PITCHER PARTNERS

APRIL 2020

Wealth managed

Pitcher Partners Wealth Management Pty Ltd

David Lane – Director

The March quarter will go down as one of the most tumultuous periods in history, with the human tragedy emanating from the coronavirus (COVID-19), with 1.5m infections and over 88,000 deaths at the time of publishing this report.

We are all now living through a period in history none of us will ever forget. The impact on our families, communities and the world has been profound. ~60% of the world's population is currently subjected to some form of containment measure.

The first two months of the year started strongly, with the market having cautious optimism that the virus might be largely contained to China. In late February it became obvious that is not the case. The world is facing a health crisis and by extension, an economic crisis. Both are being fought with massive government and central bank policy responses, which have totalled ~US$6tn to date and counting.

Very few financial assets managed to generate a positive return in March, creating an extremely challenging period for multi-asset investors. Equities saw the most volatile and severe reactions in their history, before rallying partially off their mid-March lows. Many markets were still down somewhere between 8% and 30% over the quarter. The price of oil collapsed by 65% as Russia and Saudi Arabia threatened to ramp up production at any price despite already bloated supply imbalances. The surge in demand for cash and liquidity created stresses in other financial markets as well, particularly USD funding and credit markets, which resulted in extreme bond market volatility and pushed credit spreads out to levels last seen in the GFC; all in a period of less than 3 weeks. The listed property sector was sold off aggressively due to the pressures facing businesses, workers and consumers.

Investment market performance summary – 31 March 2020

Indices	Current	3 months	1 year
ASX 200	5,076.8	-24.0%	-17.9%
ASX 200 (Acc)	55,711.4	-23.1%	-14.4%
US S&P 500	2,584.6	-20.0%	-8.8%
Japan Nikkei	18,917.0	-20.0%	-10.8%
UK FTSE 100	5,672.0	-24.8%	-22.1%
MSCI World	1,852.7	-21.4%	-12.1%
German Dax	9,935.8	-25.0%	-13.8%
French CAC	4,396.1	-26.5%	-17.8%
HK Hang Seng	23,603.5	-16.3%	-18.8%
Shanghai Comp	2,750.3	-9.8%	-11.0%
ASX 200 Prop (Acc)	38,044.9	-34.4%	-31.7%
Global Prop	2,118.1	-28.6%	-24.5%
Australian Bonds	10,546.1	3.0%	6.8%
International Bonds	1,071.9	1.3%	5.6%
Commodities			
Gold (oz)	1,577.2	3.9%	22.0%
Oil (Barrel)	20.5	-66.5%	-65.9%
Iron Ore (Tonne)	80.7	-6.2%	-1.7%
Aluminium	1,526.0	-15.7%	-20.2%
Copper	4,951.0	-19.8%	-23.6%
Lead	1,741.5	-9.6%	-13.7%
CRB Index	121.8	-34.4%	-33.7%
Currency			
AUD/USD	0.6131	-12.7%	-13.6%
AUD/EUR	0.5560	-11.2%	-12.1%
AUD/GBP	0.4939	-6.7%	-9.3%
AUD/JPY	65.9450	-13.5%	-16.2%
AUD/RMB	4.3452	-11.2%	-8.7%

Source: Bloomberg.

Despite this extremely challenging period we are now in, there are some hopes for a brighter outlook emerging on the horizon. The policy measures undertaken by Governments and central banks around the world have been swift and substantial, aimed at softening the economic impact of the crisis. We are now starting to see early evidence emerging of a flattening in several infection curves and advances being made with respect to treatment and testing options, although some of this need further time to determine its efficacy. Testing times will continue to present themselves, but we see the potential for great opportunities ahead for discerning investors.

In lieu of our usual mix of articles this quarter, we have put together a Q&A section, which discusses our views or observations across of a selection of key COVID-19 related issues we are thinking about currently. We also end this newsletter with a summary of our key asset class views.

Lastly, we hope you and your family are keeping safe and healthy in these challenging times. We very much look forward to keeping in touch with you all as developments continue to unfold over the coming months.

