Where The Puck Is Going

Newsletter for December 2020

Many investors are familiar with ice hockey legend Wayne Gretzky's famous quote about playing "where the puck is going to be". It is now part of common investing parlance. It could not be truer at this stage, as we stand on the cusp of having not one but potentially a slew of COVID-19 vaccines becoming available commercially to mankind early next year, which could change the economic outlook swiftly.

The obvious 'vaccine' trades - the outright beneficiaries of the unfreezing of such businesses - have got off the blocks in a trice. The dual events of the U.S. presidential elections and the positive outcome on the imminent arrival of vaccines have changed the narrative on a dime in a matter of weeks, setting off a massive unwinding of the concentrated bets on chiefly technology and biotech stocks globally.

This has led pension funds and large institutional money managers to begin rebalancing their portfolios and think about the possible outcomes these significant events will bring to bear on the investment landscape in the next few years.

The Shifting Sands

Since 2010, pension assets have grown over 70% and are projected to cross US$50tn by 3Q'20. This represents over 85% of GDP output (within the OECD area) in 2019. The U.S. is the largest contributor, representing over 65% of the global market, followed by the U.K., Canada and Australia. On the back of strong performance in equities after Q1, current allocation of equities is above the historical average of ~40%. Small moves of capital within such an ocean can have amplified effects on many markets, especially in countries in EM.

The positives investors are now looking at more benignly include continued stimulus in the U.S., an ongoing earnings recovery and progress of the vaccines. Against this backdrop, other factors such as the relative thawing of U.S.-China tensions, rising inflation, weaker dollar and their likely beneficiaries in 2021 and beyond are coming to the fore. A structural long trade on EM v/s DM is being talked about after EMs spent many years in the wilderness. Within Asia, preference of ASEAN and Australia over the likes of Taiwan and China tech, which have been crowded trades for much of the last two years, are seeing lively discussions and debates.

Even as investors are slowly beginning to reposition portfolios to a brave new world, there are swathes of the market in different countries where investors are yet to react or have escaped attention. The rising tide so far has, as yet, not lifted all boats.

To us, current earnings forecasts look “wrong”, in that they reflect a guess at the net impact of COVID-19 v/s the arrival of the vaccines and their macro impact within the forecast period. Considering the imperatives of governments and employers to get their hands on one or more vaccines as fast as possible, we think the markets are adopting a “shoot first, ask questions later” approach right now towards the “vaccine trade” stocks, here and now.

Playing the ‘Puck’

This brings us back to figuring out where the ‘puck’ is likely to be in the next twelve months. Our attention is drawn to those stocks/ sectors where investors have been tentative to acknowledge the normalisation of economic activity and where there could even be a further improvement in the earnings trajectory and pace of recovery beyond what is being currently estimated and priced. It is here that we see further value and the greatest upsides. The way we are thinking about this is to look for companies in the categories below:

- Those that have **suffered mildly in absolute terms** in 2020 and where the 2021E growth expectations look very conservative in light of the potential reacceleration/ recovery of growth and where valuations are below or close to the 5yr mean;
- Those where 2020 earnings are **modestly impacted** and where the 2021E earnings are being modelled at well below 2019 actual levels but where we expect the vaccines’ arrival to force the street to upgrade earnings and reprice stocks higher;
- Those whose businesses have been **impacted solely by the multiple lockdowns** and the weakened economic activity consequently. Here, the underpinnings of margin growth, mix change and structural growth drivers remain intact, but stock prices are yet well below their pre-COVID-19 levels.

To illustrate, we enumerate a few specific instances that are keeping us busy these days. While we are cognizant that banks, energy and travel & tourism stocks are the obvious places to seek good value and play the economic rebound, these are now consensus trades. Our work takes us to those parts of the market which could be niche sectors or stocks that stand to benefit directly in 2021 and where the market is not paying attention just yet and where the opportunities reside.

First Stop: China

China, as always has a plethora of investment opportunities and the HK-listed stocks offer a smorgasbord of choices. Even though China has come through relatively unscathed economically, the recovery unfolding since July is now beginning to take firm root in sector after sector. High frequency data coming out of there suggests that this recovery has almost normalised several deeply wounded sectors. It is here that certain sectors which suffered for longer from the impact of the lockdowns and then the post opening recovery pain are coming to the end of their woes.

