alphinity INVESTMENT MANAGEMENT

Monthly Comment – May 2020
Alphinity Sustainable Share Fund

Crisis? What Crisis?

Market comment

We were all wondering whether the strong bounce in global equity markets during April would turn out to be an anomaly resulting from the incredibly sharp drop in February and March, but the rally continued through May unabated. With the virus now responsible for millions of infections and hundreds of thousands of deaths the full economic consequences are still not yet fully appreciated, however with the reopening of some economies around the world, including some that arguably should not yet be opened, market sentiment improved to the extent that the ASX300 (including dividends) rose 4.5% in the month, bringing the market's loss year-to-date to only 12%. We don't wish to minimise -12%, it is still a substantial fall, but compared to how things looked back in March a 12% drop feels like a decent outcome.

The best performing sectors in May were IT (up 15%), Metals and Mining (+9%) and Telecoms (+8.5%). Lagging sectors were Healthcare (-5%) Consumer Staples (-0.5%) and Utilities (+3%). Year-to-date IT has also been the best sector at +5%, with Financials and Real Estate lagging significantly, both 20% lower.

Economic indicators are particularly difficult to read at the moment. We all have a good idea of what is happening but, due to the time lag in official economic releases, it is difficult to know just how bad it is. The Australian economy for the March quarter was shown to have shrunk fractionally, by 0.3%. While this was much better than many other countries (US and Europe for example were between -5% and -6%), it still hurts. The official June quarter numbers are still months away but the verdict is already in, the only doubt is just how negative they will be. The Government conceded that our economy has finally dipped back into recession (if you use the classical definition of two consecutive quarters of negative growth), 29 years since the last one.

Global markets were as usual mixed. Australia compared quite well: the only major countries that did better than us were Germany and Japan which were both up about 6% in $A terms. The US S&P500 was surprisingly firm, up only 3% in $A despite the ongoing high Covid infection and death rates, which were compounded by an explosion of racial violence at the end of the month. Asian markets generally struggled: Hong Kong and Singapore down more than 5% and the various Chinese markets -3%. European bourses varied between Belgium's +4% to a flat UK.

Commodity prices were more volatile than usual as the world tried to work out what was really going on and to what extent demand would be affected. Oil in the US rebounded sharply from the extreme lows of April, with West Texas Intermediate crude almost doubling to $US35 a barrel. The other grades of oil, Brent in Europe and Tapis in Asia, also rose to a similar price but those were 36% and 25% increases respectively. Iron Ore was up 15% in $US terms, although only 12% in $A, with further signs of economic recovery emerging in China, but Thermal and Metallurgical Coal were 3-5% lower after signs of trade retaliation in those areas. Base metals were largely unchanged over the month.

Portfolio comment

The Fund outperformed even the strong market in May, benefitting from our holdings in affordable housing provider Lifestyle Communities, logistics asset manager Goodman Group, data annotator Appen, iron ore miner Fortescue Metals, data company Megaport and not owning Woolworths. The only noticeable negative was from not owning millennial payment platform Afterpay Touch.

Performance*	1 Month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	7 years % p.a.	Since inception^ % p.a.
Fund return (net)	5.3	-7.7	-2.1	8.9	6.7	8.4	9.0
S&P/ASX 300 Accumulation Index	4.6	-9.7	-6.5	4.5	4.3	6.7	7.3

*Returns are calculated after fees have been deducted, assuming reinvestment of distributions. No allowance is made for tax. Past performance is not a reliable indicator of future performance. **Source: Fidante Partners Limited, 31 May 2020.**
^The Fund changed investment manager and investment methodology on 12 July 2010, at which time Alphinity Investment Management commenced managing the Fund and started the transitioning of the portfolios to a structure consistent with Alphinity's investment views. The transition was completed on 31 August 2010. The inception date for the returns for the Fund is 1 September 2010. For performance relating to previous periods, please contact the Fidante Partners Investor Services team on 13 51 53 during Sydney business hours.

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Market outlook

The rapid pace of the equity market rebound has confounded many investors, including us to some extent. The market has, in our view, been driven higher by two main factors: huge global monetary stimulus leading to, amongst other things, record low interest rates; and expectations of a rapid earnings recovery supported by the same low interest rates and significant Government stimulus.

Of course, we like everyone else are relieved to see the Government restrictions being lifted here in Australia and other parts of the developed world. And while it's difficult not to feel a bit concerned about the speed at which restrictions in parts of Europe and the US are being eased, Australia has been able to open up faster than expected after a rapid decline in new cases. However, we do wonder if some of the Government's new-found urgency is perhaps not driven by an increased realisation of just how severe the economic fallout from the restrictions are likely to be, even as they are lifted. It remains to be seen whether the record fast decline in the economy will be followed by a record fast recovery but history suggests that recoveries play out over years rather than months.

