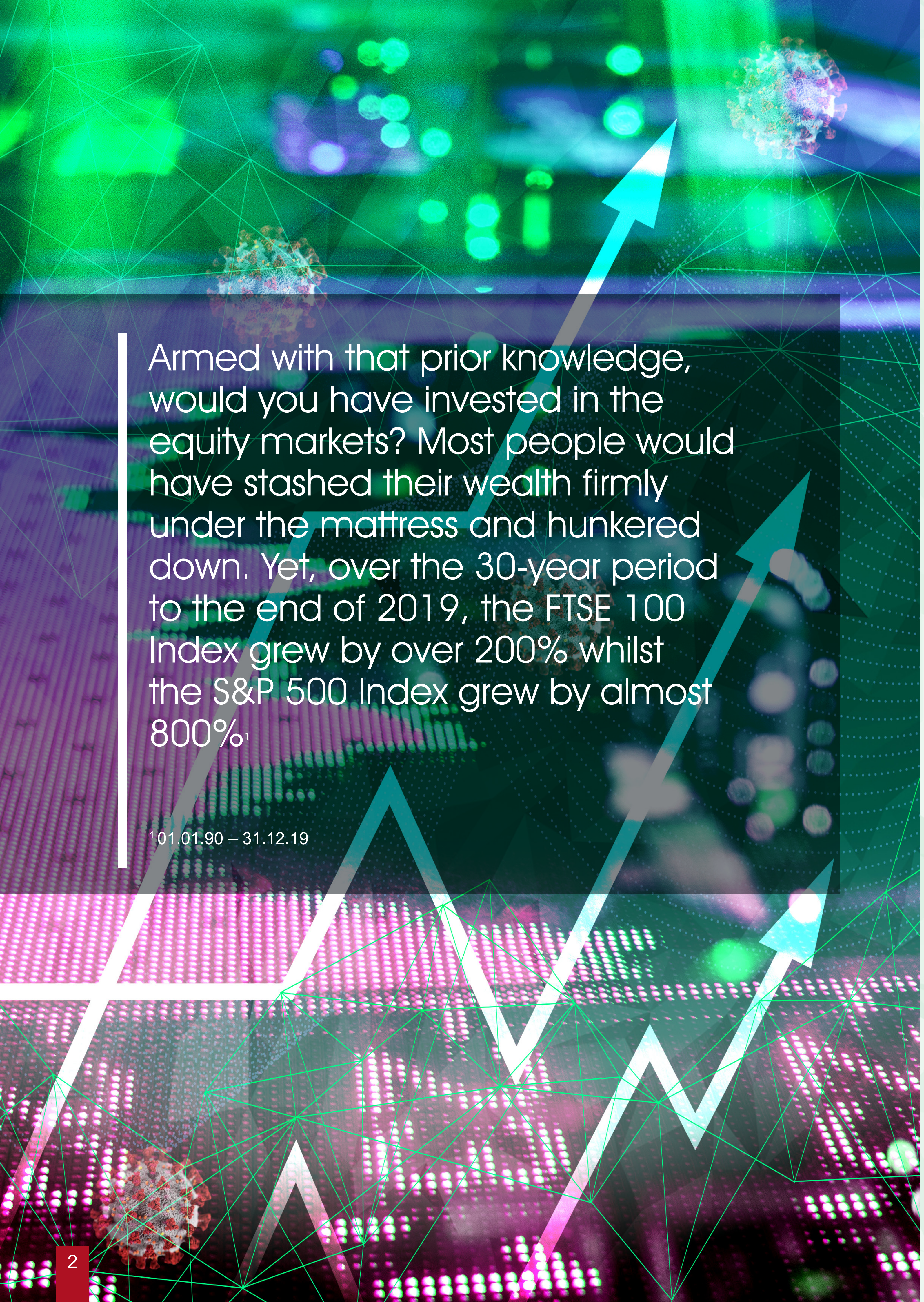
Janus Henderson
INVESTORS

WHITE PAPER

INVESTMENT THEMES FOR A POST-COVID WORLD



Armed with that prior knowledge, would you have invested in the equity markets? Most people would have stashed their wealth firmly under the mattress and hunkered down. Yet, over the 30-year period to the end of 2019, the FTSE 100 Index grew by over 200% whilst the S&P 500 Index grew by almost 800%[1]

[1] 01.01.90 – 31.12.19

INVESTMENT THEMES FOR A POST-COVID WORLD

Humankind obliterated from the face of the earth as a consequence of a global and lethal virus has proved to be fruitful subject matter for novelists and film-makers alike – hence the success of books like The Andromeda Strain and movies like Contagion. Despite being fictional, these portrayals are terrifying. It's hardly surprising, therefore, that when a real-life pandemic – the novel coronavirus, also known as 2019-nCoV and SARS-CoV-2 – grips the planet, a descent into panic borders on the inevitable.

