Perpetual

"DON'T FIGHT THE FED", NEGATIVE OIL PRICES, VIRGIN CRASHES AND THE RETAIL REIT REVOLUTION

PERPETUAL INVESTMENTS
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"Don't fight the Fed"

This has been one of the key watchwords of bond investors for many decades. If the Federal Reserve (Fed) is changing interest rates or gushing money in one direction, don't stand in the way. They will knock you down. Previously though this applied primarily as a warning to bond traders. As the Fed balance sheet has expanded in recent years the gush has made its way to other asset classes. The extended suppression of bond yields in various forms of quantitative easing has helped to deliver the most long-lived growth stock booms on record. Nothing could prepare anyone for the gush since the COVID-19 crisis though. Even junk bond ETFs got a geyser of money with some ETFs trading at a premium to NAV days after the Fed unleashed the valve.

The Fed has stabilised markets for the time being and prevented the financial system from completely buckling. But whilst it can print money, it can't print confidence, it can't print jobs and it can't print GDP. At some point these things will have to be priced and work their way through the system. The strong bounce in equities from the bottom should not be a surprise given the speed and depth of the COVID -19 crash in March and the level of Fed support.

It should also not be a surprise if we get more volatile moves up and down in the months ahead. With so much still up in the air it's no time for heroic bull/bear calls on the market. It is a time for careful analysis and steady allocation of money into pockets of opportunities, preferably with companies we know well and have good management teams to manage the shoals ahead.

The domino effect of contagion: whether they are economically light (2001) or severe (2008) these crises always cause a chain reaction of secondary effects once the tide goes out. The GFC started in subprime mortgages but soon moved to the banking system, government sponsored entities (Fannie and Freddie), insurance companies (AIG) and the car makers. It also flushed out a giant ponzi scheme run by Bernie Madoff before the market finally bottomed in March 2009, a full year and a half after the crisis

began.

In 2000 the least viable of the dotcoms went bust in the months immediately after the peak but even survivors saw their share prices plummet, with Amazon and Priceline both declining more than -90% before finding a bottom. OneTel in Australia didn't go into administration until May 2001. The after-wash of the tech bust eventually flushed out accounting frauds (WorldCom and Enron) before the market finally rebased.

In the COVID -19 crisis, despite the sharp recovery in risk assets so far, we have to be thinking what are the second, third and fourth round effects? Which accounting frauds and ponzi schemes will this crisis flush out? They are almost certainly coming and despite the fact they will shock and surprise investors, they are often hiding in plain sight right now. The elephant in the room even before this crisis, was corporate debt. Just as housing debt was the problem heading into the GFC, corporate debt is the outstanding problem today. We think the implications of this have a long way to play out.

Below we address some of the things we are grappling with this week:

Oil

Who would have thought oil would trade at -$40 a barrel? In some respects, it highlights technical glitches in the futures markets. No office-based paper shuffling investor wants to take physical delivery of vast quantities of commodities and the negative price reflected the desire to exit futures at almost any price when delivery was imminent and storage capacity was full. Oil is experiencing a collapse in demand like we've never seen - "demand destruction" on steroids - yet this has occurred just as oil producers had entered a supply war where Russia wanted to raise production.

Energy is also the largest segment of the US corporate debt market, highlighting a risky financial dimension of the energy supply war. Rationalisation of production has already started, but it is now chasing the collapse in demand. The reality is however, that all these crises end primarily because demand will recover, even if not immediately to pre COVID-19 levels, but vast swathes of energy production may be cut on the nearer term as it is simply uneconomic at current prices.

Portfolios: We have taken the opportunity to top up our holding in Oil Search when the company recently raised equity at $2.10. Oil Search, like so many others, will need a higher oil price eventually, but the attraction for us was the ability to buy into what we believe is possibly the best LNG project in the world at a steeply discounted price to recent history. The rights issue gave us the opportunity to buy into the company at the lowest price in 15 years.

Airline wars, Act 2

The collapse of Virgin Australia into administration is regrettable but not surprising. Whilst Virgin has been quite a stayer in the market (over 20 years) through some tough conditions including the GFC, it did have some challenges. It was thinly capitalised and carried a high level of debt, with close to $7 billion in liabilities as it collapsed. Indeed, it was the level of debt that made it unattractive to even its many high-rolling equity owners, who seemed to baulk at recapitalising.

Governments had no interest at this stage in getting involved in a rescue, especially with well-resourced existing owners on the sidelines and knowing that any support for Virgin would have immediately sparked calls for several times the same support for Qantas. Nonetheless Virgin has developed something of a strong brand, has loyal staff and owns valuable terminals slots as well as other assets. These may prove critical in ensuring that a new carrier is quickly assembled from Virgins ashes, maybe even the brand itself.

With international travel closed for the foreseeable future, Virgins recurring domestic revenues would be attractive to several players. The government is not averse to a new low-cost carrier entering the market, although this may prove a headache for Qantas, which faced just enough competition from Virgin without ever putting it under real pressure.

Portfolios: We have never owned Virgin (too leveraged for our quality filters) and the future of Qantas depends on both, COVID-19 and competition they face in the future on the domestic front. The entry of a highly competitive and well capitalised low-cost carrier could be a stronger threat than Qantas has previously faced. We did however enter Flight Centre via a rights issue at $7.20. Flight Centre hadn't traded at this price since near the lows of the GFC. Not only did the rights issue give the company the capital resources to operate for well over a year, the CEO has committed to drastically reshaping the business by slashing operating costs and setting up the business for the new realities of the future.

REIT revolution?

We are starting to see the makings of a potential revolution in the way real estate investment trusts (REITs) operate, earn money and are valued. Some of these trends have been established for some time, but COVID-19 has accelerated the change.

Retail has faced the growing incursion of online for several years. Some retailers have adapted well, but others haven't. But as their monopoly on retail access loses ground to online, so the retailer's power has grown at the margin. COVID-19 has dramatically accelerated this power, backed by new government guidelines. Some retailers are pushing hard to not only lower rents, but to fix them as a percentage of revenue. This has profound implications for the retail REITs.

First, it means potentially lower overall revenue. But it could also result in more volatile rental streams linked to the revenue of discretionary retail businesses. This might have severe implications for both, the percentage of income they can sustainably pay out as distributions as well as their borrowing capacity. Long famed for their combination of equity and bond characteristics, retail REITs would instead start to become more like any other equity.

Meanwhile the general success of working from home (known by the increasingly ubiquitous acronym WFH) is beginning to raise questions about the need for so much office space and the value of Office REITs in the years ahead. Even Industrial REITs might not be immune from change with growing pressure to locate industrial property assets closer to customers in more expensive inner-city locations. Whilst the demand for industrial property will continue to rise, this presents greater complexities for the sector.

Portfolios: We have begun to reassess our valuations of retail and office REITs. We purchased Mirvac as the market sharply sold it off. Whilst all property developers have been punished we believe Mirvac stands out for the quality of its assets and management team and trades at a rare discount to book value.

Find out more about Perpetuals range of Australian Share Funds.

FURTHER READING - COVID-19

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