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Two viruses are accelerating round the world **9th March 2020**

The first, COVID-19 already has killed more than 3,000 people. 100,000 cases have been reported. The speed and extent of its progress has provoked the other virus – fear – now infecting global equity markets.

We have no special expertise on the risks posed by COVID-19. We read the same material as everyone else whether from the World Health Organisation or other authorities. COVID-19 has the potential for widespread infection accompanied by high mortality. Attempts to stop its spread have included closing down large parts of China's economy. Yesterday Italy placed a quarter of its population in quarantine.

However, we have a bit of experience of the fear virus. Like influenza, which continually mutates and so requires new vaccines each year, the fear virus also adapts and presents itself differently each time it re-appears. So the notes below are our working thoughts / hypotheses as of today, 9th March 2020 and are subject to change as developments occur.

1. Global corporate profits will fall because of the anxiety provoked by COVID-19 and the measures taken to stop its spread. If the 'feared thing' which has taken markets down is the prospect of zero global growth or even a world-wide recession, then those concerns are valid. People have decided not to travel while several countries are curtailing personal freedoms to stop the spread. Economic activity will shrink as a result.
2. The effect on the travel and tourism industries illustrates the potential impact. Last Friday, March 5th the International Air Travel Association, IATA, estimated that 2020 revenues for the passenger airline industry would decline by 11% compared to last year, a reduction of $63 billion. Those figures assume the disease is contained at present levels. If things worsen, IATA indicated that the revenue decline could reach $113 billion or 19% versus last year. These figures exclude any impact on global freight aviation. A UK regional airline, Flybe, ceased trading last week. It had been in difficulties and cited COVID-19 as the final straw. Many of the world's airlines are in similar financial health. Others will face Flybe's fate.
3. $63 billion in lost revenue for the world's airlines will have a multiplier effect on hotels, travel insurance, retailing and the oil industry. Transportation fuel is the single biggest source of oil demand.
4. Some companies we know well have said that COVID-19 is affecting their businesses. The global luxury goods conglomerate, Louis Vuitton Moet Hennessy, and L'Oreal, the world's biggest cosmetics group, have both advised that sales are affected. Our portfolios hold both companies.
5. The impact of COVID-19 follows an 11-year bull market in which the MSCI All Country World Index returned just less than 12% per annum in US Dollars, a remarkable return by any historical standard over such a long period of time. It was led by the USA which returned 15% per annum. *'How long can this continue / are markets too expensive?*' were frequent topics of discussion with consultants and clients in 2019 and early 2020.
6. Equity returns rest on earnings and dividend growth. COVID-19 puts pressure on 2020 earnings by reducing global economic activity. IATA's forecasts for the passenger aviation sector imply a significant slowdown.
7. The multi-decade collapse in global bond yields since 1979 has been a major boost to equity market valuations. The financial crash of 2007/08 saw government and central banks drive rates downwards to prop up financial asset prices and house prices. Today the yield on US ten-year treasuries is 1%.

In Japan the equivalent figure is zero. Ten-year government yields are negative in nine European countries. It is improbable that any major economy will increase interest rates in the face of a widespread health crisis.

8. With rates this low, the great boost to equity valuation from 40 years of falling bond yields is behind us. Once we're through the worst of COVID-19, equity returns will rest on earnings and dividend growth and nothing else. Europe's flirtation with negative interest rates hasn't boosted equity valuations. Its main effect has been to corrode the banking sector's profitability.
9. The other factor challenged by COVID-19's progress is the role of leverage and financial engineering. The soaring performance of the US equity market since 2008 has been helped by $5 trillion of share buy-backs. The buy-back bonanza reflected a unique combination of circumstances, namely (1) a persistently strong economy helping companies generate cash flows over and above their reinvestment and dividend needs, (2) increasing linkage of CEO remuneration to Earnings Per Share growth which is all but guaranteed if a company buys back its own shares, (3) corporate tax cuts and (4) a deep, liquid bond market which has been willing to finance share buy backs when corporate cash flow was insufficient for the CEO's EPS growth ambitions.
10. But the peak force may have passed. Measured by the MSCI USA index, America's equity market was worth just less than $9 trillion at the end of 2008. By the end of 2019 it was worth $30 trillion. How much of that $21 trillion advance came from $5 trillion of corporate cash splurged on share buy backs? A further $5 trillion of buy backs won't have the same effect on a market with a starting valuation of $30 trillion than was felt on one of $9 trillion.
11. Buy-backs are financial engineering to leverage revenue and profit growth into higher reported Earnings Per Share growth. Unfortunately, they work just as well in reverse. Equity is the cushion upon which a company's balance sheet rests, protecting it from shocks. The $5 trillion splurged on buy-backs would be helpful in a recession. Plenty of fear-fodder should Mr. Market come to loathe buy-backs as reckless conduct by EPS-incentivised CEOs.
12. Has the fear virus run its course? Is it time to buy? If your investment horizon stretches beyond a minimum of five years, it's always time to buy. Today's bond yields imply little confidence in future economic growth. The US buy-back craze is a manifestation of that pessimism, encouraging CEOs to engineer 'shareholder return' even if growth is modest. If COVID-19 delivers the 'reality check' that the only source of sustainable growth is businesses that can grow their earnings, dividends and cash flow without artificial support, then so much the better.

Alan McFarlane & Russell Hogan
Dundas Global Investors