Aviator Update – June 2020
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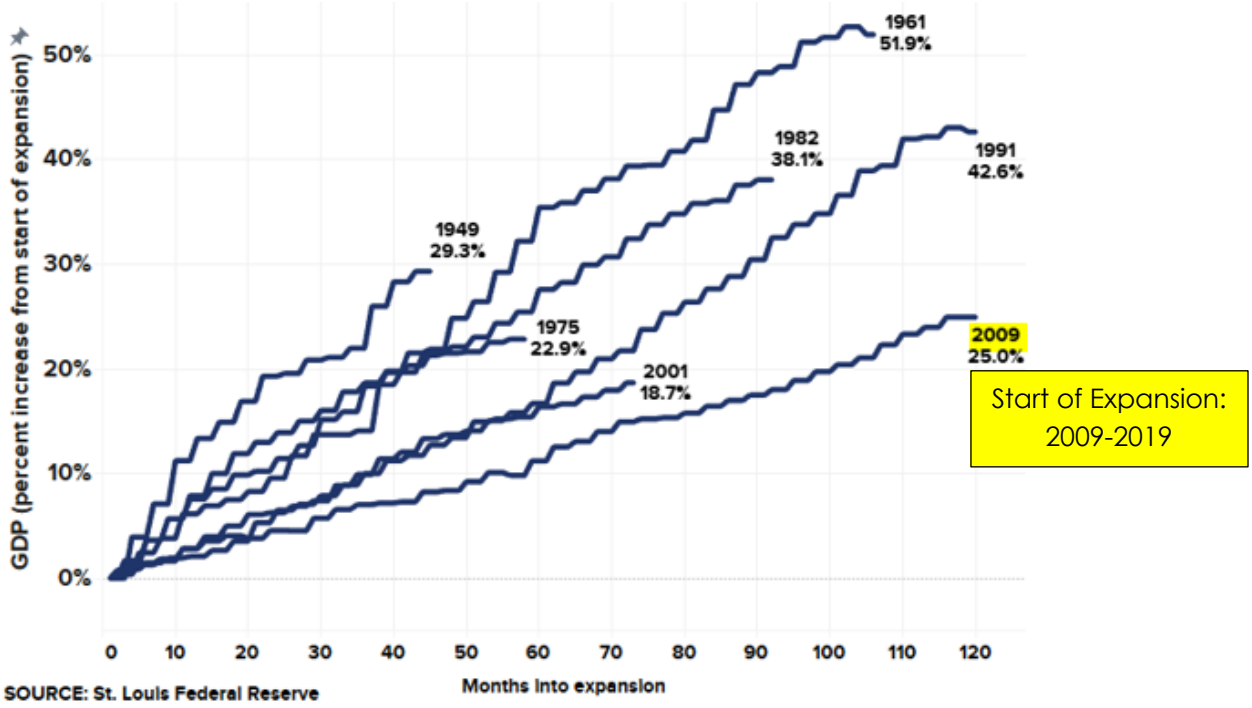
Sitting… Watching… Waiting…

Another month has passed us by and with it half the year has gone. Time sure flies when you're having fun! I really don't have an awful lot to talk about this time given little has happened in the last month – not much in financial markets land, that is.

One of the key reasons I have always enjoyed writing research and commentary is because it requires me to focus and collect my thoughts – I probably get as much out of writing as any of my audience gets from reading. Today is very much going to be a "thought-gathering" exercise.

Where to start… Let's start at last year.

As 2019 drew to a close the USA was enjoying its longest ever economic expansion – having eclipsed in July the previous record of 120 months set between 1991 and 2001. However, the scale of the expansion was one of the worst on record:



Digressing for a moment, there's a reason why we focus heavily on the USA. Or in fact there's a few reasons. The USA is by far the largest economy in the world with a GDP of around $22 trillion. Its equity capital markets are also the largest in the world accounting for over half the global market capitalisation. Economic output is also diverse and "high quality" – for the most part in any case.

