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Asset Management

Global Earnings

Assessing 2020 prospects in a fast-changing world

Global Core team
April 2020

At a glance

- Published earnings forecasts are not a reliable guide in these uncertain times with many companies suspending forward guidance
- Our global analysts comment on what they are seeing in their sectors — industrials and financials are the most vulnerable, while health care has been resilient
- We are stress-testing scenarios to find stocks that are attractively valued even in a worst-case situation, while avoiding those with balance sheet risk and structural headwinds
- Secular trends, particularly in technology and consumer discretionary appear likely to be accelerated by recent events. Therefore, it may be dangerous to assume that stocks and sectors will follow the pattern of previous downturns and we look to see where things may truly be different

2020 had generally been expected to be a year of earnings growth for most markets. This earnings growth story has been derailed by the coronavirus (COVID-19) pandemic and we expect earnings growth to weaken this year, with cuts already evident in first-quarter earnings.

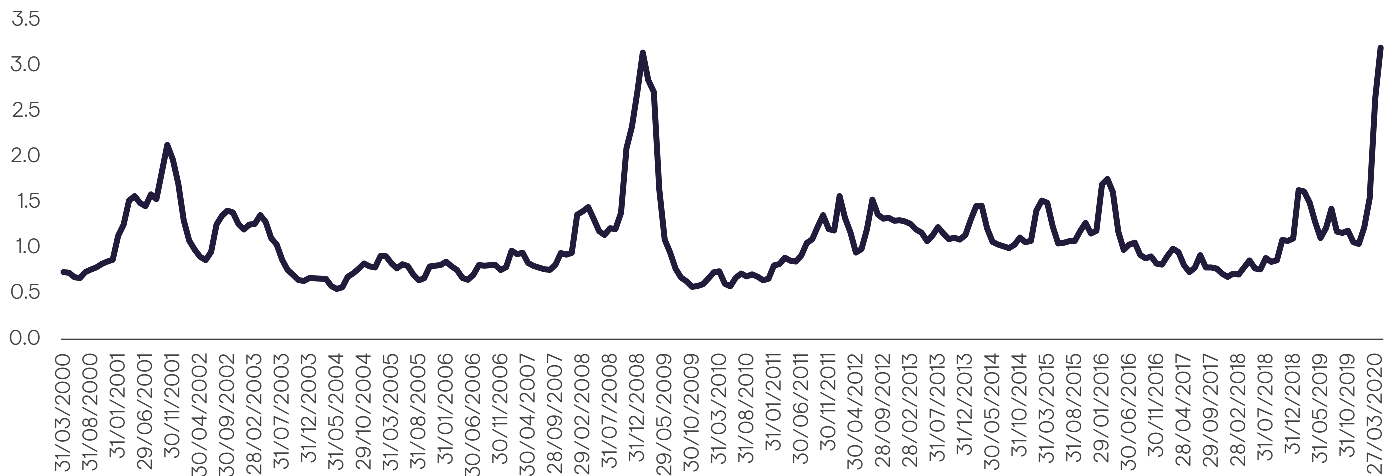
Several extremes in markets have emerged from the hit to global economic growth, exacerbated by the lowest oil prices ever seen. Never has there been such a global coordination of mandated economic inactivity, bringing businesses and activity to an abrupt halt. However, there has been an equally unprecedented monetary and policy stimulus response to attempt to bridge the gap. Nevertheless, it is clear that the pandemic will have a profound effect on people's lives, and on the prospects for companies big and small around the globe.

In light of the uncertainty, many companies are understandably reluctant to comment on their outlook for the year or even on current trading. Companies in the UK, for example, have been urged to delay full-year results and similarly in the US, the Securities & Exchange Commission (SEC) has granted a delay in quarterly reporting for companies impacted by the coronavirus. With companies worldwide suspending profit guidance and delaying reporting, it is perhaps not surprising that aggregate profit forecasts have not fallen as much as the sharp fall in markets indicate. It is worth bearing in mind that these earnings estimates are a lagging indicator.

The value of investments, and any income generated from them, can fall as well as rise.