Q&A: COVID-19

Duncan Niven – Director, Research

The tragic scale and speed of events that are continuing to unfold in relation to COVID-19 are bombarding all forms of media on a daily basis – be it financial, social, health or policy related.

In this article, we have included a selection of key higher level questions at this point in time, complete with our current views and observations.

We do not profess to be epidemiologists or any other form of healthcare specialist within this field. Our comments below relate to our reading and research to date, which has helped formed our views to this point in time.

One of the questions we would love to be able to answer accurately is when will all these measures end and we return back to a more 'normal' environment – that I'm afraid is still uncertain, whether it is within Q2 or later in the year? However we hope this note provides a glimpse into our current thinking and what we are focussing on.

Are we now in a recession?

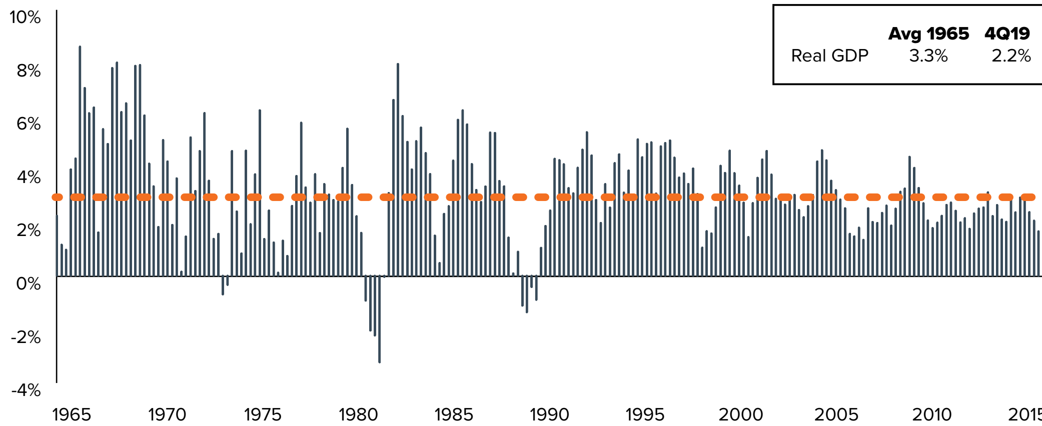
It is extremely likely that Australia and many major economies globally, are now in the midst of a technical recession. Australia's golden run of economic expansion, as well as the longest post war expansion in the US, is likely to be confirmed when Q2 GDP data is released in August/September.

Last week, the Organisation for Economic Co-operation and Development (OECD) released its estimate of the economic impact of COVID-19 lockdown policies around the world. The sobering conclusion of the OECD's work is that the initial direct impact of the shutdowns could be a decline in the level of output between one-fifth to one-quarter in many economies. This implies a decline in annual GDP growth of up to 2% for each month that strict containment measures continue. If the shutdown continued for three months, with no offsetting factors, that could total in excess of a 6% decline.

We note that in times of rapid change such as that we are experiencing, economic forecasts can vary markedly from economist to economist. Indeed there are many who have stated it is too difficult to make any reasoned forecasts in such uncertain times.It would be unwise to simply rely on consensus based approaches. However of most interest to us is the range of views and the trend and levels of variance in forecasts.

