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Update on equities at Capital Group

Key points:

- Recent action by the US Federal Reserve is intended to avoid a seizure of financial markets.
- Our economic team believes there is a 70% chance of a US recession.
- They also note that the average market decline when accompanied by a recession has been 31%.
- China is beginning to stabilise two months after the outbreak of COVID-19.
- As fundamental, bottom-up investors, we are looking to identify long-term winners and losers.

Before the outbreak of COVID-19, there was mounting evidence that the global economy was starting to recover as the headwinds of 2019 defined by a protracted slump in industrial and export activity faded.

Now Capital Group's economists put the odds of a US recession at 70%, and an equally high probability of a global recession amid significant supply-side and demand shocks to the global economy.

Investment implications

The questions Capital Group's equity investors are asking are: What will be the depth and persistence of such a recession? And where will we see risks and opportunities among companies? As bottom-up investors, we are assessing:

- Who will see temporary destruction of demand that will rebound?
- Where is demand likely to see a more permanent shift?
- Who is going to see supply chains irrevocably disrupted?
- Where will those impacts be temporary?
- What shifts in behaviour will become somewhat permanent?

In this brief write-up, we are not going to discuss specific companies. It is not advisable to discuss companies in which we are building positions, and the investments are not the same across different strategies and funds. Rather, we provide you a broad view here of the discussions that are taking place among the equity portfolio managers and analysts amid this period of extreme market volatility as it relates to relative value among sectors and industries.

We've seen trading volume in exchange-traded funds (ETFs) rise to around 40% of total volume, compared with a historical average of 20%. The demand of liquidity has led to this dramatic increase in volume, but it has also led to indiscriminate selling. There is still some price discovery going on, to the extent that airlines and cruise lines have declined a lot more than food companies. In this environment, there is interest among our investors in quality companies that benefit from people having less face-to-face interaction and companies that have been less affected by the coronavirus. These include the areas of gaming, media, data centres (and second-derivative beneficiaries of data centres growth), storage and residential housing apartments.

Broadly speaking, our portfolio managers and analysts believe that consumer behaviour patterns are unlikely to change much for travel and hospitality industries. When disposable income increases, we drive farther, fly farther, take longer vacations, spend more, etc. The events of 9/11 did not derail this megatrend, and it is unlikely that COVID-19’s impact will over the long term.

As such, managers will look for appropriate entry points to add to or begin positions in companies in structurally advantaged industries with pricing power that stand to benefit from the secular trends and, at the same time, have long-term advantage due to tight supply-demand dynamics. Aerospace, airlines and cruise lines are areas of focus, although it may still be early. I think it's reasonable to ask if anyone would ever invest in cruise ships again. But as some analysts point out, we have seen big shocks in the past, and customers for cruise lines have tended to forget and move on after a year. This is a structurally attractive industry; there are a limited number of suppliers, which gives them sustainable pricing power, and there's a demographic tailwind with a significant portion of the older population getting older and wealthier. In aerospace, there are only two major companies that supply the world’s airplanes.

Semi-conductors and software are other industries that command durable pricing power, given the consolidation in the industry over the past decade and durable long-term demand. E-commerce and social media companies are others that can tap into an acceleration of existing online trends.

Many portfolios have held significant investments in health care as new sciences and technologies enable the development of an entirely new array of treatments for a variety of diseases and ailments. Attitudes toward health care are likely to further evolve as a result of the recent virus outbreak. Our analysts have started the work on what this will mean for the various health care providers and biotech companies.

Meanwhile, the impact of lower oil prices, with new levels likely to remain in the $30 range for some time, is not good for the energy sector by any stretch of the imagination. Yet, there are economies around the world that are net importers of oil and stand to benefit immensely from lower oil prices, India being the most prominent example. Energy is an area that has mixed views among Capital Group’s PMs and analysts. Some are concerned about a shift to a less attractive supply-demand equation in the oil industry, while others are drawn to the extremely low valuations of these companies compared to their history.

Turning to financials, many of our investors are also cautious about investing in banks amid a paradigm shift with interest rates near zero or negative in the major economies. Low interest rates and liquidity challenges in the fixed income markets present significant challenges to banks, and we remain cautious in this area. At the same time, the major US banks are much better capitalised than in the Great Financial Crisis. US banks have also committed less capital to market-making in bond markets, and we are seeing it in the valuation differentials between the US banks and the European banks.

Finally, perhaps we can glimpse green shoots in the place where this all started, although the pattern could still reverse given new stress we are seeing in the financial system. China has begun to stabilize, with President Xi visiting Wuhan, the number of new cases declining and the economy slowly restarting, roughly two months after COVID-19 became more widespread. Similar patterns are emerging elsewhere in Asia.

As long-term investors, our PMs and analysts will continue to monitor markets and invest in areas where they see the greatest discrepancy between prices and fundamentals.

All data as at 16 March, unless otherwise stated.

David Polak is an equity investment director at Capital Group, leading the investment specialist team for equities and representing a number of Capital's global equity strategies. He has 36 years of investment industry experience and has been with Capital Group for 14 years. Prior to joining Capital, he was a managing director in the equity businesses of UBS and Deutsche Bank. He holds a bachelor's degree in economics from University College London graduating with honors. David is based in New York.

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