What about fledgling powerhouse China? Well, their GDP still registers at around $15 trillion. And the quality of a lot of the output is somewhat dubious. Australia? We have around $1.4 trillion that is of pretty good quality although diversity is a bit of an issue.

In essence, in this globalised world the USA is the major driving force. That's certainly not to say that other nations are unimportant or do not offer attractive investment opportunities – quite the opposite. But in our efforts to predict the movements of the global economy and global assets markets, focusing on the most influential is an important starting point.

Back in 2019, it was observable that USA equity markets had worked their way to a point where they were the most richly-valued in history. Not totally unsurprising given the long economic expansion.

To say that the USA was "due for a recession" is a bit feeble. Its technically true, but it's the equivalent of saying the next spin on the roulette wheel is more likely to be red given the last 3 have been black. You should never be predicting a recession based on one being "overdue". Nevertheless, markets were behaving in a way typical of late-stage expansions and combined with very stretched valuations. I spent most of last year describing the USA markets as "fragile".

A pretty similar story for the rest of the world, including Australia. 2019 saw us continue our record-breaking economic run yet under the bonnet there was already signs our economy was spluttering – a key example being GDP on a "per-capita" (per-person) basis which was in decline.

And then along came Covid-19.

Most "sell-side" economic analysis (being analysis generated by organisations selling financial services such as investment banking, stockbroking and investment management firms) tends to be perennially optimistic. Its good for business. On the flipside, being negative isn't good for business. Embedded within much sell-side forecasting is an implicit caveat – "unless something unexpected happens that we're not predicting".

All too often, the "unexpected" event that ends up rendering their forecasts incorrect wasn't exactly "unexpected". The 2001 "tech-wreck". The 2008 "global Financial Crisis". These events were largely avoidable for any investor willing to heed warnings and then step aside and simply observe rather than participate. I know it's hard when lots of people are making lots of money buying shares in tech companies barely a few weeks old with no discernible

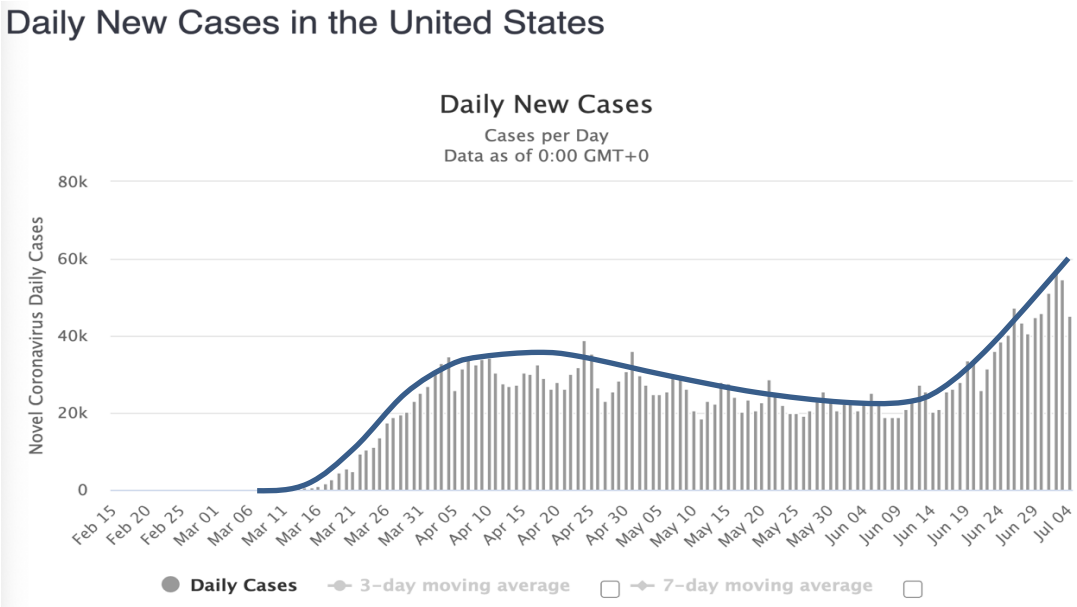
business plan or investing in companies leveraged to a continued property construction bubble (or the properties directly). Patience is a valuable and under-appreciated trait for investors. It's certainly a value Aviator wholly respects.