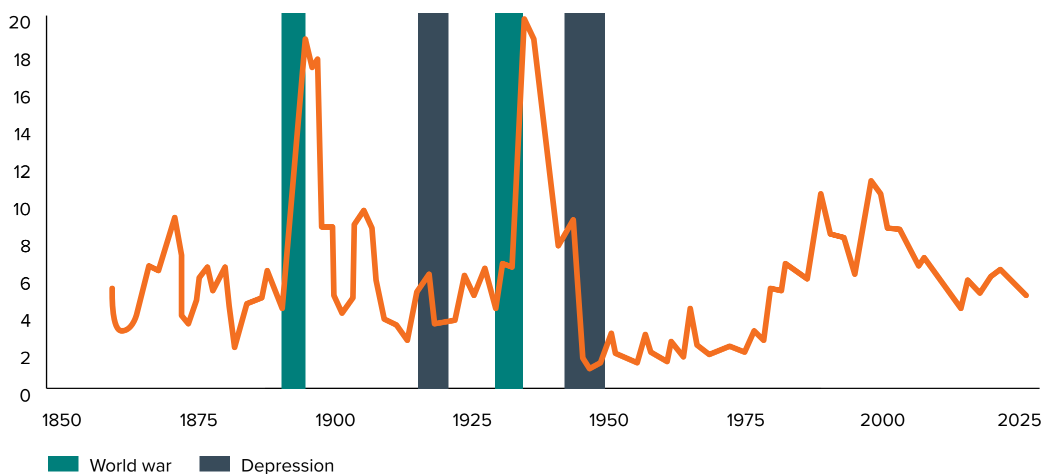
Westpac economists believe we could be in the midst of an 8% contraction in growth over the June quarter and even with an expected rebound in Q4, They believe the Australian economy could shrink by ~5% over the full calendar year. The unemployment rate may not reach the levels reached during previous recessions thanks to the Jobkeeper allowance, but could well be in the high single digits or higher by the middle of the year.

Australia year-on-year GDP growth



Source: Australian Bureau of Statistics, FactSet, J.P. Morgan Asset Management. *Values may not sum to 100% due to rounding. *Guide to the Markets –Australia*. Data as of 31 March 2020.

Australia's historical unemployment rate



Source: Australian Bureau of Statiistics, Melbourne Institute, Ville and Withers (2015), National Australia Bank

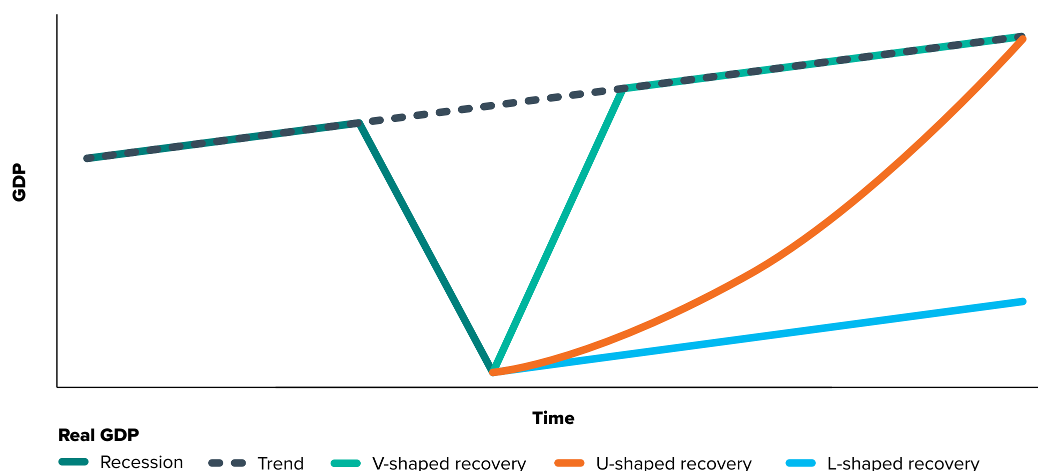
Looking offshore, most leading estimates are for a 4–8% correction in US GDP. The impact on labour markets has been swift and severe – we only need to look at the surge in jobless claims in the US, with initial claims jumping from ~300k to over 6m within the last few weeks.

We have seen over US$6tn (~6% of global GDP) so far in announced stimulus programs from central banks and Governments globally in a bid to prevent their economies from entering an economic depression. The key to success is that the financial assistance flows through to the targeted and most appropriate channels and mechanisms. One of the key aims of this is to ensure that when containment measures eventually play out and are being eased, each economy will be able to recover relatively swiftly.

What shape is the economic recovery likely to be?

Much debate has been made around what eventual economic recovery will take form as the containment measures begin to ease – particularly with respect to whether there is a 'L', 'U' or 'V' shaped recovery.

Profile of the recovery: L, U or V?



