The New Abnormal

Where is the L U V ?

May 13, 2020

Beutel Goodman
Fixed Income Team

About 65 million years ago, an asteroid wiped out the dominant species of the time, the dinosaurs. This cleared the way for the Tritheledont, a rodent-like hybrid mammal no bigger than 20 cm, to lead the evolutionary charge that resulted in mammals – and ultimately humans – emerging as the new dominant species of the planet[1]. In the winter of 2019/2020, a similar event occurred – not an asteroid this time, but a virus. While still existential, this one is also economic in nature. It is devastating in many regards, but ultimately, we believe the nature of our economy is dynamic and will provide several opportunities as it did for the Tritheledont.

The extinction of the dinosaurs didn't occur immediately upon the asteroid hitting the earth, but during the long dark winter that followed. Similarly, the global economy will likely feel the most pain from the COVID-19 pandemic in the months ahead as it adjusts to the drop in demand for certain products. What economists call the "external shock" of COVID-19 will likely be felt for years by many sectors. While some will see a V- or U-shaped recovery (see box below for details) and eventually flourish like the Tritheledont, others will likely meet a fate similar to the dinosaurs and never fully recover.

Winners and Losers in the Corporate Debt Sector

Corporate bonds have seen the largest dispersion in yields and spreads and thus have the greatest opportunities for investing. Delving more deeply into the corporate sector of the FTSE Canada Corporate Bond Index, we identify industry groups affected by the external shock, and the potential dinosaurs ("L") and Tritheledonts ("V" and "U") in each.

V- and U-Shaped Recoveries

Industrials – Consumer staples (U and V)

Consumer staples such as groceries are fairly pandemic-proof, and are benefiting from consumers' tendency to hoard (remember the toilet paper frenzy). They will likely face a V recovery. The more retail-oriented consumer cyclical companies that are considered non-essential will be more exposed to the pandemic, as stores are mandated to be closed or limited to e-commerce channels for sales. They will therefore likely face more of a U recovery.

Transportation – Rails (V)

Demand for rail seems to be resilient; their diverse commodity base helps mitigate the risk of steep volume declines due to any one particular commodity (i.e., oil). In addition, Precision Scheduled Railroading (PSR) ensures the efficiency of operations and minimization of costs by optimizing schedules and routes.

Communication (V)

This sector has been a strong performer in this crisis amid skyrocketing demand for remote communication. During the pandemic, telecommunication companies have become the new utilities as internet access becomes a necessity to work from home and home school. It is likely that 5G deployment will be delayed by the pandemic, which alleviates pressure on augmented capital spending.

Financials –Banks (U)

Canada's banking system will be significantly impacted on a number of fronts. The most immediate concern surrounds existing loan books, both corporate and consumer, and the potential for a sharp uptick in delinquencies and charge-offs. Thus far, we've generally seen global peers increase provisions between four-fold and eight-fold vs. levels one year ago, but we'll have to wait until end of May for additional colour. Fortunately, the Canadian banks entered these unprecedented circumstances with strong capital positions, and at this point our internal stress tests have concluded that each institution should be able to withstand even the most severely adverse scenario. Moreover, for its part, OSFI has been quicker to act this time around than in previous downturns, having already announced a series of regulatory adjustments to support the financial and operational resilience of federally regulated banks, insurers and private pension plans.

Financials – Auto Finance (U)

Prior to the pandemic, auto manufacturers were already under pressure due to changing industry dynamics. The disruptions caused by COVID-19 have led to further pressure as auto sales fall and the potential for loan losses at the captive finance arms could pressure balance sheets. The current environment has resulted in industry-wide downgrades and an underperformance in the bonds.

Infrastructure (V)

The infrastructure sector will likely outperform, as it represents recession-proof demand. The regulated nature of utilities provides downside protection; we are all not going to freeze in the dark. There may be some concern on rising bad debt expense; however, it is likely most regulators will allow companies to establish regulatory deferral accounts to mitigate that risk. Some infrastructure (i.e., toll roads) do present volume risk and have seen demand sharply decline as employees work from home and the commuting and travel congestion is absent.