Equity markets will as always be forward looking but earnings are at this stage likely to disappoint for some time. The impact of ultra-low interest rates on the equity market is a technical but perhaps a more rational explanation of the market recovery than is earnings expectations at this point. The equity market risk premium, i.e. the additional return investors typically require to buy equities over bonds, has over time averaged just under 6% in Australia. Based off current real bond yields the equity risk premium is still well in excess of that on 12 month forecast earnings, suggesting low to mid-single digit returns are possible even if consensus earnings expectations turn out to be 10% too high; or double digit returns if current expectations prove to be correct. This is a complicated way of saying that with monetary stimulus at current levels, it is presently hard to find attractive investment alternatives to equities.

Top five active overweight positions as at 31 May 2020	Index weight %	Active weight %
Goodman Group	1.5	2.7
Lifestyle Communities Ltd	0.1	2.6
APA Group	0.9	2.4
Steadfast Group Ltd	0.2	2.1
Macquarie Group Ltd	2.2	2.0

Asset allocation	31 May 2020 %	Range %
Securities	97.9	90-100
Cash	2.1	0-10

Source: Fidante Partners Limited, 31 May 2020.

Portfolio Outlook

Notwithstanding our best attempts (but admittedly limited ability) to forecast short term market direction, our focus remains primarily on stock selection and in this respect we remain steadfast in investing in companies we believe will exhibit earnings leadership – by that we mean positive earnings revisions relative to the rest of the equity maket. This has resulted in the current portfolio which is dominated by stocks that have been less impacted by the Covid-hit economic situation from an earnings perspective, along with a number of companies we believe are well positioned to be early beneficiaries from an easing of Government-imposed restrictions. Stocks in the former category include gas pipeline owner APA as well as those whose main exposure is to Chinese infrastructure spending such as Fortescue Metals and BHP.

One of the many unique features of this crisis has been that not only have the usual cyclicals been impacted but so have stocks with typically very defensive earnings profiles. Two such stocks are tollroad operator Transurban and private hospital owner operator Ramsay Healthcare. Both were, at first, significantly impacted by reduced volumes (for one of vehicle movements and the other the halting of elective surgery). Both are now seeing conditions quickly normalising and are the types of companies we have been adding to recently.

There are however also companies that initially looked like they would be largely unaffected, and as a result performed very well during the selloff, but are in our view at risk of delivering disappointing earnings over the next 12 months. Examples include medical equipment maker Resmed and vaccine and blood products company CSL. Resmed has thus far been benefitting from increased demand for ventilators but its much larger sleep apnea business is likely to see reduced demand following lower rates of sleep apnea diagnoses over the last three months. We have as a result gone underweight this position.

We also significantly reduced our holding in CSL. Like Resmed, CSL is a world class business with strong long term growth drivers. However, its reduced ability to collect blood plasma as donors have been more reluctant to go to blood collection centres, and emerging risks to the demand for some of its specialty products causes us to suspect that the company might deliver disappointing earnings for the next financial year.

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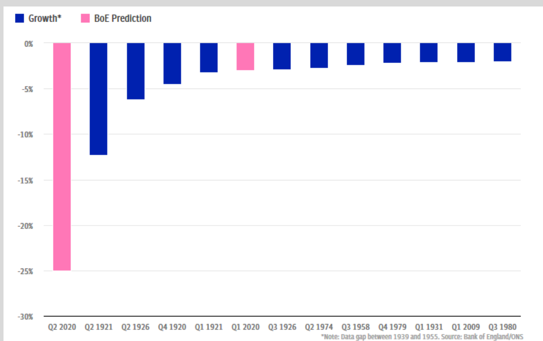
BTW

It was 250 years ago in April that Captain James Cook sailed into Botany Bay. He didn't discover what we now call Australia as there were people who had already been living here for thousands of years. He wasn't even the first European to get here: fellow Brit William Dampier had landed on the West coast 70 years before, and of course Dutchman Dirk Hartog made it to the West 80 years prior to Dampier. But Cook's arrival was still a significant development as it was a precursor to, some years later, the arrival of a bunch of boat people. It was then and is still the greatest country on earth.

250 years seems like a long time to us but we saw some stats recently that put it into perspective. Covid-19 is having an incredible impact on many countries to the extent that Britain's central bank, the Bank of England (BoE), has forecast that economic activity there would fall by 25% in the current (June) quarter. -25% in a quarter is huge: the very worst quarter of the Great Depression in the 1930s was less than half as bad. Tens of thousands of deaths and having one's PM in intensive care probably didn't help consumer sentiment very much. Interestingly, the March quarter also rates as one of the worst in a century.