A 'V' shaped recovery implies a very swift rebound from the lock down measures in place. While some economies will recover at a faster pace than others, we believe this is unlikely to occur on masse as Governments implement caution as opposed to optimism when infection curves flatten, in order to avoid a scenario where a repeat of a lock down is required.

We believe a 'U' shaped recovery is most likely at this stage. Our base case is that a gradual 'phase-in' will occur, with constraints relaxed across certain geographies, sectors, industries, movements of individuals – therefore it's unlikely that an economy will be operating at 'full steam' on an immediate basis. This will guard against the risks of the virus mutating or providing some flex to quarantine any re-emergence of a viral outbreak. Global businesses will also be reliant to some extent on offshore supply chains and underlying demand, so a recovery here is also likely to be non-linear.

What is the risk of an 'L' shaped recovery? While we don't believe this can be ruled out, there is a huge co-ordinated global response in terms of containment efforts, shared learnings, vaccine/treatment research, stimulus packages to name just a few. Whilst we acknowledge the severe impact on growth in the near term, and we are beginning to see hard reported evidence of this, we believe the policy action taken to date will circumvent any prolonged recession or economic depression at this stage.

The caveat to all of the above analysyis is that the major unknown is the length of the lock-down, or 'business hibernation'. The longer it lasts, the deeper the economic impact will be, and the longer a recovery will take.

What are the impacts on company earnings in a recession? Can we rely on history as a guide?

With respect to using history as a guide, the short answer is not really. The sharp contraction in global activity, different index composition, surge in unemployment and unprecedented policy response makes this a relatively unique event from a historical perspective.

However if we do go through the passage of time, UBS recently published a report showing that in the average Australian recession, Earnings Per Share (EPS) has fallen by 32% peak to trough, with an average fall of 44% for resources, -37% for financials and -25% for industrials ex financials.

EPS falls 32% in an average regression

Source: Datastream, RBA, UBS, reported trailing EPS, Daily All Ords price index

For the US S&P500, the average decline in periods of EPS declines (measuring peak EPS to trough EPS) is ~28%. The industry mix is more evenly balanced given the different industry composition and sensitivities of the index.

A challenge we face currently is that given the uncertain backdrop, a large number of ASX companies have now withdrawn earnings guidance to the ASX. As at the end of March, this applied to over a third of ASX 100 companies, over a quarter of the ASX Small Ordinaries Index (our proxy for small cap companies) and ~5% of companies that are listed outside of the ASX 300. The bulk of these companies, perhaps unsurprisingly, fall within the consumer discretionary and industrials sectors.

With a lack of transparency around future earnings, it is more challenging to assess the current valuation of Australian equities. We also note that this withdrawal of guidance could well be a signal of future capital raisings, a trend which has already commenced with several issues announced to date.

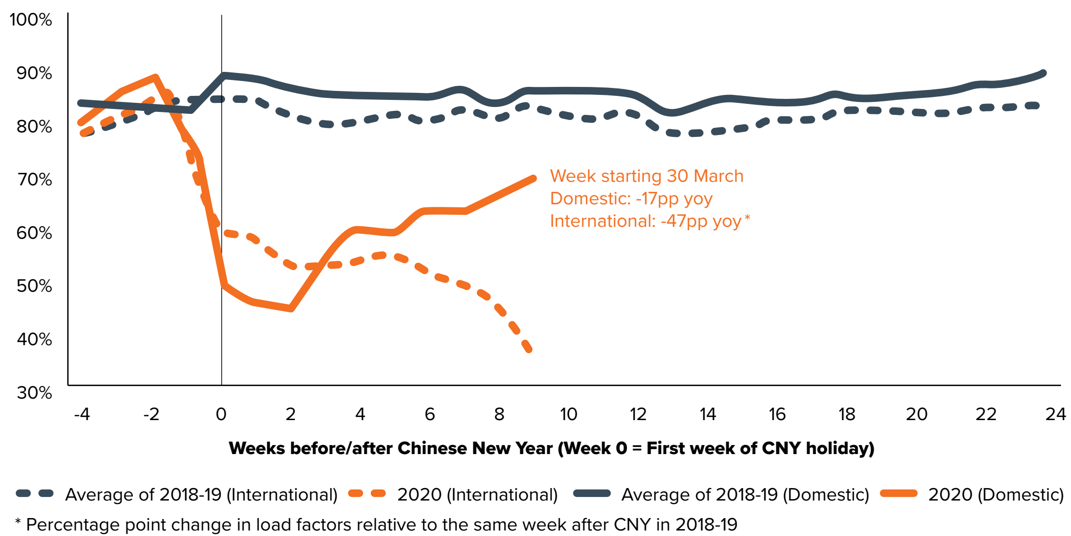
In looking at potential impacts offshore, we are seeing a wide divergence in many strategist forecasts . Of particular note has been the wide dispersion in aggregate forecasts between 'top-down' analysts (those that make forecasts from a macro/strategic perspective) and 'bottom-up' analysts (those who research individual companies). We are seeing top-down forecast declines in the order of ~30% of earnings compared to bottom up forecasts which range from small positive to negative declines depending on which region you look at. We feel the bottom-up analysts are behind the 8-ball here, which perhaps isn't that surprising given how fast events have unfolded to date. This environment we believe will generate some attractive opportunities for active fund managers going forward.