Global Earnings

Figure 1: Downgrade to upgrade ratio as shown by the 4Factor ‘Earnings’ factor

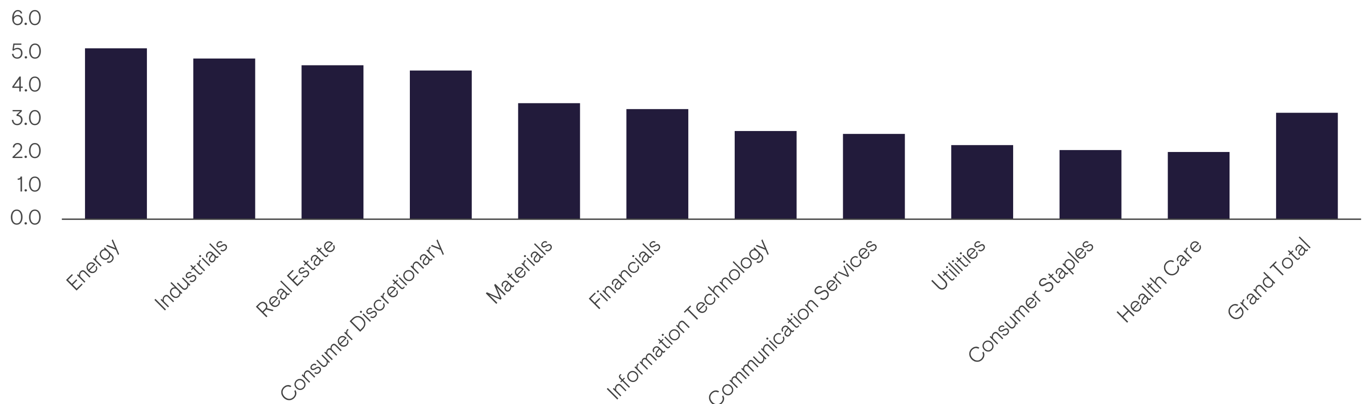


Source: Ninety One, 6 April 2020.

According to our 4Factor data, by the beginning of April there were more than three downgrades for every one upgrade on the current financial year earnings, a pace of decline as bad as the worst point of the global financial crisis (GFC) (Figure 1)[1]. At a sector level, it is perhaps no surprise that the latest figures show the energy sector suffering the worst of the downgrades alongside cyclical sectors, while defensive sectors, such as health care and consumer staples, are faring less badly. (Figure 2)[2]. Analysis varies on the extent of cuts already baked in. According to Bernstein, some 70% of earnings forecasts have yet to be updated for recent events[3]. JP Morgan Cazenove observes that aggregate revisions have seen a very modest trim of 3% compared to the 40% and 20% cuts they saw in the last two recessions, respectively[4].

Figure 2: Cyclical sectors most affected by earnings downgrades

Ratio of downgrades to upgrades of current year forecasts over the last month, by sector



Source: Ninety One, April 2020.

How can an active approach bring clarity?

While the response has varied by sector and company, the common inevitable focus is on maintaining or increasing cash on balance sheets at the expense of capital return. Companies have accordingly suspended buybacks and dividends, while others have announced rights issues. In the same vein, the market has been quick to punish those companies with more leverage on their balance sheets. This hypersensitivity to debt levels can benefit from some greater context. In March, US corporates drew down US$549 billion in bank lines, which is slightly higher than the last four years combined[5].

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[1] Source: Ninety One, 4Factor, as at 6 April 2020.
[2] Source: Ninety One, 4Factor, as at 6 April 2020.
[3] Source: Bernstein, as at 30 March 2020.
[4] Source: JP Morgan, Cazenove, as at 30 March 2020.
[5] Source: Autonomous sales daily, 3 April 2020.

