investors CHRONICLE alpha

17 April 2020

Phil Oakley's Weekly Round-Up

A great deal of damage is being done to the UK economy in lockdown, but a few shares look to have a more interesting trade-off between risk and reward

This week I'm going to let off some steam and have a look at the damage being done to the UK economy at the moment. I will end on a positive note and discuss some shares that are interesting to me right now.

Fantasy Sipp & UK Quality Shares performance

	Portfolio total returns (%)			
	1 month	Year to date	1 year	2 years
Scottish Mortgage Investment Trust	15.2	6.8	18.9	39.6
LF Blue Whale Growth Fund	6.5	-5.0	3.9	31.1
Fundsmith Equity T Acc	11.9	-5.6	1.7	26.6
Lindsell Train Global Funds	13.4	-6.2	-1.7	24.3
Martin Currie Global Portfolio Trust	3.1	-7.0	4.9	25.5
Smithson Investment Trust	9.0	-7.3	0.8	
Mid Wynd International Inv Trust	8.0	-8.0	5.1	19.4
Vanguard S&P 500 ETF	8.6	-8.4	1.1	19.7
Phil Oakley Fantasy Sipp	**6.0**	**-8.6**	**4.4**	**26.7**
Finsbury Growth & Income Trust	10.2	-14.1	-7.8	5.9
Castlefield CFP SDL UK Buffettology	14.2	-19.6	-9.6	1.1
Phil Oakley UK Quality Shares	**3.8**	**-20.0**	**–**	**–**
Vanguard FTSE 100 ETF	5.6	-24.2	-19.7	-13.6
FTSE All-Share - Total Return	4.2	-24.9	-20.3	-15.5
Vanguard FTSE 250 UCITS ETF	-1.1	-29.3	-19.3	-16.8

Source: SharePad

Crony capitalism is alive and thriving

Imagine walking into a casino. You are warmly greeted by its owner who gives you a wad of cash and tells you to put it all on black. You take his advice and leave at the end of the evening considerably richer on the back of someone else's money. This is kind of how the US stock market feels to me right now.

Despite the International Monetary Fund (IMF) coming out and saying that the world economy faces its worst crisis since the Great Depression; despite over 16 million Americans filing for unemployment insurance in recent weeks; despite major US banks saying that loan losses are likely to be worse than in 2008; and despite fund managers having their lowest equity allocations since March 2009 (the last major stock market bottom), the S&P 500 is

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staging an incredible rally.

It fell by 34 per cent from its high on February 19 to its low on March 23. It has since rallied by a staggering 27.2 per cent, meaning its losses are 11.9 per cent for the year to date. However, the S&P 500 is only 2 per cent lower than a year ago and trades at the same level as it was back in June last year.

According to S&P Capital IQ, the earnings per share (EPS) for the S&P 500 last year was $159.9, meaning that it entered the year on a trailing PE of 20.2 times. Consensus forecasts for EPS for 2020 started the year at $179.6 and have only come down to $168.3 as of 15 April – a reduction of just 6 per cent that looks way too low to me in an economy suffering an unprecedented hit to demand and supply.

The forward PE started 2020 at 18 times and is still 16.9 times, yet this is irrelevant as no-one seriously believed that the constituents of the S&P 500 will make more money this year than they did last year. On a trailing basis at 2,846, the S&P 500 trades on 17.8 times.

My guess – just like most forecasts – is that a conservative investor might assume EPS to fall by at least 20 per cent at times like this, which would give an EPS estimate of $128 that equates to a PE of 22.2 times. Whichever way you care to look at valuations, they are expensive even when you consider the “no alternative” argument.

It seems as if the US stock market and the real world are worlds apart. Big brokers are bullish with some predicting that the market will reach record highs again within the next year, mainly because of all the money the Federal Reserve has thrown at it and that the economy will soon get back to normal again and bounce back strongly.

Nobody knows how fast and by how much the economy will recover, but if the bulls turn out to be correct then surely a good deal of this outcome is already priced into the shares.

A brief study of the Spanish Flu pandemic from 1918 will inform you that the virus came in three separate waves, with the second wave being the most deadly. The US stock market seems to be priced on the assumption that a vaccine has already been found and that there will be no further economic disruption if the virus goes away for a while and then comes back.

What we are witnessing is the unashamed bailing out of the rich at the expense of the ordinary person on the street – even more so than in 2008-09. The Fed has created money out of fresh air to buy government bonds, corporate bonds, municipal bonds and now even high-yield exchange traded funds (ETFs).

What is the purpose of this?

This money does not end up on main street, but on Wall Street. It allows hedge funds who have gambled with other people's money and got it wrong to be bailed out. It allows highly-indebted private equity funds to avoid crippling rates of interest.

