Taking Stock

April 2020

Fundamental Value Equities

Conviction You Can Count On

STATE STREET GLOBAL ADVISORS

The Big Picture

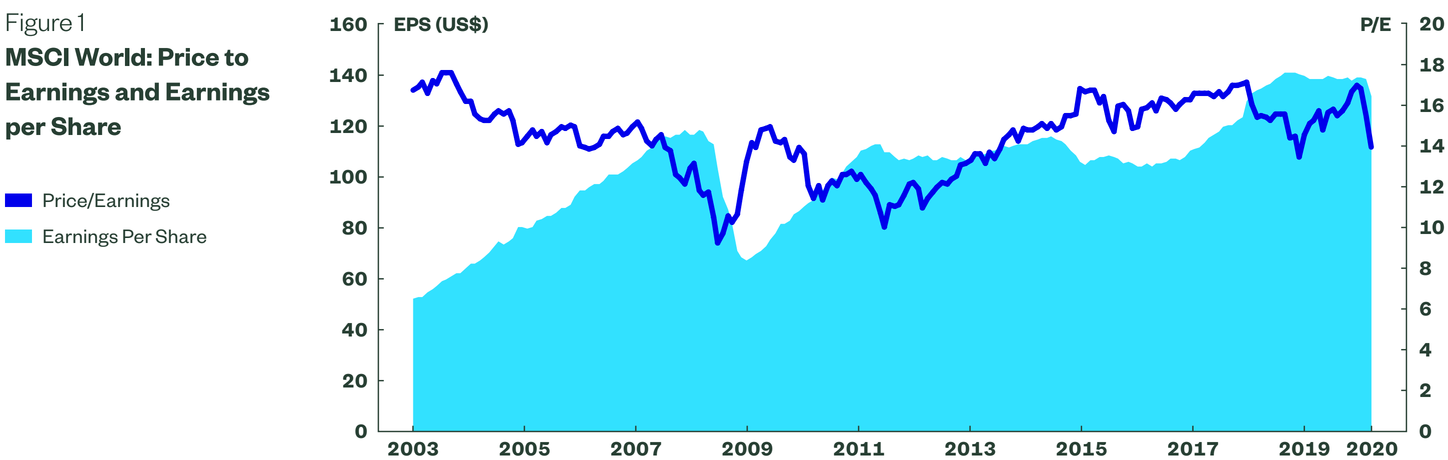
Barry Glavin
Chief Investment Officer

As the human cost of the COVID-19 pandemic plays out on our screens and in our communities, the economic cost of containing the virus is becoming increasingly apparent. And the impact on capital markets has been dramatic; the fall in equities, in particular, was record-setting in many respects.

In the wake of the sell-off, we thought it might be helpful to put this move in context: how does it compare to previous downturns? In terms of valuations, what has been priced in?

The most immediately-striking observation is that, despite the speed and scale of the market decline, equities don't look cheap. At a price-to-earnings (P/E) ratio of 14 (Figure 1) and a price-to-book (P/B) ratio of 2 (Figure 2), the MSCI World index has plummeted from elevated valuations to something closer to normal or average. We would also note that the valuations remain significantly above the troughs experienced during the eurozone crisis in 2011 and the Global Financial Crisis (GFC) in 2008–2009. There is no rule that says we have to get to those levels before this is over, but it is important to step back from the recent carnage and recognize that, while the market is lower than it was, it's nowhere near cheap or distressed levels of valuation.

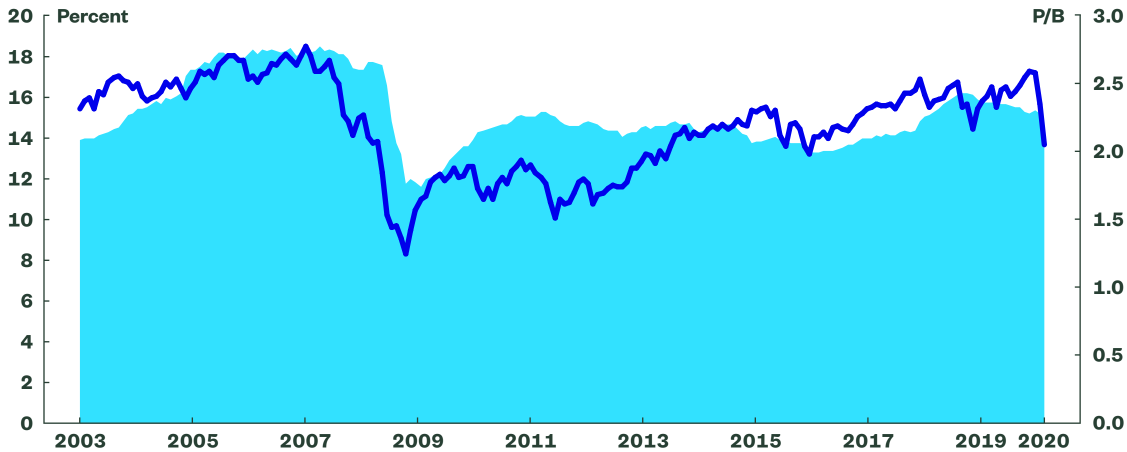
Figure 1
MSCI World: Price to Earnings and Earnings per Share



Source: State Street Global Advisors, MSCI as at 31/03/2020.

Figure 2
Price/Book Valuation Shifts Lower

Price/Book
Return on Equity



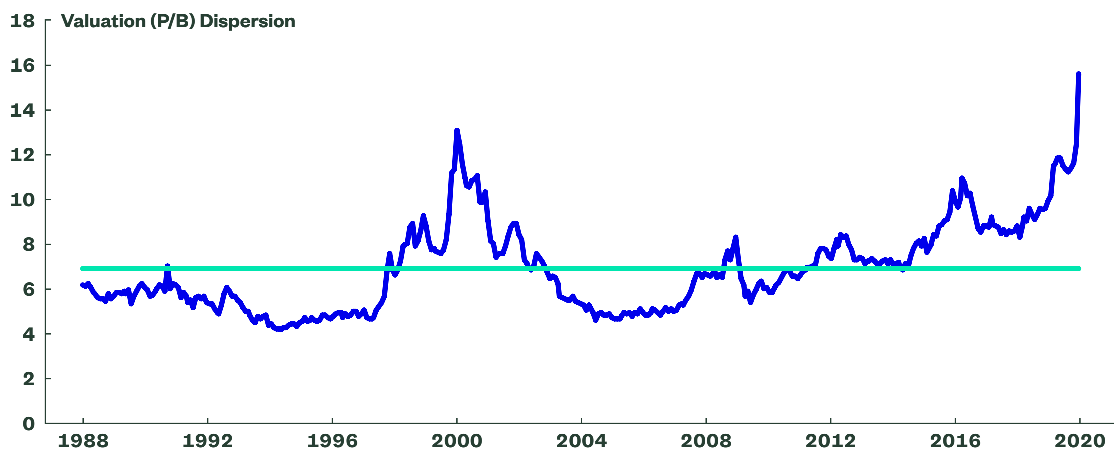
Source: State Street Global Advisors, MSCI as at 31/03/2020.

Expensive Stocks Get Relatively More Expensive

The extremity of the current market is not to be found in headline valuations, but rather in the dispersion of valuations around that index, which has never been so extreme. Figure 3 is a chart we've shared before — it measures the median P/B of the most expensive quintile of stocks in the index relative to the median P/B of the cheapest quintile. This metric now exceeds levels seen in the DotCom Bubble of 2000.

Figure 3
MSCI World: Median Price to Book of Most Expensive Quintile of Stocks vs Cheapest Quintile

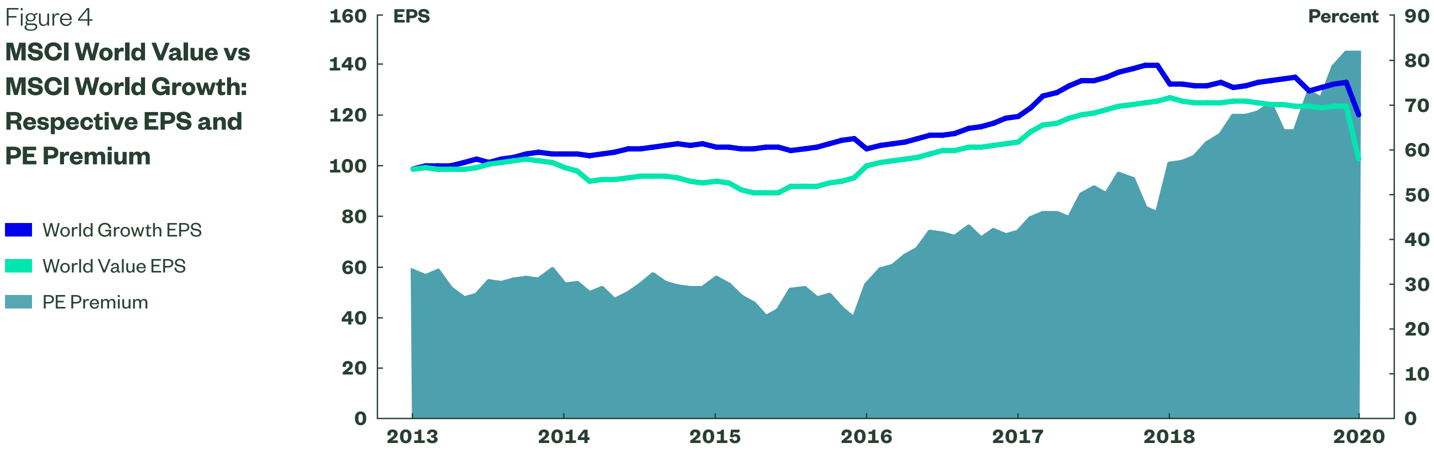
MSCI World Index: Valuation Dispersion
Average



Source: State Street Global Advisors, MSCI as at 31/03/2020.