The pandemic originated within China, how is its recovery now?

Post a ~3 month period, there is a relaxation of some of the containment measures imparted on Wuhan and the broader Hubei province. Whilst there is conjecture surrounding the infection testing and other data presented by China to the world, if we assess what it is doing by action, it's clear that they are beginning to adjust back to a more 'normal' state. Its 2 month containment period is shifting to a mitigation stage, an experience which is likely to provide some guidance for other countries to observe and learn from.

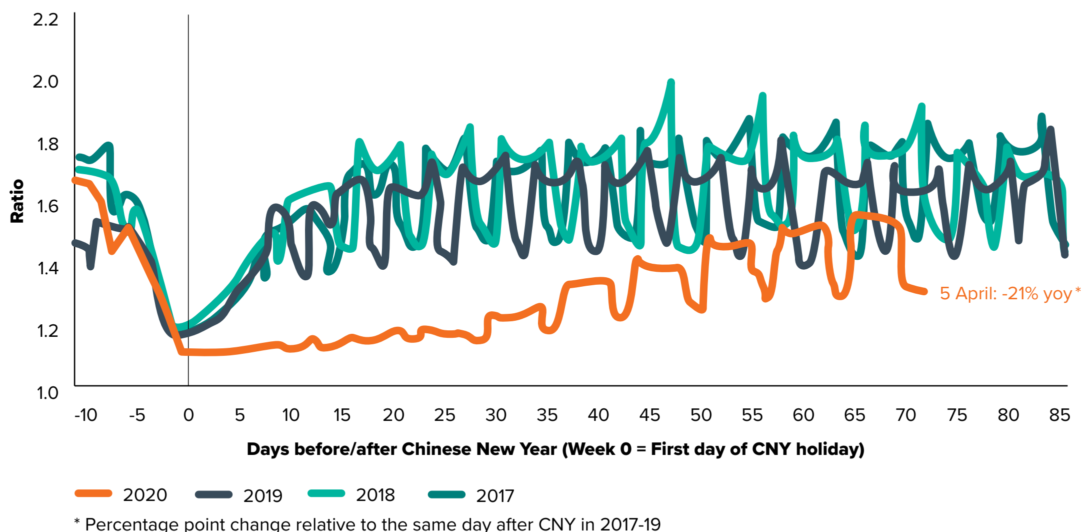
Goldman Sachs produce a regular report monitoring more 'real time' activity data within China and whilst levels are still below previous years trends, there continues to be an upward inflection of activity around coal consumption from major electricity providers, air pollution levels, traffic utilisation, subway usage and domestic air travel (international is still very weak). Other indicators are still range bound or weak, namely unloaded coal volumes (proxy for port logistics), steel demand and major city property sales.