These are groups that earn obscene amounts of money when times are good for contributing very little to society as a whole apart from demand for luxury goods and services. They rarely invest in new productive economic capacity, but are happy for the taxpayer to underwrite their losses.

Fortune this week cites the ultra wealthy clients of wealth management companies borrowing money to gamble on the stock market (the word "invest" has been avoided here for a good reason).

The stock market seems to have lost – or is close to losing – any relationship with the key business fundamentals that are behind the stocks on it – profits, cash flows, assets and dividends. Throw in the extreme levels of uncertainty that makes prediction of the short-term future almost impossible and all we are left with in many cases is just rampant speculation.

We should not forget that there were signs of trouble before the coronavirus was even heard of. The Federal Reserve had to intervene in the repo market (where it provides short-term cash in return for collateral assets such as bonds) because banks had problems with liquidity. Over half of the traded US investment grade corporate debt was rated at the lowest BBB level (the next step down is junk debt status). I'll save you from my concerns on debt-fuelled consumption.

The reason I keep going on about stuff like this in my weekly columns is to hammer home my belief that investors need to pay attention to the risks that they face. Mixed with cautious, but rational, optimism on the future and backed by a conservative judgement of the facts, there is no reason why investors can't get decent long-term results from owning shares, but to do so they also need to minimise the risk of big losses.

Risks are very high right now. What happens on Wall Street will undoubtedly spill over to UK markets and I think the behaviour of the US market brings a lot of risk right now without being favourably priced.

It is not just economic risks that need to be considered. Social and political risks are increasing too. Governments across the world are asking their electorates to accept very harsh restrictions on their way of life. This is falling hardest on those who have lost their jobs and have little savings or assets to fall back on.

There's a lot of talk at the moment as to how the government should give people some hope that there is an end to the current lockdown. This is difficult, but what's more important is that the majority of people should see that the system treats them fairly – if it ever has– and at the moment it is becoming abundantly clear that it does not.

This is an ill wind that will blow no good if left unchecked.

UK economy to get hammered but is expected to bounce back

This week saw the Office of Budget Responsibility (OBR) give its view on what the impact of the current UK lockdown will have on the economy.

In short, the OBR thinks it will hammer it.

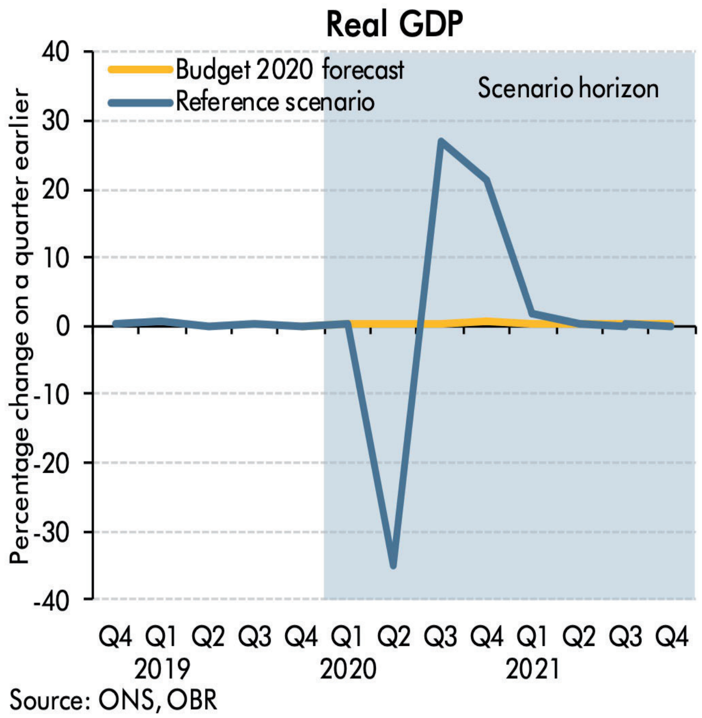
It has based its view on a three-month lockdown of the UK economy and then assumes that it will take another three months for things to get back to where they were before. It estimates that this will cause the UK economy to shrink by 35 per cent in the second quarter of 2020 and by just under 13 per cent for the year as a whole.