For those who are less convinced of the relevance of P/B today, Figure 4 paints a similar picture. It shows the earning per share (EPS) evolution of both the MSCI World Value Index and MSCI World Growth Index over the last five years, and then plots the relative P/E multiple that the market has been willing to put on those earnings streams.

Figure 4
MSCI World Value vs MSCI World Growth: Respective EPS and PE Premium



Source: State Street Global Advisors, MSCI as at 31/03/2020.

The data highlights that the earnings of companies in the "Growth" index have grown faster than the earnings of companies in the "Value" index. But, the difference isn't sufficient to explain the huge outperformance of Growth over Value in the last few years. The share price performance has rather been driven by the premium that investors pay for growth soaring from 40% to 80%.

Opportunity for Value

At an overall level, the average valuation of global equity markets is roughly in line with long-term averages, but the range around that average has never been so wide. And therein lies the opportunity: for investors with the appropriate risk appetite and investment horizon, there is a significant swathe of the market for sale at extremely attractive prices.

As long-term value investors, our goal is to exploit such anomalies. Our team has spent the last number of weeks focused on two things:

1. Stress-testing all our current holdings to satisfy ourselves that we have a margin of safety in this new environment; that the companies we're invested in remain attractively valued when current headwinds are factored in, and most importantly have the financial strength and available liquidity to avoid a capital event.

2. Looking for new investments that compare favorably versus those existing holdings.

In the following pages, our portfolio managers and analysts share their thinking about their areas of specialization: what's been driving performance, putting that performance in context and highlighting where they see potential opportunities.

We don't have any privileged insight into how the pandemic plays out. Our working assumption is that it will pass, and as such we don't expect current pressures to impair the long-term earnings power of our holdings. But we do recognize that there is a valley to cross. As long-term investors, we're looking to hold and identify stocks that will survive the journey and thrive in the aftermath — stocks that are cheap on the basis of long-term earnings power, and with the financial strength to withstand adversity.

Regional Snapshot
North America

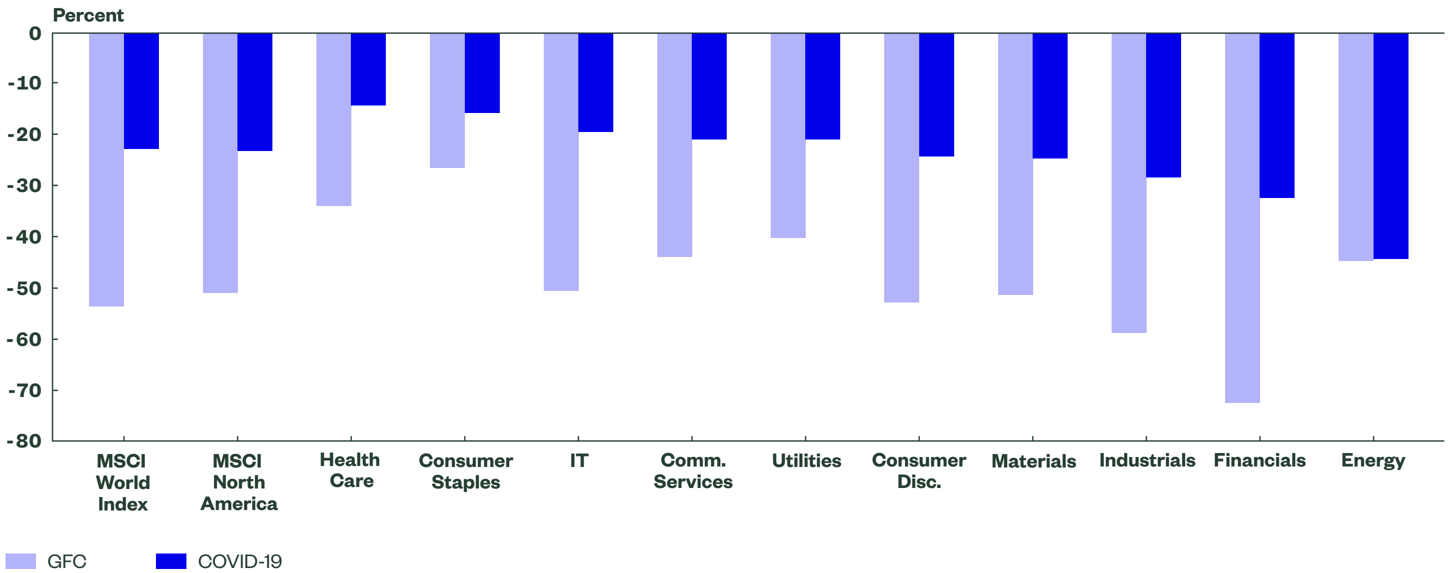
Brian Routledge
Head of Portfolio Management

After reaching all-time highs in February, North American stocks reacted last to the spread of the COVID-19 virus and have thus far been amongst the most resilient regions. The US, with its lower exposure to energy and financials versus Canada, has outperformed the World index since late-February and for the year to date.

Since the start of the COVID-19 crisis, it appears investors have dusted off prior playbooks from situations like SARS, 9/11 and the GFC, liquidating banks and the most economically sensitive industrial companies, along with leisure and travel holdings. However, while US financials were the epicenters of stress during the GFC, the financial system is significantly healthier than in 2008; banks have materially higher capital levels and loss-absorbing buffers and already trade at lower multiples of less-leveraged book values.

In the real US economy, businesses may face weeks or months with no effective revenues in some of the most impacted areas and there is no corporate playbook for that scenario. Uncertainties are very high, as evidenced by extreme daily volatility, but officials recognize this and are reacting faster than in past crises with significant monetary and fiscal supports; the Federal Reserve pledged unlimited liquidity and Congress passed a $2.2T rescue package.

Figure 5
COVID-19 vs GFC Performance (US$)*



Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.
* COVID-19=21/02/2020–31/03/2020. GFC= 31/10/2007–28/02/2009.

In North America, dominated by the size of the US market, Energy has borne the brunt of underperformance as the virus shock was compounded by the oil price crash (Figure 5). Financials have been next hardest hit, followed by Industrials and Materials — all of which considerably underperformed the MSCI North America index. Within Consumer Discretionary, the collapse in leisure-exposed industries has been masked somewhat by the Amazon effect.

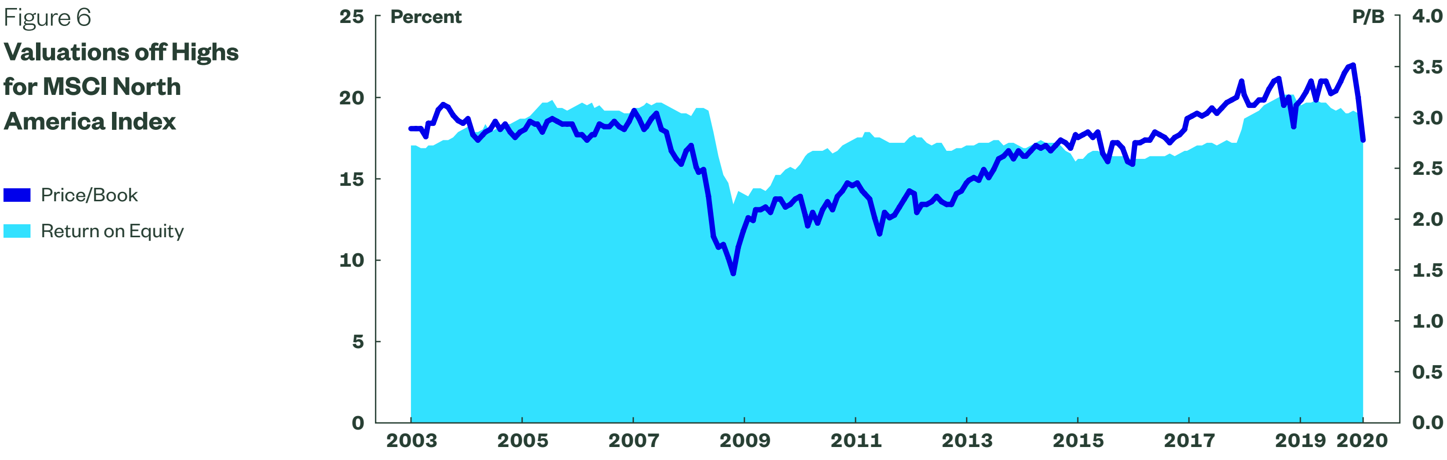
Relative outperformers in the sell-off have been a combination of defensive Healthcare, Consumer Staples and Utilities, and, perhaps counter-intuitively the most expensive sectors of the market coming into 2020, cyclical Technology and Internet Media. As a result, the performance spread between Growth and Value widened 1200 basis points in just three months, similar to the entire spread in 2019.

Valuation

Relative to the GFC in 2008–09, North American stocks entered this crisis trading at higher multiples of book value and earnings with only slightly higher returns on equity (ROE); for now at least, the de-rating has been modest in a historic context (Figure 6).

However, while the large Technology and Internet sectors have seen modest relative declines and little valuation corrections versus prior crises, Energy, Materials and Financials began the crisis from lower levels and thus are closer to prior trough levels of valuations. Not surprisingly given performance, Healthcare and Consumer Staples have maintained their premium valuations. Valuations for perceived long duration growth went into the crisis at much higher levels than prior to the GFC and have widened that gap (Figure 7).

