ESCALA
PARTNERS

*June 2020*

# MONTHLY AGENDA: THE WALKING FED

*Chief Investment Office*

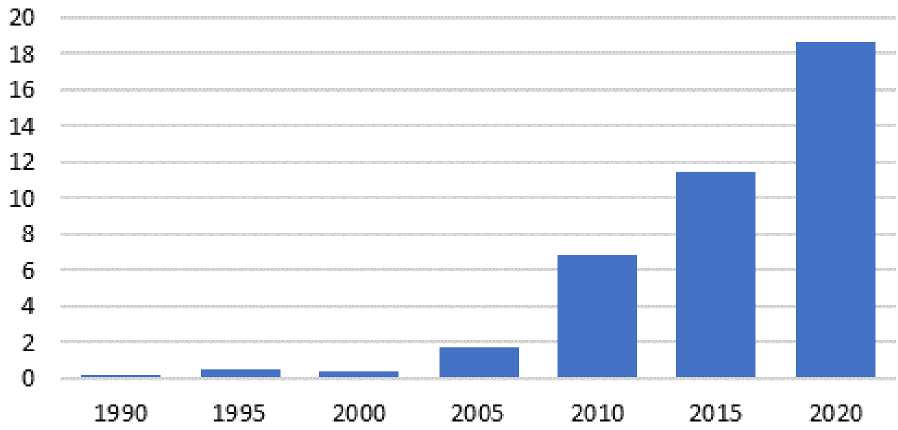
## The Walking Fed

Twenty years ago, "The Simpsons" famously aired an episode of Donald Trump as President of the United States. Ten years ago, the television series "The Walking Dead" introduced us to a virus that creates a zombie apocalypse on earth. Today, (the real) President Donald Trump oversees a virus-hit economy increasingly occupied by zombie companies. It's strange how prescient fictional television programs can be.

## What is a zombie company?

A zombie company is a company whose profits are less than its debt servicing costs. The term rose to prominence in 2018 when the Bank of International Settlements (BIS) researched the rising incidence of these kinds of companies. The BIS studied the factors behind the rising prevalence of firms that could not meet their debt servicing costs from current profits. It found the increase was linked to reduced financial pressure, which in turn was linked to lower interest rates in the economy.

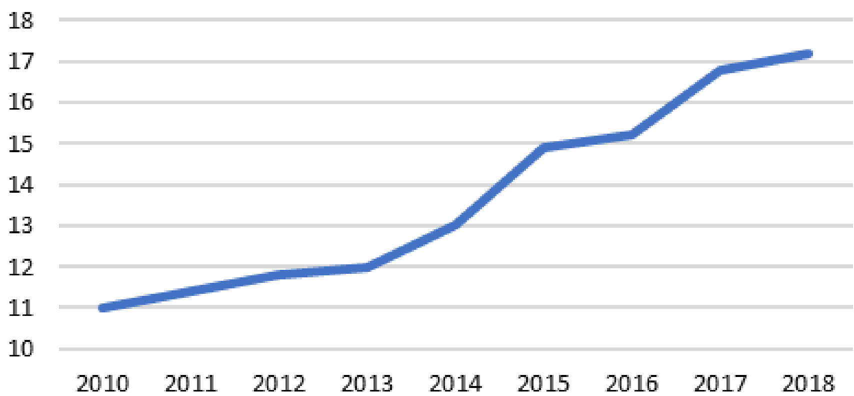
**Chart 1: The share of zombie companies listed in the US (%)**




Source: Deutsche Bank

Chart 1 shows how after a small decline in the late 1990s the number of zombie companies in the US increased in the early 2000s and then increased exponentially in the wake of the global financial crisis in 2008. A similar situation occurred in Australia (Chart 2).

**Chart 2: The share of zombie companies listed on the ASX (%)**




Source: Coolabah Capital Investments

True to their fictional form, zombie companies are a problem for society and for the economy. They are less productive than other firms; they crowd out investment; and they reduce employment at healthier companies.

