24.03.2020

Stanford Brown – Changes To Portfolio Positioning

This note is to advise you of actions we have taken in all of our diversified investment portfolios for discretionary clients to help protect investors from further downside, as the outlooks for corporate profitability and share markets are deteriorating here and around the world.

This note addresses the following questions:

- What actions have we taken?
- Why now? Why didn't we act sooner?
- Why reduce shares? Why not buy, since shares are now 30% cheaper than a month ago?
- Why we believe the hits to corporate profitability and share prices will be more than mild and temporary?
- How we track the coronavirus spread, containment, and the signals for investors?
- Why US dollars?
- What are the opportunities and when might we look to buy?

What actions have we taken?

Although our diversified portfolios were already a little 'under-weight' shares (relative to their long term 'neutral' positions) prior to this change, we have taken action to significantly reduce holdings of Australian and international shares in all portfolios, and increase the holdings of cash, primarily in US dollars. We are constantly reviewing events as they unfold and assessing their potential impacts on financial markets and on our client portfolios, and we will continue to take additional actions where necessary to protect and further the interests of our long term investors.

Why now? Why didn't we act sooner?

Events have unfolded extremely quickly here and around the world over the past four weeks. While the main medical concern is the virus itself and peoples' health and lives, the big share price falls and the extreme market volatility have been triggered by an almost continuous cascade of announcements by governments of progressively dramatic and economically damaging restrictions and shutdowns. This has been compounded by a parallel cascade of announcements of increasingly dramatic and potentially market-distorting programs by governments and central banks to try to stem the potential economic damage from the shutdowns.

The announcements of these actions – the restrictions and shut-downs aimed at containing the spread of the virus, and also the stimulus programs aimed at containing the economic damage of the shutdowns – are completely unprecedented in their nature, scale and speed. Added to this is the vagueness of their implementation and uncertainty of their potential implications, making it very difficult to calmly and carefully assess the likely impacts on investment markets.

We are not short term traders and therefore we don't suddenly jump in to sell, or buy, every time the market has a sharp fall. We take time to carefully and calmly assess the likely returns and risks before taking action. For example, before share markets fell by 20% around the world in late 2018, we acted to under-weight shares in all portfolios before the falls because there were a number of observable indicators of economic and market activity leading up to the falls, which we wrote about at the time. This current crisis is very different because the almost instantaneous collapse of economic activity, corporate revenues and profits has been caused by sudden government edicts.

It has been only a very short time - just four weeks - since local and global share markets were hitting record highs. Several of the big daily share market falls during the past four weeks have been followed by equally dramatic recoveries the very next day. This is a sign of widespread market panic reactions to specific announcements, rather than calm and careful analysis of the situation as a whole.

Most share market falls are recovered quickly and warrant no action, but occasionally the initial sharp falls in the first few weeks continue into deeper, sustained sell-offs with longer-lasting implications. It takes a little time to assess whether the underlying causes of the initial sell-off are likely to be quickly forgotten (which is the case for most sell-offs) or whether it will continue to compound into a more sustained crisis.

Why reduce shares? Why not buy, since shares are now 30% cheaper than a month ago?

When the price of any asset falls suddenly, as long term investors our natural instincts fall into three main camps:

- 1. we could see it as a **buy**ing opportunity as the asset is now suddenly better value and should rise again as others see that the underlying fundamental value of the asset has not changed materially. This would be consistent with our overall philosophy of buying good value assets;
- 2. we could **sell** – if we believed that prices will fall further, because the underlying fundamental value of the asset is even lower, or may fall further; or
- 3. we could do **nothing** – if we believed that prices will eventually recover, or we believed the new lower price more or less reflects a new lower fundamental value of the asset, and that the fundamental value is unlikely to fall further. This is the case for most short, sharp sell-offs.

In the case of shares, the underlying fundamental value of the asset is the aggregate corporate profitability of listed companies in Australia and around the world.