Figure 6
Valuations off Highs for MSCI North America Index

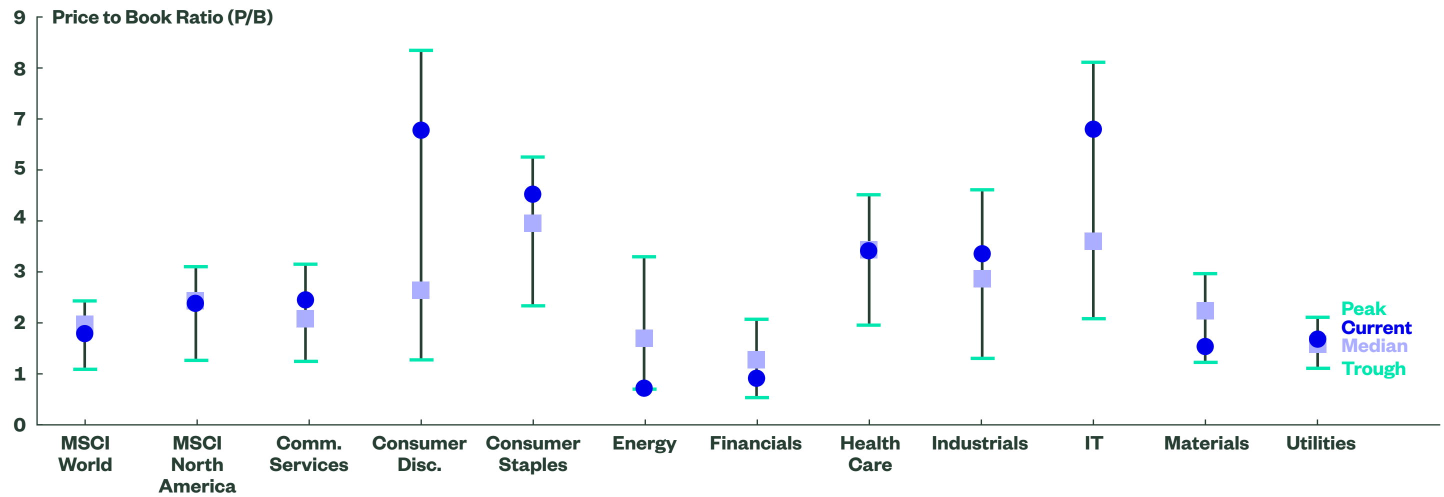


Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.

Opportunity

In terms of opportunities, what we have yet to witness is more indiscriminate de-rating and rotation from broader swathes of quality businesses that would build up a clear margin of safety in the price. As always, we are on the lookout for stocks that are cheap on long-term earnings power and have the resources to deal with the current adversities; but, they must also offer a superior proposition to our current attractively-valued holdings.

Figure 7
P/B Valuation Range (MSCI North America)
Jun 2003–Mar 2020



Source: State Street Global Advisors, MSCI as at 31/03/2020.

Regional Snapshot

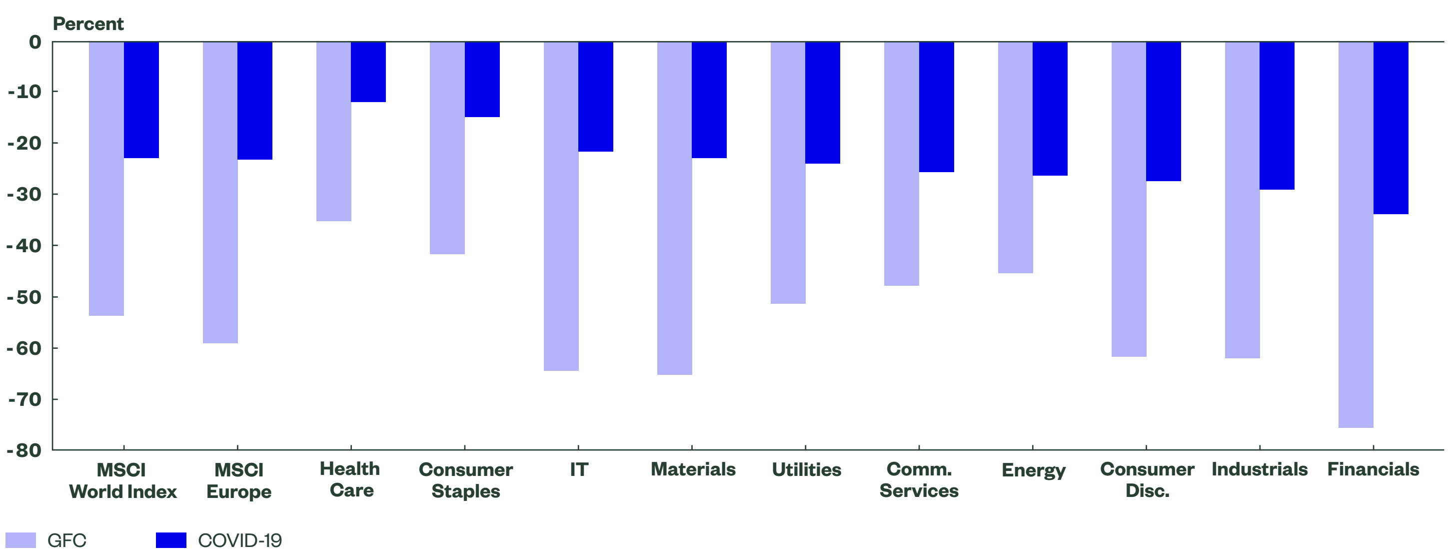
Europe

Lance Graham
Portfolio Manager

Following a quarter without precedence, start-of-year expectations for Europe's economic and corporate prospects have been revised dramatically. The falls in share prices are broadly similar to the worst quarterly declines of the financial crisis, but the full impact on businesses from COVID-19 may take time to fully play out.

The earlier infection cases within Italy (and then the rest of Europe), coupled with the export-driven nature of the wider European economy, led to a Q1 fall that was similar to the worst quarters of the financial crisis. In what is an unprecedented situation, many companies will have little to no revenue for several months, something we are cognizant of in our analysis. However, our team has been through many turbulent periods, including the Great Financial Crisis (2008), Eurozone Crisis (2011) and Brexit (2016).

Figure 8
COVID-19 vs GFC Performance (US$)*



Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.
* COVID-19=21/02/2020–31/03/2020. GFC= 31/10/2007–28/02/2009.

At a sector level, similarities to the GFC are evident in terms of the resilient performance of Healthcare and Consumer Staples, while the cyclical sectors Financials, Industrials and Consumer Discretionary have experienced steeper declines. Information Technology and Materials have been relatively more resilient so far versus the GFC (Figure 8). Energy has performed poorly, but the main issues there are less to do with the current situation (although it is a material factor) and more with the rise of shale oil that has created an existential crisis for OPEC. It should be noted that post the GFC in 2009, the underperforming sectors recovered substantially.

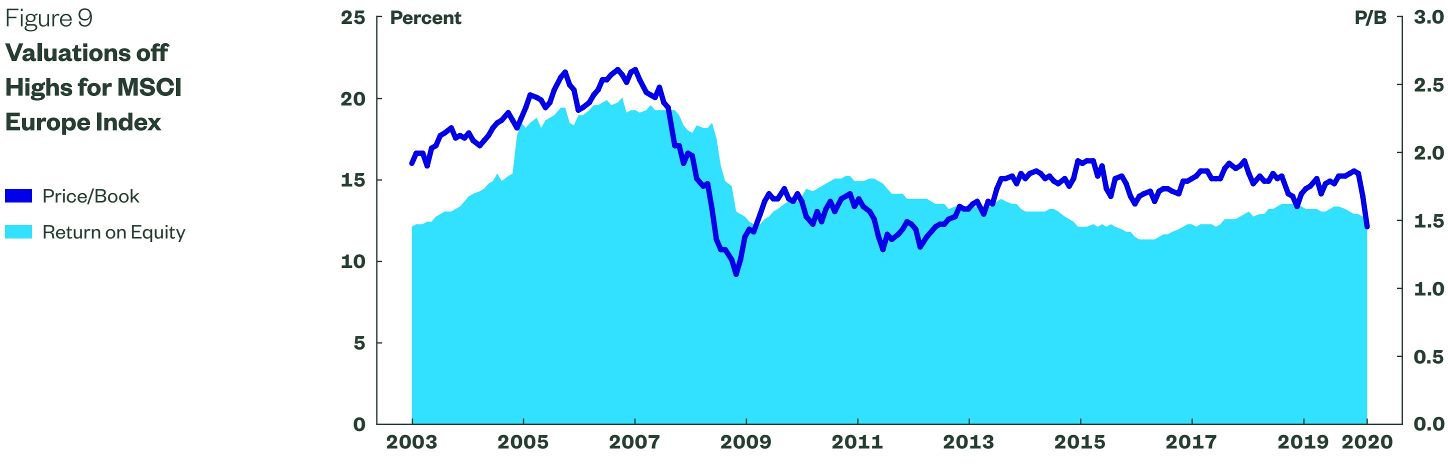
While European financials formed the epicentre of stress during the GFC, they are more of a solution this time. The financial system is in much better shape than in 2008; banks have materially higher capital levels, less levered balance sheets, better risk management and are trading at significantly lower multiples than they were at the start of the GFC. Additionally, governments are reacting much quicker than they did in 2008, which should also help to alleviate the situation.

As in the GFC, Value as a style has severely underperformed relative to Growth; but one key difference is that Value had outperformed for many years leading up to the GFC, whereas the complete opposite has occurred this time. As a consequence, the performance gap to Growth has widened to unprecedented levels. The solid recovery in value seen during the second half of 2019 has been temporarily derailed by the coronavirus outbreak and its severe disruptive impact on economic activity.

Valuation

Shifting our focus to valuations, the price-to-book (P/B) multiple for Europe is now closer to where the market traded during the eurozone crisis, but it is not near the lows recorded during the GFC (Figure 9). However, it is worth noting that stocks with a high P/B multiple now make up a bigger proportion of the market than they did in either 2008 or 2011.