Table 1.1: Selected external estimates of GDP impact of coronavirus

	UK				
	Percentage change on previous period				Percentage change in level
	2020 (annual)	H1 2020	Q1 (Q-on-Q)	Q2 (Q-on-Q)	
KPMG (main scenario) (23 March)	-2.6		-1.2	-2.1	
KPMG (downside scenario) (23 March)	-5.4		-1.6	-3.9	
Morgan Stanley (23 March)	-5.1				
Bloomberg (4 weeks lockdown) (24 March)			-0.7	-9	
Bloomberg (6 weeks lockdown) (24 March)		-14			
Capital Economics (24 March)				-15	
OECD[1] (26 March)					-26
CEBR (30 March)			-0.5	-15	
OBR coronavirus reference scenario	-13	-17		-35	
	US				
Goldman Sachs (20 March)				-24	
Morgan Stanley (23 March)				-30	
OECD[1] (26 March)					-25
	France				
OECD[1] (26 March)					-26
INSEE[2] (26 March)					-35

Source: OBR

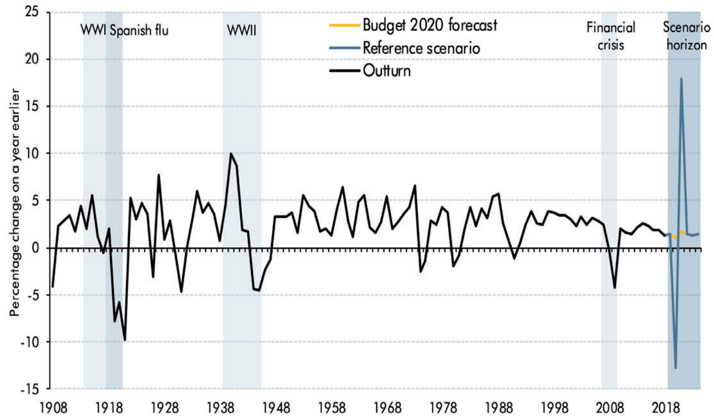
However, it also seems to think that things will get back to normal very quickly and that the economy will start growing at the same rate as was expected in the budget. This is the "V" shaped recovery that so many people are talking about – and hoping for – right now and is the best case scenario according to the OBR.



I don't envy the OBR's task in predicting the future, but this may be wishful thinking. Clear risks to this rosy view come from the likelihood that many businesses will go bust, investment projects that were cancelled don't get revived and that some people who lost their jobs don't come back to the workplace. There's also the risk that more economic lockdowns may be necessary if the coronavirus is not beaten. Let us all hope that the OBR is right.

As we can see, the hit to the economy is expected to be worse than anything that has been witnessed in living memory. The hope will be that after a big hit that occurred with the Spanish flu in 1918, history does repeat itself and the economy bounces back.

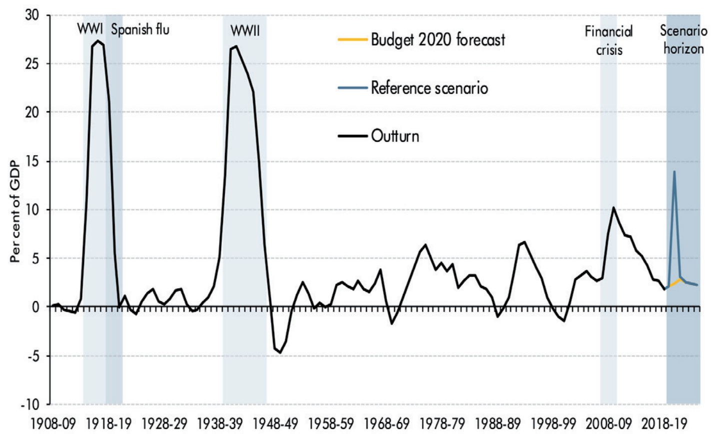
Chart 1.2: GDP decline in historical perspective



Source: Bank of England, ONS, OBR

The effect on the government's finances is going to be horrendous, according to the OBR. The assistance given to the NHS, households and businesses is going to cost an estimated £100bn. The lost tax receipts from the decline in the economy are estimated to be £130bn. This means that the government is expected to borrow £273bn in 2020 or 14 per cent of expected GDP – a level not seen since World War II.

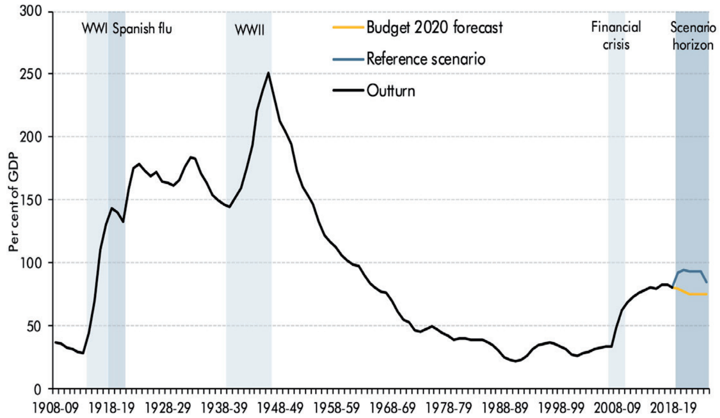
Chart 1.4: Public sector net borrowing: reference scenario versus Budget forecast



Source: Bank of England, ONS, OBR

Government debt levels are expected to take a one off hit and get close to 100 per cent of GDP – a level not seen since the 1960s.

