Finding Overlooked Opportunities in the COVID-19 Market

A concentrated stock market recovery has left behind long-term winners.

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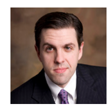

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KEY INSIGHTS

- The stock market recovery has been concentrated among growth stocks, upending the traditional playbook for investing in a recession.
- The divergence in equity markets has left behind a large group of stocks that may offer significant upside potential over the next three to five years.
- We believe some sectors, like utilities, are poised to perform well, while others, like real estate, will face heightened headwinds.

Equity markets have bounced back sharply from March's lows. What do you make of the rally?

David Giroux: With people spending a significantly larger percentage of time in their homes, dollars that would have been spent on gas, travel, restaurants, in-person shopping, and even medical care have been redeployed. Instead, customers are buying goods online, upgrading PCs and home offices, ordering food delivery, installing or upgrading broadband connections to enable Zoom calls, buying more packaged food in lieu of eating out, adding Netflix, and playing more video games.

This has upended the traditional playbook of buying defensive companies such as staples and utilities in an economic downturn. In fact, through the first half of 2020, staples and utilities have underperformed the market! Based on our extensive work on prior recessions, this has never happened before. In many respects, Amazon, Netflix, Teladoc, and Microsoft have become the new staples in this pandemic.

Traditional growth stocks, as opposed to the growth-at-a-reasonable price stocks that we love, were up almost 30% in the first half of the year. These stocks typically trade for more than twice the earnings multiple of the average S&P 500 stock. Their share of the S&P 500's market capitalization rose from 21% to 27% in the first half of the year, and this essentially offset most of the weakness in the rest of the market.

We don't invest in the market, and we are not index huggers. We go where we see value and long-term opportunity to create strong returns. Unlike in January and February, when we saw few, if any, compelling opportunities in any sector or

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asset class, today we still see compelling opportunities in select equities, along with leveraged loans in the fixed income space.

There is a large group of stocks with very attractive long-term fundamentals and attractive business models that are still down significantly from their pre-COVID-19 highs that offer compelling double-digit return potential over the next three to five years, as we enter a post-COVID-19 world.

COVID-19 has upended the economy. Do you think the shifts we've witnessed, both in markets and consumer behavior, represent lasting changes?

DG: While the pandemic will clearly accelerate or pull forward secular trends that were already underway such as e-commerce, digital banking, telemedicine, and food delivery, we are firm believers that once our scientists find a vaccine for COVID-19 and the majority of the U.S. population is vaccinated (hopefully by the second half of 2021 or 2022), the U.S. economy that will emerge on the other side will look very similar to what it was pre-COVID-19, with maybe one exception.

The one exception is that the work-from-home experiment many of us are living through today appears by all accounts to have gone materially better than expected. This has the potential to save companies billions in real estate costs, in addition to allowing them to attract talent that wants to live in a different geographic region, and potentially in lower-cost regions, which can result in lower salary and benefit costs for employers. If we're right, the big long-term losers here are high-cost-of-living cities, commercial real estate companies focused on offices, and apartment real estate investment trusts with big concentrations in these high-cost-of-living cities.

Are there any sectors that are particularly compelling right now?

DG: One of our favorite sectors continues to be utilities. The equity market has yet to fully grasp just how attractive utilities are today relative to the past. The emergence of low-cost renewables is a game changer for the industry. This megatrend will likely continue for the next two decades to drive an elongated cycle for replacing coal, nuclear, and inefficient natural gas with wind, solar, and battery solutions that can drive mid- to high-single-digit rate base growth, mid-single-plus earnings per share growth with attractive dividends, only modest growth in customer bills, and a dramatic reduction in carbon emissions. Given this very attractive long-term outlook combined with this significant underperformance, we believe the long-term opportunity for utilities is compelling.

Moreover, in this case there is some free optionality in this sector that most market participants fail to appreciate. If former Vice President Joe Biden becomes our next president and Democrats recapture the Senate in November, it is highly likely that corporate tax rates will go up, and many sectors could be negatively impacted due to additional regulatory, legislative, or antitrust pressures (big tech, broadband regulation, pharmaceuticals, offshore energy, etc.) as well. We think that there is no sector that would benefit more from a Democratic victory in November than utilities. Utilities is the one sector in which higher taxes don't negatively impact earnings, as taxes are a pass-through item from a regulatory standpoint. Utilities would also benefit from a likely extension, and potential expansion, of wind and solar tax credits for renewables.

USD 6 Trillion

Deficits the U.S. government is likely to run in fiscal years 2020 and 2021.

Do you see any similarly appealing prospects for investments in fixed income?

DG: We see attractive opportunities in leveraged loans. Leveraged loans are typically at the top of the capital structure and have a much higher recovery rate in bankruptcy than high yield bonds (normally 2x recovery rate). With the market pricing in very low interest rates for the foreseeable future, many of these loans are trading at discounts to par and offer the potential for mid-single-digit returns with a very low risk of default. While the return potential here is not as good as in the opportunities in equities we favor, the risk-adjusted returns might be higher. In addition, leveraged loans are the only fixed income asset class that benefits from rising rates. If we can truly conquer COVID-19 sometime next year, I would expect the economy to strengthen immediately after that. While I am not anticipating runaway inflation post COVID-19, if the economy is stronger than expected, it is possible that we could see the Federal Reserve raise interest rates earlier than expected. This is essentially a free option that has the potential to boost what is already a very attractive risk-adjusted return for leveraged loans.

We've just come through a period of historic volatility. With the possibility of further turmoil top of mind for many investors, what are your views on the investment-grade debt space?

DG: We find the rest of the fixed income market, outside of short-duration high yield bonds, to be extremely unattractive and, in fact, the most unattractive it has been in my whole career. Just think about how poor the risk/return dynamic appears for Treasury bonds. The U.S. government is likely to run massive deficits in fiscal years 2020 and 2021, in the neighborhood of USD 6 trillion. Right now, that massive issuance is being offset by massive Federal Reserve bond-buying programs and by contracting GDP. Neither of those events is likely to persist into 2022, and investors are likely to demand a higher return than 0.6% (the current yield on the 10-year note) in the future. When it is hard to envision a scenario in which an investment generates a mid-single-digit return—and when it is easy to envision a scenario in which an investment generates a double-digit loss—one should stay away from those investments. Unfortunately, that is the circumstance that investors in Treasury bonds find themselves in today.

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