Quarterly Thought Piece
October 2020

NOVAPORT CAPITAL

Change = opportunity

The trends which have been driving markets have remained the same for a long time.

1. Cheap money
2. Scarce growth

Anyone who has taken an interest in stock markets over the last decade has needed to take a view on the valuation of growth (and in particular technology stocks). There has been a lot written about this topic so we will summarise it briefly:

- 'Cheerleaders' for the IT sector have justified extreme valuations as an outcome of businesses at the forefront of changing technology. They are expected to innovate and expand in a world where interest rates are low, and growth is scarce. COVID-19 has reinforced this, boosting technology expenditure while shutting down many other industries.
- 'Sceptics' highlight the eye-watering premiums being paid for growth which raises the stakes to a point where there is extra-ordinary downside risk should these companies fail to meet the market's lofty expectations.

The cheerleaders have been in front and enjoyed rising share prices on expanding multiples which have been supported by falling interest rates. At the same time, despite deploying monetary stimulus in the most aggressive manner anyone can remember, economic growth failed to inspire, even prior to the COVID-19 gut-punch. Cheap money has driven markets ever higher and technology stocks have led the way.

The backdrop is changing

investors have heard this all before. What is new, is the growing consensus that now is the time for fiscal policy to take the lead. The recent Australian Federal Budget is a clear example of this. The coalition abandoned their long held fiscal conservatism and embraced a big spending, debt funded budget. The question investors need to ask themselves is whether this change will alter some long-entrenched dynamics in the market?
In short, we think it does.

Easy money as far as the eye can see

since the GFC central banks have forcefully deployed monetary policy. The result has been a long, although at times, fragile, economic expansion. Yet despite falling unemployment and easy money, economic growth has failed to generate inflation which has helped keep interest rates low.

Monetary intervention may not have supercharged inflation nor growth however it has been spectacularly successful in supporting asset prices. The last two years provide two outstanding examples. From mid December 2018 the small ordinaries index rebounded 17% over three months in response to the US central bank's concerted efforts to reignite credit growth via expanding liquidity in the Repo market. Secondly, in the second quarter of this year, in response to extravagant stimulus, the small caps index recovered some 34% from its COVID-19 lows. These gains were made despite ongoing uncertainty and economic fallout from the global pandemic. In both cases, central bank announcements were the catalyst which turned the market around.

There can be little doubt that monetary policy supports asset prices, or that the benefits also trickle down into the broader economy. We believe that it would take a significant and unexpected event to dissuade central banks from providing markets with cheap and abundant credit. Absent a currency crisis, easy money seems here to stay.

Fast & furious fiscal policy

in the aftermath of the GFC governments were reluctant (or discouraged) from providing strong fiscal stimulus. Austerity measures were enforced in Europe. In the USA, growth in government spending was constrained by legislative roadblocks and arguments about the debt ceiling. Politics made fiscal stimulus an unrealistic option.

Today, post the initial COVID shock, the narrative has changed remarkably. Fiscal stimulus is now at the forefront economic policy discussions. Central banks are openly calling for fiscal intervention. Governments have abandoned caution and are expanding deficits at extraordinary rates. Even governments which had previously upheld fiscal restraint as a hallmark of prudence (e.g. Australia and Germany) are now embracing deficit spending. The change has been fast, furious and it cannot be ignored. **It is both a change in narrative and a fundamental change. Investors must adapt their outlook to account for it.**

What does it mean

central banks have limited capacity to cut interest rates much further however it seems likely they will maintain low interest rates for a long time yet. It is important to understand that expansionary fiscal policies are aimed at providing additional stimulus and are not a replacement for monetary stimulus. **We expect fiscal and monetary levers will be deployed simultaneously until inflation is firmly established.**

A difference between the fiscal and monetary policy levers is that unlike monetary policy (which relies on the financial sector to channel stimulus to the economy) fiscal measures enable the government to target their stimulus via tax and spending initiatives. *For example, youth employment is being directly stimulated with wage subsidies for trainees / younger workers.*

Owners of assets (such as houses) were frontline beneficiaries of decades of monetary stimulus. Lower interest rates reduced holding costs and increased asset values. However, the recent Australian federal budget's emphasis on fiscal policies to stimulate the economy will now channel money to corners of the economy which may have been at the back of the 'monetary queue'. Job seekers, unemployed youth and parents using childcare have all benefited from government spending targeted to improve their circumstances.

It is important to note that Australian voters appear to have applauded the budget, which will likely encourage continued fiscal activism by governments. We observe similar experiences overseas. Central banks have also been supportive and expressed a greater tolerance for any ensuing inflation.

The outcomes are,

1) Central banks want higher inflation and want governments to spend money to create it.
2) Fiscal spending seems to be popular and is winning voter support (so governments will probably continue doing it), and
3) There is little risk that central banks will spoil the party by increasing interest rates.

Change creates opportunity

we believe the renewed appetite for large scale government spending will drive growth in segments of the economy which had not benefited directly from monetary stimulus. Some sectors where we see possible benefits accruing from increased fiscal stimulus include:

i) Consumer spending
ii) Infrastructure and regional development
iii) First home buyers
iv) Health, (non-university) education, childcare, aged care
v) Government service providers

In the last decade monetary policy dominated economic planning and successfully supported economic growth, yet the recovery was fragile and narrowly focused. These economic settings failed to create an abundance of captivating growth themes for investors. As a result, technology stocks did not have to contend with much competition for investors' attention and thus attracted significant valuation premiums.

Today we are witness to a significant change. Governments around the world are deploying fiscal stimulus aggressively. If sustained, we believe alternative themes and investment opportunities will emerge in new companies and sectors. An opportunity arises from this change because some of these businesses have been languishing for years and are 'priced' for limited growth. Investors looking to profit from this change are likely to find opportunities across a broader range of sectors and not confined to the technology sector.

In summary, for decades monetary policy has been the preferred method of supporting the economy. As such, economic stimulus has largely been allocated by banks and credit markets or expressed in asset prices and wealth effects. Fortified fiscal policy will now see governments assume a much more important role in allocating economic stimulus. The incentives for Governments and markets are vastly different, therefore we expect quite different outcomes. This will change economic dynamics. In our experience, change creates opportunities, and when combined with our optimism that the world will develop effective treatments for COVID-19, we see exciting new prospects for investors beyond last decade's winners.