Fortunately for those bullish analysts, this time around its fair to say that Covid-19 was genuinely unexpected. A "Black-Swan Event". We have spent the last 3 months trying to understand what the financial ramifications of this event will be. We haven't seen anything like this before – the complete shuttering of large parts of the global economy.

The response from governments has been as you would expect. Most governments, having spent years collectively gnashing their teeth over debt and deficits, have been forced to support their economies via various debt-fuelled stimulus strategies. Central banks have made money as cheap as possible in addition to engaging in numerous "unconventional monetary policy" strategies.

Is it working? Of course it is – to an extent. Take some of the measures here in Australia – "Jobkeeper" is letting a lot of people continue to live. However, the stimulus doesn't fully replace the lost economic activity and soon paying people to do nothing must end – if for no other reason due to governments' fretting over debt.

I've noted in recent months that the economic outlook is especially uncertain at this point. Nothing has changed in the last month that changes this. Covid-19 remains out of control in many parts of the world – including important economic centres such as the US. And last I checked its hasn't suddenly become less deadly. However, as Abraham Lincoln reiterated in his Gettysburg address; "government of the people, by the people, for the people". Many Americans don't take kindly to being told what to do by their government. It's their right as American citizens to go out and catch Covid-19 if they wish… and many Americans are exercising that right.



Source: https://www.worldometers.info/coronavirus/country/us/

This aside, it's probable that we're in the midst of the worst of the economic fallout. The global economy abruptly closed in April and in many parts, it is starting to reopen. We are going to see improvement in economic data. Month-on-month improvement in some indicators should prove spectacular. However, initial improvements will typically be from "diabolical" to "terrible". It's a start, but its far too early to say it's a strong uptrend, or any trend at all. Everyone wants a V-shaped recovery, but this is not going away any time soon, and the longer the downturn, the harder the bounce-back.

One anecdote here… China has recently reported industrial production numbers indicating that sector of their economy has recovered substantially. A positive sign, right? But does that really pass the "smell test"? A key component of industrial production is factory output. We know China is the world's factory. A recovery in Chinese factory output would imply a recovery in demand for Chinese "stuff". With millions of their customers unemployed, the idea that demand for Chinese goods has largely recovered is odd to say the least.

Turning to investment markets, little has changed in the last month. Valuations in key developed nation markets, such as the US, remain among the highest ever recorded whilst economic readings are among the worst ever recorded. True, the stock market is not the economy but given companies derive their value from the earnings they derive from the economy, there's a strong correlation between economic performance and stock market performance. Make no mistake – the chasm between share markets and the economy will close in time.

I sense that a lot of investors are being rather myopic on a number of fronts. Firstly, there's the view that "reopening of economy = shares of companies affected by lockdowns go up". Secondly, with respect to upside potential, the perception is one of "what price was it in January?" Whether they realise it or not, those investors that willingly hold shares at these levels are betting on the chasm between markets and economy resolving via a V-shaped bounce in economic activity. I'm not saying that won't happen – my consistent message in recent months has been that we simply don't know what will unfold and that should encourage all investors to take pause.

I constantly refer to valuations as the key to long-term returns. With that in mind, I've directed quite a bit of my focus at getting a sense of where valuations stand in different parts of the world. Some markets are exhibiting some attractive valuations – certainly when compared to other markets. Some of these markets are surely being overlooked at present due to Covid. East Asia is one area where markets exhibit much better value. That's not to say they will sail through Covid better than western nations. But this really has nothing to do with Covid. Lower valuations increase prospective returns and also make markets more resilient to negative news.

Some of the good old-fashioned pairs trades from years gone by might be due for a resurgence – particularly the "short developed markets/long emerging markets" trade.

The opportunities are out there, but at this juncture a little more creativity is required. We'll keep looking, in amongst a lot of sitting, watching and waiting. Patience is a virtue.