It is our view that the compounding effects of the government containment measures, together with the potential distortions and side-effects of the government stimulus measures aimed at addressing the economic effects of the containment measures, present a relatively **high** risk of resulting in deep and sustained reductions in local and global corporate profitability. We believe that there is a relatively **low** likelihood that corporate profitability will experience merely a minor and temporary hit this year and suddenly recover next year. Consequently we believe that the crisis is far from over, and that share prices are unlikely to achieve a sustained rebound to higher levels for some time yet.

Why do we believe the hits to corporate profitability and share prices will be more than mild and temporary?

There a five central reasons for this view:

- 1. The share price falls so far have been based merely on **fears** of corporate profit hits and/or collapses, but no actual collapses yet.
- 2. The impacts on economic activity and corporate profitability risk being deeper and longer-lasting than currently expected
- 3. Central banks and governments have little ammunition left to support jobs and spending
- 4. For a sustained rebound – shares would need to be 'cheap' or good value – and they are not yet
- 5. Virus containment measures (shut-downs, etc) are likely to be tightened even further (and remain tight) for some time – especially in the US, which is the biggest problem but also the engine of world growth and financial markets. Since the share price falls are due to fears of potential impacts on corporate profitability of the current and possible future government containment actions (and also fears of potential impacts of the government and central bank actions to contain the economic damage of the containment actions), corporate profitability is unlikely to rebound soon.

Looking at each of these in turn -

1. So far there have been no actual corporate collapses or crises yet

The share price falls to date have been based on fears of hits to corporate profitability, but not any actual instances as yet. Almost all of the big share prices falls in the past – including the 2008-9 GFC, the 2001-2 'tech wreck', the 1973-4 collapse, and even the 1929-31 crash - were a 'death by a thousand cuts', where the initial falls were caused by fears, but the market was subsequently sent progressively lower by a long succession of corporate collapses, bankruptcies, defaults, and other negative news hitting the market over many months, usually more than a year.

2. The impacts on economic activity and corporate profitability risk being deeper and longer-lasting than expected

There is now general consensus among economic bodies that economies all around the world including the US, Europe and China are already in deep recession. Many are also mentioning the 'D' word, which means more than a few quarters of contraction, and unemployment up to 30% or more. This has even been mentioned by US Treasury Secretary Mnuchin.

The extremely quick descent into recession/depression is likely to produce widespread corporate bankruptcies on a scale of the GFC or worse. This is speculation at this stage of course, but if it happens share markets would probably be significantly lower, and for a more sustained period like prior episodes.

Many large companies with political connections and large employee bases are likely to be rescued by governments, but this is often at the expense of ordinary shareholders. The GFC provided examples of this. On the other hand medium and small companies with no political connections are likely to fail outright.

An added level of stress is likely to be seen in households and business which are carrying record levels of debt across each of the major economies, including Australia. Nothing was learned from the GFC it seems – except load up on more cheap debt!

3. Central banks and governments have little ammunition left to support jobs and spending

Central banks are already running zero or negative interest rates so they can't cut further. In this environment rate cuts don't make more people borrow more anyway. That was the lesson from the last 12 years of ultra-low interest rates. All of the main central banks (including Australia's RBA) are frantically buying up bonds and other assets to try to prop up prices ('QE'). The lesson from post-GFC QE efforts (and from 30 years of failed QE in Japan) is that at best it just artificially inflates asset prices and does little or nothing for the 'real' economy.

Governments have also run out of ammunition, and cannot possibly lend to or buy up every business to keep them afloat and people employed. Governments everywhere are already running large deficits and large debt burdens (Australia is one of the few countries with relatively low debt levels and a AAA credit rating still). Over the past two weeks, government bond markets have been in turmoil due largely to fears of how they will handle the flood of new bonds that will need to be issued to pay for the trillions of dollars of government spending promises.

4. For a sustained rebound – shares would need to be 'cheap' or good value – but they are not yet

Just because share markets have fallen by 30% does not make them 30% better value now. Share prices have certainly fallen, but the problem is that the world has changed and underlying profitability is now much lower.

