlook in January. To contextualize this, the 2008-09 financial crisis caused the global GDP to shrink by 0.1%.

More than 30 million Americans (20% of the current US labor force) have filed for unemployment benefits since the lockdowns began due to COVID-19, and the surge in unemployment had wiped out more jobs than what were created in the US since the financial crisis of 2008-09. Similar deterioration of economic activity is observed worldwide where according to Financial Times, over 30 million people in Europe have turned to their State for wage support.

Chart 1: 2020 Growth Outlook Projections



Source: International Monetary Fund (IMF), World Economic Outlook (April 2020)

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The Oil Shock

While effects such a spike in unemployment, larger deficits and rise in defaults were somewhat expected, oil trading in negative territory caught most investors by surprise. On April 20th, May futures on Crude Oil (WTI) closed at -USD37.63 - an unchartered territory. This was a result of the collapse in demand due to restrictions and lockdowns imposed on the back of Covid-19 and the oil glut further exacerbated by the Russia-Saudi Arabia feud. In early April, the agreement between OPEC and Russia to reduce oil supply by 9.7 million barrels/day was welcome, but soon dismissed by analysts as being “too little, too late”. Mounting fears that oil storage at Cushing, Oklahoma could reach full capacity, resulted in a scramble among those holding long future positions which were expiring (May contract CL1). This led to widespread unwinding of positions, resulting in the unprecedented negative price. The effects of unwinding were further exacerbated by ETFs (who were holding the largest positions), as they rolled over their positions from front month (selling CL1) to the following expiry (CL2). The market now awaits to see if the June futures would tread along the same path.

Making Sense of the Market Rally

There has been a clear segregation of companies during this time: those who benefit from the COVID-19 situation (such as companies in the e-Commerce, Logistics and Pharmaceutical space) and other businesses that have taken a beating due to the pandemic (i.e. F&B, Consumer Discretionary). The companies belonging to the latter group are currently - to quote Guillaume Faury, Chief Executive Officer of Airbus - “bleeding cash”. The main problem faced by investors now is an “illusion trap”. As an illustration, the S&P 500 index has rallied 28% from its March lows, supported by “liquidity steroids” from Central Banks. The problem with such move is that it implies a 12-month forward P/E at 21.6x, a level last seen in 2002 (shown below in Chart 2). Even if the largest market capitalizations (Tech and Pharma largely) tend to benefit from this pandemic, most businesses worldwide are experiencing drawdowns, with a significant number expected to restructure or default. While Central Banks’ support is welcome in the short run, distorting markets with abundant liquidity could turn out to be counterproductive and dangerous in the long run - especially if the economic situation continues to deteriorate. Sharp market movements have become more frequent and, unfortunately, larger due to the reduction of volumes and the concentration of market players (Central Banks, ETFs).

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Chart 2: S&P 500 Index Price to 12M Fwd. Earnings

Source: Bloomberg

The Way Forward in these Unchartered Territories

In a highly uncertain economic environment, we remain extremely cautious - keeping in mind that it took more than a year for investors to capitulate the first signs of a sub-prime stress (with few funds being frozen) in 2008 despite these signs appearing as early as August 2007. We hold a view that the recent rebound in equities has been fueled more by Central Banks' intervention rather than adhesion from long term investors. We also think that the high yield space is a landmine waiting to go off - triggered as soon as the inevitable downgrades and defaults start occurring. With oil trading barely above US$10, and industries such as aviation, hospitality, retail and F&B taking a hit, the cracks are likely to surface soon.

With a potential recession looming, pressure is building to re-open economies, sooner rather than later. We tend to agree with that approach – but of course thoughtfully. While we understand that it is important to protect and save lives before the government allows any form of "normalcy" back into the economy, keeping economies shut for too long could have far-reaching consequences – especially when there is no clear timeline. New waves of contamination are likely to happen, and countries will need to find ways to work around it until a vaccine is developed.

We continue to reiterate that investors should have a diversified portfolio that includes quality names and a large allocation to non-correlated and non-directional strategies. For our investors considering increasing their allocation to equities on the back of the recent market correction, we will continue to favour companies with strong fundamentals such as a strong balance sheet and low debt and in sectors which will benefit from this “disruption” in the medium to long term. Our conviction in uncorrelated strategies has proven its mettle with our own in-house strategies, LCV Trade Finance Fund and LC Beacon Global Fund which have successfully delivered positive performance year-to-date despite the highly volatile markets. These Funds continued to provide the much-needed diversification benefit and stability to the portfolio in these trying times.

Yours Faithfully,

The Lighthouse Canton Team

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