Don't waste a crisis

- **We are amidst an unprecedented crisis. For investors, this is the time to look at their current positioning and to identify relative winners and losers in their portfolios.**
- **In this note, we outline our thoughts on some themes – listed under eight different categories – to assess if COVID-19 crisis has impacted any of them.**
- **We find that most of our preferred themes (new economy, consumer facing-tech, quality etc.) get a positive reinforcement, in fact. Big tech particularly stands out.**

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As someone once said, a good crisis should never be wasted. Crises do provide a moment for reflection and deliberation and allow for more radical changes than would be possible during normal times. For the business sector, times of crises do also provide great opportunities for improvement. Certain sectors and selected players could see an improved outlook while weaker and disrupted players could end up leaving the game. A post-crisis world could see higher barriers for new entrants.

For investors this is also the time to look at their current positioning and to identify relative winners and losers in their portfolios. For long-term investors, crises also present opportunity to think about how their portfolios should look like in the future. Undoubtedly, we are amidst an unprecedented crisis – both by magnitude and by scope, and one should not let this crisis go waste.

In this note, we outline our thoughts on some themes – listed under eight different categories – to assess if COVID-19 crisis has impacted any of them. We will follow-up with a note that details more actionable ideas.

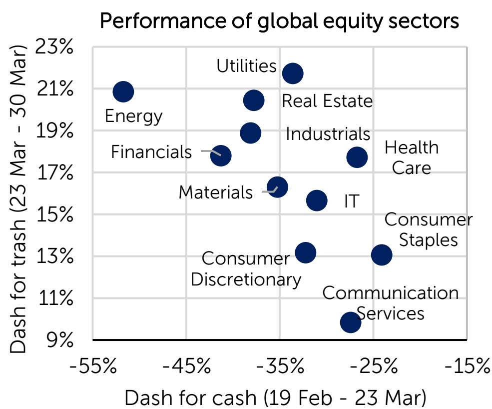
1. Cyclicals vs. defensives
2. Large caps vs. Small & mid-caps
3. Policy support – winners and losers
4. Accelerated deglobalization
5. Disruption fast-tracked
6. Make-over plays
7. All-weather portfolios
8. Opportunities amidst slowing benchmark returns

We find that most of our preferred themes are likely to experience a positive reinforcement from the crisis. In recent years the rise of disruptive technologies coinciding with growth in share of millennials (and digital natives) in the populations has resulted in the development of several 'new economy' themes (which we discuss in some detail in this note). We see the post-COVID-19 world becoming more conducive for a faster development of such themes. Particularly, the 'Big-tech' segment is likely to emerge the winner – given its balance sheet strength (that helps survive this crisis), supportive business dynamics of the crisis (that improve the outlook) and social-engagement during the crisis (could translate into less regulatory pressure subsequently). Further a deglobalizing world might motivate countries to develop their next-gen national champions of tech.

1. Cyclicals vs. defensives: we continue to prefer non-cyclical growth

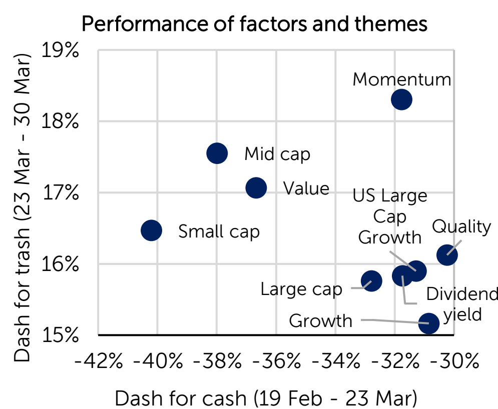
First massive leg down (from February 19 to March 23) saw a 'dash for cash' where some of the safe haven assets like US treasuries and gold sold off along with risk assets. During this period, within equities we saw the cyclical sectors (energy, financials, materials and industrials) underperform non-cyclical growth sectors (consumer sectors, communication services, IT and health care). At the same time, small & mid-caps underperformed large caps and value underperformed growth. This trade however reversed when the markets experienced a cyclical bounce (from March 23 to March 30) where there was a 'dash for trash' (exhibits 1 and 2). At some stage when the market finds its post-COVID-19 bottom, cyclicals are likely to outperform defensives largely because the former underperforms the latter during downturns. However, we think investors should not fear when there is 'dash for cash' and should not be greedy when there is 'dash for trash'. In that context, we strongly prefer non-cyclical growth sectors (to cyclicals), quality and large caps (to mid and small caps). This also ties in very well with our preference for US (over the rest of the world) and with our focus on 'new economy' themes that we discuss in the following pages.