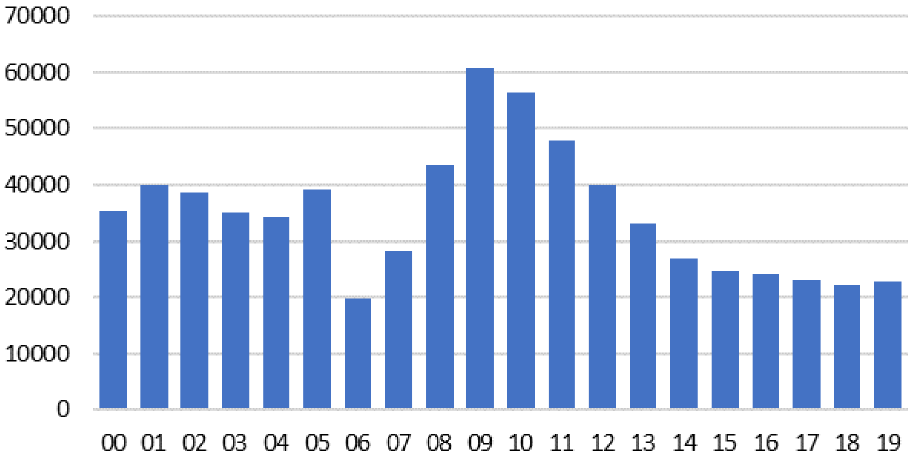
## How do they survive?

The rise and fall of zombie companies can be explained by the interest rate cycle. When interest rates are decreasing, highly levered companies have more room to survive and so grow and increase in number. When interest rates are rising, financial conditions tighten forcing companies to restructure or declare bankruptcy, therefore decreasing the number of zombie firms.

A healthy economy is one where companies are allowed to fail. Historically, one new business is born every minute in the US, while another one fails every eighty seconds[1]. In Australia, a new business is created every ninety seconds while one fails every one hundred seconds[2].

As can be seen in Chart 3 however, since peaking in 2009, the level of bankruptcies in the US has been steadily declining. There are around a third fewer bankruptcies today than the long run average.

**Chart 3: The number of US business bankruptcies**




Source: United States Courts

These members of the walking dead remain animated because they are being sustained by the US Federal Reserve (the Fed). Cheap credit is abundantly available allowing them to term-out their debt well into the future. A frighteningly high percentage of the record bond issuance in the US currently is targeted for refinancing purposes. A healthy economy would see such credit creation going toward new, productivity-enhancing, investment.

Never mind that profits are wafer thin and that their business operations aren't viable right now. As long as they are propped up by the Fed, investors are willing to lend to the zombies.

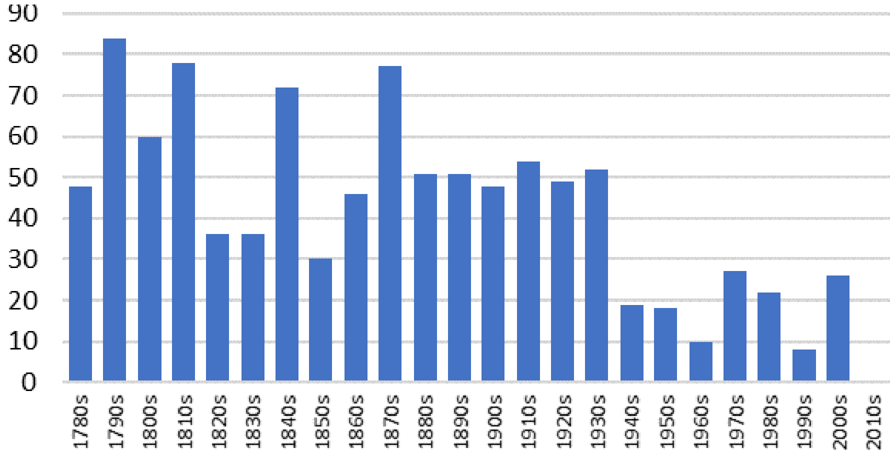
## Why is the Fed supporting the Walking Dead?

The US economy, like Australia, has just passed through one of the longest periods of uninterrupted economic growth on record. The expansion that began in 2009 was the longest on record for the US economy (until it ended in February this year). In fact, the twenty-tens was the first (and only) decade to have passed where the US didn't experience a recession (Chart 4).

This is good because it reduces the amplitude of the economic cycle and the level of uncertainty with it. It is bad because the side-effect is greater risk taking. US corporate debt levels have risen to the highest level ever as a share of GDP (Chart 5).

[1] U.S. Census Bureau, Business Dynamics Statistics
[2] Australian Bureau of statistics, Counts of Australian Businesses, Cat No. 8165.0

**Chart 4: The number of months the US has been in recession (by decade)**




Source: Deutsche Bank

As the late American economist Hyman Minsky wrote in his book "Stabilizing an Unstable Economy[3]", long periods of uninterrupted economic growth leads to complacency, and complacency leads to excessive risk taking which ultimately leads to vulnerability.