For example, sportwear brands and their retailers, a usually multi-year high growth category, saw sales recover but margins hurting in 2020 as excess inventories are being worked away at lower prices. This 'clean-up' is likely to end soon, leading to 2021 seeing normality return to their earnings. This combination could lead to 2021 earnings for the sector return to 2019 levels. While the branded sportswear companies' stocks have re-rated, it is the retailers and the manufacturers where the value resides yet.

As industrial activity has picked up and people have begun to travel domestically in China, either by road, rail or air, all these modes of transportation are seeing a swift return to normal growth rates. While the market has been quick to latch on to travel-related stocks, it is the toll road operators which have gone abegging. China's toll roads have a history of being well-regulated and well-run and generate copious free cash flows once they achieve maturity in traffic volumes. This is precisely what is happening since China began opening up its economy. Toll roads are reporting steady pick-up in traffic plying on them. Toll road operator stocks routinely trade at dividend yields north of 5% on a prospective basis and their valuations on P/B and P/E basis on current 2021 estimates render them at between -1 and -2 SD of their long-term mean, even after their stocks' feeble bounces off the floor.

Chinese ports, capital goods producers, select consumer staples, warehousing and logistics players, Chinese property, are all off their lows but, given their considerably deep declines and the recovery that lies ahead, stocks have plenty of room to trade higher.

Asian Consumption: Devouring Ever More

In Asia, beverage and spirits, food staples like noodles and snacks, restaurants, dairy products companies have seen the on-trade (consumed outside of home) business impacted for the period of lockdowns as people shifted consumption to off-trade (from home) and resorting to pantry-loading (stocking at home). This led to some revenue loss (though some, like noodles, gained) and margin loss too as on-trade sales are more profitable generally. Now as we come to the end of lockdowns, the lost portion of higher margin on-trade sales could return stronger than expected owing to the pent-up nature of demand of people wanting to socialise and head out to dine and travel. A plethora of such stocks continues to trade well below their 2019 levels even as their earnings recovery is likely to be smoother and quicker; in fact, the last period results of many such companies have beaten analyst estimates, seen earnings upgrades and still the stocks have not responded yet.

Property: Where The Debate Is At

Property markets have been the centre of raging debates of what life might be like in a COVID-19/Post-COVID-19 world. The jury is still out on office and retail sub-sectors. The arguments for the world to arrive at a more balanced outcome in the future seem more plausible than the strident doomsday prognosis one heard in the midst of the pandemic.

Stock prices have taken it on the chin naturally, barring the odd exceptions in sub-sectors such as logistics. The China property sector is replete with stocks whose P/E ratios are less than their dividend yields despite the entire sector reporting positive new sales growth in 2020. Indonesia and Singapore have both reported strong recovery in property sales post their economies' re-opening. Singapore REITS have been super-busy with new acquisitions being reported every passing week over the last few months, suggesting that managements are quite confident of navigating the short term and that they see things recovering beyond the next twelve months. Still, we have yet to see yields compress anywhere to the extent they had just before COVID-19 struck.

Keeping The Faith

We could go on and on with such examples. The simple point is that events of the past ten months have made it obvious yet again that there is no limit to human ingenuity and resolve to overcome crises. Faster now than one can fathom, given the vast technological advancements and availability of capital. The tackling of the infections post the initial struggles and the swift availability of funding, people and every available resource to develop vaccines at the fastest pace in history are truly astounding. The role of Central Banks to provide copious liquidity and support to the financial systems to keep them functioning has ensured that an exogenous shock did not translate into another financial crisis. The drug regulatory agencies are working overtime to approve drugs and vaccines in the fastest timeframe in their history.

The learning from these is that, regardless of the challenges, societies and corporates have found ways to come through quickly and that in a fast-normalising world in 2021, the human response may yet surprise on the upside.

Poring over mobility data, tracking earnings estimates and macro-economic data is just one important dimension of understanding the changes in economic landscape of countries and companies. The harder part is to handicap the human response post every crisis. History has proved that such responses have been stronger than previously expected and reposing faith in humanity's resolute strength should not be underestimated.

A global recovery in 2021 is a certainty. Having come out on the other side of 2020 was no mean achievement. But now the next task is to profit from the recovery that lies ahead in 2021 and beyond.

Faith: you know you're gonna live thru the rain
Lord you got to keep the faith
Faith: don't let your love turn to hate
Right now we got to
Keep the faith
Keep the faith
Keep the faith
Lord we got to keep the faith
--Bon Jovi 1992

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