Chart 1.5: Public sector net debt: reference scenario versus Budget forecast



Source: Bank of England, ONS, OBR

Quite rightly, people are beginning to ask how the government is going to pay for this. Given that it has promised not to raise income tax, national insurance and VAT, this has led to speculation that the government will resort to wealth taxes, end the triple lock on state pensions and the higher-rate tax relief on pensions.

Governments can and do break promises, but I think this kind of talk is wide of the mark. Instead, the government will simply ask the Bank of England to print money to buy the gilts it will issue to raise the cash that it needs.

The government can currently borrow for 10 years on the financial markets at an interest rate of around 0.4 per cent. An extra £300 billion of debt would cost it an additional £1.2bn in annual interest. This is not to be scoffed at, but would actually be quite manageable.

The danger is that people will pay the bill not in higher taxes, but in the reduced buying power of the pound in their pocket if inflation takes off. We are not yet facing up to this risk and may yet get away with it as the rest of the world faces similar issues.

That said, it's hard to view this as a positive development or see how it helps the UK economy to grow faster in the future.

Can travel and leisure shares keep on recovering?

In my round-up of 20 March I highlighted the bloodbath in the transport and leisure sector and the devastation inflicted on many share prices by the lockdown. I had highlighted that while National Express' shares were high risk, they were very, very cheap if you believed that the hit to profits was temporary and it could get back to what it was earning in 2019.

Travel & leisure share price falls in one month to 18 Mar 2020

Company	Market Cap	Price	%chg 1m
National Express	412.2	81	-81.7
Dart Group	569.1	382	-80.2
SSP Group	714	160	-76.1
WH Smith	858.1	746	-68.7
easyJet	2062.8	520	-65.2
Wetherspoon (JD)	631.5	603	-60.4
Stagecoach	310	56	-59.4
Whitbread	2976.9	2213	-53.7
InterContinental Hotels	5019.9	2748	-44.2

Source:SharePad

Since then the shares have almost tripled in price. This week, the company has come out with a fairly encouraging trading update, even though it has understandably chosen not to pay its final dividend from last year.

Its US school bus and transit operations are currently receiving around 60 per cent of the pre Covid-19 revenues, with school bus revenues expected to increase through government support over the next few weeks. Shuttle buses are running at around 70 per cent of previous revenues.

Spain and Morocco have around 40 per cent of their revenues protected by contracts, and going forward existing contracts are likely to be extended so that lost revenues can be recovered.

The company has £200m of cash on deposit and £1bn of undrawn bank facilities. While its profits are well down it is actually still generating positive cash flows.

The bottom line here is that this company does not look as if it is going bust anytime soon, whereas it was arguably priced to do so a month ago. As with many companies, it is likely to come out of this crisis with more debt, but an amount that the normal cash flows of the business can cope with. It therefore has a good chance of growing its profits and cash flows from its 2019 levels, in my view. On that basis, the trailing 12-month PE of 7.4 times still looks very good value to me.

Travel & leisure: Price changes between 18 March and 15 April 2020

Company	Price 18/3	Price 15/4	% change	TTM PE 18/3	TTM PE 15/4
National Express	81	240.3	198%	3.8	7.4
Dart Group	382	581	52%	4.6	6.6
SSP Group	160	280.1	76%	7.4	10.3
WH Smith	746	1091	46%	7.9	10.3
easyJet	520	613.5	18%	6.8	7.6
Wetherspoon (JD)	603	837.75	39%	9.4	12
Stagecoach	56	77.4	37%	3.4	4.3
Whitbread	2213	2672.5	21%	9.2	10.9
InterContinental Hotels	2748	3311	20%	11.8	14.3

Source:SharePad

I still like WH Smith shares, as I wrote last week, even with the dilution that comes from its recent share placing. Whilst the shares may not trade on 20 times earnings anytime soon, I still see the shares as cheap under more normal business conditions.

Two other shares to consider are Whitbread and Inter-Continental Hotels. The latter has one of the best global hotel brands and is a franchisor with great cash flows. I continue to believe that Whitbread's Premier Inn hotels would be more valuable to its shareholders if it copied Inter-Continental and became a franchisor rather than an owner, despite the current difficult UK market.

In many ways, the principles of good investing have not changed in the current turmoil. Business quality should always be the most important consideration of any investor and is more important than valuation.

As we have seen, cheap shares have become cheaper, but high-quality businesses with more robust revenues and profits are still very expensive to buy now, in my opinion.

The UK stock market is a difficult hunting ground at the best of times, but the shares I have mentioned here are good businesses in a most difficult sector. The bonus is that their valuations seem to offer the sort of attractive risk-reward trade-off that are few and far between right now.

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