

25 May 2020

Collins St Value Fund Macro-Economic Strategy Paper: May 2020

Written by Anton Lawrence - Chief Strategist

Last month we were sitting, as we suspected, at the peak of the health crisis component of Covid-19 in Australia. Last month we said that current Government advice remains is that a full return to 'normal' social and business interaction will not occur until late this year and that it will be a staged process. Other than the transportation of exports and imports and the transfer of funds, Australia is likely to remain largely isolated from the rest of the world for many months. This advice has now turned into reality with a staged re-opening of the economy and society underway, at somewhat different speeds due to the existence or otherwise of community transmission of Covid-19 across each state and territory.

In this, the second edition of our Collins Street Asset Management strategy paper, we maintain the entirety of our investment thesis and supplement it with new information that has come to light over the past month.

The priority when faced with a new and dramatic event is to detach from the emotion of what is unfolding and identify the key drivers at both the global and Australian level that will shape what our Prime Minister calls 'the bridge' to the other side of this global event. At Collins St Asset Management we continue to review and refine our investment strategy and consider new realities as they unfold. We recognise that our strategy needs to provide clarity in our assessment of each investment we consider but must also be able to be refined as new information comes to light from national and international authorities.

At the outset, and in order to establish some ground rules for adjusting our settings for transactions going forward, we focussed on the economic consequences of the primary drivers:

- Government economic stimulus, both at the Federal and State level
- Government intervention in private markets
- Financial regulator intervention
- National quarantine measures, specifically the banning of international arrivals and departures
- Social distancing, and in this update, as the COVID-19 crisis moves through its global peak, we now add
- Geo-political positioning

Our investment proposition which is being used as an overlay for all investment opportunities that we identify is therefore as follows:

Investor psychology: The investor, as a global entity, is now moving from a state of shock to one of denial. There continues to be a level of disbelief that what has unfolded since the beginning of 2020 - infection, death, job destruction, long lines of the newly jobless and the inability to hug one's parents and grandparents - is real and persistent. This is normal human reaction to distressing events and no one is completely emotionally detached from those feelings. As mentioned earlier, our job as investment managers is to focus rather than freeze. As shock turns to distress and denial, we continue to expect the recovery seen on global share markets, including Australia's at the time of writing, based on hope and or denial rather than fundamentals in our view, to be proven to be a temporary phenomenon.

Consumer behaviour: There will be no snap-back in consumption to what existed in late 2019. In many sectors of the economy we will see permanent changes to the way goods and services are demanded and provided. Other sectors will see a gradual return to previous levels and behaviours, but the emphasis must be on gradual.

An example is the way we travel. As the Australian economy attempts to re-open, we may see a dramatic decline in public transportation usage and a corresponding gridlock on our urban roads as people practice social distancing.

COLLINS ST

— ASSET MANAGEMENT —

In the coming months, will people be prepared to resume close proximity travel on the train, tram or bus or will they turn to their cars in droves, thus producing a windfall for toll operators (and causing massive congestion)? Similar questions apply to many sectors of the economy including the hospitality and fast food sectors (when will you be happy to dine at your favourite restaurant?) and insurance (remember that moment when we realised pandemics weren't covered?). To say nothing of air travel.

Demographics: All demand for goods and services is driven by demographics. The current situation has moved the dial in many ways, but the primary focus for us right now is the complete cessation of overseas migration to Australia. Overseas migration accounts for between 45% and 70% of population growth depending on which state and city you are in. It has been a primary reason why Australia has not had a technical recession since the early 1990's. The cessation of overseas migration in Australia will result in sharply lower population growth which in turn will result in lower demand for new housing, household creation, which in turn will see a decline in demand for whitegoods and furniture, construction materials and lower employment in the construction and property sectors. In the past this has at times created a vicious cycle of higher and persistent unemployment which results in declining housing and commercial property values, tenant demand and so on. Property is proving to be the last sector into the downturn and the last one to emerge.

Government policy settings: True leadership is not a popularity contest. It is our view that Governments, both Federal and State, regardless of their political stripe have acted with clarity and responsibility. The amount of money being poured into the economy at this time to support households is unprecedented and there has been a quality of leadership that has not been seen in many other countries.

While the fiscal and monetary policy settings put in place by Government, the Reserve Bank and APRA are commendable, we believe there is a dark side to them that will become apparent in the years ahead. This dark side comes in the form of what we in Australia know as 'kicking the can down the road' particularly in respect of debt. It is not so much the national debt that worries us, as compared to almost all other economies we started off in a position of relative strength. Our concern lies in the debt carried by both ASX listed and private companies as well as households.