This has been proven to be true time and time again. The period from the mid-1980s to 2007 was known as The Great Moderation. The business cycle was thought to be dead. Economic growth was high and volatility was low. As we now know, complacency set in, imbalances built up and the onset of the global financial crisis in 2008 proved that the business cycle was very much alive.

**Chart 5: US corporate debt levels (% of GDP)**


Source: Bloomberg

Today, what the Fed, and indeed some twenty-five other central banks around the world, are trying to do is to stabilise the (now) unstable economy. Corporate debt levels have built up to such an extent over the past dozen years that the economy has become vulnerable. The illiquidity issues caused by the COVID-19 crisis risks transforming this debt load into a serious insolvency crisis.

The Fed is using every tool in its armoury to try and avoid this. Unfortunately, the tools available are far from precision instruments. In the process of supporting genuinely healthy companies, the Fed is also supporting the unhealthy. Fiscal policy is a far more precise instrument but has been missing in action until recently.

---

3 Minsky, H., 2008. *Stabilizing An Unstable Economy*. [New York]: McGraw-Hill.

## The consequences

An economy that is filled with the walking dead is one that is less dynamic, less productive, and less efficient. A healthy economy is one where the weaker companies are allowed to die, creating room for the living to thrive. This is known as “creative destruction”.

Business dynamism is inherently disruptive; but it is also critical to long-run economic growth. Research has shown that this process of creative destruction is essential to growth in the economy. More productive firms drive out less productive ones, new entrants disrupt incumbents, workers become better skilled and living standards rise. In other words, a dynamic economy constantly forces labour and capital to be reallocated and put to better uses.

Since 2008, the Fed has progressively interfered in this process. The original intention of the asset purchase program was to lift asset prices, raise the level of household wealth and so boost consumption. The problem with that thesis is that not everyone owns the assets whose prices are rising. And so instead of seeing a boost in wealth leading to a rise in consumption, we saw a rise in wealth for the higher income groups only.

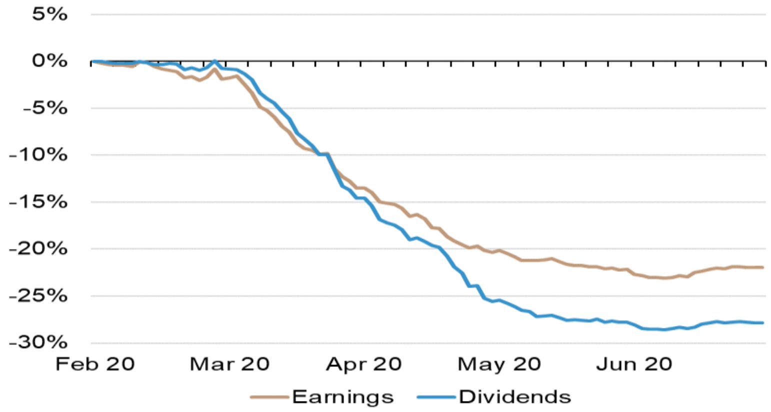
This time around the intention of the Fed to is to intervene in the market in order to “extend the cycle”. The level of corporate indebtedness is now so high that the process of creative destruction could potentially be too destructive for the economy to bear. Extending the cycle is seen as the next best option – encourage the economy to grow and inflate its way out of the debt issue.

## How do you survive a zombie apocalypse?

**Investors need to be equipped with the right tools in this environment:**

1. Know your zombies. This is where active management is required. Passively investing into an index assumes the benchmark against which the index is managed is a risk-free starting position. It is not. There are many risks embedded in a passive benchmark that are not worth taking. Active management allows investors to strip out the risks not worth taking and only take those that are.
2. Explore corners of the market where the walking Fed doesn’t tread. Private markets are becoming more interesting in this regard given they are outside the scope of the Fed’s asset purchase program.
3. Elevate risk management in your thinking. Investing in private or unlisted corners of the market introduces illiquidity risk which must be balanced within the overall portfolio. Having a genuine “liquidity bucket”, a portion of the portfolio made up of securities that have been liquidity tested under extreme conditions, will help to balance the overall portfolio.
4. Focus on growth over value. The growing number of zombie companies will weigh on economic growth by suppressing productivity. The implication is that interest rates and inflation will similarly remain low. In this environment, growth-oriented investors will do better than value.
5. Dial down the tactical tilts. A market haunted by zombie companies draws in short-term speculators looking to benefit from the momentum they create. This momentum can turn quickly making it a very difficult market to time. Only make tactical decisions when there is a clear and large disconnect. Otherwise, stay close to your strategic benchmark.