Passenger load factor in international flights and domestic flights continued to diverge



* Percentage point change in load factors relative to the same week after CNY in 2018-19

Traffic congestion has seen a mild rising trend over the past few weeks



* Percentage point change relative to the same day after CNY in 2017-19

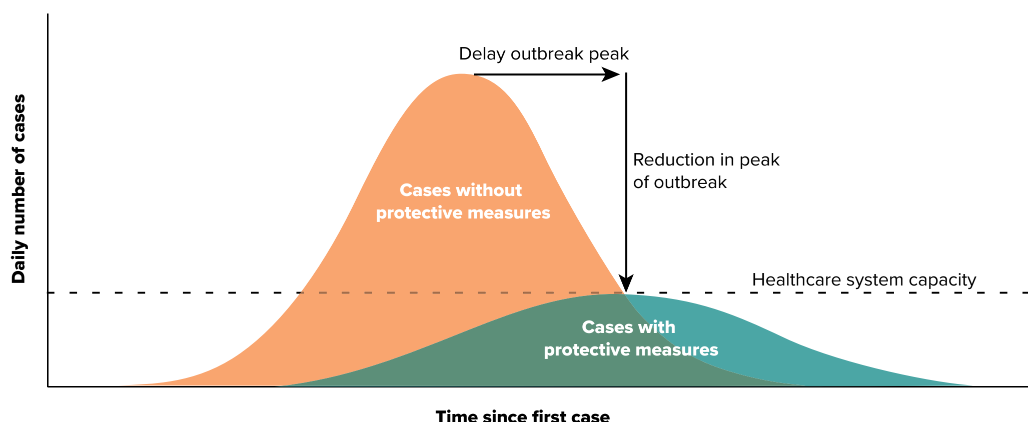
Source: Wind

What are the key pieces of data we should look at right now during this pandemic?

Right now we are looking closely at infection curves across the major economies. The aim is to see a flattening of the curve as per the schematic below. If a curve is flattened, while it may drag out the impact from the virus, it will ensure that healthcare and related vital infrastructure are not fully overwhelmed and collapse, leading in turn to a steeper curve and more tragic consequence for human life. A flattening curve also indicates that containment/quarantine measures are being successful in limiting the spread of the virus.

This milestone is crucial for financial markets to gain confidence that policy decisions and health systems are working to combat this virus effectively.

Flattening the curve



Source: CDC (Centers for Disease Control and Prevention)

Australia's curve is beginning to show signs of flattening out, indicating that our containment measures are starting to have an impact. Many other countries are still tragically experiencing steeper infection curves, as total reported global infections now pass the 1.5m mark at the time of writing. However we are also seeing some very early evidence that the growth rates are dipping lower, but it is early days.

Until the curves of major economies are flattening and trending lower, we are unlikely to see any broad relaxation of containment measures. Governments will be laser focussed on avoiding a renewed breakout of infections, even President Trump has recently begun to back away or soften slightly his rhetoric toward about Americans returning to work.

The US continues to worsen and is now the country with the most infections and steepest curve. Counter-intuitively though, the US share market has begun to rally on hopes of an improvement in containment. Rather than provide us with optimism, this gives us cause for concern of further volatility and falls if this hope has been misplaced.

Other areas of focus for us are the immediate hits to economic activity, whether the flow of stimulus programs to the desired and most needy targets are being successful, credit markets, capital management initiatives within Australian equities and of course announcements with respect to vaccines, testing and other treatment programs.

When containment measures eventually begin to be relaxed, we again will be looking at more immediate measures of economic activity (PMI, ISM, various leading indicators) and also various forms of capacity utilisation – just indicators that can point to a troughing or gradual recovery of economic activity.

What is the process in identifying a vaccine or medicine to treat the virus?

What other tests could help with our ability to combat this virus?

In reading through various sources, the usual process for the development of a vaccine is 12 to 18 months, but it can vary depending on the complexity of the virus. The process has begun at a fast pace and an early form of the vaccine has already gone into people's arms in Seattle (Phase I Safety Trial) and the Australian "protein clamp" vaccine is in lab animals. Global healthcare businesses such as Moderna, Gillead, Johnson & Johnson and Regeneron appear to be more advanced than others at this point.