This 'can' that has been kicked down the road has the potential to blow up because of:

- The uncertainty that debt will be available when it needs to be refinanced, or at least without more onerous covenants.
- The pressure put on debt providers (both bank and non-bank lenders) to provide companies with a 6-month interest payment holiday to help their customers 'reach the other side of the crisis' to quote the Prime Minister again. This interest will still need to be paid.
- The directive for APRA to lower Tier 1 capital requirements for banks so that they can lend more. This would expose lenders to greater stress in the event of a protracted property downturn which as mentioned earlier is part of our macro investment proposition.
- The directive for ASIC to allow companies to continue to trade in the current environment when in reality many of them, without many or any customers are technically insolvent. This is a situation that would in normal circumstances result in potential prosecution. How this is unwound is uncertain because a snap-back to the previous regime at a point in time would result in companies large and small being forced into administration to meet Corporations Act obligations.

To quote Federal Treasurer Josh Frydenberg in his Ministerial Statement on the Economy on 12 May, "The proven path for paying back debt is not through higher taxes, which curtails aspiration and investment, but by growing the economy through productivity enhancing reforms".

The Global Interface: At the onset of the current crisis, Australia like other liberal democracies with free and open trade has been fully integrated with the global economy. Since the floating of the dollar in the mid-1980's followed by the deregulation of the economy in the 1990's though the removal of almost all trade tariffs and quotas, the Australian economy has evolved in four important ways that will be well known to readers:

- A long-term pivot in trade from Europe and the United States to Asia, especially China. It is worth noting that this is in comparative terms only and the inflation adjusted trading volumes with both Europe and the United States have risen consistently. Of just as much importance is that the United States remained the largest investor into Australia throughout the past decade of strong Chinese investment.

- A decline in the manufacturing base to high end production only, with some exceptions such as State and Federal Government local content clauses in contracts with global transportation and defence manufacturers. Examples include the manufacture of trains and trams by Canadian group Bombardier in Ballarat and in the south-east Melbourne suburb of Dandenong and submarines and other naval defence vessels in Adelaide. We are a card carrying member of the club of nations who practise what is known as the international division of labour, where products and services are provided from the locations where they can be produced most cheaply - witness 'fast fashion' from China, then Bangladesh as Chinese wages and conditions improved and the migration of call centres and back office IT to India. Therefore, we no longer manufacture cars. By contrast we can provide the quality and service at an economically viable price for financial services, education, and high-end engineering output such as winglets for the Boeing 787 aircraft.
- The ever-increasing cost of infrastructure provision compared to developing economies and even those such as the United States which has far greater wage flexibility. By way of example, a new rail tunnel in Melbourne or Sydney costs around \$1 billion per kilometre, almost double the equivalent cost in the United States. To say nothing of China. We are a high cost economy, ranked only 21st in terms of purchasing power in 2019.
- A political balancing act between an ascendant China and the western democracies, especially the United States.

There remains a tendency in Australia to consider ourselves a small economic player on the world stage. That is a fallacy. As the world's 14th largest economy with an even higher ranking in terms of gross domestic product per capita (Source: International Monetary Fund World Database October 2019), we are considered a relevant and respected voice in all global economic forums, and respect for our economic prowess extends well beyond our natural advantages in the mining and gas sectors.

We recognise that the Covid-19 event will change the global business and political map permanently. The most powerful manifestation of this will be seen in the aftermath of the health component of this crisis where the economic fallout will linger for several years. It will come in the form of a from-the-ground-up societal shift from an ever-decreasing emphasis on the nation-state to a demand for Governments to assume a 'my country first' approach to economic activity.

The ascendancy of the ‘my country first’ nationalism has in recent years been an ever-increasing counter force, some would say push-back or even revolt, to the idea that multilateralism is the ideal world order. The push back in multilateralism has manifested itself in the United States through the election of President Trump, in Britain via the BREXIT event, in eastern Europe through the strong growth of nationalist political parties and in China via strong support for President Xi’s ever more centralised and powerful authority. That was all before the Covid-19 crisis.

In the eyes of the global body politic, it is the ineffectiveness of the flag bearers of multilateralism – the United Nations, the European Union and most damningly the World Health Organisation – that create the stark impression that as the famous fable goes, the emperor has no clothes. This shift in sentiment from what is ultimately the consumers of the goods and services offered by our investment universe necessitates a shift in our investment settings and our identification of winners and losers.