Whilst the waters we're currently navigating are largely uncharted, we do know that it's instructive to look to historical data for direction, and to explore how markets have reacted over time during previous epidemics and significant geopolitical events. Such an exploration reminds us of three things:

- predicting the exact spread of an epidemic or its economic effects with any precision is nigh on impossible
- previous pandemics have adversely affected markets, and often profoundly, but those markets have always recovered
- whilst it's natural, and in the main prudent, to want to reduce one's exposure to riskier assets, the best overarching strategy is to stay calm whilst invested.

Constructing a scenario to endorse that strategy is far from difficult. Imagine, therefore, that, at the beginning of 1990, you were in possession of two things: a healthy amount of capital to invest and a supremely efficient crystal ball which allowed you to see the future with total clarity. Projecting forward over the ensuing 30 years, your trusty crystal ball would have revealed the impending arrival of:

- four bear markets
- the first and second Iraq wars plus the conflict in Afghanistan
- 9/11
- the demise of a major hedge fund, Long Term Capital Management, which almost collapsed the entire global financial system
- the bursting of the largest investment bubble in financial history
- a global financial crisis almost on a par with the great depression of the 1930s.

Armed with that prior knowledge, would you have invested in the equity markets? Most people would have stashed their wealth firmly under the mattress and hunkered down. Yet, over the 30-year period to the end of 2019, the FTSE 100 Index grew by over 200% whilst the S&P 500 Index grew by almost 800%[1]. Knowing what they know now, the smart response from our hypothetical investor couldn't be clearer: they should have invested in the markets. Admittedly, each of the aforementioned crises hit the markets hard but, not only did those markets recover, they rose to new all-time highs. Whilst waiting for that recovery to take hold, the majority of investors would have missed out on the best days to be in it – proof, if proof were needed, that time in the market is much more important than timing the market.

[1] 01.01.90 – 31.12.19

It's a maxim that's well worth heeding – not only is the current pandemic nothing new, but experts the world over are confident in the view that it's unlikely to be the last, with some publicly predicting that humanity will be forced to confront a major crisis caused by the emergence of a virus every five years on average, given that the world's population is becoming both increasingly dense and increasingly mobile.

The table below shows the impact of previous outbreaks:

Epidemic	Result
SARS-CoV - 2003	8,098 people infected across 29 countries, 774 deaths, Nearly 10% fatality rate.
Swine Flu (H1N1) 2009 - 2010	300,00 people died with more than 12,000 dying in the US. THere were cases of Swine Flue in all 50 states.
MERS-CoV - 2002-present	MERS cases have been reported in 27 countries, killing 858 people. THe mortality rate was about 35%.
Ebola - 2013-2016	28,600 cases of Ebola were reported with 11,325 deaths - about 40% fatality rate.
Zika - 2015-2015	Over 500,000 cases of infection in the Americas which resulted in nearly 4,000 confirmed cases of birth defects in newborns.
Seasonal Flu (Influenza B)	9.3 million - 45 million cases annually in the U.S. and between 12,000 and 61,000 deaths.

Source: Centers for Disease Control & Prevention and the World Health Organization.

Six months after COVID-19 caused global markets to crash, and sent economies across the globe spiralling into lockdown-induced paralysis, considerable uncertainty remains regarding what the post-COVID world will look like and the full extent of the damage that has been inflicted.

On 19th February, the US stock market, as measured by the benchmark S&P 500 Index, hit an all-time high. Within just 22 trading days, the Index had dropped by 30% – the fastest stock market crash of that magnitude ever to occur in the US, surpassing even the speed of the great stock market crash of 1929 which triggered the Great Depression.[2] Almost every stock market in the world has been similarly affected, with most having experienced declines of over a third in value … such as the UK's FTSE All-Share Index which fell by almost 35% from its 2020 peak to its low-point in March.[3]

[2] Source: Bank of America Global Research
[3] Source: 17.01.20 – 23.03.20

After this severe and rapid downturn, as markets began fully to grasp the significant economic implications of a world where almost half of the population of the planet was in lockdown, assets have regained ground substantially. Between 23rd March and 11th September, the FTSE 100 index rose by over 20% and the S&P 500 Index by almost 50%. Whilst the rally is encouraging, there is a sense that markets may have been over-optimistic given that the likelihood of economic disruption lasting well into 2021 or possibly even 2022 is not low, and that many countries are felt to teetering on the brink of a second wave of infections.

A key question arises therefore: are any broadly consistent themes emerging for a post COVID-19 world which give a clear indication of how fund managers are seeking to respond to the pandemic in an attempt to maintain the momentum? Based on our research, four key investment themes seem to enjoy widespread support.