In humans, the standard protocol is to go through a small phase I safety trial, a larger phase II safety/efficacy trial, then a large phase III. If all that goes smoothly, then the rate of production for vaccine doses obviously depends on the nature of what has to be made. The problem with any vaccine is that, as it will be given to large numbers of regular individuals, it has to be both safe and efficacious. Earlier, experimental SARS and MERS vaccines gave some negative safety signals in lab animal tests, though at least one SARS product looked to work well and have no serious side effects when tested. Many experts in this field are confident of making a successful vaccine, but advise caution. There have been tragic consequences reported of individuals self-administering supposed treatment options that have mentioned in many forms of the media.

One of the key stepping stones in order to gradually release containment measures is a rapid antibody test, that can test on a mass-scale for already infected individuals that carry the requisite antibodies and whom now offer herd immunity. These tests will tell us how many people have been infected and have recovered. These tests are close to fruition and, as the technologies have been established for other viruses/pathogens, the tests should soon be fit for purpose. We believe the production of massive numbers of antibody test kits will be a major priority for Governments as once people are antibody positive, they will be at (or near) zero risk of being transmitters, and will be able to return to normal life.

The data emanating from these antibody tests may also be able to be modelled by specialists in this field (epidemiologists) to better gauge the likely spread and impact of COVID-19 to ensure a better planned and managed exit from containment measures. A successful antibody screening test will ensure we also won't need 7bn doses of a vaccine which is still yet to be developed!

What are the biggest risks and implications going forward?

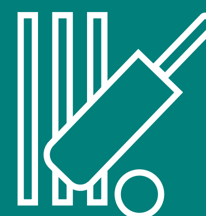
There are a number of areas which remain of high concern currently, ranging from more immediate issues through to the longer term impacts arising from this pandemic.

The biggest risks we see on a more immediate basis are those which would lead to persistent upward sloping infection curves. Be it a spike in reinfections, a too hasty relaxation of containment measures, mutation of the virus into a more virulent form, capitulation of healthcare systems and ongoing bottlenecks in the distribution of various forms of medical equipment, amongst other factors. We are also watching for evidence of the successful distribution and speedy transmission of the stimulus programs to those who require it. Any failure/bottleneck will create longer lasting economic damage.

Over the medium to longer term, it's the level of permanent damage that has been caused to economies, the speed of any economic recovery. Any prolonged period of infection could push beyond the reach of current support programs offered by Governments, which could lead to far greater spikes in unemployment. The amount of Government spending/debt will need to be addressed, which could mean higher taxes and inflation long term (although we see a deflationary impulse near term given the collapse in pricing across several industries, especially within energy markets and the fact that consumers are being quarantined). We also believe that this pandemic could prompt further de-globalisation impulses. Supply chains will be re-organised away from China, or at least greater contingency measures be designed and built. The US China relationship could well sour even further, especially if the Trump administration goes into PR overdrive into the run in to the November Presidential election.

Trade could well re-emerge as a primary issue and we have seen anecdotal evidence of constraints on cross border movement of medical equipment and supplies to date, across multiple continents. Whilst perhaps underreported, members of the Eurozone could well clash more publicly on this matter further down the road. There will also be a need to balance the books. With budget deficits blowing out, currency devaluations could also re-emerge as a threat to several economies.

The Pitcher Pitch Report



Pitcher Partners Wealth Management Pty Ltd

The Pitcher Partners Wealth Management Pty Ltd Investment Strategy Committee is composed of senior advisers and researchers with the purpose of framing the near to medium term investment outlook. The committee's views are summarised below.