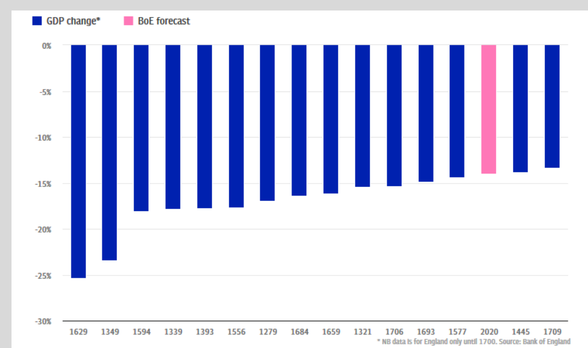
An article in UK newspaper *The Telegraph* had this chart → showing that even if the economy recovers to only -13% this year, as is the current BoE forecast, 2020 will record the biggest single drop in Britain's economic output since the UK was formed in 1706. In fact it will be one of the biggest in 750 years! The BoE has various measures of the size of the economy that stretch back to 1270. They didn't call it Gross Domestic Product (GDP) in those days but the BoE has made estimates of what it might have been.

There have been plenty of disruptive events in England over the past 750 years but the current projection of Covid's full-year impact is up there with the worst. Not as bad admittedly as 1629, after King Charles I dissolved parliament and took over the running the country. It didn't end well, either for Charles or for the country, and England's economy fell by about 25% that year.

Nor is the current situation as dire as 1349, another tough year. This was the peak of the Black Death (bubonic plague) during which about a third of the population died. Per capita GDP was actually pretty strong; the capitas themselves however really struggled. England' economy fell by more than 20% that year.

1594 was another bleak year although with GDP falling 17%, it was not much worse than what Britain is going through presently. At that time England was experiencing a population boom but, after several successive years of crop failures, agricultural output was insufficient to feed all the people causing immense suffering. Queen Elizabeth I (we couldn't find a photo of the Queen so here's one of the great Cate Blanchett playing her) initiated laws at that time that essentially formed the basis of today's social welfare safety net.

1339 marked the beginning of the Hundred Years War. In modern times war often bolsters economic growth as governments tend to throw out any notion of fiscal responsibility and turn their efforts to defeating the enemy at hand, as is happening presently in the war against Covid-19. Back in medieval times however there were fewer options for government borrowing, and King Edward III was essentially bankrupt. He ended up borrowing vast sums from Italian financiers at usurious interest rates – when he ultimately defaulted on those debts it sparked an economic crisis in Italy.



So, as we have said before, we should be thankful that we live so far away from all of this. Australia is suffering too but by a much smaller degree. Yes, we are in recession. Yes, government debt will blow out to an extent that was unimaginable just a few months ago. But we've thus far largely escaped the worst of the virus; with a bit of luck and hopefully some good management we might avoid the worst of the economic impact too, China willing.

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Non-Traveller's Tale

We saw some research recently which suggested that, with this whole virus thing, we might be heading back to the future in terms of international travel. Remember the early days of the Boeing 747, the aircraft that did more than any other to democratise international travel? Probably not, most people reading this publication would not be old enough. In the late 1960s, around the same time there was one small step for man and a giant leap for mankind, Boeing launched this magnificent beast, capable of carrying hundreds of people in comfort across vast distances. Their first customer was now-defunct US carrier Pan Am.

Its planes had a shag-piled spiral staircase leading from the main cabin to a lounge/bar area upstairs. That's traveling in style!

According to Macquarie Research the total number of people who travelled by plane in 1970 was 310 million; last year it was 4.5 billion. The amount of freight by air in 1970 was 15 billion freight-tonne kilometres; last year it was well over 200 billion. What will 2020 look like? Not so good. Covid-19 has already caused traffic to more than halve. This is the biggest fall since 2001, in the aftermath of September 11, and the inevitable outcome of so many countries closing their borders. The fall should be fairly temporary, but it would be optimistic to think that things will bounce back quickly.

Macquarie's view is that the pandemic will significantly dampen peoples' future propensity to travel, even if there are no further waves of infection. People concerned about being infected or unwilling to undergo interminable quarantine periods will add to the existing unease already felt in some circles about the environmental impact of fossil fuel-powered flight. This will result in a lower level of travel in the future, likely leading to higher prices and, therefore, greater exclusivity. In that sense, it might almost be a return to the Clipper Class of Pan Am when air travel was glamorous rather than being on a glorified bus trip, as sometimes presently seems the case. Industry body IATA is now predicting a $US200-300 billion (40-60%) fall in the amount spent on international travel this year, meaning that some airlines will not be able to survive without massive government support. IATA doesn't see pre-Covid transport volumes returning until 2023; the reality is it might take even longer than that for prices and confidence to return to acceptable levels.

Domestic travel will be much more country-specific. In Australia, considering the low rate of infections, one might expect the major routes to open up again before too long, at least when the restrictive state borders are resolved. A Trans-Tasman bubble – maybe including some Pacific Islands as well – might also ease the pain for our domestic operators. Or, more correctly, our sole operator: Qantas is well positioned to survive but Virgin still has to navigate through its own turbulence.

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