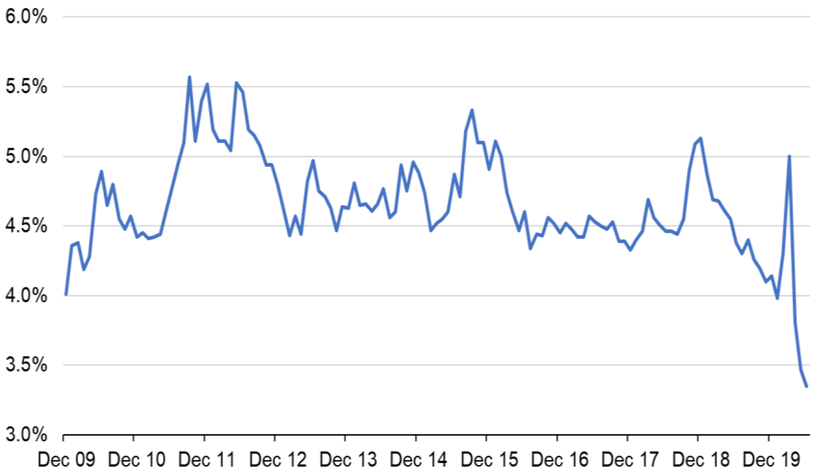
**Chart 6: ASX 200: Forward earnings and dividends revisions**




Source: Bloomberg

Forward earnings revisions for the ASX 200 have stabilised since early May, as analysts look towards the prospect of a recovery as the economy reopens. Since the market's peak in February, earnings estimates have been cut by 22%. Dividend forecasts, however, have been cut by a greater degree than earnings and are 28% lower as companies look to preserve capital and protect their balance sheets through this uncertain environment.

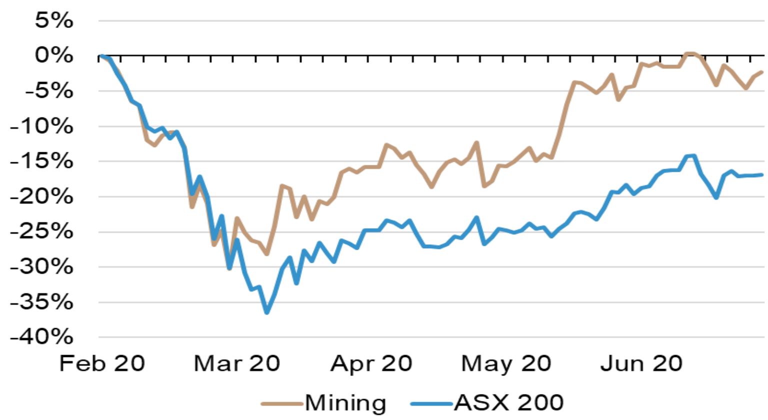
**Chart 7: ASX 200: Forward dividend yield**




Source: Bloomberg

With the Australian equity market recovering a substantial proportion of losses in the last three months, the forward dividend yield has experienced a large contraction. Currently, Australian equities offer a yield of just 3.35%, well below the average of the last decade, which detracts from the case for investing domestically.

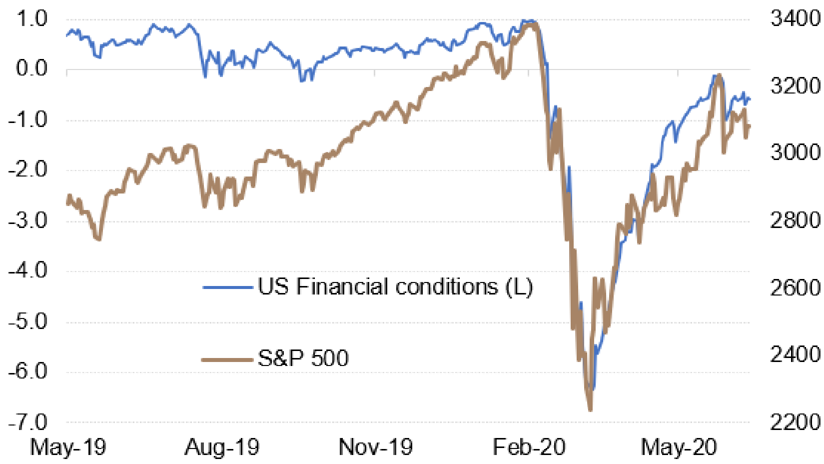
**Chart 8: Mining index vs ASX 200 since market peak**