FLIGHT TO QUALITY

Quality never goes out of fashion. In a world characterised by unprecedented uncertainty and resultant market volatility, the defensive virtues of high quality stocks are difficult to ignore… which is why they are likely to remain a core holding of many portfolios for the foreseeable future particularly given that, since the theme is global in nature, it can be applied in all equity markets.

When defining 'quality', the key criteria are typically a strong balance sheet, low gearing, high profitability and good visibility on earnings growth. Quality stocks are known to deliver above average returns during downturns – and indeed recessions – and indeed this was manifest during the first half of the year as the major economies struggled to function with any semblance of normally.

Naturally, these stocks may look expensive relative to the sector and, to that point, some might well claim that their high valuation is their single biggest disadvantage. Nevertheless, and whilst few managers chase quality at any price, we're minded to heed the words of Benjamin Franklin: "The bitterness of poor quality remains long after the sweetness of low price is forgotten." Quality stocks may well continue to be expensive but are likely to prove resilient in what would seem to be a low growth environment for some time to come, and one experiencing significant structural change, obvious trends being deglobalisation and the need to deleverage. All of these factors should serve to fuel sustained demand for quality stocks, thereby safeguarding their higher valuations.

DEGLOBALISATION

The risks inherent in outsourcing the bulk of production to a single specific geographic area were becoming more apparent due to issues before the current pandemic, not least due to the ongoing trade war between the US and China. The COVID-19 crisis has led both governments and businesses around the world to consider more deeply the vulnerability of their production capabilities, and so there seems little doubt that we will see an acceleration of the trend towards deglobalisation and the reshuffling of global supply chains towards local production on a regional basis, already underway in a number of major economies over recent years due to a combination of technological innovation (allowing shorter supply chains), and rising wages (and therefore manufacturing costs) in emerging countries.

The significant commercial risks of economic stoppages and supply chain disruptions have been markedly exposed by the pandemic and, in particular, the high dependency of most global businesses on China's manufacturing output. Governments have therefore responded by embarking on a range of initiatives designed to stimulate the increased domestication – or 're-shoring' as it has come to be known – of production capabilities. For example:

- Japan has declared its intention to allocate $2.2 billion of its record $993 billion stimulus package to assist domestic manufacturers in the relocating of production from China either back to Japan or elsewhere in south-east Asia
- The US is contemplating funding the relocation costs of domestic manufacturers looking to exit China
- Trade commissioners in the EU have declared an intent to dilute their trade dependencies outside the region, thereby bolstering the bloc's strategic autonomy
- After announcing a much lower tax basis for new manufacturing companies relocating to India, the government has offered generous incentives to manufacturers seeking to move out of China.

The beneficiaries of this growing phenomenon will be local economies everywhere, with China almost certainly finding itself compelled to reorientate its activities more towards domestic demand. Most governments will experience strong pressure to enhance self-sufficiency in strategically important areas, healthcare and medical supplies being an obvious example.

More specifically, the growing redistribution of supply chains under a widespread 'homecoming' policy is likely to benefit southern Asian countries for low-end consumer goods, as well as 'tech-heavy' Taiwan and South Korea for sophisticated components and products, given the global technological disruption brought about in the fields of 5G, artificial intelligence and the 'Internet of Things'. In the North American markets, this is expected to benefit Central America and the Caribbean and, in both the US and Europe, the major winners will be those businesses operating in the high value-added industries, such as pharmaceuticals and advanced engineering.

TECHNOLOGY

Certain themes are referred to as ‘structural’ or ‘secular’, in that they operate both globally and largely independently of the economic cycle. Technology is one such theme, and it has grown in significance as a result of the coronavirus crisis, which has revealed major constraints on networks, businesses and individuals. There is little doubt that, as digital transformation inevitably accelerates, operational practices and methods of communicating with customers, suppliers and colleagues will change permanently into the future, and working from home and relying on remote access becomes accepted as an increasingly viable way to function, having been put to the test during the COVID-19 lockdown. Online communication and collaboration platforms, such as Microsoft Teams, Zoom and others, have become new corporate forums rather than used simply for face-to-face meetings or phone calls as previously. As a consequence, we would anticipate the world’s leading technology companies to continue to dominate investor returns. In May, Satya Nadella, Microsoft’s chief executive officer, referred to “two years of digital transformation in two months”.

Furthermore, none of us will have been unaware of the marked shift towards online shopping, and the resultant spike in e-commerce sales, which were already booming well before the coronavirus emerged on the horizon – the crisis will only serve to accelerate that switch from ‘bricks to clicks’. Whether it’s driverless cars, digitalisation in financial services, or robotics in manufacturing, most sectors of the economy are seeing paradigm shifts in the way business is conducted. Indeed, the protracted lockdown periods which were imposed on the populations of all five continents led to a hitherto unseen intensity in use of the internet. In the US, for example, surfing exploded by 50%, forcing various services, such as Netflix and Facebook, to reduce the quality of their streaming by 25%. The need for businesses to enhance their communications infrastructure, thereby accelerating both productivity and efficiency, has now become mandatory rather than simply pressing.