Energy – Power Generation (V)

The power generation sector is relatively immune from COVID-19 effects as power demand will remain robust. Any weakness in demand from industrials is likely offset by an increase in demand from the residential sector when shelter-at-home is in place. The residential sector is a higher-margin business versus industrials. Most of the power generators in this sector have low merchant power exposure and sell their power under long-term power purchase agreements. For the whole sector, there may be slight delays in the construction of major projects and/or refurbishments as workers practice social distancing protocols.

Energy – Midstream and Pipelines (U)

The midstream sector is indirectly impacted by the commodity price downturn, mainly as volumes through their processing and fractionation facilities and pipelines will be negatively affected by production cuts and shut-ins. This risk is offset by the level and nature of the companies' contracts. The majority of cash flows in this segment are underpinned by long-term, take-or-pay contracts, fee-for-service contracts, and regulated structures. Counterparty risk is also a concern, but the vast majority of the offtakers are rated investment grade.

Airport Authorities (U)

Canadian airports have seen muted activity as repatriation flights have brought home the majority of Canadians abroad during the pandemic. Cargo flights are still flying, spurred by the online shopping boom that's taken place as customers stay home. However, overall airport activity is down significantly and as a result, so is airport authorities' revenue. In response, the government has waived all ground lease rents from March 2020 to December 2020 for the 21 airport authorities who pay rent to the federal government. This is a welcome development for credit in the airport sector as it will directly help offset the impacts of COVID-19 on margins and cash flows due to lower aeronautical revenues, airport improvement fees, and commercial cargo revenues. An additional positive for credit is that the airport authorities have the legislated ability to set rates and charges levied on airlines and passengers, which will help grow revenues back to pre-pandemic levels.

L-Shaped Recoveries

Real Estate (L)

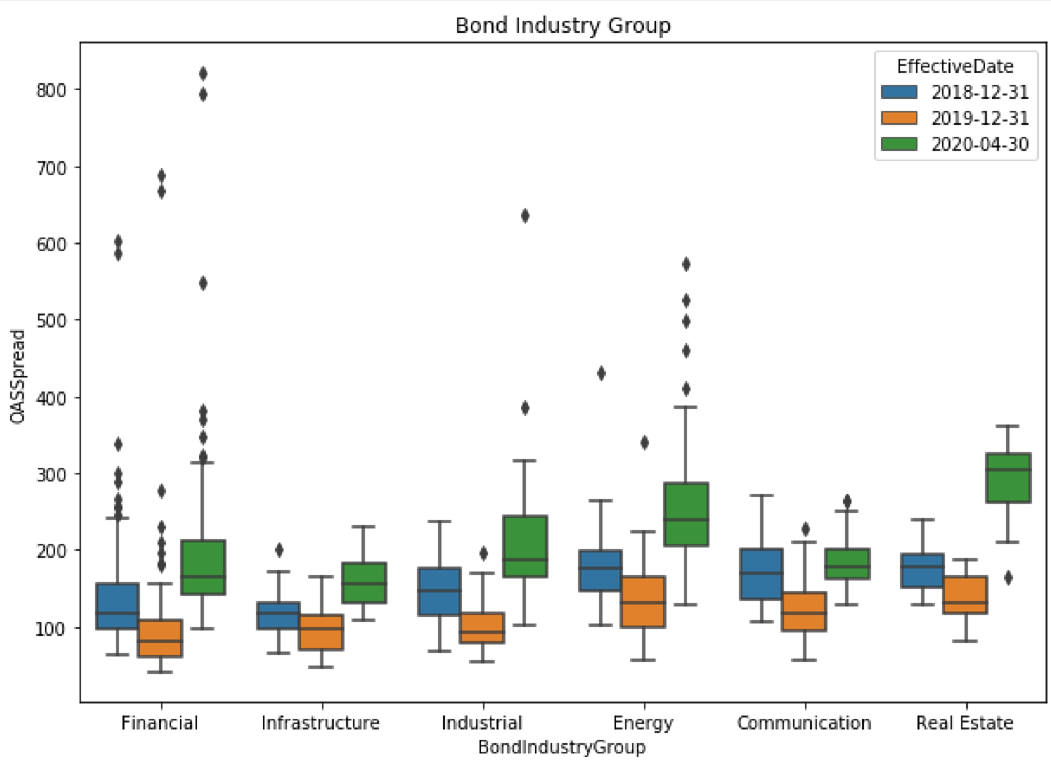
The largest impact in this space will be on commercial real estate. Will COVID-19 change the way we work? Will it change the way we shop? There is a high likelihood that a number of people will continue to work from home for a prolonged period and maybe even stay at home permanently, which will negatively affect commercial real estate as companies downsize their office space requirements. Many retail businesses and restaurants/bars may not survive, leading to higher vacancy rates. We have already seen bankruptcy filings for major retailers such as J. Crew and JC Penny, which may impact the make-up of malls. It is also likely online shopping will continue to increase, decreasing foot traffic in malls as well.

