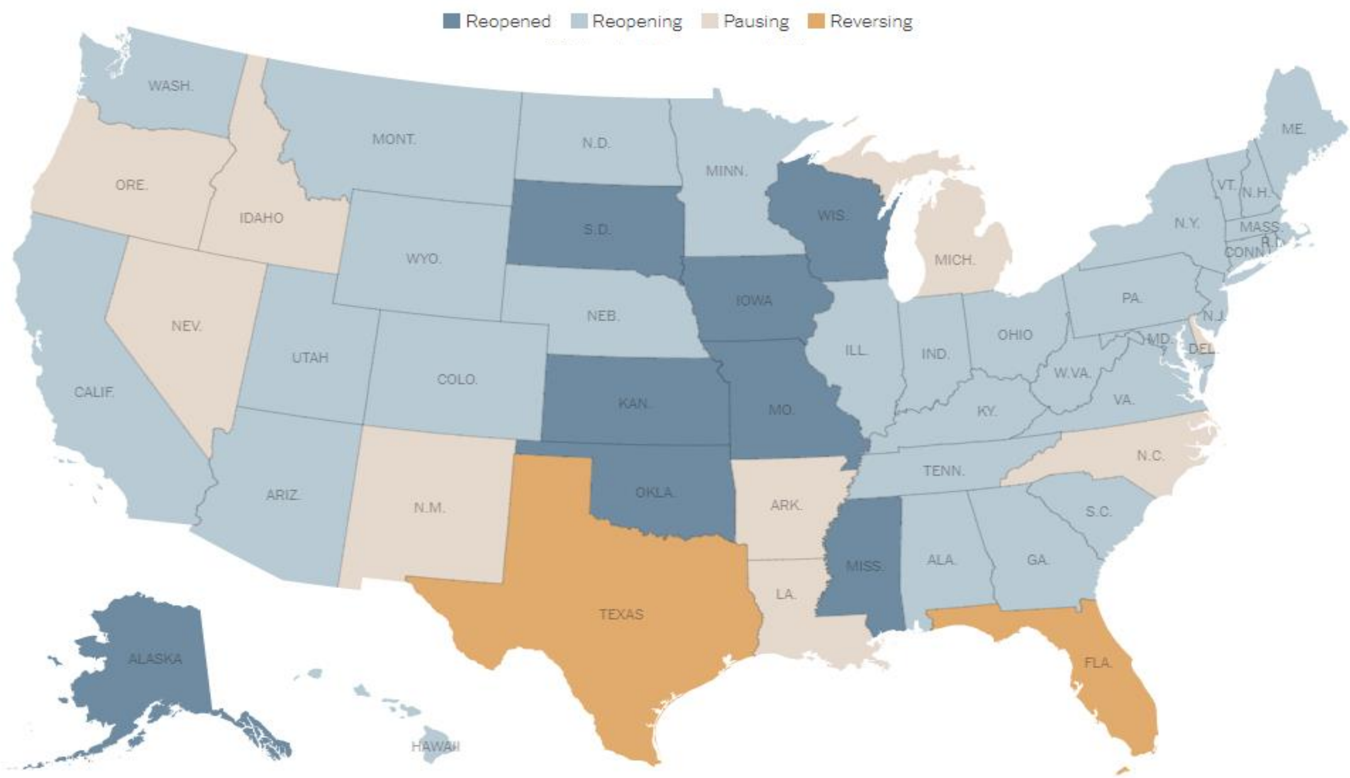
Trade Ideas

July 2020

Promising Global Industries

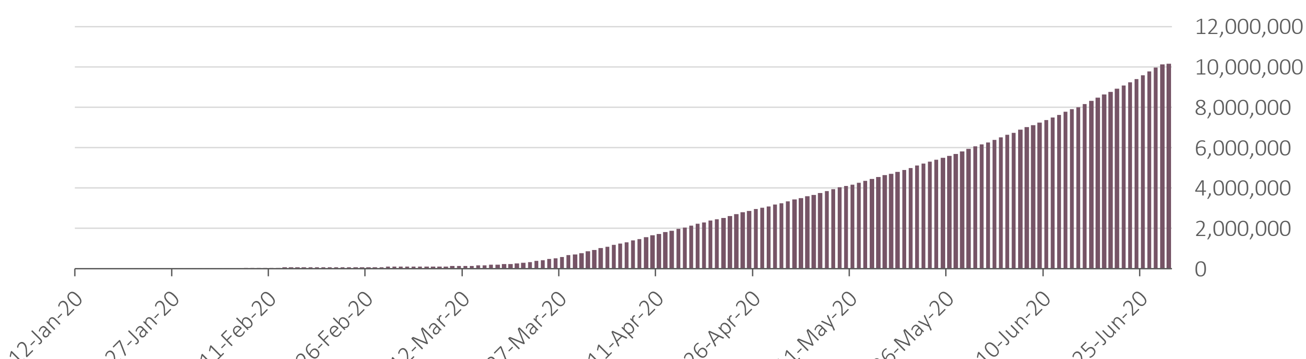
Market environment

Economies and countries around the world are beginning their tentative opening, and yet we see already the first re-imposed lockdowns in certain areas. While Europeans are slowly going back to the office and resuming other basic social activities – most states have legislation covering until the end of June or mid-July – Arkansas, Texas and Florida are the first three US states to have reversed the opening trend, as American health authorities sound the alarm of a second contagion phase (let us remember the US holds the most cases among all countries).



Source: New York Times

COVID-19 cases have simply not slowed down in pace globally, now standing at just over 10m, as seen below.



Source: Bloomberg

Rather than a second wave, this looks like no lockdown ever happened. Will this realization change the recovery trajectory for the worst?

We have noted from the first half of the year that markets enthusiastically anticipated the reopening trend without much support from data provided by health authorities worldwide. We came to the conclusion that the choice is simple: heavy damage to the economy by way of lockdown, or heavy loss of life by way of no lockdown. In the end, this is both a health and economic choice, that's why different