The US still dominates global markets, accounting for around 55% of the total, so the US is the key. The problem is that US shares are not yet cheap. The question is: Cheap relative to what?

Price/earnings ratios

One way of assessing whether shares are cheap or expensive is to look at the price relative to company profits. Totalled across the US share market, share prices relative to the most recent year's profits (known as the '*trailing* price/earnings ratio') has come down from an expensive 24.3 at the start of 2020. Ratios above 20 are sustainable when the economy is humming and unemployment levels are at record lows – but the world has changed. The recent falls in share prices have brought the ratio down to 16.5 now, but this is still not cheap now that conditions have changed.

More important than prices compared to the *past* year's earnings, is prices relative to the most likely earnings for *next* year (the '*forward* price/earnings ratio'). The forward price/earnings ratio for the US market was 19.9 at the start of the year, but this has reduced to 16.5 now. On the surface this appears to be back into 'fair market' territory, but the problem is that it assumes aggregate company profits across the US will increase by +11% in the coming year. This is no longer the case, as we see company profits across the US being hit severely over the coming year as a result of the dramatic government containment measures and also from the stimulus measures and distortions aimed at countering the negative impacts of the containment measures.

While most of the news headlines are about possible impacts on unemployment numbers and economic growth rates, our main focus is on the impact on company profitability. It is very early days yet in the US federal and state governments' attempts to contain the spread of the virus, but it is looking increasingly likely that aggregate company profits could be cut by up to 20% or more over the coming year. This makes US shares as a whole expensive again even after the recent share price falls.

The recent oil/gas collapse in 2015 resulted in a -15% hit to aggregate profits *across the entire US stock market*, so as a comparison, this year is likely to be much worse this time for aggregate profits as many sectors of the stock market are likely to be hit, not just oil/gas and related engineering companies like last time.

Another common measure of fundamental valuation is the Nobel laureate Robert Shiller's 'CAPE' ratio (cyclically adjusted price-earnings ratio). This was a very high 32 at the end of 2019 (on par with 1929 before the crash, higher than 2007 prior to the GFC, but not as high as 1999 before the tech wreck). This measure forms part of our long term valuation process for the US market.

The CAPE ratio for the US market has come down to 21 now. This is still above the long term average CAPE ratio and therefore is not a bargain yet. The market index is still some 25% above the cheap levels it reached in early 2009 before the post-GFC rebound. If and when those levels are reached again, global investors will see the market as a bargain and jump in to buy. At current levels even after the recent sell-off, this measure is forecasting share price growth of less than 4% per year from current levels ~~(black line in upper section)~~. This is still lower than average, and so is still relatively bearish - ie the market is still expensive.

Other pricing ratios for the US are also not indicating the market is cheap yet. Dividend yields have risen back above 2.5%, but this will probably be reduced by dividend cuts in the coming year, which are looking like being widespread.

Other global markets

Other global markets were generally not as expensive as the US before the sell-off. Most emerging markets were considerably cheaper on several metrics, and they have fallen by less over the past month. European markets were also expensive before the fall, and are still vulnerable to lower trade and lower consumer demand as the crisis unfolds, especially the global consumer brands.

Australia

The Australian share market was less over-priced than the US market before the recent fall, and it is moderately cheap now at current levels. Even without the coronavirus problems, aggregate profits were already falling - mainly in the banks, but they also would be joined by profit declines in the oil/gas sector as well. If we add the increasingly likely fall-out from the government shutdowns and restrictions, overall profits across the share market could easily fall by more than 20% in the coming year, and take another few years to recover.

Dividend yields at the moment look historically attractive at 5.6% and that's before franking credit refunds. Again this looks good on the surface but is an illusion. The big banks are almost certain to cut their dividends, and also perhaps reduce franking in the coming year. The recent windfall dividend increases from mining and oil/gas companies would also probably be reversed, and so the dividend yield for the market is likely to be closer to 4% than 5% for the coming year.

