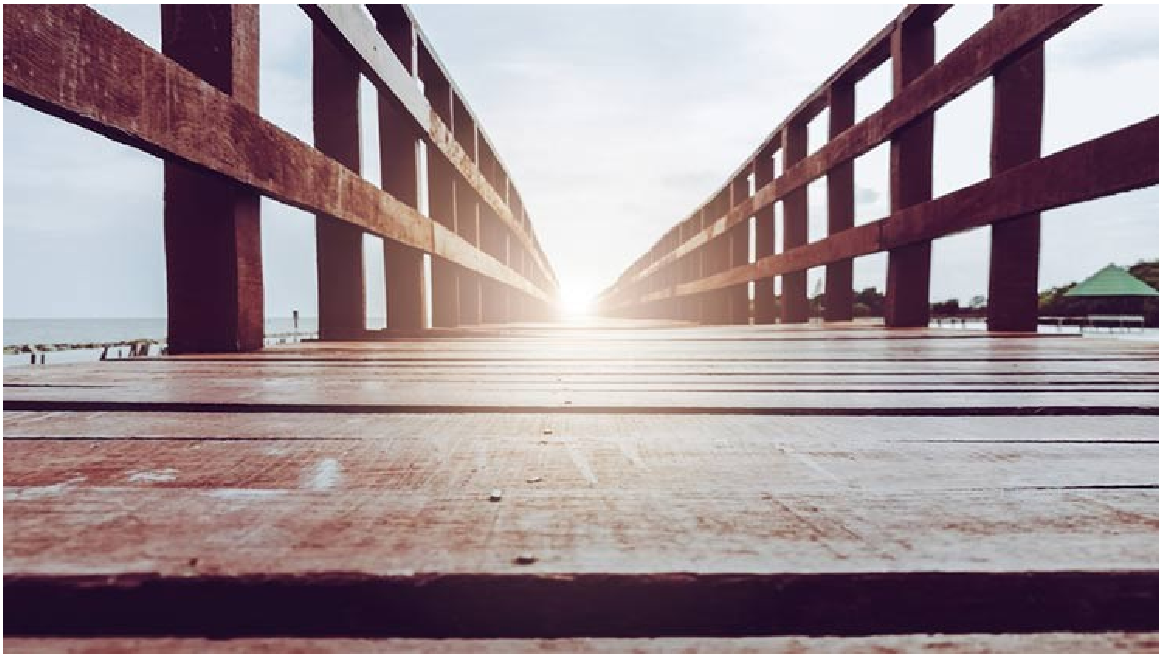
AN ECONOMIC OUTLOOK IN UNCERTAIN TIMES



PERPETUAL ASSET MANAGEMENT
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There's so much noise. Market volatility, the impact of COVID-19 on the global economy, an abundance of risk. Where there is risk however, there's usually opportunity, even if it doesn't seem immediately apparent. Unfortunately, it tends to get drowned out by the information overload and negativity assailing us through our computer screens, television and radio and any other form of media we consume.

The issue at hand for most economies is the government and corporate policies established to restrict the spread of COVID-19. In aggregate, the impact of bans on travel, enforced working from home and a sudden drop in consumer confidence is going to impact the global economy.

This impact will be more acute for some industries – travel, entertainment, hospitality and retail – than others. This sudden demand shock in certain industries is going to provide both liquidity pressures and cause problems in supply chains. Given the integrated nature of international trade, when China shuts down, it negatively impacts everything from car parts to hospital supplies; in turn this culminates in a lack of consumer confidence. When this happens suddenly on a global basis, it's challenging for corporates big and small to be prepared.

How will this likely play out over the next three to six months?

Initially, we're likely to see a pick-up in small business bankruptcies; many smaller companies already struggling will be pushed over the edge by a liquidity crunch.

Many casual employees will lose their jobs and hiring freezes will be widespread. For example, Qantas has cut international capacity by 90 percent until end May, as well as announcing redundancies. This will become more common as companies try and reduce their fixed base to negate the impact on margins. The longer the shutdowns, the more intense the impact on employment.

The longer the demand shock, the bigger the impact. The canary in the coal mine for a credit crunch will be the pay day lenders and buy now pay later providers, given their exposure to a demographic likely weighted to casual employment. Some buy now, pay later do little in the way of credit checks and hence will have a book full of people close to the edge already. At this point, we don't expect the current events to lead to a fully blown credit cycle incorporating residential property.

Will we invest in this environment?

Despite market volatility, we continue to look for (and find) invest opportunities. The team scrutinises companies' cashflow and balance sheets and examines each company's debt profile. We also focus on understanding each company's operating leverage, because companies with high fixed costs and low margins are more prone to generating negative cashflow in a demand shock rather than companies with high margins and low fixed costs. These are things we spend an enormous amount of time analysing whether in a bull or a bear market.

Some of our observations include:

- A demand shock will result in a liquidity crunch for many companies and a not insignificant number will have to come to market with an emergency capital raising, which could in turn permanently impair long term value.
- A strong balance sheet will put a company in a great position to acquire other companies at depressed prices.
- In a market environment where asset sales and equity raisings are more difficult, cashflow poor companies could be impacted.
- Stocks without real earnings, those that rely on capital raisings to operate could be at risk.
- Low interest rates are likely to persist, which will impact investors looking for yield.
- Volatility creates opportunity, particularly for value investors – after all, shares are 30 percent cheaper!

As value investors, the environment will most likely play to our strengths for several reasons:

- Lower interest rates will increase demand for companies with stable dividend yields.
- Companies able to deliver earnings growth will experience a P/E re-rating – while this is not a typical value metric, the market sell-off gives us the opportunity to buy some high quality growth stocks at a good price.
- Momentum managers, which have been the best performing over the past five years, will sell down good stocks because their price is falling, irrespective of a company's valuation.
- Similarly, passive funds linked to a market index will sell down stocks as markets fall, creating some excellent buying opportunities as good quality stocks are dumped because their index weight has fallen.
- Quant and other algorithm-driven funds are also likely to sell down stocks based on a falling price, irrespective of fundamentals.
- A number of ASX-listed companies will need emergency capital injections, giving us the opportunity to buy quality companies at a significant discount.

Having cash to deploy when the likes of passive or momentum funds are selling opens up plenty of opportunity. While we are not complacent about the significant issues facing the global economy in these unprecedented times, we're confident that we'll uncover opportunities to add value for investors. It's important for us to remain patient, have some cash available and buy shares even if we expect a downgrade. This should be a great time for those with cash on hand to capitalise on great opportunities and we intend to do so.

We will do this with care. While the demand shock should be transitory, we need to be forensic on the balance sheet, business model and cash generation. We definitely won't get them all right, and we won't buy the shares at the exact bottom. However, as long as we find companies with quality management, good business model, pristine balance sheet at dirt cheap prices, it doesn't matter if we get the bottom…we will more than likely make a good return from that investment over the medium term.

Find out more about the performance, strategy and holdings of the Perpetual Share-Plus Long-Short Fund.

› FURTHER READING - COVID-19

Visit our COVID-19 Insights Hub for economic and market updates to keep you informed as the situation evolves.