PERSPECTIVES, MARCH 2020

COVID-19: Portfolio Playbook

As the fallout from COVID-19 impacts our professional and personal lives, we have received numerous questions from our clients about what segments of their portfolios are most impacted. These concerns have been amplified by the sudden and swift movements in equity prices, interest rates, bond spreads, and commodity prices. To protect the health and well-being of capital markets, central banks around the globe have reached into their Great Financial Crisis toolkits to calm investors and restore order. Going further than they did during the last recession, the Fed is about to embark on buying corporate bonds through two new facilities to provide liquidity as fund flows pressure money managers and ETFs to sell short duration securities. This is in addition to unlmilited purchases of Treasury and mortgage-backed securities. Given this backdrop, and as a result of conversations with our clients, we thought we would share a playbook our analyst team created to identify which industries were facing the most scurtiny.

Travel and leisure

Airline traffic has collapsed to levels approximating a complete shutdown and exceeding the drawdowns experienced in any historical crises. Despite entering the year with a healthy industry structure and financial position, the unanticipated demand shock and potential for a full domestic shutdown has led U.S. airlines to petition the federal government for broad-based assistance. Looking beyond the immediate term, the lost demand has been partially offset by much lower oil prices contributing to a lower industry cost structure given limited hedging. Beyond the U.S., the situation is more dire for foreign airlines competing in more fragmented markets with less mature competitive environments. With North American routes forming a fifth of global air traffic yet driving two thirds of global profitability, restrictions on international routes to the U.S. are disproportionately painful for foreign carriers. For Europe in particular, where the bottom 35% of carriers lost money or broke even in a relatively strong 2019 and hedged 2020 fuel at prices at higher levels, the COVID-19 response is likely to drive an accelerated period of industry consolidation and global capacity reductions. Despite substantial financial flexibility relative to historical metrics and a favorable competitive position, U.S. airlines are sensitive to the duration of the disruption. Yet to the extent traffic has begun a process of recovery in the third quarter, the industry backdrop into next year will be exposed to a confluence of tailwinds.

The COVID-19 outbreak is impacting hotel bookings and setting up the lodging sector for its worst year since 9/11 in 2001 and the Great Financial Crisis in 2008/2009. U.S. RevPAR (revenue per average room) is expected to heavily decline due to the impact of event cancellations and less travel. We remain hopeful that we will see progress on fighting the virus by May or June, but a recovery to pre-outbreak levels will be slow, as businesses may remain cautious about corporate travel and social distancing practices may continue beyond any recovery. The magnitude of the earnings hit from COVID-19 is difficult to estimate, but to contextualize the magnitude of these slowdowns, we saw 18% declines in RevPar and a 2-year recovery in 2009 and after 9/11 to pre-event levels, with an average EBITDA decline of 30% across the hotel sector

Car rental companies will be impacted on two fronts, first through lost demand and secondly through lower residual values on vehicle dispositions. Truck lessors are experiencing substantial disruption but maintain robust balance sheets and customer contracts working to partially mitigate near term disruption. Additionally, the sector exhibits countercyclical cash flows as the lessors dispose of fleets to match demand.

Retailers and restaurants

Before the outbreak of COVID-19, department stores were already in a weakened position due to lower foot traffic and e-commerce disruption. But despite a weakening earnings profile, we feel the investment grade department stores are sufficiently capitalized and have adequate liquidity to weather a harsh downturn, though we may witness ratings downgrades pushing issuers into high yield indices. The department stores are cognizant of the huge free cash flow pressures they currently face, and our view is share repurchase activity will be pulled back, with reductions in capex, and potentially a reduction in dividends to shareholders.

The rapidly adopted practice of social distancing and government mandated takeout and delivery only food service will have a detrimental effect on the restaurant industry. Larger, investment

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grade companies should have the operational and financial capability to weather a downturn. For quick service restaurants that have a high percentage of revenue from takeout and drive-thru, a dine-in restriction should not be overly problematic.

Energy

COVID-19 is causing a demand shock in the energy sector. Oil prices are further pressured by a supply shock caused by a sudden breakdown between major producers who once supported prices with quotas, to now competing in an all-out price war. We expect bankruptcies (high yield entities) and fallen angels (investment grade entities) to pick-up in the energy sector despite companies having shored-up their balance sheets and lowered their cost structure compared to the last downturn. Within energy, investors should focus on midstream companies that have operations backed by fixed fee contracts, are with companies that have large diversified integrated systems, and whose volumes are demand-pulled (counterparties with utilities and refiners rather than producers).