In this market setting, our analyst team is stress-testing companies for a range of scenarios. This involves monitoring the stress that such events have on their credit worthiness, with an emphasis on balance sheet strength, a key component of our 'Strategy' factor analysis. We are re-evaluating each of our companies on this component of the overall 4Factor score as well as their individual investment case in the new environment, assessing their likely valuation in a bear case scenario. This involves modelling the liquidity stresses they could see in such an event, including free cashflow analysis. Given the widespread suspension of capital return policies, we are also evaluating how these could impact the investment case. In our view, it is in such tumultuous times that a consistent, repeatable approach helps to guide us. We are working hard to assess where the risks and opportunities may lie, in particular what the future may hold for companies' end-markets. Here we share our sector analysts' insights on the impact of the coronavirus outbreak on companies' prospects:

Cyclical sectors

Financials

Global financials are once again the lightning-rod for macro shocks to flow into the real economy. In comparison to the onset of the GFC, banks are far better capitalised and have amassed significant liquidity buffers, the limits of which will be tested as cash-hungry corporates continue to draw down credit. Regulatory forbearance contrasts to the draconian measures implemented post 2008, which frees up capital and increases balance sheet flexibility. The monetary policy playbook has been magnified in order to bring significant liquidity to the system. Time will tell what effects these measures will have, but it seems unlikely to lead to questions around solvency and share count for financials. Rather, this has become a question of earnings power in the face of a significant ramp up in loan losses.

Notwithstanding being on a more solid footing, global bank indices have fallen significantly as the market has rebased earnings back to a low rate paradigm, lowered growth, and used the GFC blueprint to gauge what loan losses could potentially look like. Global insurers are down significantly too, driven by the life segment in particular, as higher mortality rates combine with the effects of low rates on investment portfolios.

Capital light financials continue to outperform, with insurance brokers and property and casualty insurers doing particularly well, and stock exchanges holding up on the back of strong volumes and volatility. In general, the bias of the portfolio is towards these types of stocks and away from banks with potential balance sheet risks. Alongside this assessment, we have also steered the portfolio away from companies with high interest rate sensitivity.

Industrials

Industrial company earnings are facing significant negative headwinds from the coronavirus and associated containment measures, with many already suspending their full-year guidance. While manufacturing PMIs suggested an acceleration in the first two months of the year, there has been a sharp slowdown in recent weeks as containment measures ramp up in Europe and the US. Meanwhile, the supply chain disruption that began in China will likely become a more widespread feature during the second quarter.

The aviation industry is an area of notable stress. With some countries closing their borders and placing severe restrictions on freedom of movement, global air travel is expected to fall over 70% year-on-year in the second quarter[6]. Airlines globally are seeking support from national governments to deal with unprecedented pressures on near-term cashflows from booking cancellations as well as measures to support staff without resorting to mass layoffs. The dash to preserve cash and cut spending is leading airlines to defer the delivery of new planes. It is conceivable that this crisis may result in longer-term restrictions on free movement, or make companies reconsider the need for so much international travel as virtual conferences and webinars become the norm. So, the shape of the aviation industry may be very different in future years.

The portfolio is focused on stocks with robust balance sheets that have relatively sustainable cashflows and the flexibility to meet the evolving needs for infrastructure spending. When assessing bear case scenarios with little visibility on near-term earnings, we have considered whether there is a structural issue that could impede the investment case.

Consumer discretionary

The pandemic has polarised equity returns within the consumer discretionary sector. Positively, internet retail companies have been among the best performing, not just within the sector but within the MSCI All Country World Index as a whole[7]. In the short term, these companies are expected to be beneficiaries of higher e-commerce sales as more people shop from home, a trend that has been accelerated by the outbreak. Over the long term, online retailers could benefit from increased stress among bricks-and-mortar retailers, many of which will need to close stores or enter bankruptcy in the coming months.

Other sectors, such as automobiles, hotels, restaurants and leisure, have drawn down liquidity or pursued additional financial flexibility, reduced their workforces, and have sought additional expense relief through rent holidays or forgiveness. The more capital-intensive

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[6] Source: International Air Transport Association, 31 March 2020.

[7] As at 31 March 2020.

sectors with high fixed costs have responded most rapidly to preserve cash and stave off serious balance sheet strain.