Source: IRESS

Since the market's peak in late February, an index of the Australian market's mining companies has materially outperformed the ASX 200, a rare occurrence through a downturn. Mining shares are only slightly lower over this time, compared to the market's 16% decline, with commodity prices holding up relatively well on the combination of robust demand and disrupted supply.

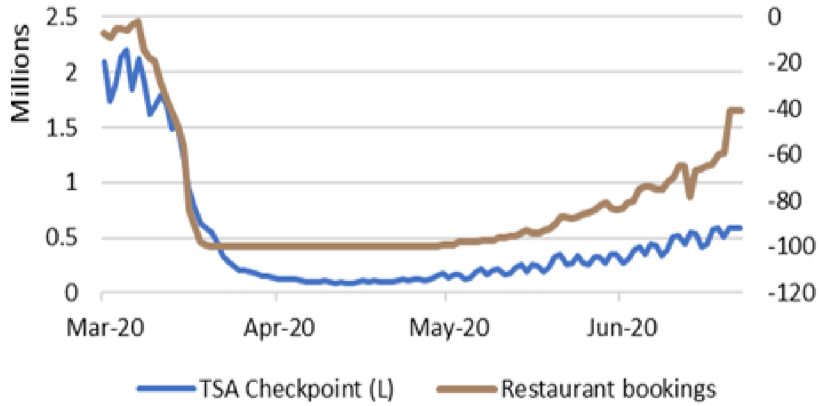
**Chart 9: US financial conditions continue to drive equities**




Source: Bloomberg

Governments around the world have approved almost $11 trillion to fight the pandemic, and an extra $5 trillion is still in the pipeline, according to the Institute of International Finance. That easily eclipses the stimulus provided during the global financial crisis. As the chart below shows, economic activity is beginning to recover as economies continue to open up.

**Chart 10: Activity indicators continuing to recover**




Source: Bloomberg

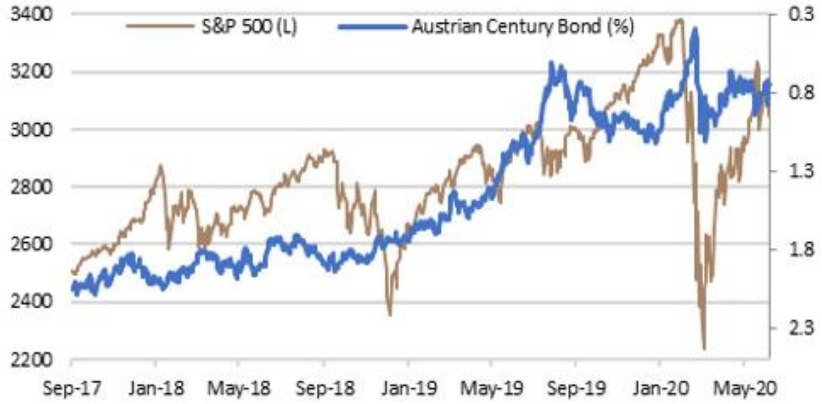
Despite an acceleration of the Covid-19 cases in a few states, business activity in the U.S., such as restaurant diners tracked by OpenTable and mobility monitored by the Transportation Security Administration (TSA), remains firmly on a recovery path. That's perhaps why risk markets remain resilient.

**Chart 11: Growth investors continue to trounce value**


**Source: Bloomberg**

The rotation to value stocks that seemed so full of vim and vigour a few weeks ago is fading again. Once again, the longevity of the rotation from growth to value was short-lived - compressed into the end of May, beginning of June. And while the ratio of the Russell Growth Index over the Russell Value Index surpasses the previous peak in 2000, the difference in valuation between the two indexes is far less extreme. Earnings among the growth companies, lead by the tech sector, this time around are substantially higher than in 2000.