Automotive

COVID-19 will significantly disrupt the automotive industry, which had already been dealing with underlying cyclical and fundamental issues before the outbreak. A double-sided hit from the supply and demand side is expected to meaningfully impact sales and profitability in 2020 for the industry. Auto manufacturing plant shutdowns will significantly affect supply, having a ripple effect from the auto assembly plant to auto parts manufacturing to dealerships. U.S. domestic automakers could lose roughly 50,000 vehicles per week from plant shutdowns. Dealerships will face supply disruption from lower parts deliveries as well as lower vehicle inventories. On the demand side, global vehicle sales will be weakened by lower discretionary spending and an uncertain economic backdrop. U.S. auto sales, which peaked in 2016 at roughly 18 million vehicles sold, could challenge the lows of 2008 when about 9 million vehicles were sold.

Auto and auto parts manufacturers face significant credit and balance sheet pressures due to supply chain interruptions and demand slowdowns ahead. Many are in liquidity protection mode and have fully drawn on credit facilities and revolvers in preparation for tougher times ahead, including the large domestic automakers. Government stimulus and central bank actions are expected to relieve some liquidity concerns, but only partially.

Basic materials

Petrochemical producer business models for North American producers relies on capturing the arbitrage between lower cost natural gas feedstocks used along the U.S. Gulf Coast and the higher priced petroleum-based feedstocks (Naphtha) used throughout Europe and other higher cost regions. Aside from the demand impact, the sudden decline in oil prices has eroded this central profitability advantage of the business model and will likely exist as an overhang for the foreseeable mid-term. As a mitigant, the premier petrochemical producers maintain sound balance sheets and still exist at the lower end of the now flattened global cost curve. They maintain substantial levers and motivation for defending their investment grade ratings, with the ability to contain the problem to earnings weakness.

Agri-chem producers are relatively sheltered from many of the above impacts, aside from general demand destruction tied to COVID-19. The sector has been working through a down cycle over the past year, driven by excess supply and the effects of trade friction. However, the sector is investment grade with generally strong balance sheets.

Having recently exited a commodity crisis in 2015-2016, the mining sector enters this crisis with strong balance sheets, management focus on cyclically robust behaviors, and more efficient operations. Substantial margins exist below current spot prices for most producers and CAPEX budgets are reasonable. Additionally, producers are experiencing cost relief from local currency weakness in their jurisdictions as well as the decline in oil prices which remains a substantial input.

Media and entertainment

The media and entertainment space can be split into certain subsectors which are defensive in nature, such as entertainment providers who benefit from people being at home. On the opposite side of the spectrum, broadcasters, who derive a portion of revenues from advertising will experience volatility, in particular those reliant on live sports, which are virtually nonexistent worldwide. These broadcasters will continue to see financial and programming disruption as they are paying for sports rights and expect to see advertising dollars decline. Additionally, movie releases are being delayed due to governmental decrees for social distancing and crowd avoidance, impacting major releases for studios. Additionally, ad agencies that derive large portions of revenue from traditional advertising, will be hit particularly hard by lower advertising spending.

Technology

In the technology space, we are focused on semiconductor manufacturers, which operate complex global supply chains and potentially face a demand shock as recession risks rise around the world. Smartphone sales and corporate IT spend could be hardest hit in an extended economic downturn while software and IT services should be more resilient. Due to a potential slowdown in smartphone, server, storage, and networking gear, manufacturing leaders like Flex generate the bulk of their sales from those industries.

Insurance

COVID-19 has introduced four main risks to the insurance space: (1) unprecedented low interest rate levels (2) potential for mortality spikes (3) increase in business insurance claims (4) equity market volatility. Each is negative for the overall industry, varying by different degrees by risk and company. Most pressing is the sharp reduction in interest rates to the life insurance industry. While the sector's solvency and liquidity are not at immediate risk and a commitment to asset-liability matching should help ensure that rate moves do not impair the sector's economic profile, regulatory accounting does not mirror economics entirely, potentially exposing gaps that could impact capital adequacy. In addition, the sector's ability to mitigate extremely low interest rates is somewhat limited, increasing the risks for further spread decompression and negative outlooks, though rating actions are not expected in the short term. Property and casualty companies face the risk of elevated claims from business interruption, though the impact is projected to be comparable to a mild-to-moderate hurricane, which typically results in manageable losses. While investment portfolios are also negatively impacted by low interest rates, the P&C sector is viewed as defensive during periods of volatility, particularly the brokers. Managed Care continues to benefit from the emergence of Joe Biden and the corresponding fall of Bernie Sanders, while user-adoption of cost-effective telemedicine is expected to accelerate due to COVID-19.

Consumer non-cyclical

Personal and household consumer product companies are always defensive given their durable business models, market leadership positions, and liquidity, but they also stand to benefit from consumers' COVID-19 concerns. An increase in dining at home is a short-term positive for both food and beverage companies as well as supermarkets, at the expense of leisure and restaurants. However, volatility is expected for those food and beverage companies who sell into bars and restaurants given social distancing, CDC guidelines to avoid groups in excess of 25 people, and outright bans on bars and restaurants. This will negatively impact food service providers and Wholesalers as the industries they supply close operations to limit the spread of COVID-19. Importantly, impact is company specific and dependent on degree of leverage, near term liquidity needs, geographic production and distribution as well as other factors with the larger, more diversified players better positioned to manage volatility.