Defensive Assets	
Cash	We believe this asset class provides optionality/flexibility in wake of higher levels of volatility. We recommend gradual reductions during any periods of elevated volatility. Maintain holdings toward short term or at call facilities to maintain nimbleness.
Fixed Interest	The RBA are now implementing unorthodox monetary policy, undertaking yield curve control measures up to around the 3yr end of the curve (+0.25%). We hope the high degree of fiscal and monetary stimulus announced to date should start to settle the extreme volatility witnessed at the longer end of the curve, however those focused on capital preservation should remain underweight rate duration at this time given the high degree of macro uncertainty. We have witnessed a rapid expansion in credit spreads and also trading margins of hybrid securities. With pricing of some sectors indicative of a recessionary environment, we expect skilled active managers to take advantage of dislocations in the market, which is currently being exacerbated by a lack of liquidity. Direct opportunities are likely to present themselves also. We have a strong preference for active management in this environment. Rate settings globally are likely to remain very low to negative over the near to medium term , as economies deal with the fallout from the coronavirus. We expect volatility within most treasury and credit sectors to begin to settle as funding channels open up, supported through central bank intervention and other ongoing QE programs. Interest rate duration shows a distinct unfavourable asymmetry for risk and return at this point, while the shift in credit spreads, particularly within high yield and global loan markets has rapidly re-priced to GFC levels. Whilst we expect a severe shock to growth, we believe the volatility will unearth lucrative investment opportunities over the medium to longer term. We recommend exposure to investments that sit higher up the capital structure, via assets of identifiable quality and through proven, high quality and experienced investment managers.

Growth Assets	
Australian Equity	Australian equity markets are effectively now pricing in a recessionary environment. The full human cost and economic fallout from the coronavirus and efforts to limit its impact are still unknown. Many companies have now withdrawn earnings guidance and as such, factors such as balance sheet strength and strong free cash flow generation are clearly favoured over earnings based measures. Should the economic fallout drag longer than anticipated, the risk of dividend cuts and dilutive equity capital raisings will loom large. The significant price dislocations observed to date are creating some attractive medium to longer term opportunities, especially when reflecting on the unprecedented level of fiscal and monetary policy measures announced to date. But until infection rate curves plateau and the growth impact is more fully known, we continue to expect a choppy path. In the meantime, we suggest only very gradual deployment of any cash into periods of weakness.
International Equities	The outlook for earnings is extremely opaque at this point, especially in areas such as Europe and the US which are battling rising viral infection rates. China is more advanced through this process and supports an incremental overweight exposure at this time, however other emerging market nations may struggle in the near term due to the strength in the USD, driven by the repatriation of foreign capital. We favour exposure to companies with competitive moats, balance sheet strength and resilient levels of free cashflow generation. We continue to support a tilt toward unhedged exposures given the diversification it provides at this dislocated time, but we would consider neutralising this tilt in any further $A weakness. We continue to recommend building up any underweight exposures very gradually in bouts of excessive market volatility, which we expect could will occur until the impact to growth becomes clearer.
Property	The retail sector is facing significant earnings headwinds in the form of pressure to offer rent abatements to tenants, as well as other impacts from containment measures announced to date. Residential exposed businesses are also likely to struggle in the face of disruption around construction activities and potentially extended or disrupted financial settlements. We believe the industrial and office sectors are likely to outperform on a relative basis on account of their more resilient contractual terms with its tenants during this downturn. We emphasise a focus on asset quality, cash backed earnings streams, lower leverage and strong balance sheets. G-REITs are facing similar economic pressure points as the local A-REIT sector, however this segment provides broader sector, currency and geographical diversification. We continue to recommend avoiding any retail themed investments at this time. We recommend using specialist unconstrained active managers that can take advantage of any price dislocation, but who can also play defence in periods of market stress. Whilst G-REITs are trading at a sizeable discount to private market values, we expect asset write downs from unlisted funds to occur in the coming months. Like A-REITs, we recommend focusing on quality biased metrics as opposed to short term earnings and yield metrics.
Alternatives	This asset class provides an attractive source of diversification in more volatile investment markets. This sector won't be immune from market contagion and the possibility of negative returns, however we believe sectors such as Real Assets (Infrastructure, Private Equity, Venture Capital), equity market neutral and other directional strategies such as global macro and market futures are well positioned to augment risk adjusted returns for investors. We recommend avoiding products that have high leverage to single asset class exposures. Product selection is crucial in order to maximise diversification benefits.

This is our high-level view, and we recommend clients speak to their advisers as to how this may guide or impact your individual investment portfolio.

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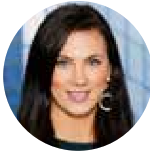

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