Other measures like the 'CAPE' ratio for Australia are also now back near historical average levels – indicating fundamentally around 'fair value'.

Although the Australian market is less over-priced than the US market is now, and has the advantage of miners which should do relatively well in the aftermath of the crisis, when the US share market falls heavily, our market always follows, regardless of local conditions and local pricing. For this reason we have reduced allocations to Australian shares along with global shares.

5. Virus containment measures (shut-downs, etc) are likely to be tightened further (and remain tight) for some time

This is especially the case in the US, which is the biggest problem and the last big country take containment action, but it is also the engine of world growth and main driver of financial markets.

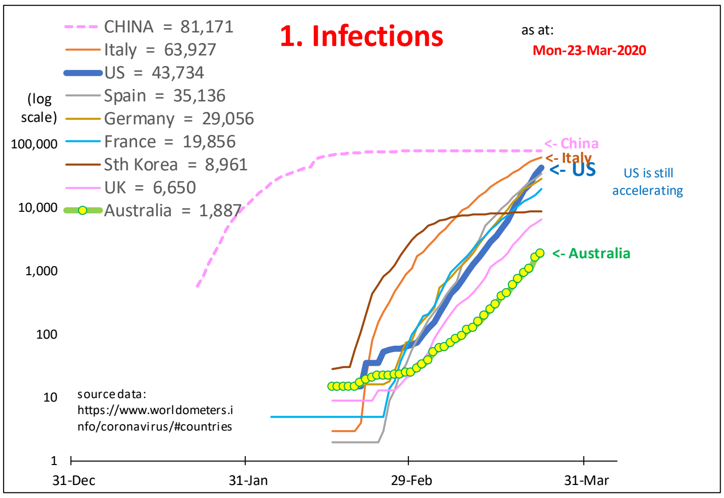
Since the share price falls are due to fears of potential impacts on corporate profitability of the current and possible future government containment actions (and also fears of potential impacts of the government and central bank actions to contain the economic damage of the containment actions), corporate profitability is unlikely to rebound soon, as the shutdowns are likely to get worse and stay in place for many months.

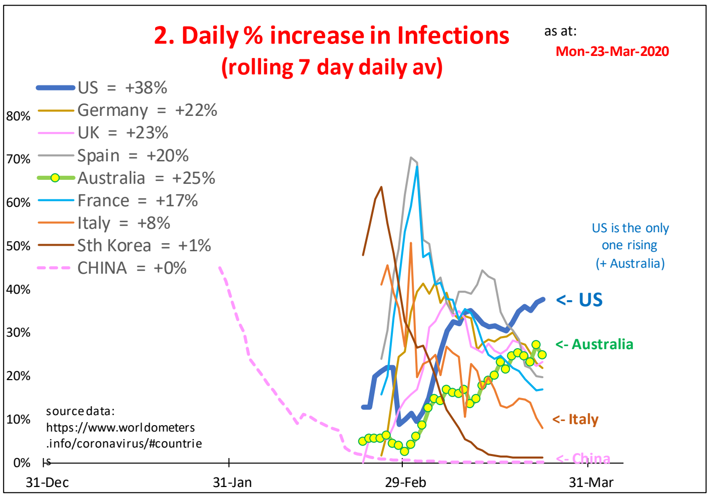
Coronavirus - How we track the spread, containment, and the signals for investors