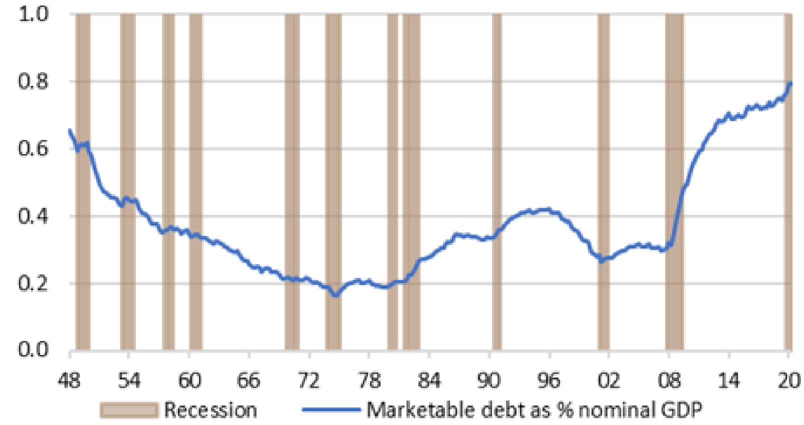
**Chart 12: The Austrian century bond vs US equities**




Source: Bloomberg

Austria's mandate to issue another century bond is bound to be lapped up after the runaway success of the 2017 issue. Investors who bought and held the 2.1% bond three years ago would have made a total return of 86%, a stunning annualized return of almost 25%, compared with 10.6% on the S&P 500 over the same period. The bond is not without risks. Investors who buy and hold it face an enormous duration risk at a time when it looks like bonds are in a bubble. At current levels, the 97-year maturity is trading on an equivalent P/E of 114 times, and - unlike equities - won't pay a cent more than promised.

**Chart 13: US debt outstanding as % nominal GDP**




Source: Bloomberg

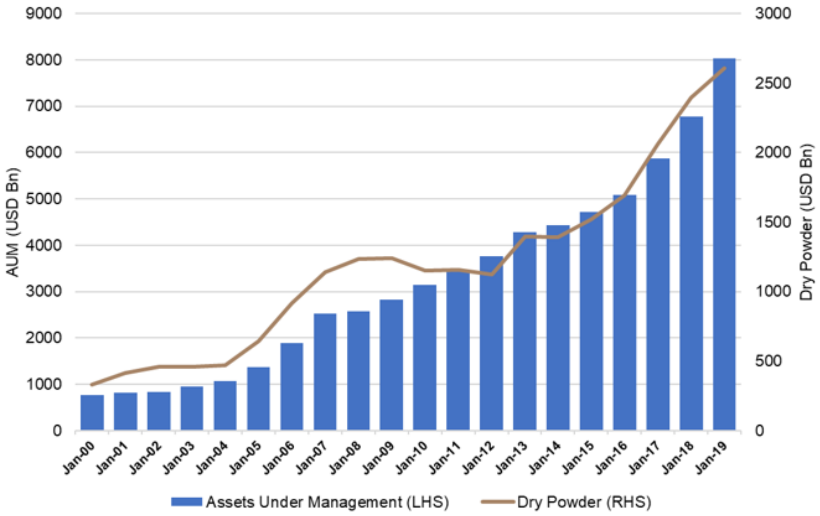
The $17.1 trillion of outstanding U.S. Treasury securities is almost 80% of the country's annual GDP and rising. The bond market can accommodate that without a jump in yields given the Federal Reserves' asset purchase program. Moreover, increased issuance of Treasury debt to finance government deficits doesn't have a strong correlation to yields. This is in part because the bonds are seen as haven investments when the economy is weak.

**Chart 14: Risk premium on corporate debt after the Feds bond buying**


Source: Bloomberg

Having already begun buying corporate debt through ETFs, the US Federal Reserve announced that it will carry through on its pledge to buy corporate bonds by pegging its purchases to a custom portfolio of bonds based on its own "broad market index." Because so much money is now riding on just how the Fed defines that index, there's been a lot of attention paid to just how the thing might be composed. In that respect, it's a great reminder that index construction is a subjective exercise full of implicit values and assumptions rather than a risk-free starting position.