countries with different culture reacted in different ways. In particular, it is clear the US administration wants all states to re-open, both because President Trump wants a strong economy to sustain his second term candidacy and because the American society is intrinsically capitalistic and highly individualistic. Furthermore, the Western world is engulfed in an unfruitful but inevitable political polarization, rising social unrest, plateauing economic power and the inevitable struggle with the Chinese economic rise.

In light of these recent developments and of the stretched status of market valuations in equities and bonds, we expect some turbulence in the short term, as these tensions have created many chances for global equity valuations to sudden fall.

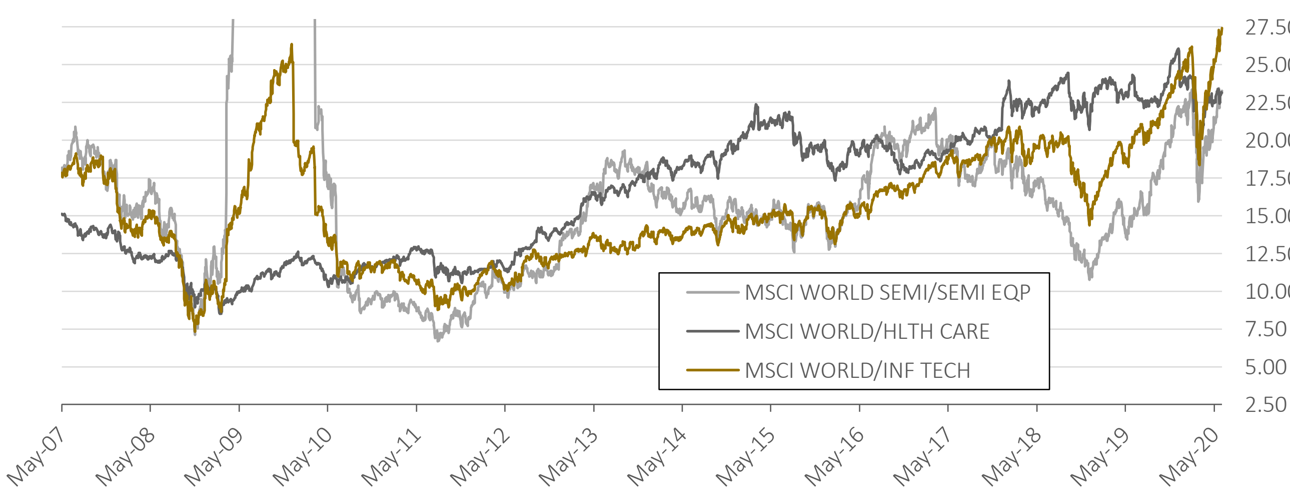
Despite this potential pitfalls for market valuations, we believe that future earning power of selected industries has not materially changed. At the same time, the fixed income market offers very little opportunities to get any meaningful return, so the focus remains strongly on equities. In such environment, a diversified exposure to major industries in equity form and with solid tailwinds can be selectively achieved at current market prices. Should a wave of depreciation happen, it will be possible to acquire positions at a further discount by exploiting the fast movements of today's market.