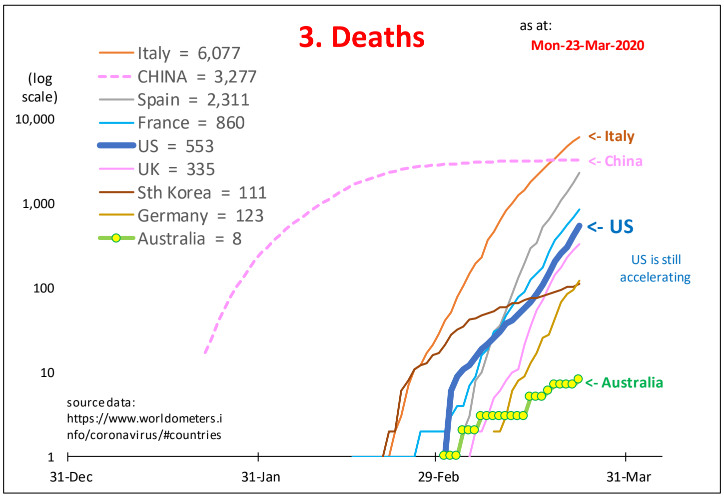
This is important for investors because it is extrapolations from these infection and death rates that are driving containment actions in each country, and it is extrapolations of the likely flow-on impacts of these and likely future containment actions that are driving stimulus responses and also driving share prices.

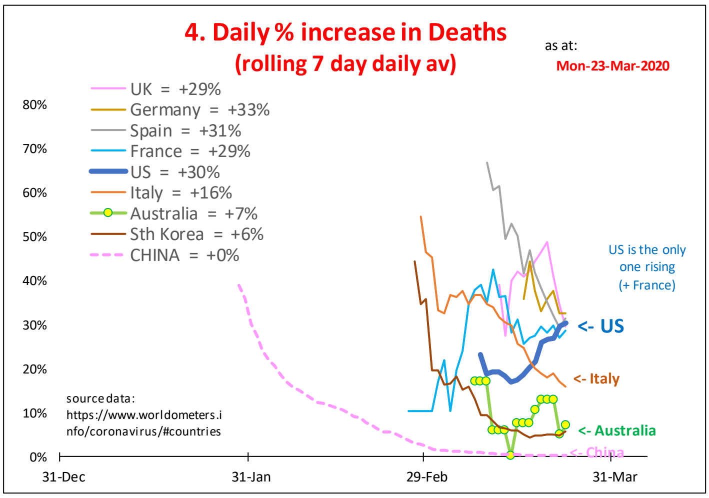
Since the US is the key market, a sustained rebound in share prices is not likely until there are solid signs that containment measures in the US are bringing down the infection rates and death rates. We believe this is some weeks or months away at least before containment measures are eased.

The key numbers we use to track progress of the virus, and the impacts of containment measures, are summarised in four charts. Chart 1 shows the numbers of infections in several key countries over time; chart 2 shows the daily growth rates of infections; chart 3 shows the numbers of deaths; and chart 4 shows daily growth rates of deaths from the virus. (The charts are current as at Monday night 23rd March, and we track them daily).









I have included China (dotted red lines) and South Korea (maroon) as the model for early containment and early flattening of the curves. Other smaller markets like Hong Kong, Taiwan and Singapore are also in this 'go early / go hard' camp. The curves for numbers of infections and deaths (left charts) have flattened (note the left charts use a log vertical scale, so the slope of the curves are what count), and the curves for daily increases in infections and deaths (right charts) have reduced to near zero. China has re-opened activity in all provinces except Hubei – factories and other businesses are operating again – but at very low capacities and volumes at this stage.

China spent January denying, delaying, and silencing whistle-blowers, but then spent February imposing comprehensive lockdowns in Wuhan then Hubei province and then across China, and is now spending March crowing about how China (and Xi personally) saved the world. This has been Xi's 'Chernobyl' moment. Despite doubts as the veracity of Chinese official numbers, the flattening curves for China are being echoed in the data from South Korea, Hong Kong, Taiwan and Singapore – all of which took early hard-line containment action.

At the other extreme is the late/slow action model – epitomised by Italy. Italy overtook China last week in the total number of deaths, and is about to overtake China in the total number of infections. Although the numbers of infections and deaths are very high in Italy, it is encouraging to see the daily growth rates in infections and deaths have started to come down (now below 20% per day) following the lockdown actions taken in recent weeks.