Exhibit 1: Fear of 'dash for cash'...



Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 2: ... and greed of 'dash for trash'

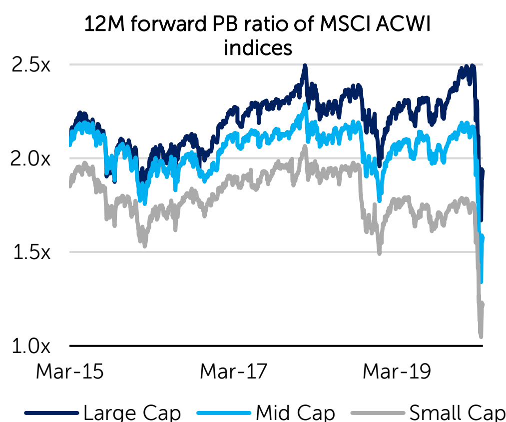


Source: MSCI, Bloomberg and ADCB Asset Management

2. Large caps vs. Small & mid-caps: in large caps we trust

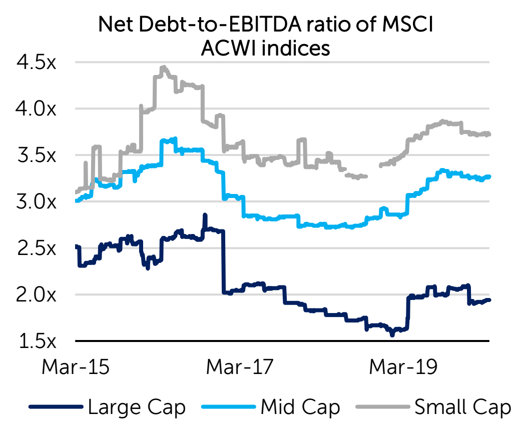
We prefer large caps over small & mid-caps for reasons mentioned above: large caps are non-cyclical and rich in quality. Further, whilst large caps tend to trade at premium valuations compared to mid-caps and small caps (exhibit 3), such premium in valuations is also justified by higher return on equity for large caps. However, during crises when balance sheet stresses are often closely monitored for, much better debt service ratios of large caps make this size segment very attractive (exhibit 4 shows the net debt to EBITDA ratio for three size segments).

Exhibit 3: Large caps' premium valuation ...



Source: MSCI, Bloomberg and ADCB Asset Management

Exhibit 4: ... is justified by better fundamentals



Source: MSCI, Bloomberg and ADCB Asset Management

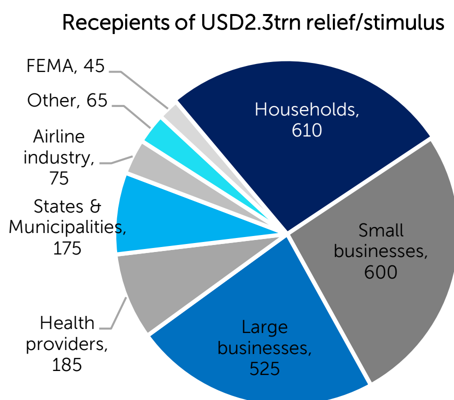
3. Policy support – winners and losers: big tech stands out

There is undoubtedly massive policy support – both on fiscal as well as on monetary fronts. The global policy stimulus/relief is estimated to be more than 5% of the global GDP. However, this is likely to bring to surface relative winners and losers in this context. What is worth noting is that the relief measures are targeted towards consumer and small businesses with the consumer likely to benefit the most. For example, in the USD2.3trn Coronavirus Aid, Relief and Economic Security (CARES) Act in the US, households are the major recipients of funds (exhibit 5). Even the loans given to businesses come with conditions that they should use a sizable part of the funds to pay out salaries. Thus, most relief comes to households and consumers.

Looking at other segments, both small and large businesses are likely to receive some support. However, we believe that such Government aid is likely to come with strings attached. This will result in increased State participation in private sector at the margin. In general, equity investors associate state intervention in corporates with lower valuations. This can be seen in the huge discount in valuations for the India's Public Sector Unit (PSU) banks compared to the broader banks sector (exhibit 6). Therefore, there are reasons to expect lower valuations for global equities at the margin.