Figure 9
Valuations off Highs for MSCI Europe Index



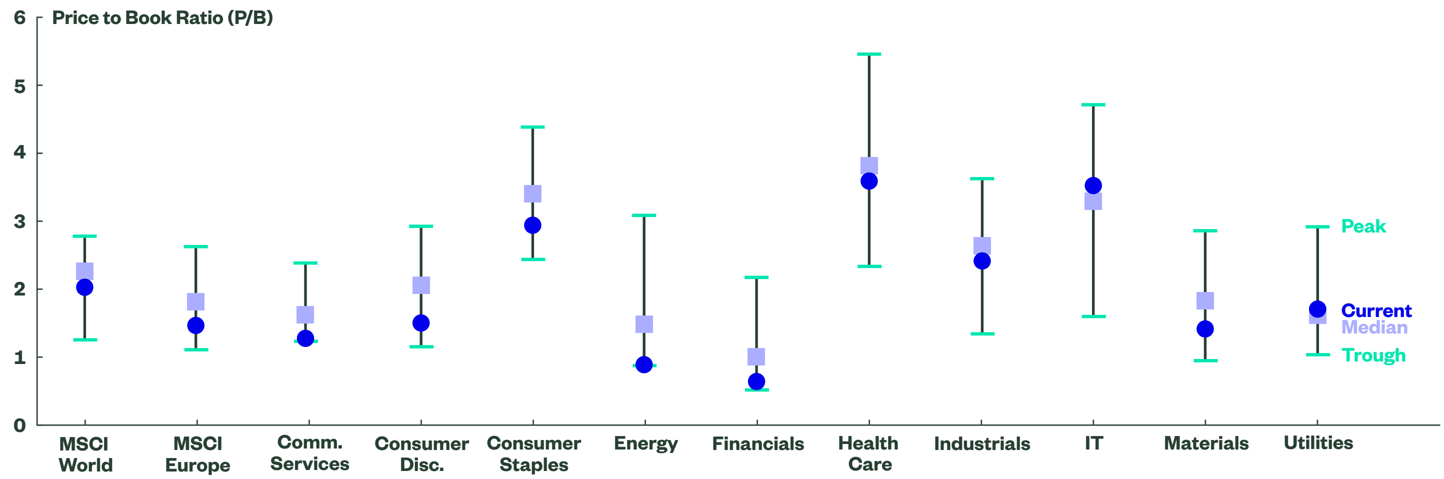
Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.

Valuations have dropped across the market and sectors such as Financials, Communication Services and Energy are trading at close to all-time lows (Figure 10). Information Technology has suffered modestly relative to the GFC so far, while the support for Utilities and Healthcare stocks mean they don't offer much value relative to other sectors. Industrials have underperformed and there remain good opportunities within this sector, but it is stock dependent as the better quality names still achieve a significant premium; this is similar to what we witness across most sectors.

Opportunity

From an investing point of view, this is a very challenging but equally exciting time for long-term value investors. Extreme dislocation and volatility are creating emotional responses in investors that bear little resemblance to the long-term value of many businesses. We will continue to monitor the situation and take appropriate action if long-term fundamentals deteriorate in our existing holdings, while at the same time seeking out cheap new opportunities where we are confident in the financial strength of the business and long-term earnings power remaining intact. Given the severe sell-down in cyclicals, we believe there are more opportunities currently in areas such as Financials, Industrials and Consumer Discretionary, compared to defensive sectors such as Healthcare.

Figure 10
P/B Valuation Range (MSCI Europe)
Jun 2003–Mar 2020



Source: State Street Global Advisors, MSCI as at 31/03/2020.

Regional Snapshot
Asia Pacific

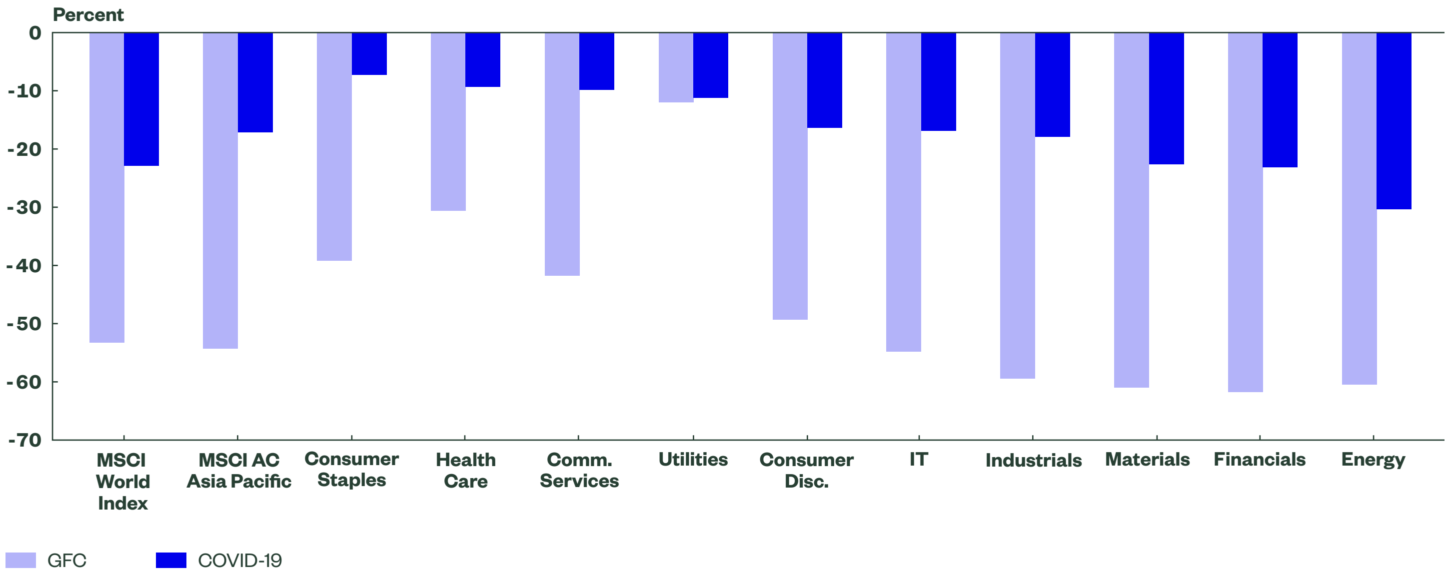
William Killeen
Portfolio Manager

Equity markets in Asia Pacific have been relatively resilient since the COVID-19 crisis started. Better preparedness for such outbreaks likely played a role in that, as did the fact that overall market valuations were lower on account of trade-related issues and worries about slowing Chinese growth.

Asia has been somewhat better prepared for this crisis, helped by the experience of SARS in 2003, and the resultant development of testing and quarantine techniques that were used during that era. This has meant that a number of Asian countries (China, Japan, South Korea, Singapore) have been quicker to implement the sort of draconian measures required to flatten the epidemic curve.

As measured by the MSCI AC Asia Pacific index, the region's equities fell by -17.2% (in USD) in the first quarter of 2020, compared to -23% for the MSCI World index. To get a sense of how this compares historically, the MSCI AC Asia Pacific index fell -54.6% during the global financial crisis (Figure 11). Ironically, the best performing market in the region in Q1 2020 was China, with the Shanghai and Shenzhen CSI 300 index falling about -11% (in USD terms), compared to Japan's Topix (-17.7%), Korea's Kospi (-23.6%), Thailand's Set (-35.2%) and India's Sensex (-33.1%). The diversity of Pan-Asia, with emerging markets alongside developed markets, has its advantages.

Figure 11
COVID-19 vs GFC
Performance (US$)*



Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.
* COVID-19=21/02/2020–31/03/2020. GFC= 31/10/2007–28/02/2009.

Sector performances have so far stacked up very differently in Asia Pacific during the COVID-19 crisis compared to the GFC. Communications, Consumer Staples, and Health Care have shown the greatest resilience in this downturn. More economically-sensitive sectors such as Financials, Energy and Materials, on the other hand, were among the worst performers in Q1 2020. However, even in these sectors, COVID-19 does not compare to the drawdowns during the GFC.

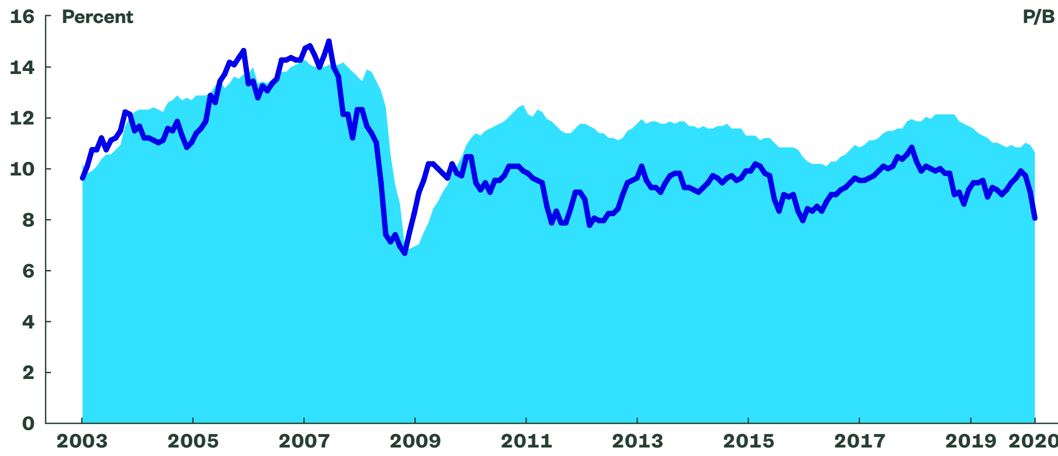
Valuation

There are two further observations that set the scene in Asia Pacific:

1 Overall equity market valuations in Asia Pacific were relatively lower compared to other regions coming into this crisis, given the concerns on the trade-war, the attendant volatility in emerging market currencies, and slowing pace of China economic growth. The current Price/Book of 1.26x for Asia Pacific is near the low struck in 2009 (Figure 12) and sits well below that of the MSCI North America (at 2.77x), for instance.