Last month we wrote that any objective assessment of Australian – Chinese economic and political relations must conclude that in the aftermath of the Covid-19 crisis, relations will not be the same. This will have consequences, both positive and negative for the shape of our economy and our strategic global settings. It requires an adjustment in our funding expectations for some companies in our investment universe. In the past two weeks this relationship has worsened dramatically with China imposing tariffs on Australian barley, banning meat exports from four abattoirs, and threatening a raft of further measures. Language employed by Chinese diplomats in respect of Australia (and for that matter France, the Czech Republic, Austria and the United States), has become poisonous. Australian companies can no longer assume supply from China or the continued existence of export markets and there is a dramatic pivot away from China happening beneath the surface by all sectors of the Australian economy with the clear exception of the minerals sector.

On the ground in Australia, there will be a push to create a core manufacturing capability for essential items, not just medical items but also food and other essential goods. Inevitably, this feeds into a debate about sovereign risk and whether Australian ownership of these supply chains is an essential component. The Covid-19 experience has shown that Australia has more than enough food supply even in the aftermath of a devastating drought. The question to be answered in the coming months and years is how far this core capability extends and how is it achieved.

There is a prospect of additional Keynesian economic levers being utilised to in effect pick winners, which would re-shape our thinking on which sectors and companies need to be re-priced on a risk / return basis. After all, nothing lowers solvency risk more than a Government subsidy. Chinese airlines anyone?

Economic sector prospects: Having re-adjusted our investment overlay at the global and Australian level on both economic and political terms, we can now shape our sector specific investment strategy within our investment universe of ASX listed companies.

There will be a large difference in the timing and shape of recovery across different sectors of the economy and this must be considered in the context of our pricing of investments. For example, any company exposed to international tourism, whether it is an airline, travel agency, tourist operator or an exposure to the international student market needs to be considered in the context of a five year timeline to the resumption of the previous volume of business, if at all. Other industries such as oil and gas, rather than losing their entire customer base are likely to see only a gradual recovery in demand and prices that reflect that reality. Gold has yet to benefit from a rush to safety due to non-existent inflation, but this is now changing as the global recession sets in. In the past month there has been a strong pivot to Gold as a risk mitigated exposure to that psychology of denial we spoke of earlier. Retail is in deep distress but there will be opportunities in that sector that will emerge as new consumption patterns establish themselves. We are watching closely. Construction and property, two of the largest employers alongside retail, are also in a state of flux. As we said earlier, we expect the worst conditions in these sectors to be sometime away yet. Finance and banking will provide opportunity, but the downside risk right now is high. The regulatory pressure on banks not to declare dividends to preserve cash does not help. The best opportunities are yet to come. Finally, the health and biomedical sectors may appear to be the place to be, and we have identified some opportunities. However, many companies are already overvalued, Government intervention will reward some and damage others and beware of unrealistic timelines for the development of new drugs.

.....

Last month we advised that we are identifying a range of opportunities that we would take advantage of in the weeks and months ahead. We also said that we were expecting a continuation of the steady stream of institutional placements and discounted capital raisings as companies attempt to shore up their balance sheets for the medium term. Our strong cash position and continued inflows enables the Collins St Value Fund to participate in these raisings where we can identify both attractive pricing and that management understand the outlook for their sector, have internalised long term or even permanent changes in their customers consumption of their product and have charted a way forward for the company that aligns with our settings outlined above. We are now moving to execute on some of these opportunities and look forward to sharing these with you over the coming months.

About the Collins St Value Fund

The Fund is managed to an unconstrained Australian equities mandate and is currently ranked [#1 out of 97 peers](#) over the 3 years to 30 April 2020 based on after fee returns, and with gross returns of ~14% p.a. since February 2016.

Top in class performance has been underpinned by a range of bespoke convertible note, take-over arbitrage, special dividend and management buy-out investments, alongside unconstrained access to any ASX listed stock.

This approach has resulted in a distinctively different portfolio when compared to the broader market and is presently invested in a selection of uranium (an interview we gave on this topic can be accessed [here](#)), gold, financial services and pharmaceutical companies (an interview we did on a company developing a treatment for osteoarthritis can be accessed [here](#)) amongst others.

Importantly, investments into the Collins St Value Fund attracts absolutely no fixed management fees. The only remuneration the Fund Manager receives is success based and requires that investors make money before they do. This incentivises a very sharp focus on both capital preservation and also capacity management so that we can continue delivering superior returns to our investors over the medium to long term.

For more information please contact:

Rob Hay – Head of Distribution and Investor Relations

Ph: 0423 345 975

Email: rhay@csvf.com.au

www.csvf.com.au

Disclaimer

Collins St Asset Management

This document does not constitute and should not be construed as an offer, invitation or recommendation to apply for units in a fund or to purchase any specific investment. Investors should seek independent, professional and licensed advice and read all relevant disclosure documentation prior to making a decision to buy, sell or continue holding any particular investment or investment product.