Australia

Australia is in the middle of the pack on these measures – with daily increases in infections running at less than 30%, and daily increases in deaths running at below 10%. Australian authorities to date have been very effective in limiting the deaths to just a handful, but the growth rate of infections is still running at high levels. Although local containment action and stimulus actions are important for local jobs and companies, Australian share prices will not rebound until the US market rebounds, and conversely our local share market will fall heavily when the US market falls.

There are two main centres of attention for investors – Europe and the US. Global share markets sold of heavily starting in the last week of February as the infection numbers started to increase in Europe and the US, which were met with inconsistent policy responses, including outright denials.

Europe

Europe is now the site of the largest numbers of infections and deaths, and it is still the largest economic bloc in the world. There is a political battle going on between Germany's Merkel representing the frugal north, who favours consensus and debate, and France's Macron representing the spendthrift south, who appears more willing to take more decisive, compressive, speedy action. European economies were already flat-lining before the crisis anyway, and Europe has the added problems of having high government debts, negative interest rates, budget deficit limits, lack of fiscal integration, lack of a lender of last resort, the inability of ECB to lend directly to governments, etc. These materially affect the likely speed and effectiveness of Europe's policy responses.

The US

The US is the most important market for US and global investors and the US mix of containment and stimulus responses are going to continue to dominate financial markets prices.

The top right chart above shows that daily growth rates of infections in the US (heavy blue line) is now running at well above 30% per day and the US is the only major country where this is rising. The lower right chart shows that daily growth rates of deaths is also running at around 30%. This is not as high as in UK, Germany, Spain and France, but the US is also the only country where the daily rate of increases in deaths is rising.

It is extrapolations of these rates that have policy makers worried, and in turn have investors the most worried about the likely effects of governments' drastic containment measures, and also worried about governments' and central banks' equally drastic and distorting stimulus measures.

There have 'only' been 553 deaths so far in the US, but if we extrapolate this current 30% per day rate of increase for deaths for say 30 days we get 1.6 million deaths. If the US can lower the rate of increase to say 20% per day (like Italy has done), it could mean around 130,000 deaths within 30 days. If it can lower the rate of increase to say 15% (which no country as done yet, apart from the go early / go hard group led by South Korea), it could contain the deaths to around 40,000 in 30 days.

US	deaths	days	@ daily increase	= millions dead
Current:	553	30	+30%	1.609
		reduce rate to:	+20%	0.131
		reduce rate to:	+15%	0.037

It is important to bear in mind that countries in the 'go early / go hard' camp took radical comprehensive measures very early on, and also that their citizens are relatively accustomed to following autocratic government orders. Even at a personal level before government measures were introduced, we can all remember footage of people on the streets in Hong, Kong, Korea and Singapore wearing face masks back in February when word first hit the streets of another possible SARS-like outbreak. Americans and Europeans (and Australians) are still not doing this en masse even now.

Faced with these startling extrapolations and the rapidly rising numbers of new deaths being reported each day, what is worrying investors is the massive shut-downs that governments may undertake to get the curves down, and in turn the massive amounts of government stimulus, deficits and debts that are likely to be required to rescue jobs, incomes, companies and banks to try to limit the impact of the shutdowns.

We track the above numbers daily and will provide regular updates for clients.

Why US dollars?

The traditional 'defensive' assets in diversified portfolios are usually high grade fixed rate government and corporate bonds. These rise in value when bond yields fall, which is traditionally what happens when shares sell off with fears of economic slowdowns and recessions. Investment grade bonds posted good positive returns during numerous prior crises like the like the 2008-9 GFC, the 2011 sovereign debt crisis, the early 1990s recession, and in many others.

This current crisis is different in that bonds are unlikely to provide the usual buffer against share market falls. One of the key elements in this crisis is the prospect of rapid expansions of government debt that will need to pay for the trillions of dollars of spending programs that governments in Australia and around the world are committing to try to counter the impacts of the government shutdowns to stem the outbreak of the virus. Governments almost everywhere are already running big deficits and high debt levels, so the prospect of even higher deficits and debts is causing some disturbances in bond markets.