2 Balance sheets in Asia Pacific have far less leverage than Europe and the USA. Asia is both an earnings story and balance sheet story.

Figure 12
Valuations off Highs for MSCI AC Asia Pacific Index



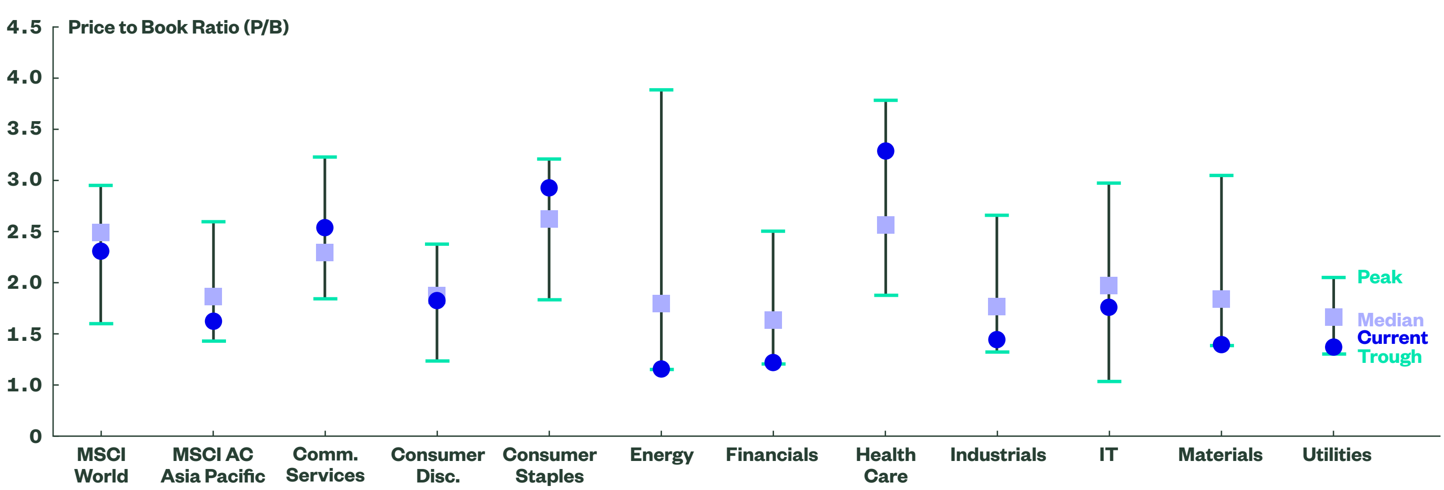
Source: State Street Global Advisors, MSCI as at 31/03/2020.

Opportunity

The opening quarter of 2020 has shown indiscriminate selling of both good and bad businesses alike in Asia. That is often the silver lining in painful episodes like the one we are currently experiencing. Pan Asia is a rich and varied universe for value investors, and we are currently scouring developed and emerging markets for value.

We have already built up a clear picture of the competitive landscape at the sector level in Asia over the last decade. We will use this work as a roadmap to monitor strong businesses with a demonstrable moat that now appear attractive according to our value framework. We are also conscious of the structural changes that might be brought about by this crisis. The focus on balance sheets that arises naturally in our consistent framework will be invaluable in the months to come.

Figure 13
P/B Valuation Range (MSCI Asia Pacific)
Jun 2003–Mar 2020



Source: State Street Global Advisors, MSCI as at 31/03/2020.

Sector Snapshot
Financials

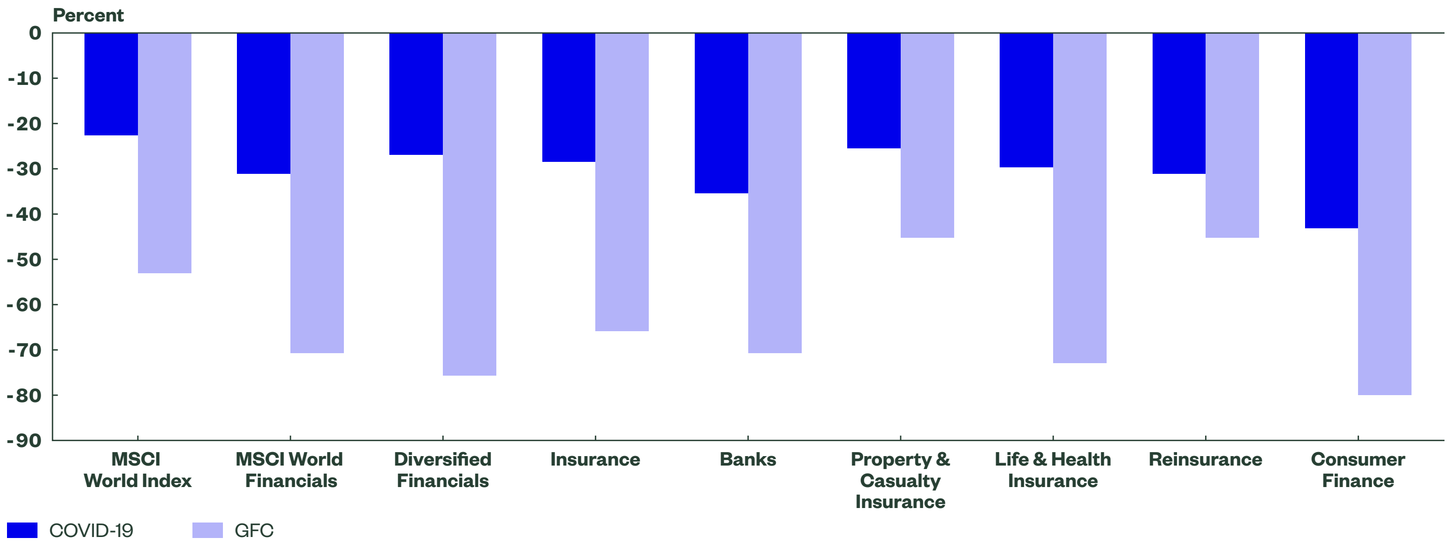
Oliver McClure
Head of Research

Sharp share price falls across the Financials sector have been a feature of the COVID-19 crisis. However, banks are in much better shape than ahead of the Global Financial Crisis, leaving them well placed when current conditions improve.

Since the start of the COVID-19 crisis, the Financials sector has underperformed the broader market by over 9%, making it the second worst performer after Energy, as determined by the MSCI universe (Figure 14). Heading into this period, financial stocks were already trading on relatively low multiples and now some parts of the sector are approaching valuations not seen since 2008–09. The low starting valuation, along with the positives from over a decade of improved banking regulation, are likely to be key in averting a repeat of the experience during the global financial crisis (GFC) when the sector declined more than 70%.

Looking at the dynamic within the sector, there has been substantial divergence in terms of performance through the recent correction. Banks have been hardest hit and now appear to be pricing in an outcome worse than the GFC. Others to perform poorly have included those most exposed to the effects of unemployment, such as credit card companies. At the other end of the spectrum, areas that fundamentally benefit from current conditions, such as Exchanges (where increased volatility is good for business), have outperformed. Within Insurance, Property & Casualty insurers have been more resilient than weaker performing Life Insurers and Reinsurance firms.

Figure 14
COVID-19 vs GFC Performance (US$)*



Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.
* COVID-19=21/02/2020–31/03/2020. GFC= 31/10/2007–28/02/2009.

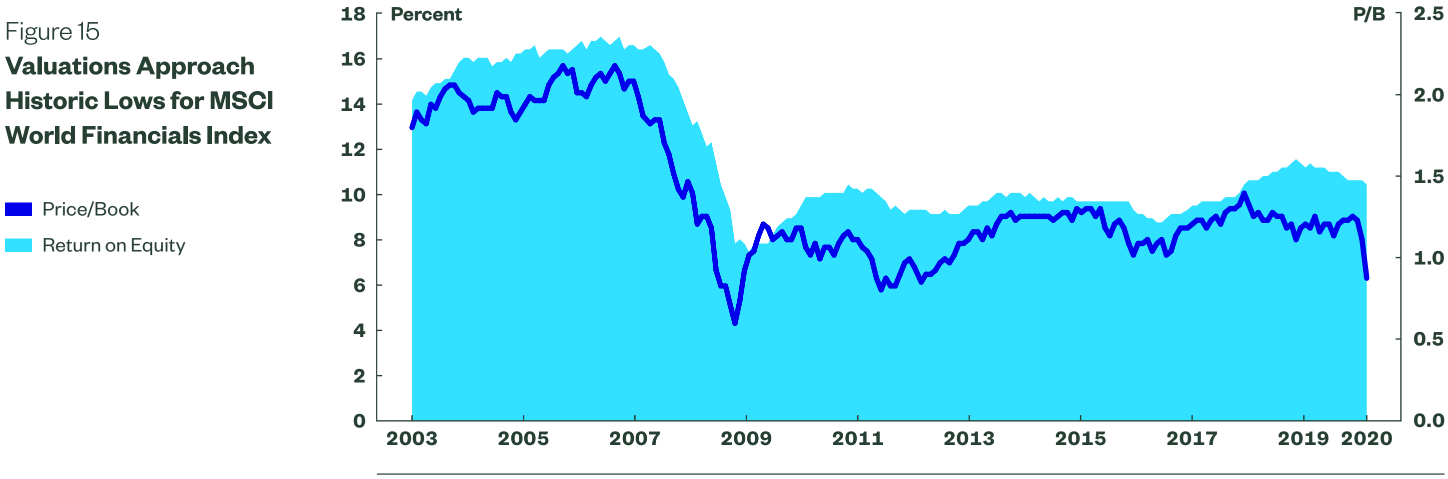
The GFC in 2008–09 is fresh enough in market participants' minds to have become the default reference point for how things might play out this time. While clearly there is a huge amount of uncertainty as to what the near-term holds for economic activity, there are important differences worth highlighting:

- In the GFC, the banking system was the cause of the crisis. This time around it is already clear that banks are going to be a critical part of the solution.
- Over 10 years of regulation has created a banking system that is much better capitalised and vastly improved from a risk management perspective.
- Policymakers' memories of the GFC are also fresh and this has driven a much quicker and larger response in 2020.