More business will be handled remotely, requiring improved internet services, bandwidth, streaming technology and training, and more goods will be delivered directly to homes or businesses, driving increased sophistication in warehousing, logistics, and distribution. Disruptive technologies are at the forefront of this progress, 5G – the fifth generation of wireless technology – being the leading example. Among others, it encompasses component and mobile network operators, semi-conductors, antenna towers and software companies. A potent stimulus for digital transformation, it is markedly expanding the potential for artificial intelligence, the ‘Internet of Things’, robotics and automation, and cloud computing, all brought about by massive advances in speed and reliability, coupled with a sharp reduction in energy consumption. The appeal of artificial intelligence, for example, is that it is considered as a technology which can be embedded in almost every stage of a company’s value creation process, and can benefit a wide range of sectors: media, telecoms, consumer staples, financial services and healthcare to name but a few, its core benefit being improved collaboration between humans and machines, thereby enhanced productivity and lowering costs.

[4] Source: MSCI World Index, 01.01.20 – 30.06.20

HEALTHCARE

Whilst most sectors have endured something of a battering post-COVID, healthcare – somewhat unsurprisingly – has weathered the storm reasonably well: at the mid-year point, it was one of only three sectors to show a positive return year to date.[4]

Three factors largely explain this superior performance:

- businesses manufacturing the equipment required to treat pandemic sufferers have experienced a marked increase in demand;

- a similar boost in demand has been for seen for COVID-19 testing and diagnostics specialists, both for the presence of the virus itself and for the antibodies to detect a previous infection;

- with hopes for a return to 'normality' hinging on the discovery of a vaccine, all those businesses involved in medical research and trials (over 100 potential vaccines are currently in development) are being viewed closely, and enthusiastically, by fund managers and the wider investor community alike.

Moreover, even prior to COVID-19, the healthcare sector was trending positively and there are multiple reasons to conclude that, even after the emergence of an effective vaccine, we believe, it could remain a sustainable growth area for some time to come, with demand remaining robust across the globe – the pandemic has merely accelerated that growth. A number of factors are pertinent:

- **Enhanced Resilience:** in common with the financial services sector, which invested heavily in risk management after the global financial crisis of 2008, the pandemic has firmly placed under the spotlight those countries whose medical services fell demonstrably short when they were needed most, and a lengthy period of uplifted spending by many nations is widely anticipated;

- **Ageing Populations:** the simple demographic challenge throughout the majority of developed countries is that people are living too long (in the mid 1700s, UK life expectancy was under 40, yet it is now over 80), which places an ever-increasing burden on national health services, driving an acceleration in spending;

- **Efficiency:** vast proportions of state healthcare spending are regarded as allocated unwisely at best, and entirely wasted at worst, and there will be a renewed focus on ensuring that taxpayers receive improved value for money, creating a significant opportunity for innovation-driven efficiency, particularly in areas where little in the way of innovation currently exists, such as generic drugs and relatively standard equipment and medical procedures;

- **Technology:** whilst innovation in healthcare is hardly new, the current importance of technology to the sector could not be more pronounced, from the delivery of medical services via mobile phones and laptops, to video-conference consultations with doctors, to the use of artificial intelligence in the quest for a coronavirus vaccine; there has been a huge increase in medical research and development spending over the last decade and the resultant stream of new, disruptive technologies is in itself creating new markets in healthcare;

- **Emerging Markets:** increased healthcare demand is a phenomenon associated not solely with developed markets and, across many emerging nations, greater access to healthcare – a function of growing urbanisation and the burgeoning middle classes – should see medical industries as source of long-term growth potential over the next decade, driven primarily by Asia.

Across the world, the coronavirus crisis has compelled investors to confront two fundamental, but intrinsically linked, issues: first, and more immediately, to ensure that their portfolios are shielded – to the extent that it's possible – from the worst ravages of the pandemic and its resultant effect on economies, and, second, to determine which areas of the investment landscape appear more prosperous once the worst of the crisis is behind us.

Addressing the first issue is largely about examining balance sheet strength, the ability to manage costs dynamically and structural demand; in developing this thinkpiece, we have attempted to shed some light on the second, and to unearth a number of key themes which are engaging the close attention of Janus Henderson's investment trust managers. In so doing, we have tried to identify investment areas which are not simply places to 'hunker down' defensively during a crisis, but which offer genuine opportunities for long-term growth.

We hope you find it useful.

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