Banking

Profitability will be under pressure as COVID-19 continues to take its toll on banks' operating conditions (weaker growth/recession, higher unemployment, lower interest rates and flatter curve) and asset quality (increased loan loss provisions, lower security valuations and weaker loan growth). Focus on banks that are solidly positioned in terms of liquidity, funding, and capitalization, which should allow them to weather the downturn for the foreseeable future.

Agency residential mortgage-backed securities (RMBS)

As a result of the wrap on these securities, credit losses are absorbed by the issuing Agency (Ginnie Mae, Fannie Mae, or Freddie Mac) and not borne by the investor. What will change in these securities is the speed of prepayments. Earlier in the year, as mortgage rates fell, the market forecast a large wave of refinancing and home sales driven by inexpensive borrowing. As social distancing expands and intensifies, courthouses close, and economic uncertainty grows, the number of home sales and mortgage refinances could slow relative to expectations. In addition, if measures to allow mortgagees to defer payments are passed, this could further influence prepayment speeds.

Asset-backed securities (ABS)

Within the broader ABS sector there are multiple asset classes that will all have varying degrees of impact from the current COVID-19 situation. Sectors with a high economic sensitivity should be viewed cautiously, including aircraft ABS, timeshare ABS, rental car ABS, container ABS, and railcar ABS. Whole business securitization, which heavily consists of franchise restaurants, should also be monitored as social distancing relegates restaurants in many areas to only drive-thru and takeout. Subprime consumers will be stressed and require extra monitoring. The relative safe havens within ABS are the senior tranches of prime auto and credit cards, as well as government guaranteed FFELP ABS. As with all structured product, it is important to know the details of the collateral in the individual bond and not paint a whole class with the same brush.

Commercial mortgage-backed securities (CMBS)

Agency CMBS guaranteed bonds will be directly supported by the Federal Reserve and will remain safe haven assets. Non-guaranteed agency CMBS bonds will be adversely impacted to the extent tenancy of the underlying multi-family collateral is compromised and more so for non-core assets such as manufactured, student and senior housing. More recent vintages with looser underwriting standards and lower levels of credit enhancement will be subject to more defaults and higher losses, but only for class B and C bonds.

Non-agency CMBS will benefit from the Fed's support of ABS and corporates, with commercial real estate (CRE) being an indirect beneficiary of aid provided to firms and mom-and-pop businesses, both large and small. Any fiscal stimulus will likely mitigate economic fallout, thereby cushioning the blow to the CRE sector. The tiering of quality among CMBS issuers will serve to distinguish the winners from the losers. Better metrics, such as loan-to-value ratio and debt service coverage and more favorable market statistics, such as primary market, trends of new construction, occupancies and rental rates, will further distinguish one deal from the next. Some property types, such as lodging and retail, will show signs of strain but the impact of a stressed economy will spread to office and multi-family soon after.

Longer term, we will likely see a more rapid shift in retail given the acceleration expected in e-commerce. Office use and the amount of space allocated per employee will likely come under review as employers evaluate the success (or lack thereof) of telecommuting and working from home.

Municipal*s*

There are segments of the municipal market that could be significantly impacted by the spread of COVID-19. Our primary focus has been on airport exposure, since airports are expected to suffer from reduced enplanements and lower rental car usage. Securities from airport issuers tend to be backed by general airport revenues or supported by rental car revenues. Positively, airports with residual rate-making agreements with airlines (which are the norm) benefit by being able to pass along revenue shortfalls from reduced enplanements to airlines.

Special tax (sales tax, gas tax, toll road revenue) securities could be impacted by decreased economic activity that leads to lower sales tax collections, and fewer commuters could impact gas tax and toll road revenues.

Despite increased demand and federal aid being positives for the hospital sector, resources are expected to be strained as more patient are in need of healthcare services. We are biased towards higher-quality, larger, geographically diverse healthcare systems.

As college students are being sent home due to fears surrounding COVID-19 spread, schools are facing strain on their resources as well as the potential for tuition reimbursements. There is also some concern regarding endowment investment returns in this negative market environment. Again, our bias is towards high-quality issuers with strong reputations, which should be able to support students during this period and continue to be an attractive destination to those pursuing higher education.

Our analyst team believes these sectors will be most impacted as measures to contain COVID-19 are kept in place. The more prolonged that steps like social distancing and stay-at-home orders are prescribed, the greater and deeper the contraction could be for the U.S. economy and these specific industries. The case could be made that every industry is impacted by the change in behavior of consumers, business, and governments. Hence the quick and robust response by central banks which recognize what is at stake. Lawmakers are working on a sizable stimulus package to aid the business community and to those employees that are directly impacted. Together, these actions should allow for a rebound in late 2020. Please contact us if you would like to discuss further.