Valuation

Heading into this period, financial stocks were already trading on relatively low multiples and now some parts of the sector are approaching valuations not seen since 2008–09 (Figure 15). Given diverging performances within the sector, we believe the best opportunities in the financial sector from here appear to be in the banking segment. Capital levels are now more than double that of the pre-GFC period, which provides significant buffers to weather a spike in losses. We have forensically analyzed our own bank holdings, performing a stress test that replayed each bank's worst three-year cumulative losses of the last 20 years; all proved to be resilient and maintained robust capital levels. While there may be concern regarding regulators' calls for banks to postpone dividend payments, we view this as a capital allocation decision to support higher loan demand rather than an indication of weak solvency.

Figure 15
Valuations Approach Historic Lows for MSCI World Financials Index



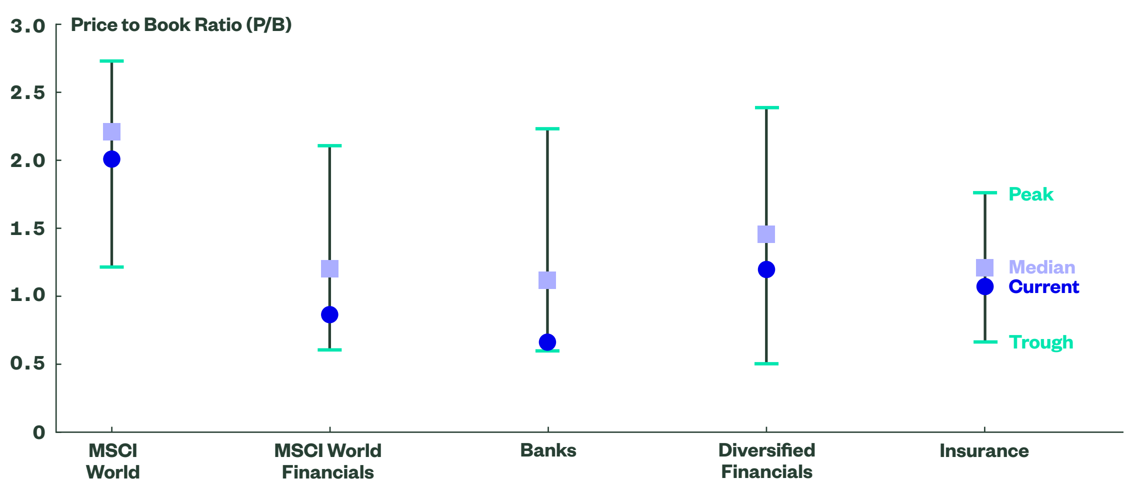
Source: State Street Global Advisors, MSCI as at 31/03/2020.

We also reviewed our other holdings for vulnerabilities and as a result sold a life insurance company where we had concerns around the impact of lower interest rates on solvency. We also added a bank with an exemplary track record of credit underwriting. We re-established the investment case for all other holdings. We believe we are invested in companies that can weather this storm.

Opportunity

In terms of new opportunities, the Financials sector looks ripe for attractive ideas, as all sub-sectors are trading below their long-term valuations (Figure 16). We are seeking institutions generating reasonable returns on equity while ensuring capital, leverage and funding levels are appropriate for the business model.

Figure 16
P/B Valuation Range (MSCI World Financials)
Jun 2003–Mar 2020



Source: State Street Global Advisors, MSCI as at 31/03/2020.

Sector Snapshot
Information Technology

Peter de Lacy
Research Analyst

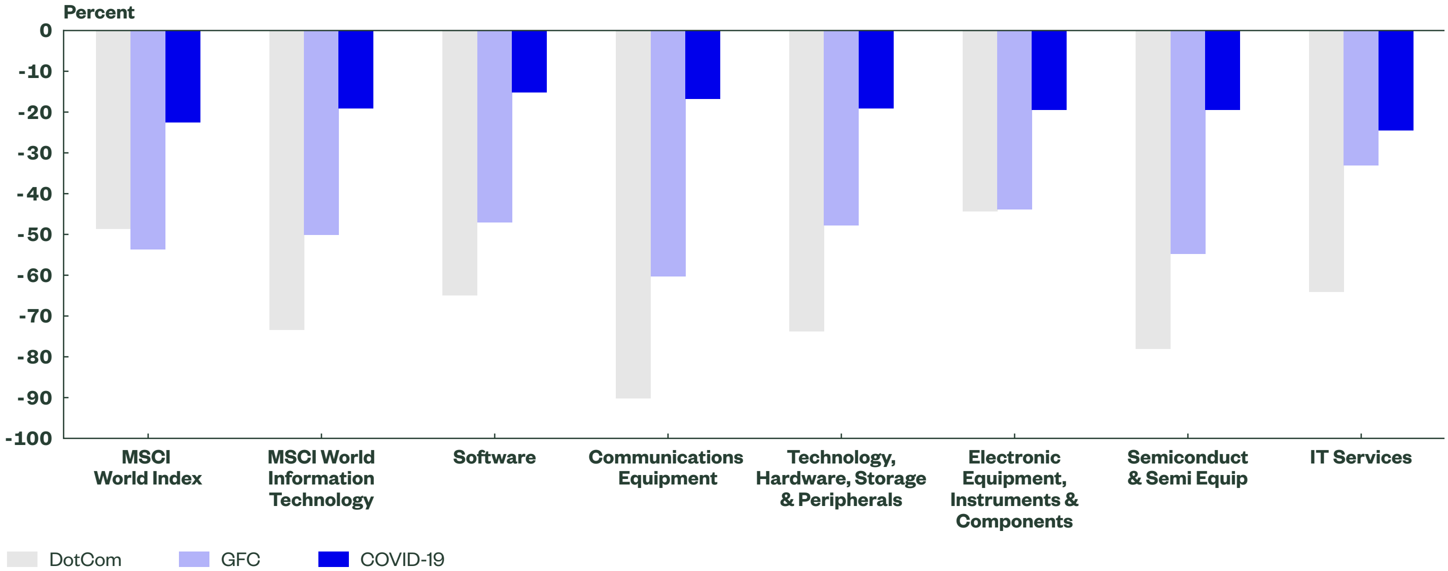
The technology sector is prone to optimistic valuations and, even after the recent sell-off, the sector is still expensive. But opportunities exist for many companies in a changing business landscape, and for investors who can see where value lies.

As with all parts of the market, the IT sector has experienced a sharp decline — from 21 February to 31 March 2020, the sector fell 19%. This should be viewed in the context of very strong returns (60%+) in 2019 and early 2020. Furthermore, as steep as the decline has been, it compares mildly to the 52% fall during the GFC and the 72% fall in the Dotcom crash of 2000–2002 (Figure 17).

Since the current downturn began, the main outperformers have been located in the Software industry. Communications Equipment also fell less than the overall sector. The common theme amongst these performers is that they have clearly benefited from increased remote working as they provide the tools — software, security or infrastructure — to efficiently and safely enable working from home capability. Japan, where the coronavirus appeared to be reasonably under control, has been an outperformer; domestically-focused IT services names have held up well, as have numerous component suppliers.

Underperformance was evident in industries where companies are deep in the IT supply chain, or where the near-term demand impacts from the economic slowdown are likely to be felt sharpest and earliest. These include the Technology Distributors, Electronic Manufacturing Services and Data Processing & Outsourcing, which include travel technology, payments technology and payroll processing related companies. IT services, which has a large element of discretionary spend in the budget, was also weak. Regionally, European IT was a notable laggard as the continent became the outbreak's epicenter; moreover, the region's exposure to IT services, payments and relatively indebted IT hardware and component manufacturers also weighed on performance.

Figure 17
COVID-19 vs GFC Performance vs DotCom(US$)*

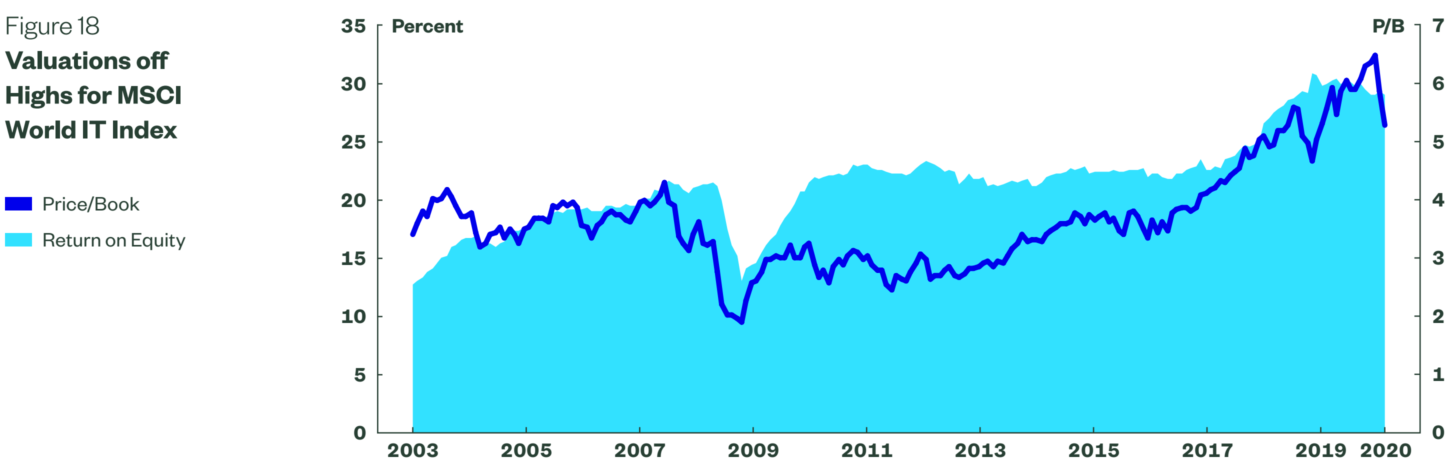


Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.
* COVID-19=21/02/2020–31/03/2020. GFC= 31/10/2007–28/02/2009. DotCom=31/03/2000–30/09/2002.