We present a list of current investment themes which could be the investment basis of engagement with our present and prospective clients.

Our analysis

Currently, investor expectations of recovery vary widely across global industries. From an equity perspective, it seems that the most sought after industries have been information technology, semiconductors and healthcare, respectively trading at 27x, 21.75x and 23x multiples on EBIT (that is a proxy for cash). Their price performance has also been impressive, as the lowest of these produced a 240% return since May 2007 (pre-global financial crisis levels).

Highest valuation (EV/EBIT multiple)

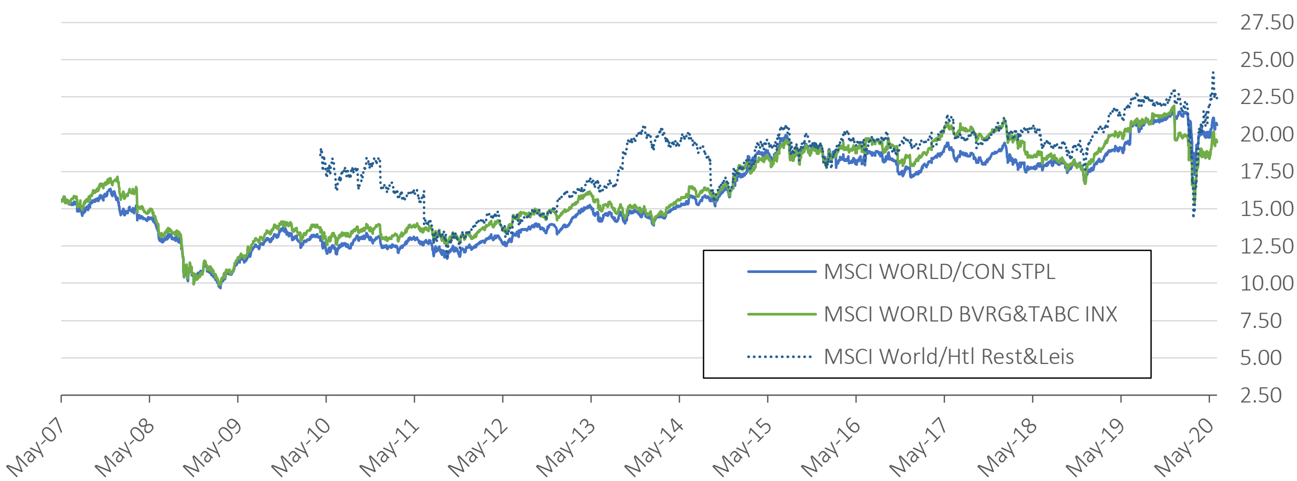


Other global industries have had mixed results. It must be noted that some industries such as automotive have seen a larger drop in fundamentals than in market prices, thus having the result of increasing market valuations. This is of course an aberration that is destined to disappear as visibility increases on future earnings evolution.