Once the various lockdowns are over, we expect consumer spending to rebound, but probably not to prior levels due to impairment of the average consumer's income and savings. That shrinking pie of available consumer discretionary spend means industry leaders are likely to continue to extend their market share gains. This will be a continuation of the disruption and consolidation which has defined the sector since the GFC. Indeed, the current situation only serves to accelerate those changes to end-markets. Consequently, the portfolio favours online retail and is generally avoiding traditional retailers and the more capital-intensive areas of the market. Where we do have exposure to physical footfall, we are considering whether the company can create value without immediate access to the asset, such as through recurring revenues like membership and service fees.

Materials

The diversified miners' earnings forecasts have held up well (flat to down 8%) over the first quarter, supported by better-than-expected resilience in iron ore prices, propped up by Chinese demand. However, other base metal prices generally have fallen around 20% over the same period as demand fell. Pure play copper miners' earnings forecasts have fallen 30 to 75% by the end of March, with the more levered and higher cost names suffering more. Conversely, gold miners have benefited from a 7% rise in gold prices over the first quarter. Our only holdings in materials are miners with two gold names and one diversified miner, where earnings have been resilient or even increased in the case of one gold miner.

Falling input prices have been only a partial help to the chemical sector, as weak demand and increased new supply supresses margins. The exception has been integrated polyolefin (thermoplastic) names where margins have increased significantly due to increased demand for food packaging materials, although more diversified chemical names are seeing earnings down between 30 to 50%. Likewise, containerboard companies are benefiting with increased e-commerce transaction volumes, with earnings falling only 5 to 10% to the end of March. A more sustained shift to online shopping could mean that end-markets prove more robust than in previous cycles. Chinese cement names have actually seen positive earnings revisions of around 5% over the first quarter, as cement prices were boosted by Chinese efforts to stimulate construction activity.

We are keeping an eye on such stocks that are benefiting from increased demand in end-markets, the impact of policy responses, and possible longer-term changes in demand patterns. One potential fertile hunting ground for opportunities is in base metal miners in markets with supply constraints, such as copper, which could benefit from a pick-up in demand in China.

Technology

What was initially perceived as a local supply chain issue in China has rapidly developed into a widespread disruption to global demand. Containment measures are affecting key demand markets as well as several supply sites globally, given the interconnected nature of world supply chains. Companies initially attempted to quantify the impact when issues were localised to China, but as visibility considerably weakened company profit guidance in many cases has been suspended. In some cases, so has capital return as companies seek to preserve cash.

Sector wise, hardware companies that rely heavily on outsourced manufacturing and have highly transactional business models look set to suffer the most from the disruption. Conversely, software companies with low manufacturing footprints and high levels of recurring revenue could be least impacted. Even here though, sales cycles are likely to lengthen as demand is deferred, in particular with enterprise and SME clients.

Semiconductors companies are seeing a contrasting dynamic of weakening demand in end-markets, while direct customers in certain component areas are continuing to add inventory due to supply concerns. In contrast, beneficiaries are companies that enable online activity in areas like gaming, remote working, and e-commerce, which all require the datacentre cloud infrastructure provided by semiconductors to deliver these services. These existing strong secular trends have been accelerated by the coronavirus. The portfolio continues to favour the market leaders that have potential to benefit from these drivers.

Energy

The energy sector has been particularly hard hit as the pandemic has significantly reduced oil and gas demand. This was exacerbated by OPEC+ not being able to agree to the split of a production cut of 1.5 million barrels a day before the pandemic hit. Russia's unwillingness to cut further prompted Saudi Arabia to open the taps. As a result, Brent Crude fell nearly 70% in the first quarter, resulting in earnings downgrades of between 45 and 75%[8] for the major integrated oil companies. With brokers still lagging spot oil prices, further downgrades are likely.

The exploration and production (E&P) names are seeing even greater earnings downgrades depending on their breakeven cost of production and leverage, with expectations down 50 to over 100% over the first quarter. Refiners have also been affected as weak demand has reduced volumes, although with margins helped by falling oil costs the resulting downgrades have been between 35 to 65%.