Valuation

Casting an eye back at valuation metrics during the Dotcom and GFC periods is interesting. We find that IT and its industries entered the current correction with higher valuations compared to median and the GFC, but were lower than the dotcom crash. Currently, industry valuations are above historic lows, but the range is wide with some well above historic medians (Figure 19). Importantly, we have not seen any rotation in the relative ranking of industry valuations.

Figure 18
Valuations off Highs for MSCI World IT Index



Source: State Street Global Advisors, MSCI. Past performance is not a guarantee of future results.

In the midst of this unprecedented crisis, it is worth reflecting on the ability many have to work seamlessly from home, to entertain and educate kids or to video conference with friends and family. It shows that, despite the "dot.comedy" tag, the visionaries were largely right. The internet did change the world. But in 1999 people were paying the wrong price, for many of the wrong companies, to participate in that future. Just as that crisis didn't stop the rise of the internet, we don't see the COVID-19 crisis permanently interrupting technology trends; in fact, some are prime candidates for even greater acceleration:

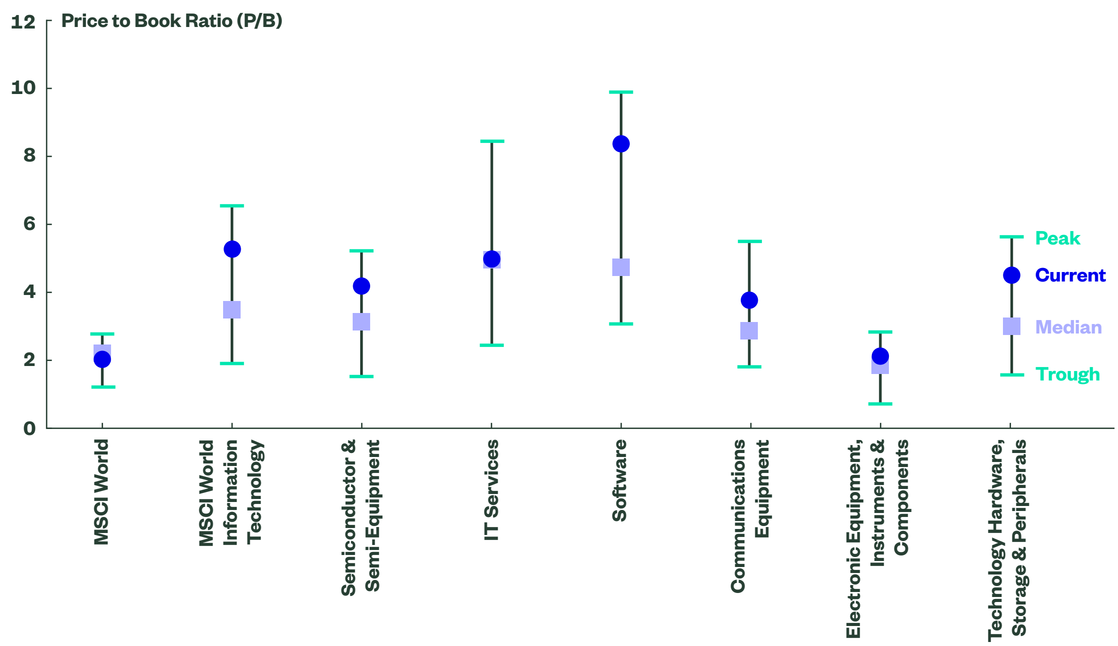
- Moves to cloud and software as a service
- Infrastructure IT security and protecting new endpoints
- Collaborative software
- Redesigning supply chains
- Industrial and transport automation

Opportunity

As in 1999, people may have been paying the wrong price to participate in these more recent trends. In analysis we produced for an article in Q3 2019, 36% of companies in our US large cap IT universe were earning less than 2% pre-tax GAAP margins, with 30% of stocks actually reporting losses. As with the shakeout in 2002, it is quite probable that stocks will start to be judged on the actual business performance rather than the halo effect of association with growth trends. We see some weaker companies being forced to cut too deep or for too long, underinvesting for their future.

The corollary is the opportunity for quality companies, those with the strength to continue to invest, organically or inorganically, through the cycle, whether in an industry that is tangible asset, R&D or sales and marketing intensive. Technology is subject to frequent disruptions, and it is not always the incumbents that are disrupted.

Figure 19
P/B Valuation Range (MSCI World Information Technology)
Jun 2003–Mar 2020



Source: State Street Global Advisors, MSCI as at 31/03/2020.

Sector Snapshot
Healthcare

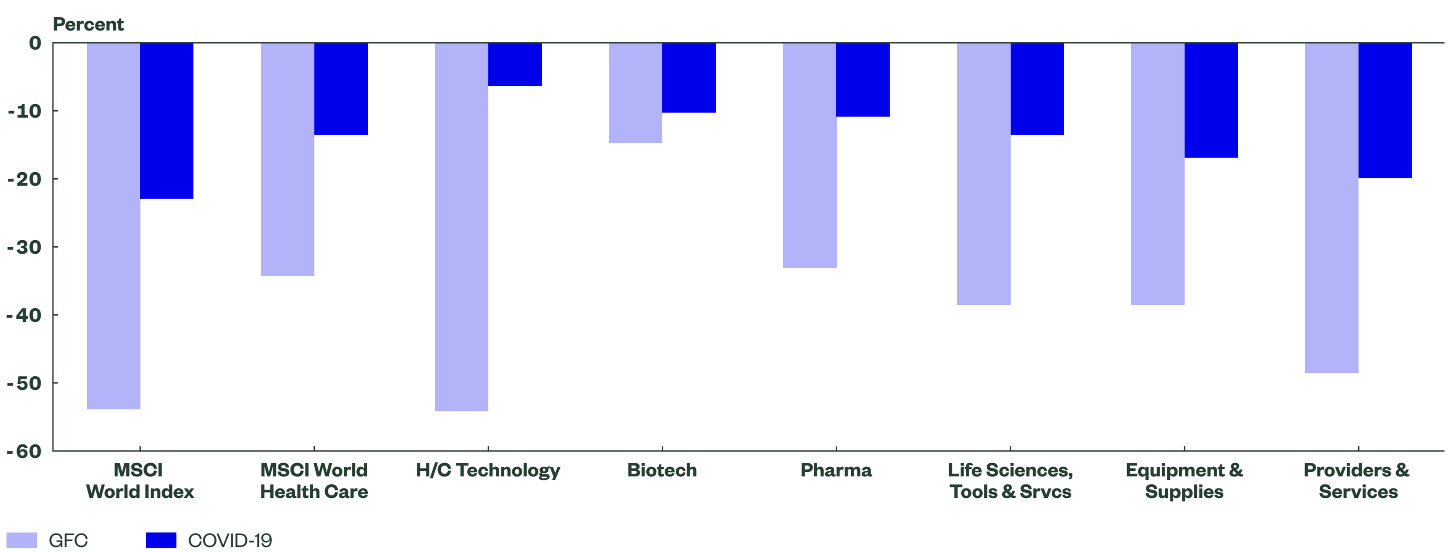
Joe Lawlor
Research Analyst

In a period when market dislocation has been driven by a pandemic, healthcare stocks invariably hold a greater interest for investors. But understanding where value opportunities may lie is key.

For the healthcare sector, the new year started in a similar vein to 2019; medical technology and life sciences stocks continued their trend of outperformance, despite their lofty valuations. Pharmaceutical and biotech stocks lagged as investors worried about potential reforms in the US, which could lead to lower drug prices.

The sell-off which started on 21 February followed a similar pattern to 2009. Those parts of the sector with the most predictable revenue and earnings outlooks, combined with the soundest balance sheets outperformed. Typically, Pharma and Biotech stocks have held up better, while Healthcare Services and the highly-valued med tech stocks have underperformed (Figure 20).

Figure 20
COVID-19 vs GFC Performance (US$)*



Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.
* COVID-19=21/02/2020–31/03/2020. GFC= 31/10/2007–28/02/2009.

In the sell-off to the end of the first quarter, North American stocks led the decline (down 14%), followed by European names (down 12%), with Asia Pacific faring slightly better (down 10%).

This has reflected the fact that the cash flows of many med tech, hospital and insurance companies are somewhat sensitive to the economic cycle. In the US, rising unemployment invariably leads to people losing their insurance coverage (in whole or in part). In turn, hospital admissions will fall, operations will be cancelled or rescheduled, and orders for consumables used in these procedures will be scaled back. In addition, cap-ex equipment orders would be expected to be deferred.

Outside the US, recessions inevitably lead to increased austerity measures, cuts in service provision, lengthening waiting lists and demands for lower prices from pharma companies or delays in the approval of new treatments.

Healthcare and the COVID-19 Impact

There are some grounds for believing that COVID-19 may have a different impact than a normal recession. Elective procedures have largely been cancelled in many countries to free up capacity for the surge in coronavirus patients. This will hammer the cash flows of hospitals and many med tech companies more than in previous downturns. At the end of March, analyst forecasts for 2020 have yet to comprehend the impact on earnings in 2020 for these companies. However, most of these procedures will be deferred rather than cancelled so there should be a rebound in 2021.

There is insufficient critical care capacity in both public and private hospital systems across the developed world. This is likely to lead to greater public funding or tax incentives to build new capacity in the medium term. This growing realisation led to a sharp rebound in hospitals and equipment manufacturers towards the end of the quarter.