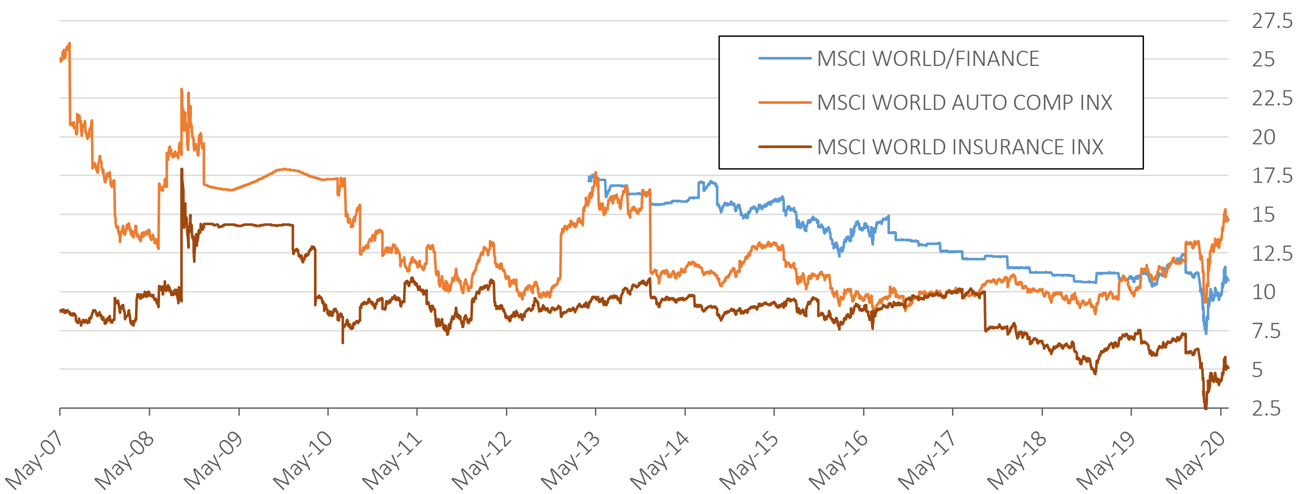
As seen in the last valuation graph in the next page, the financial, insurance and automotive sectors are the laggards by today's metrics. This is not difficult to understand when one appreciates that these three industries are very capital intensive and have seen their margins erode over time due to both commoditization and decreasing interest rates. Today, the global financial industry can only survive when there is size, government support, strong lending ties with businesses and high trading activity from its retail customers.

From the automotive perspective, the main challenge of today is to move towards electrification and away from fossil fuel. A new frontier might be found in hydrogen fuel cells for public transports, which is expected to slowly overtake transportation away from human-driven passenger vehicles in large city centers.

Medium valuation (EV/EBIT multiple)



Lowest valuation (EV/EBIT multiple)



The following two pages show our top picks among industries that we believe are long-term winners and speculative plays. As a new downward trend might be developing in global equities, this is time to start considering some of the best positioned industry and take advantage of their temporary depressed valuations.

Long-term winners

Technology & Semiconductors

The trade war between US and China that started in 2018 has effectively opened investors' eyes to the reality of imperial struggle. As the American supremacy dwindles internationally, the Chinese influence increases. The two ways the US has to maintain global power over any competitor are (1) control global finance by way of controlling USD flows and (2) remain at the top of the global tech game, which determines military and corporate dominance.

The technology sector represents the high stakes game all major empires are playing today. From a US perspective, there are indeed major players that have all the government support and global footprint to maintain power over emerging incumbents. These are Apple, Microsoft, Tesla, Amazon, Facebook, Adobe, Paypal and the two card payment giants Visa and Mastercard. To sustain these companies, semiconductor giants like Invidia, AMD, STMicrosystems and large Taiwanese players must also be considered. Their technological advancement reflects directly on to global tech giants.

