Our corona implications forecasts

A return to normality – but what is it?

By the time of writing this, many European countries have started to announce a gradual revocation of the heavy restrictions on social interaction to stave off an uncontrolled spreading of the COVID-19. The pace at which people return to their normal lives – and that of new COVID-19 infections – continue to play a major role for the market sentiment, in our view, even a bigger one than incoming economic data or the first quarter earnings that normally would steal the limelight.

We also feel that the reporting around the virus is abundant and ubiquitous, and hence we do not want to repeat what is stated in the mainstream media. Instead, we shall focus in this issue on throwing a glimpse to the crystal ball: sharing our forecasts of how the future will look like.

Changes in corporate behavior

Balance sheet prudence. All the way from the financial crisis in 2009, companies in Europe and the US have tapped into the cheap money made available to them via bond buying programs of the central banks and investors hungry for yield. Companies have used this money to lever up their balance sheets: pay ever-rising dividends, buy back their shares, issue more bonds. Whilst this has resulted in considerable earnings growth throughout the years, it has also made the companies more vulnerable to economic shocks such as the current one. We believe that the ongoing crisis will reverse this trend, and companies will focus on paying back debt in the next quarters.

Cash is king again. The past decades have been dominated in corporate finance by focus on capital efficiency. An essential part of keeping your working capital low has been to minimise cash at hand. Many companies have relied on stable operative cashflows and a revolving credit line with their house bank to manage daily expenses. Now they are fighting to stay alive because their revolving credit facility has been exhausted and they cannot access the bond market – or if they do, the cost is usurious. Hence, we believe that companies will gladly accept the cost of keeping enough cash at hand and pay due attention to issuing bonds in various maturities.

Renaissance of inventories. In the 1970's, Toyota started in Japan the trend called "just-in-time" production. It meant achieving efficiency gains by keeping the production inventories to the minimum, thereby freeing up working capital. Now, with many executives having witnessed the production of their company grinding to a halt because of a lack of supplies and components, we believe this trend will reverse. In the time of low interest rates, many an executive will figure that it makes sense to keep extra components in reserve just in case something should happen to one's logistic chains.

Reversal of globalisation. Throughout March and April, CEO's were complaining about the lack of raw materials and components, or simply about time delays in deliveries. The most frequently cited issue was that they were waiting for certain goods to arrive from Asia. Many CEOs, especially in the pharmaceutical sector, have indeed expressed their willingness to pay more for locally produced supplies to secure faster and arguably more reliable supply chains.

Increased home office. As the past weeks have shown, astonishingly many white-collar workers can work from home with little, if any, losses in working efficiency. This should lead to increased use of home office, and less demand for office space. REITs focused on commercial real estate beware.

Changes in consumer behavior

Less travel. Global tourism sector should take a long time to heal, as many of its firms are fighting for survival. The sheer prospect of having to resort to local healthcare in countries that normally would attract mass tourism, has spooked many potential vacationers. Domestic holidays will be in fashion for at least the rest of 2020. Meanwhile, both Airbus and Boeing are forecasting a sharp drop in demand for widebody, long-haul passenger planes. Airlines, in their turn, are reducing staff and project the demand for flying to stay muted for the next two-three years. With a lot of capacity being reduced, the result should be the fall of many present airline champions and the emergence of new challengers.

Golden era of e-commerce. As with any new technological invention or consumption habit, the different aspects of e-commerce are adopted in stages. Where streaming music and movies or booking a vacation online has been popular for a while, many consumers only now try ordering food from restaurants or foodstuff from supermarkets via the internet. We believe this will become a permanent phenomenon, benefiting thus a range of companies from parcel delivery services to basic supermarkets with intuitive online platforms. The trend can already be witnessed by watching the shares of companies like Amazon and Delivery Hero breaking new records.

Deferral of discretionary spending. Microeconomics tells us that the biggest explaining factor for people's present consumption is their belief of how their future disposable income will be. Uncertainty dents confidence in one's prospects. With many consumers wrestling with strongly increased uncertainty around their jobs and personal health, they are more likely to postpone big, discretionary spending decisions such as car or home purchases. Despite being temporary in nature, unlike the above other phenomena, this cautiousness will mean car manufacturers, homebuilders and other expensive item producers will have a stony road ahead for still some time.

J-shaped recovery for sharing economy. Whilst the abrupt cessation of income exposed weaknesses in the earnings model of many AirBnB and Uber entrepreneurs (especially those who acquired their income-earning assets by debt), the increased uncertainty in people's lives will make them prefer sharing instead of big acquisitions. Car-sharing instead of an own car, AirBnB instead of a hotel, additional income as food delivery driver – we believe these will flourish going forward.

Conclusions

These phenomena will entail fundamental changes in earnings of individual companies and entire branches. Technological disruption will accelerate. Accordingly, the winners from these changes will see their asset prices climb whereas the losers may be forced out of business, sooner than we would imagine.

In Zurich on 5th May 2020
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