Our bond holdings in portfolios are safe, but it is prudent to diversify into cash instead of increasing bonds at this stage. (We are also continuing to work on our plan to reduce exposure to corporate bonds and shift some of the allocation to government bonds in March. This is taking some time as global bond markets are experiencing unprecedented difficulty in executing transactions efficiently and at minimal cost to clients. We will advise of progress and outcomes on this front).

For Australian investors, US dollars have almost always proven to be the ultimate 'safe haven' when share markets fall heavily, because the Australian dollar almost always falls against the US dollar (ie the US dollar rises in value against the Australian dollar) when Australian and global shares fall heavily. Clients would recall that we also added US dollars to all portfolios in 2018 before the late 2018 share sell-off and it jumped 10% in value (as the Australian dollar fell 10% against the US dollar) while shares fell in the 'global growth scare' of 2018. US dollar cash was a more effective buffer against the share falls than bonds on that occasion, and we believe it will be again this year.

What are the opportunities and when might we look to buy?

Our base case is that a sustained rebound in share prices is unlikely to occur until either:

- A) a **cure or vaccine** is announced - we understand that cure or vaccine is not likely to be widely available for many months or even up to a year, but that does not preclude a credible announcement from a major pharmaceutical firm that they are close to a comprehensive solution – and/or a timetable for testing, approval, production, delivery, etc
- OR
- B) the infection and death rate curves for the US **flatten** materially – which is likely to be at least several weeks away, given the observable time delays in other markets

    - Until the curves visibly flatten, there are likely to be more radical and disruptive **containment** actions undertaken – each of which will create even more uncertainty as to down-stream impacts,
    - and until the curves flatten, these likely future containment actions are in turn likely to prompt further **stimulus** responses, likely to become even more radical and/or market distorting, which are also likely to create further uncertainties as to their impacts on financial markets

- AND
- C) In addition it is likely that shares would be less likely to enjoy a sustained rebound unless they are relatively **cheap** (eg as they were in mid-1932, early 2009, etc) – relative to underlying profitability. The US is the key again here – refer to the comments above.

One thing we do know is that there will probably be no cure or vaccine for many months or perhaps up to a year. The other thing we can observe is the impacts and levels of containment actions, and the time lags between containment action and the curves flattening.

Good news

The good news is that this is not the end of the world. The lessons out of China, South Korea and the other early movers is that containment actions do work, and can be eased after a relatively short period. In China the problem started to escalate in early January but all regions apart form Hubei have been opened for business less than three months later. The main reason factory activity is still very low is that demand from the rest of the world has collapsed. That will recover in time.

Although there will probably be many company failures in Australia and in most other countries affected, the vast majority of companies will live to fight another day. We hold a range of diversified portfolios that each hold shares in dozens and up to hundreds of companies across a range of industries and across the world. The funds we used have been especially selected for our portfolios for the proven ability to add value – especially on downside and in crises, and they are doing this again in the current crisis. When we make changes to portfolios we do it mainly by adjusting the passive Exchange Traded Funds while letting the 'active' fund managers earn their fees doing what they do best.

There are many companies that are holding up. We mentioned above that our emerging markets funds are holding up relatively well. The main reason is that the two largest companies in those funds are the two Chinese online giants Alibaba and Tencent. Other online players like Amazon are also doing well, reflecting the shift to online activity in the crisis. In Australia, iron ore miners like Fortescue are benefiting from the re-boot of Chinese production. Many companies in selected sectors will thrive while the others suffer.

The other good news is that share markets always rebound after collapses, usually very strongly and usually more quickly than anybody expects. The best years for share markets are in the middle to late stages of economic recessions and depressions. Share prices rebound strongly while profits and dividends are still being cut – that has been the case in almost every economic contraction from the 1930s right through to the GFC.

While our primary role is to protect investors in times of crisis, we also look to capitalise on opportunities when they arise. We continue to keep a very close eye on events as they unfold and likely impacts on markets and our portfolios and we will keep you informed regularly.

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