HOW TO PLAY IT: A way to play both themes is to buy active strategies. This is designed to limit the downside allowing for active discretional choice in single names. We see Franklin Templeton Technology Fund (LU0109392836) and JP Morgan Technology Fund (LU0210536867) as two good alternatives for this theme.

Insurance

This sector is trading at distressed levels globally. The business model is about paying for protection against health, life or death damages. It is not a renounceable option for an increasing layer of society in both developed and emerging countries. However, this business suffers from low margins, albeit constant ones due to its un-renounceable nature. In a way, it resembles the nature of a bond: it does not grow too much in price, but it pays stable coupons.

HOW TO PLAY IT: Today, the global insurance market trades below 2007 price levels and at a laughable 5x multiple over EBIT (i.e. enterprise value over annual cash generation). This is by far the lowest valuation of all sectors, even energy and banking. A good way to position oneself is KIE US, an ETF on US insurance companies providing 2.33% dividend.

Healthcare

Another un-renounceable sector for human activity. In a way similar to consumer staples, this sector is just below technology and semiconductors in valuation terms. Consumer staples companies such as Johnson & Johnson are usually included in this industry too.

HOW TO PLAY IT: Investment can be done through careful selection of individual stocks, ETF's and mutual funds. With no geographical discrimination, we prefer to look at the global industry as emerging regions will increase subscription, but developed country companies will participate in their growth too. We see IHF US, an ETF from iShares, as being a good candidate for passive strategies. The JP Morgan Global Healthcare Fund (LU0432979374) works well for active strategy, while we do like J&J as a stock pick.

Speculative plays

On a speculative level, certain industries are indeed suffering from both secular and short-term trends. These are financials, leisure and airlines, all of which suffer from enormous capital intensity and depressed margins on their way to zero.

Financials

After observing the Japanese and European business returns of the banking industry in an interest-rate-decreasing environment, it is clear the banking industry is going to zero. Only a few players will remain, specifically those which elected trading intermediation as their main revenue generator.

HOW TO PLAY IT: We would therefore stick to digital banks and brokers which get their revenues from trading fees, not market directions or interest rate levels. Names that stick out are JP Morgan, Interactive Brokers, Swissquote, Charles Schwab and Fidelity. There are no ETF we like in this space.

Hotel/Restaurant/Entertainment

This industry depends strongly on the trajectory of economic recovery. We like it as it carries a certain inevitability, as people want to eventually go back traveling the world. While the shape of the tourism industry might be difficult to figure out yet, we know certain companies are well positioned with their brands whenever people increase their leisure time.

HOW TO PLAY IT: Our top picks are Disney and Rational AG, companies that are best positioned in terms of future growth, irrespective of exactly when it will materialize. Alternatively, PEJ – the ETF for Leisure and entertainment could be the best way – has valuable holdings such as YUM, Chipotle, Hilton Hotels and others.

Airlines

Border controls, airspace opening and other more permanent changes are currently happening in the airline industry globally. As such changes unravel, there is poor visibility on whether the industry will go back to where it was prior to the Coronavirus. Therefore, it is difficult to size up the upside potential of international airlines versus that of more regional plays, such as the US domestic market.

We believe certain areas should remain consistently dependent on flights, such as the US. European airline landscape appears too fragmented, with very low margins and more prone to budget flying that the US. However, one needs to be aware of a potential bubble here – we may not see travel developing as planned by airlines from now into the future.

HOW TO PLAY IT: Our top picks for this industry are Original Equipment Manufacturers (OEM) that contribute parts to and perform maintenance for the aviation industry. These would be Safran SA and MTU Aero Engines AG, both well positioned in oligopolies (groups of companies that enjoy very stable positions and high margins). We could play the JETS theme as a US domestic recovery story, which includes Boeing, with the caveat that there will be turbulence in the short term.

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