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[8] As at 31 March.

If travel and broader economic activity recover slowly from an expected 20% fall in demand in April 2020[9], then demand may be weaker than current forecasts suggest. The suspension of new oil development projects will ultimately bring supply back into balance, particularly with the estimated decline in demand. However, with the oil producing countries at odds over how to distribute production cuts, it may be not until next year that we see oil prices recover.

Our holdings in the energy sector are either downstream names, which should benefit from lower input prices, or upstream holdings which are low cost producers with strong balance sheets or extensive hedging books. We feel comfortable that they all have levers to pull that will allow them to manoeuvre if this situation persists.

Real estate

The role of the real estate sector in the current crisis is a relatively complicated one. Generally perceived to be a defensive sector, real estate names overall have only traded broadly in line with the MSCI ACWI in the year to date[10]. This is because cashflows are more uncertain in the current crisis and because capital values (which essentially capitalise the rental stream in most instances) are closely linked to the economic cycle.

Given the role of rental or mortgage payments in total fixed costs for either businesses or individuals, we have already seen a number of companies report payment deferrals by tenants. In addition, given the perceived stability of cashflows, real estate names are some of the most highly leveraged names in the global universe, which can prove to be a toxic combination as those cashflows suddenly become more uncertain.

In general, the portfolio is not heavily exposed to traditional real estate names such as real estate investment trusts (REITs), but it has higher exposure to areas that are less highly correlated to the global economy in the short term — Chinese real estate, for example — or where cashflow drivers are diversifying.

Communication services

Corporate advertising budgets are typically a fixed percentage of sales and therefore broad economic weakness results in reduced spending. Advertising budgets are also the easiest corporate expense to affect in the short term, so there is immediacy to such cuts that negatively impacts media companies, including cable networks and online social media platforms, whose primary revenue source is advertising. Digital advertising is no different, especially given its relatively high exposure to areas that have been most hard hit by the consequences of the current crisis, such as retail, leisure and hotels.

However, the sector has also been the beneficiary of the increased reliance on social media and other digital platforms as more people are confined to their homes. The resulting growth in engagement and in a perceived sense of utility in offerings should continue to support the long-term shift in global advertising toward digital spend. In this context, the portfolio is positioned toward names where we believe engagement growth is likely to be most robust and where business models are stronger.

Defensive sectors

Utilities

Utilities are generally perceived to be one of the more defensive sectors as, particularly in the regulated space. Returns for regulated utilities are determined based on their level of investment rather than demand, which results in less economic sensitivity.

However, it is clear that overall sector performance will be more bifurcated over time as two considerations weigh more heavily. First, a number of utilities are directly consumer facing or exposed to changes in industrial demand through their unregulated merchant operations. Moreover, these names are often relatively highly levered. Second, the provision of dividends is not necessarily straightforward, either because the company is in the first camp, or because the government is a significant shareholder and keen to see companies retain funds for investment or to provide an example to the corporate sector for political reasons. We have seen two French companies eliminate their dividends and remove guidance. History is also a good lesson here, with the utility sector seeing dividends cuts of around a quarter over the GFC period, which contrasts to the general perception of universal stability.

The portfolio is skewed toward companies with more resilient growth dynamics such as renewables; a balanced geographic exposure; a strong balance sheet with ample liquidity; and some ability to act independently of national governments. However, no utility is fully independent of governments and regulators, and in these uncertain times, there is greater risk of regulatory interference.

Consumer staples

Usually a 'safe haven', many staples companies have come under similar pressure to more economically sensitive sectors, facing an unprecedented dislocation between supply and demand. A number of global companies with operations in China and Asia released

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[9] According to broker forecasts.
[10] As at 31 March.

guidance in late February or early March to account for the virus impact. Subsequently, just a few weeks later, with the virus spreading to the west, many opted to completely withdraw guidance. Share price reactions have varied depending on the company's degree of leverage, expected near-term benefits from stockpiling on revenues and anticipated long-term structural growth.