Energy – Oil and Gas (L)

Crude oil was hit by the double whammy of decline in demand and a production quota fight between Russia and OPEC. Approximately 50% of a barrel of oil is used for the transportation sector. With airplanes practically grounded and distance travelled in cars down significantly, demand for oil has cratered. Major energy companies have responded with production cuts and curtailment, trims to capital budgets, project delays, dividend cuts and suspension of share buybacks. The focus is on capital discipline to persevere through the crisis. There will likely be continued credit downgrade and bankruptcies among small- to mid-size producers and overleveraged firms.

Box plot of corporate sectors. The box plot shows the distribution of the Option Adjusted Spreads (in Basis Points). Key statistics such as median (line in the box), interquartile ranges (boxes) and 1.5 x quartiles (whiskers). The dots represent outliers within the data.
Sectors that have suffered in this crisis have seen their spreads widen and distribution increase, which may reveal a valuable relative investment.

Source: FTSE Universe & Bloomberg Barclays



Transportation – Airlines (L)

The airlines are likely going to suffer their worst financial year ever. Airlines around the world are struggling to right-size fleets and capacity in response to travel bans and an overall drop in demand from 2019 levels. Around the world, governments have been offering support to the industry, albeit with some strings attached in the form of buyback and dividend restrictions, as well as limitations on executive pay. Canada appears to be the industry hold-out for the moment, though we expect some form of support to be announced in the coming weeks.

Portfolio Positioning

Of course markets differ from biological evolution, and getting the growth trajectory correct (U, V or L) is only half the equation. The other half – how the market has priced in the growth expectations – determines the overall performance. For instance, some V and U issuers may not be a wise investment as they may be pricing in too much good news and appear expensive, while some sectors or companies that are expected to have an L-shaped recovery may be pricing in too dire an outcome and be a good opportunity. The pandemic has provided a unique opportunity to invest in sectors that have widened by too much and offer attractive yield relative to their expectations.

Within the credit allocations of our portfolios, in the long end we are focused primarily on utilities and infrastructure, as issuer-specific (idiosyncratic) risk is less for these sectors due to their regulated nature. In the short end of the credit spectrum (3-7 years), we aim to take on idiosyncratic risk as we can more accurately model economic environments, cash flows and debt levels, and judge relative value across sectors.

Biological extinctions not only remove creatures but also create excellent opportunities for new ones to thrive. The COVID-19 economic shock will likely create a similar effect. Certain sectors face strong headwinds from the Great Pandemic Halt, but certain companies within those sectors can adapt to change and weather the storm, while others who likely entered the pandemic encumbered (i.e., too leveraged) may be forced into bankruptcy proceedings or debt restructurings. The deep dive and rigorous credit work performed by our credit team help to separate the survivors from the extinct.

NOTES

[1]For further information we recommend the documentary "Your Inner Fish", which describes this fascinating evolution process.