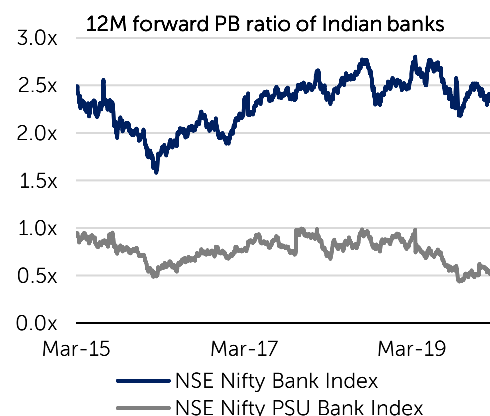
However, there are certain segments of the economy that avoid this fate. Big tech/ consumer-facing tech companies have strong balance sheets and have not sought any government aid thus far. In fact, some of the big tech companies have helped Governments by vowing not to lay off their employees/contract workers and by facilitating faster COVID-19 testing. Some small healthcare software providers have also joined forces with Governments in fighting the virus. Therefore, big tech/consumer-facing tech companies are likely to emerge relative winners for three reasons: 1) policy providing relief to the consumer, 2) avoiding state aid and eventual intervention and 3) given the help they extended to the Governments, they are likely to be considered favorably when it comes to regulating the sector.

Exhibit 5: Household / consumer at the heart of the US CARES act



Source: Committee for a Responsible Federal Budget (CRFB) and ADCB Asset Management

Exhibit 6: State intervention is associated with lower valuation multiples

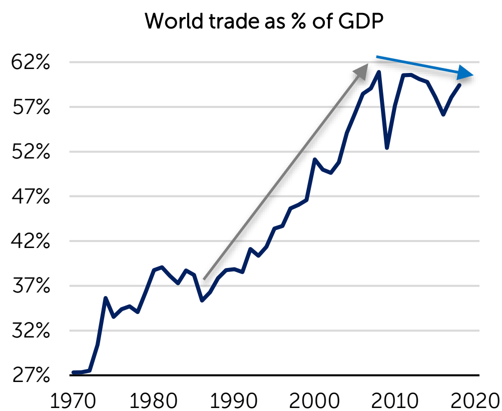


Source: NSE, Bloomberg and ADCB Asset Management

4. Accelerated deglobalization: we are believers

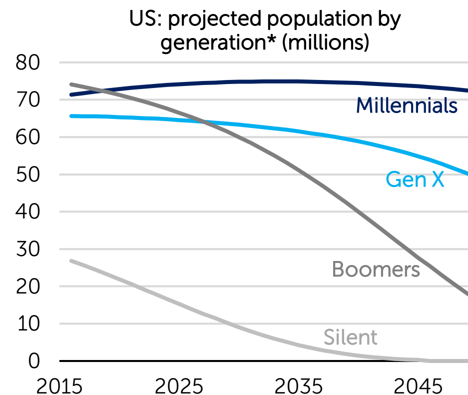
We had written in detail about deglobalization and ways investors can play the theme (see The Equity Thematician: A deglobalising world and our 'Yellow brick road', June 30 2019). In fact, we believe that deglobalization has begun a decade ago and that is already manifesting itself in faltering trade (exhibit 7) and financial flows. Cross-border movement of people and information is also being curtailed. Recent developments of COVID-19 make us believe that some of the forces of deglobalization have now received a boost and, accordingly, the process is likely to see acceleration. Some of the manufacturing companies are likely to rethink their supply chains for a post-COVID-19 world. Rise of nationalist instincts will be at the forefront and flaring of inter-regional conflicts is a major risk.

Exhibit 7: Trade-driven growth is the scenario of the past



Source: World Bank and ADCB Asset Management

Exhibit 8: Millennials (and digital natives) are key drivers of future economic growth



Source: The United States Census Bureau and ADCB Asset Management | Notes: *Age definitions: Silent (born between 1928 and 1945), Boomers (between 1946 and 1964), Gen X (between 1965 and 1980) and millennials (between 1981 and 1996)