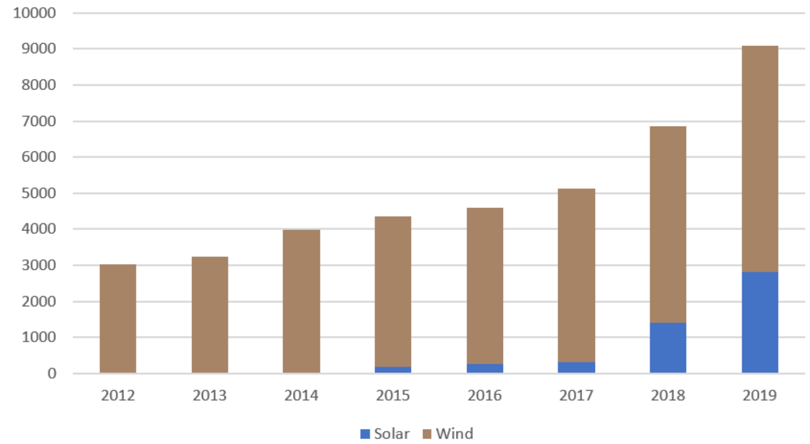
**Chart 15: Growth in private markets**




Source: Preqin

Private markets have grown more than ten-fold since the turn of the century, whilst dry powder currently stands at record levels. Back in 2000 private markets share of public markets stood at less than 2% whereas today the relative value is more than 3 times that. Crisis periods have often been highlighted as some of the best times to invest in private markets, IRRs of vintages post GFC were higher than those immediately before or after this for private equity. The growth in non-traditional transactions within private markets have also attracted many investors to the space.

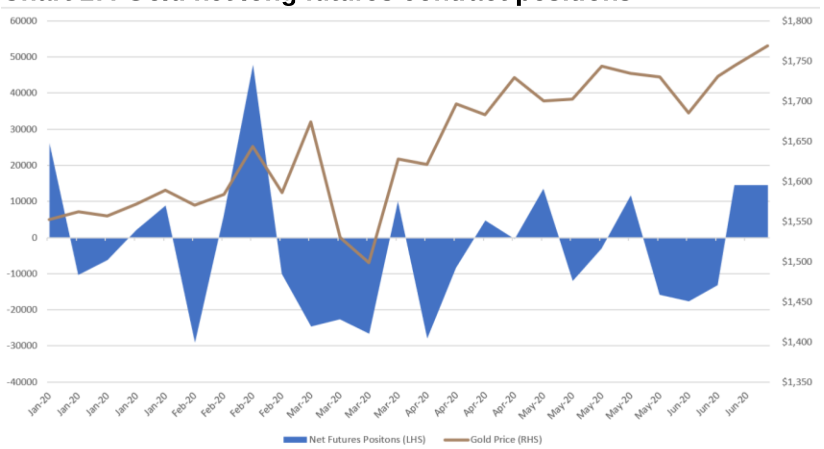
**Chart 16: Australian wind/solar installed capacity MW**




Source: Clean Energy Council 2020 Report

Decarbonisation is becoming an ever increasingly important issue as countries around the world strive to meet their commitments under the 2016 Paris Agreement to lower carbon emissions. Support for renewable energy projects has been increasing from both public and private investment. 2019 was a record year for Australian renewable energy construction with more than 2.2GW large-scale generation capacity added to the grid across 34 projects representing $4.3bn in investment. The ACT became just the 8$^{th}$ major jurisdiction worldwide to generate 100% of its energy from renewable sources, while South Australia is striving to meet this same goal by 2030.

**Chart 17: Gold net long futures contract positions**




Source: Bloomberg

Gold advanced for a third consecutive week hitting levels last seen in October 2012 finishing the week at US$1,769. Futures positions in the safe haven asset turned net long in recent weeks as the rally in equity markets loses pace and nervousness around increasing Covid-19 cases in some parts of the world have some investors looking to hedge their bets. Having broken above short term overhead resistance around $1,750 analysts are now calling for the precious metal to test the $1,800 level in the near term.

## Contact


**Chief Investment Office**

**Tracey McNaughton, CFA**
*Chief Investment Officer*

**David Bruty, CFA**
*Investment Analyst*

**Darragh Kennelly, CFA**
*Investment Analyst*

**Josh Lin**
*Investment Analyst*

**Escala Partners Pty Ltd**

**Melbourne:**
Level 19, 90 Collins Street
Melbourne Victoria 3000
Telephone: 03 8651 2600

**Sydney:**
Level 25, Governor Macquarie Tower
1 Farrer Place
Sydney NSW 2000
Telephone: 02 9102 2600

**Perth:**
1B Freshwater Parade,
Claremont WA 6010
Telephone: 08 6282 2600

information@escalapartners.com.au
www.escalapartners.com.au


## Disclaimer