Related Topics and Links of Interest:

- Coronavirus Has Infected Markets ... Now What?
- Our Response to COVID-19 — Investment Team Q&A
- Beutel Goodman Mutual Fund Profiles

L-, U- and V-Shaped Recoveries – A Stylized Model

A big question on investors' minds is the type of economic growth we will likely see when we emerge from the COVID-19 crisis. V- and U-shaped scenarios represent recoveries, with U being the slower of the two, while L is an economy that never fully recovers. As noted in the main article, the economy will likely be a combination of the letters. Some sectors will be more like a V or U, while other sectors will see an L-shaped scenario. Active management and taking advantage of mispriced assets is therefore vital in this crisis.

In this section, we analyse the impact on GDP, interest rates, wages and capital from V/U and L scenarios, using a simple Solow Growth Model. We also review a further scenario, "Depreciation" or "D", which is essentially the L scenario with the assumption that a certain additional amount of capital depreciates.

The Model

The model variables are:

Y = GDP Output	C = Consumption	I = Investment/Savings	K = Capital,
AL = Productive Labour	α= elasticity of capital	δ=depreciation	s = savings rate

… and the model is driven by the following functions:

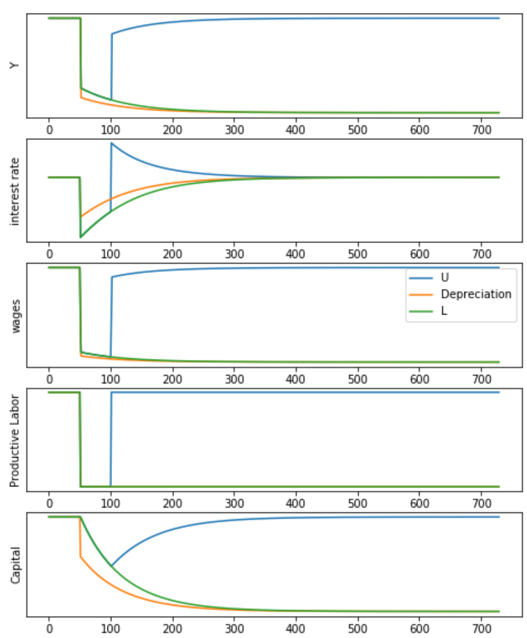
$Y_t = K_t^a AL_t^{1-a}$	Output is a function of Capital and effective Labour. In the model we shock productive labour
$Y_t = C_t + I_t$	Output is equal to Consumption and Investments
$I_t = sY_t$	Investment equal Savings, and Savings is simply the saving rate times Output
$C_t = (1 - s)Y_t$	Consumption is equal to Output times 1 minus the savings rate
$K_t = K_{t-1}(1 - \delta) + sY_{t-1}$	Capital decreases by depreciation and grows by savings

We assume our model to be in perfect competition for labour and capital and thus wages and interest rates earn their marginal productivity.

The model is simplified and assumes an economy with perfect competition, zero population growth, that savings equals investment, and that no government entity provides stimulus (both monetary and fiscal). The model deals only with real economic growth, with no inflation.

The Responses

Below are the responses of GDP (Y), interest rates, wages and capital to the three shock scenarios (V/U, L and D); the shocks are assumed to hit productive labour in either a U (i.e., a return to work after a period of time) or an L (i.e., never returns to work) manner.



- GDP (Y): In the U scenario, output falls but then recovers back to its natural rate. In the L scenario, growth never recovers. Consumption is the same, as in this model, it is simply a product of output (i.e., 80% of output is consumed, and 20% saved).
- Interest Rates: The results show that interest rates fall when labour is forced into lockdown. The excess idle capital means the rate of return on that capital decreases. In all cases, it eventually returns to its pre-crisis equilibrium as the excess capital is removed. In the U scenario, rates go above equilibrium for a while as the affected workers return and capital is more productive, before reverting back to its long-term equilibrium.
- Wages: Wages for the L never recover, while U economic wages come back.
- Capital: Initial capital falls as savings fall and can't keep up with depreciation. In the U economy, capital returns to the pre-crisis level. In the L it falls and never recovers. The fall is more drastic in the "Depreciation" scenario as more capital becomes worthless faster due to increased depreciation.