5. Disruption fast-tracked: so we think

Increasing share of millennials and digital natives in the US (exhibit 8) and across the world has given a strong impetus to the 'new economy' themes. Whist the concept of the new economy existed since 1990s and was indeed a major point of contention during the dot com bubble, we think the notion is now gaining a lot of traction due to wider acceptance amongst millennials[1] and digital natives[2] – who are increasingly driving the labour force. According to the Pew Research Center[3], at 73 million the millennials surpassed the aging baby boomers in 2019 as our largest living generation. No matter how you count them, millennials and those following them will dominate the workforce starting in the 2020s. Boomers are retiring — within a decade they will make up less than 10% of the workforce. Generation X, born between 1965 and 1981, number about 66 million — not insignificant, but not as large — and will also be beginning to reach retirement age by the end of the 2020s. Accenture[4] estimates that roughly USD30trn of wealth will be transferred from the baby boomers to 90 million millennials over the next few decades. Therefore, both income and wealth give the millennial populations the power to drive the economy into the future.

We define the new economy as the cluster of new, high-growth industries that run on cutting edge technology disrupting traditional/conventional sectors and redefine ways in which global populations live and corporations conduct their businesses. As such, we see the new economy as a combination of e-commerce, online education, interactive media & services, telemedicine/health tech, digital solutions, automation, sharing economy, gig economy, circular economy and ESG themes (for ESG see The rise of ESG – King Canute and the tide, February 13 2020).

The development of new economy meant huge disruption to the traditional (old) economic structure. It is redefining some of the traditional ways in which policy, economy and markets interact. Some of the traditional sectors like banking, mining, crude oil production and automobiles are facing huge disruption risks. COVID-19 spread has indeed fast-tracked this disruption which has now become the new normal. We stay focused on 'new economy' themes which tend to benefit from this fast-tracked disruption.

[1] Millennials, also known as Generation Y, are the demographic cohort following Generation X and preceding Generation Z. Researchers and popular media use the early 1980s as starting birth years and the mid-1990s to early 2000s as ending birth years, with 1981 to 1996 a widely accepted definition.
[2] The term digital native describes a person who has grown up in the digital age. A digital immigrant on the other hand is the person who acquires familiarity with digital systems as an adult. They are often used to describe the digital gap in terms of the ability of technological use among people born from 1980 onward and those born before.
[3] Millennials projected to overtake Baby Boomers as America's largest generation, Richard Fry, March 1 2018
[4] The "Greater" Wealth Transfer – Capitalizing on the Intergenerational Shift in Wealth, 2012

6. Make-over plays: too good to ignore

Continuing our discussion on disruption, it is worth noting that some veterans (household brands of the past) are adapting to this new normal. This transformation helps those well-established brands to leverage their long presence in the market to pursue some of the new economy phenomena. Investors, should pay attention to such make-over stories.

Here are some examples. The list is obviously not exhaustive:

- **Walmart** has partnered with Microsoft for cloud computing and with Google for voice-activated shopping. Walmart made a number of acquisitions to elevate its e-commerce platform alongside investments in in-store automation.
- **BP** has invested in industrial-grade AI software and deployed seabed robots for underwater environments and is learning to process big-data.
- **JPMorgan** invests USD11bn every year on technology. The company also invested in partnerships with high-profile start-ups. JPMorgan's corporate & investment bank division uses machine learning to personalize the digital experience of its research platform. The bank also rolled out an AI-powered virtual assistant that will make it easier for corporate clients to transfer money.
- **General Motors** unveiled a long-range electric vehicle, acquired a stake in rideshare provider Lyft and announced a new vision "a future with Zero Crashes, Zero Emissions and Zero Congestion".

7. All-weather portfolios: noise versus signal

It is important for equity investors to construct portfolios in a manner that they endure all different investment climates. For this, investors can silence the noise arising from cyclical changes in market conditions by pursuing thematic investments. Here we simply list some of the themes – admittedly not exhaustive – which are a combination of mega-trends and sub-themes. Investors can follow and invest in a theme of their choice according to their risk-appetite. On which theme could suit you best, please speak to your relationship manager or your financial advisor.

- New economy
- Value-based/faith-based
- Environmental, Social & Governance (ESG)
- Middle-class consumption
- Healthcare innovation
- Fintech/digital security
- Infrastructure/urbanization
- Automation
- Space travel

8. Opportunities amidst slowing benchmark returns: focus on themes

As we argued in our report The Equity Thematician: Bracing for lower long-term equity returns, February 2019, there are several reasons to expect returns on equities (broader indices) to be lower in the next ten years. As such, we believe that the double digit returns of 2010s are hard to repeat in 2020s. However, more concentrated investments based on themes can help investors obtain excess returns compared to the benchmarks.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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