For example, beverage companies are normally perceived as relatively immune to economic slowdowns, but a high proportion of sales comes from on-premise and away-from-home consumption. The lockdown has virtually eliminated this higher margin revenue stream. This is particularly an issue for companies with highly leveraged balance sheets, as profits could be significantly impacted. Conversely, other companies are stating that it is largely 'business as usual' and they expect an Easter season ahead of last year in the west. Importantly, sales in China have normalised seven weeks after the initial outbreak. This could be a blueprint for other economies. Similarly, it is likely that frozen food retailers will see some benefit from stockpiling. We have added some exposure to a frozen food producer and a snack food producer, as these will benefit from people consuming more at home.

Health care

In the wake of the coronavirus, pharmaceutical companies became a 'safe haven' for investors, with a reasonably constructive view of the drug industry emerging from the US, once it became clear that Joe Biden is likely to become the Democratic party nominee for the presidential elections in November. Moreover, a number of diversified pharmaceutical names have re-affirmed their 2020 guidance, which was viewed positively by the market. However, there may be some disruptions due to patients' inability to attend hospital appointments, the slower uptake of new drugs, and delays to clinical trials, but we expect the magnitude of the impact on earnings to be small. While revenues from drugs have generally been resilient during recessionary periods, we believe the two areas within the pharmaceutical sector to watch closely are physician hospital-administered drugs and new product launches.

Health insurers have also performed well post Biden's primary victories, which alleviated fears around Medicare-For-All. Insurers can also benefit from the coronavirus outbreak, as more expensive elective procedures have now been postponed. The narrative on elective procedures and economically sensitive subsectors, such as dental and hospitals, has been more negative as debates continue on the magnitude of potential headwinds to 2020 guidance. A number of companies in this area have cut or withdrawn their guidance. Medtech is more resilient than hospital and dental players. A lack of visibility on the depth and duration of delays of discretionary elective — and potentially other — procedures remains one key tail-risk uncertainty that has clearly been reflected in subsector performance.

As in other sectors, highly indebted names have also suffered the most and we remain focused on companies with the liquidity to survive and prosper in these difficult times. We have repositioned the portfolio towards the more defensive pharmaceutical names with diversified product lines or a stronghold in a particular product and away from those with heightened earnings risk due to the interruption of clinical trials.

Accelerated secular trends

The sharp dislocation between supply and demand driven by the pandemic and the associated responses to it are having an equally dramatic impact on corporate cashflows. With little clarity as to when this interruption may end and what the world will look like then, forecasting is more than usually difficult. However, despite the inevitable uncertainty over future demand, we see that there are strong secular trends that we believe will stand the test of time. This is especially true for technology companies, whether it be the infrastructure providers, those benefiting from shifts in our shopping habits and our leisure activities, or the way we pay for these.

The impact of the coronavirus will only serve to accelerate these trends, as social distancing boosts e-commerce share in retail as well as the increased use of contactless payments and online social networking to keep in touch with friends and loved ones. The demographic impetus for greater spending on health care has only been underlined by the pandemic, and both environmental and infrastructure projects are likely to benefit from the fiscal spending needed to re-invigorate economies. In the search for potential investments it is important to take a wide lens to the equity market, not be distracted by behavioural bias, and to consider other valuation metrics outside those concerned with short-term profitability or earnings. With little guidance available from companies, our analysts need to apply their expertise to identify where the risks and opportunities are.

A different future?

While certain secular trends seem set on the path for further entrenchment, our analysts are always aware of the need for the careful assessment of change. The strength of demand when the recovery finally comes is obviously a source of market uncertainty, and here our analysts are not simply assuming that things will revert to the status quo. Nevertheless, the market is following a familiar narrative, with high quality, low beta stocks with sound balance sheets significantly outperforming low return businesses with high levels of debt. However, in many ways this period is unprecedented and so it is important to be alert to sectors and stocks where the market may be too sanguine, as end-markets prove to be affected differently than in previous downturns. Therefore, we believe there is a need not just to be cognisant of earnings revisions, but to have a full understanding of current industry and company dynamics, and to be adept at understanding where the future may truly be different this time.

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