Newsletter

July 2020

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The width of discrepancy between fundamentals and market is increasing in these testing times for the capitalistic system.

Yesterday's $3 trillion tax cut and spending bill approved in US Congress – in Democrats' hands – plans to do the following: devote nearly $1 trillion for state, local and tribal governments; up to $6,000 payment per family, including to unauthorized immigrants; $200 billion for hazard pay for essential workers; $75 billion for coronavirus testing and tracing; increased spending on food stamps; $175 billion in housing support; student loan forgiveness and a new employee retention tax credit and extension of unemployment benefits. It would also require all voters to be able to vote by mail beginning this November. Of course there is a larger than average probability that Republicans will veto this bill, especially on the basis of mailing votes that President Trump has previously labeled as electoral fraud.

Despite the bill being still in progress through the legislative machine, equity markets in the US have reacted buoyantly – Nasdaq was up 1.7%. Does it make any sense at all? Not really, but the government help supersedes the creation of cash, in the eyes of retail investors at least. In reality, the economic impact just only on US business is strong, to say the least – in Europe there will be a jobless recovery, consistently with what happened in post-2008 crisis. The more government aid is issued to small and medium enterprises, the higher the motive for unemployed personnel to not go back to work, perpetuating the cycle of continued unemployment claims. In order to provide further relief to the unemployed, there are suggestions to cut the payroll tax withholding rate, currently at 6.2%, for at least 2 years – similar to corporate tax cuts the President Trump promoted in 2017. While it is unclear where these efforts will lead, it is the case that government aid is yes helping labour navigate rough waters temporarily, but it is also delaying productivity and keeping salaries depressed. In turn, consumption could be further delayed, once again delaying economic recovery.

In addition to this social challenge, there is also the difficulty to bring economic relief to the end targets. Banks have been extended credit lines from the FED and government, but these funds are not democratically distributed among those hit by the loss of consumer demand. In other words, there are rumors that government aids are subject to the discretion of banks. Considering that up to 80% of companies in the US are small to medium enterprises, and the worst hit too, it is rather imperative that these necessary bridge funds reach them. And US banks have an historically poor record in lending to SMEs, hence the surge of peer-to-peer lending platforms, further replicated in Europe over the past 15 years.

From a market perspective we continue to see tech valuations increase without much attachment to fundamentals. Valuations based on growth only are the shakiest ones, and most prone to be disappointed if earnings deviate from expectations. However, certain sectors continue to remain depressed in valuation, as further lockdowns are being discussed in various parts of the Western economic bloc and economic recovery has not fully kicked in yet. This is partly due to the market pessimism on demand coming back and partly to the fact that returns in some of these industries were never satisfactory to begin with. The aviation industry is indeed in pole position here, with energy and financials following. This situation is not uncommon in times of major shocks to either supply or demand, with rare investment opportunities arising as a consequence. As of today, we find attractive businesses in the aviation OEM segment and in the leisure industry. The thesis is a simple normalization in earnings of entrenched, sustainably levered and long-term oriented businesses, which can be found at a 40% discount to their fair value. As the reference markets seem to have bottomed out, we know these businesses will go back to their steady-state earning power, which will be reached in a time that is currently beyond the markets' short-term gaze of 6 to 12 months – and a preference for commercial, advertised and ubiquitous tech businesses.

See table below

Economic performance and balance sheet solidity, quarterly

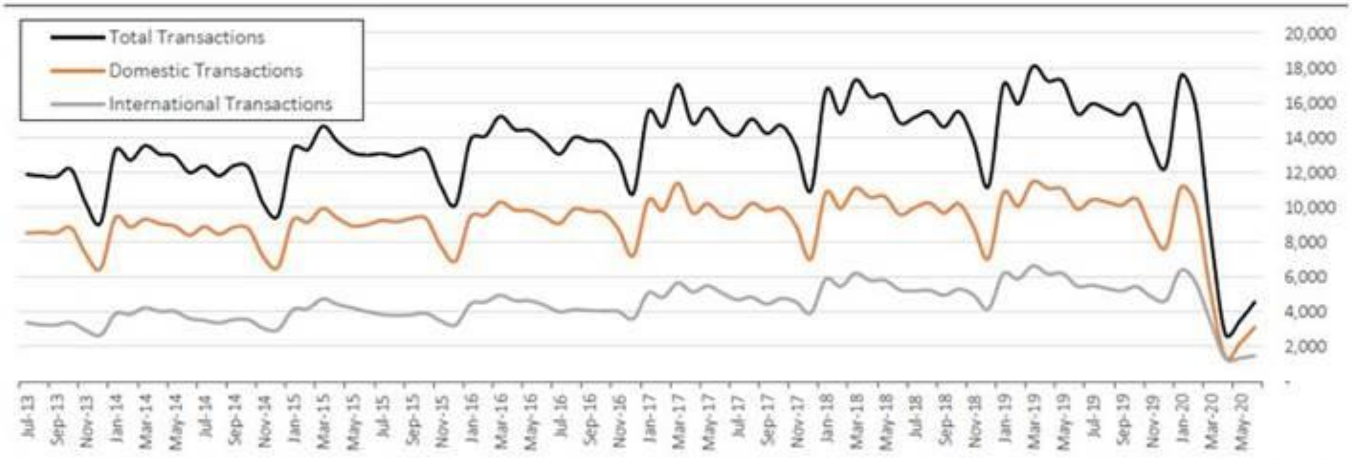
Metric	Return on Tangible Capital	Revenues	Cumulated EBIT		Net Debt			Interest Expense	
Description	Sales-weighted sum	YoY growth	YoY growth	Margin	Net debt/ revenues	Net debt/EBIT	Cash over gross debt	EBIT/Int Exp	Debt cost
Major Airlines*									
Sept-2019	4.74%	-18.32%	9.95%	11.08%	134.14%	12.11x	23.25%	6.82x	0.93%
Dec-2019	3.31%	-19.18%	9.25%	7.42%	125.39%	16.90x	25.77%	4.86x	0.90%
Mar-2020	-2.77%	-51.75%	5.56%	-13.67%	185.65%	-13.58x	30.07%	-7.90x	0.65%
Since 1999	*2.25%*	*10.48%*	*18.91%*	*6.24%*	*76.64%*	*15.48x*	*40.15%*	*3.22x*	*1.59%*
Major OEMs**									
Sept-2019	6.99%	-6.96%	8.53%	11.15%	71.86%	6.44x	46.09%	10.55x	0.79%
Dec-2019	1.06%	-7.73%	5.06%	-0.96%	42.20%	-43.83x	59.80%	-0.89x	1.03%
Mar-2020	4.75%	-9.32%	3.84%	4.06%	76.28%	18.77x	51.53%	2.89x	0.89%
Since 1999	*6.01%*	*5.63%*	*18.39%*	*7.47%*	*19.61%*	*2.49x*	*81.35%*	*7.50x*	*1.74%*

* American Airlines Group, Delta Air Lines, United Airlines Holdings, Singapore Airlines, Southwest Airlines, Lufthansa, China Southern Airlines, Ryanair, Air China, Air Canada, Easyjet, Korean Air Lines, Swire Pacific, Japan Airlines, Cathay Pacific, Qantas Airways, Air France-KLM.

** Airbus, Boeing, Lockheed Martin, Northrop Grumman, Rolls Royce Holdings, Safran.

Source: Bloomberg, companies' statements

Domestic and international flight ticket transactions – thousands



Source: Bloomberg

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