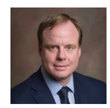
Q&A With David Eiswert

Dealing with the coronavirus pandemic and its impact on global equities.

May 2020



David Eiswert
Portfolio Manager, Global Focused Growth Equity Strategy

KEY INSIGHTS

- Establishing a framework for managing through this crisis was crucial. We identified early on three key signals of the "stop getting worse" point, with the subsequent change in sentiment around this point crucial for equity returns.
- Markets have rebounded from their March lows, and we have sought to capture the opportunity presented by the market's dislocation, especially in secular growers.
- Active decision-making is essential through the next phase of the crisis, given the stages of recovery that we expect to observe.

Q. How are you dealing with the current period of volatility, and does this differ from others in your career?

I have been through three market crises during my career (the technology bubble, the global financial crisis (GFC), and now the coronavirus pandemic), and, I would argue, several mini crises as well. The fundamental difference this time is that this is a natural disaster. The tech bubble and GFC were man versus man. That is, they were man-made events, as opposed to this current crisis, which is very much man versus nature. So this is a very different kind of crisis, and it has elicited a correspondingly different response from both central banks and governments.

Q. How were you positioned coming into the crisis, and what were your immediate actions once you saw the extent of the coronavirus crisis unfold? Have your actions changed as we have started to see some improvement?

We came into 2020 in what I would call a Goldilocks situation—President Donald Trump had managed to get the Federal Reserve to cut interest rates, and tensions from the China trade war were subsiding. Risk appetite had risen, and investors were looking for cyclical recovery.

In our first response to the crisis, we cut any places where there was balance sheet risk. We have a saying on the team: If you're going to panic, panic early. So we tried to panic early and remove any kind of balance sheet risk, credit risk covenants, or anything in the portfolio that we thought could be

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balance sheet risk. Then we established our framework for the crisis. Who benefits from this crisis, and what names do you really want to own on the other side? We wrote a three-part series for our clients detailing how we were activating this process (Crisis Playbook Parts I, II, and III).

Q. Are there any datapoints that you are looking for to make you more optimistic that we are beginning to see improvement?

One of the most important gauges is the "stop getting worse" point. Whether it's the prospects for an individual country or individual company, this idea of "stop getting worse" is one of the most powerful things I have learned in my career. What it means is that markets tend to bottom, not in the absence of risk, but when risks stop accelerating—when you start to see how risk could moderate. We identified early the three key indicators of the "stop getting worse" point in this market:

(1) Government and central bank response

What would governments and central banks do in reaction to this crisis? You can argue about this philosophically, but I believe that the U.S. Federal Reserve and government have done a good job of stepping in and keeping the financial plumbing functioning.

(2) Treatment and testing for the virus

The second indicator was around treatments and testing. Although we have a long way to go, we believe that we are past the worst in how we test and treat the virus. Importantly, we are seeing hospital admissions pass their peak. The lockdown was really a function of saving our health care systems, and we appear to have succeeded.

(3) Peaking infection rates

The third indicator was around when cases would peak in major economies. We have already seen that in China, and we are using that to project how the U.S. and Europe can potentially play out. There are clearly differences, but this idea of peaking cases is the third important signpost.

Those three elements are crucial to the "stop getting worse" process. I believe we are through that now, and when markets sense that "stop getting worse" point, they should begin to rally.

Q. Do you think markets have rallied too much in the near term, given the uncertainty?

When we look out 12 to 24 months, we think equities offer good return prospects versus most alternatives. We must remember that this is a natural disaster and not a credit cycle. That's important.

For example, if you look at automobiles or semiconductors, usually when there is a downturn, it is accompanied by a big negative inventory and distribution cycle. Since semiconductors already had that cycle in 2018 and 2019, you are not getting that this time.

Another point is valuation. Companies like Netflix, Amazon, and Zoom were not overvalued (in our opinion) going into this crisis. The coronavirus boosted their positions and accelerated their adoption—this is part of what makes this kind of cycle very different.

A final point here is more academic: If the Fed is potentially going to buy every asset class, and if central banks are going to step in and support the economy through the coronavirus pandemic, then earnings multiples should go higher, especially since there is more credit available and interest rates are lower. The fact that asset prices go up after that sort of response is not surprising. You could argue that there is now even more liquidity out there than before the virus.

We are moving in stages where certain decisions were important. Our first

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decision was to sell unwanted risk, especially balance sheet risk. The second was to own the companies that would potentially benefit from the lockdown situation. The next phase we believe we are entering now is more what we call "pleasant surprise", where companies are reporting better developments than expected.

While there are parts of the economy that are disasters—and that entails risk to the equity market recovery—there are many that are likely going to improve. This bifurcation means a more challenging job for stock pickers.

Q. Can you give us your perspective on value versus growth spreads? Do you see opportunity in value-oriented stocks?

It's often difficult to clarify what stocks are "value." I believe there are some bad neighborhoods in value, but whether it's commodities or financials, there are some good ideas out there.

Some U.S. banks, for example, have good idiosyncratic stories behind them. Banks that exhibit characteristics that can make them more of a growth-style asset, despite the fact that their short-term earnings may be sensitive to interest rates. We are trying to be carefully contrarian in the portfolio stock by stock where we see potential for improving returns, but won't just rush into value as a "factor." If you can pick off a cheap stock that you think has growth characteristics, you should be willing to do that.

Q. The U.S. economy is the largest economy in the world. How is the lockdown impacting the U.S?

The U.S. economy has been strong, and unemployment has been exceptionally low. We went into this crisis from a position of strength. But the country is very divided right now between those who are pro-Trump and those who are not. Individual states are also divided along those lines. More democratic states in the Northeast where the lockdown is more severe, and Republican states in the South, where you see much more willingness to get back to work quickly. Is an early return to normality a positive or a negative? That is going to be tested, whether it's Georgia or Florida, states that are going to be more aggressive in releasing lockdown measures.

To a certain degree, I see the U.S. potentially taking more risks than China, which implemented a severe lockdown and is only now easing restrictions. Although there are some people back to work in China, there are still government rules that people are adhering to closely. In Europe, there is an element of more cooperation. In the U.S., you see a more heterogeneous group of people who are willing to take potentially more risk, and we are going to see the implications of whether that causes reinfection rates to spike or not.

Importantly, when we move out of this phase, I see no reason why we can't get back to that stable economic environment that we had before.

Q. Prior to this crisis, there was a huge focus on the U.S. election. Can you give us your perspectives on the election, and how this period may influence the outcome?

First of all, let's hope we have the election. If we did end up with a second wave of infections, then you have an issue of in-person ballots. The main risk for financial markets was taken off the table when Joe Biden became the nominee for the Democratic party. The risk of Bernie Sanders versus Donald Trump was an extremely uncertain proposition. Therefore, the biggest risk is off the table, and so that's positive for us in that it has implications for how we invest in health care, for example. Managed care becomes more attractive in a Biden versus Trump election.

It is not clear whether Trump's handling of the coronavirus and his war with

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different governors around the country has improved or reduced his popularity. In the next few months, we should start to see an improvement in dealing with the coronavirus, and if the U.S. economy emerges very quickly and strongly, that could be in President Trump’s favor. However, if we start to see an increase in cases, that could be very negative for President Trump.

Either way, I believe that much of the political risks in 2021 and beyond have come off the table due to the two candidates we now have fighting this election. I do believe that both candidates will be negative on China, and we have to think about that in the portfolio, but the risks we had before have been somewhat removed.

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