There is also likely to be increased expenditure on strategic reserves of personal protection equipment, testing kits and drugs for the treatment of pandemics. There may also be greater demands to onshore manufacturing capacity to increase security of supply.

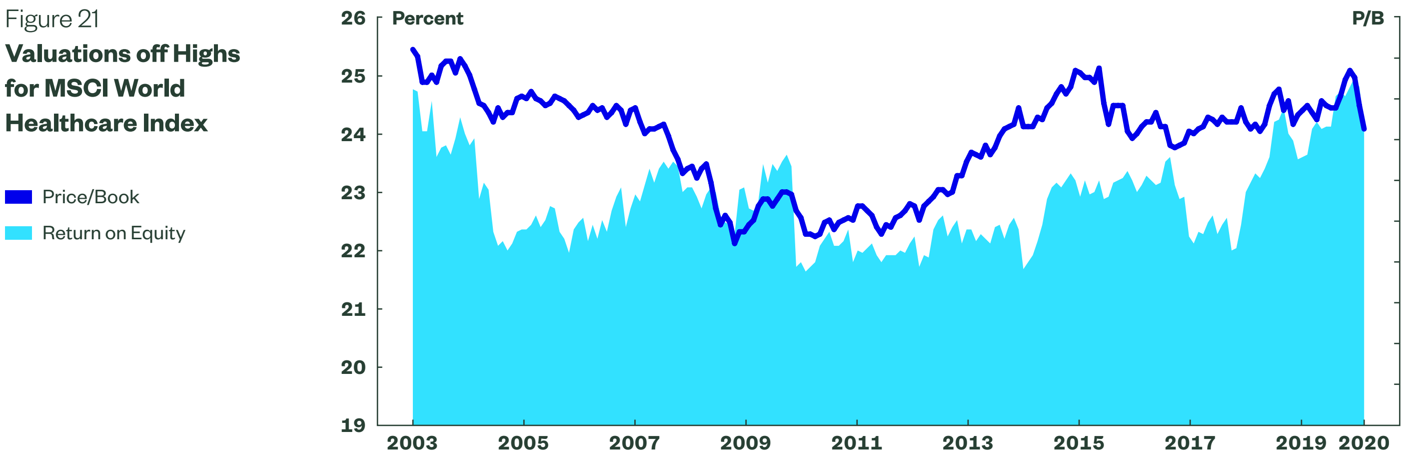
Vaccines, treatments and testing will have a vital role in the path to normality. On the vaccines front, there are several RNA vaccines in phase 1 and the first data may read out in mid-2020; the first broadly available vaccine is likely to reach the market in 2021. In the interim, it is likely some existing compounds may be repurposed to treat COVID-19, based on evidence from small-scale clinical trials. As regards testing, combining molecular diagnostic testing to see who is infected with large-scale serology/antibody testing to see who has been infected may offer the potential to get large numbers back to work.

One of the effects of this crisis is the greater state supervision of healthcare delivery in many countries with state-funded bailouts of care delivery systems inevitable. This is likely to change the sector in fundamental ways in the medium term.

Valuation

On a price-to-book (P/B) basis, the Healthcare sector trades marginally below the top end of the range for a return on equity (ROE) that some might argue looks close to an all-time high (Figure 21). This suggests that investors should be cautious, especially given the risk that payers look for savings elsewhere in the system to offset some of the emerging COVID-19 related expenditure.

Figure 21
Valuations off Highs for MSCI World Healthcare Index



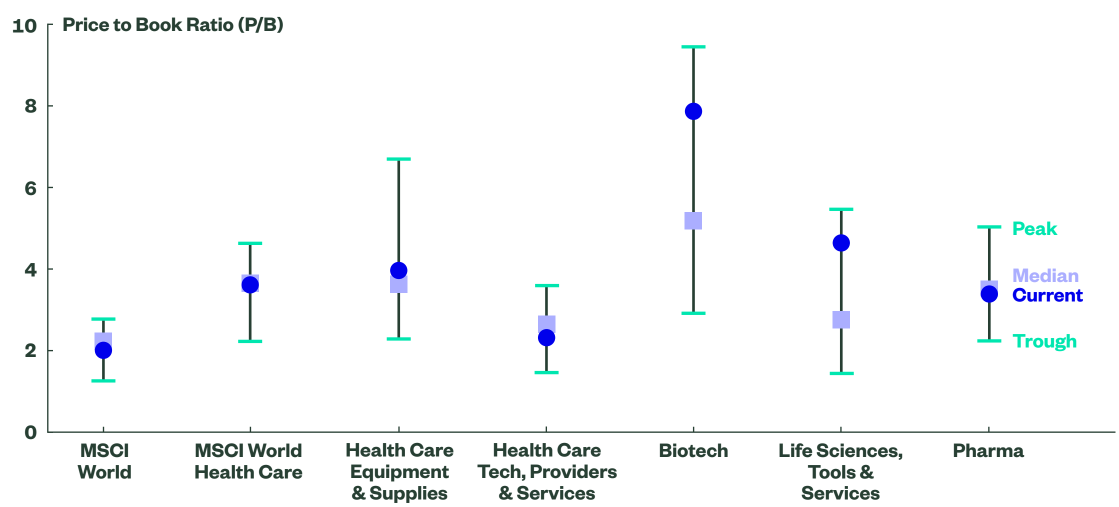
Source: State Street Global Advisors,MSCI as at 31/03/2020. Past performance is not a guarantee of future results.

Opportunity

At the industry level, P/B valuations are currently expensive in the case of biotech and life sciences (Figure 22). Caution is warranted in the former due to the emergence of bio-similars, and in the latter in the case of cutbacks on R&D in a weak economy. In other industries, P/B valuations look more reasonable and reflective of the risks facing the sector. We believe the best opportunities may be in the pharma, services, and in equipment and supplies now that valuations have declined.

In Q1, we sought opportunities to reduce our exposure to the more defensive pharma sector and to add to our positions in the healthcare services and equipment space which had sold off heavily.

Figure 22
P/B Valuation Range (MSCI Healthcare)
Jun 2003–Mar 2020



Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.

Sector Snapshot

Industrials

Joseph McGann
Research Analyst

With the global economy stuttering to a near-halt, the economically-sensitive earnings of many industrials have come under pressure, dragging share prices lower. For the first time in a number of years, the sector is trading below its long-term average valuation. However, identifying bargains still requires a highly discerning approach.

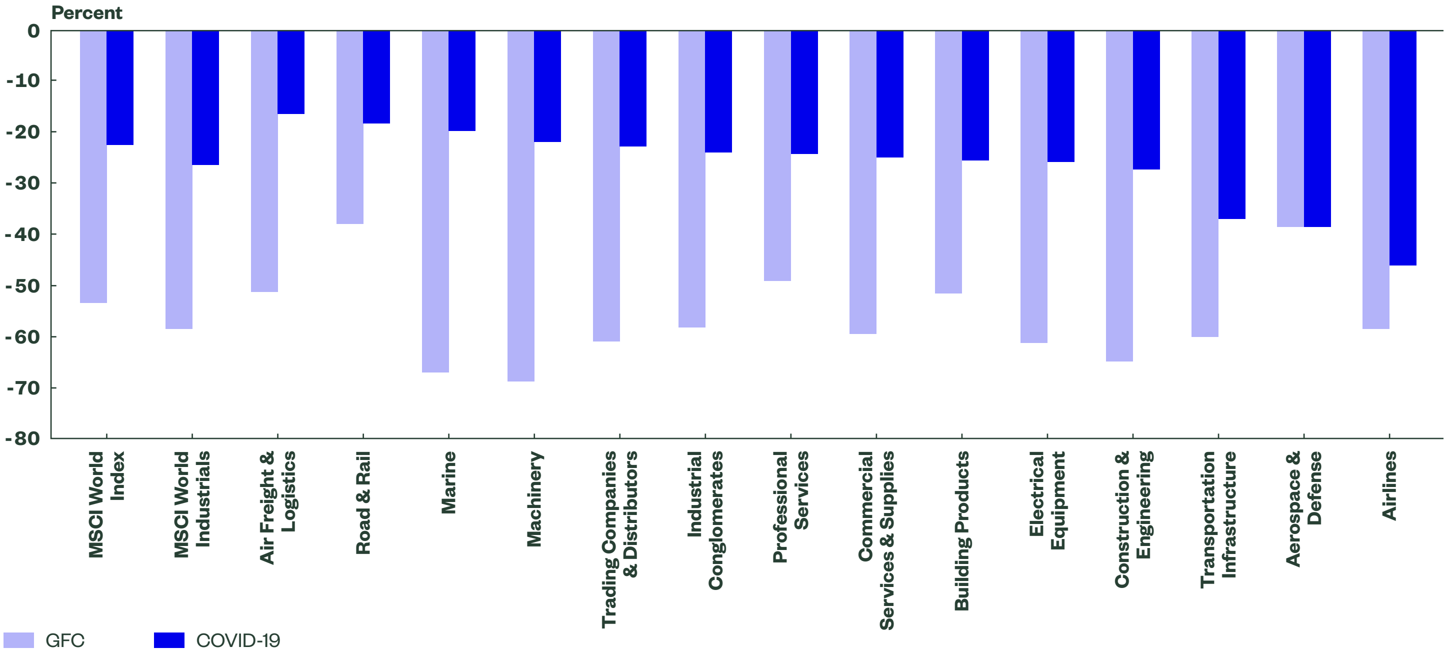
The opening quarter of 2020 has proven difficult for large parts of the Industrials sector. Against the backdrop of closed factories and grounded flights, the MSCI World Industrials index fell 26.4% to lag the broader index by almost 4% (Figure 23). Share prices moved rapidly lower as the market attempted to anticipate the inevitable impact on earnings, for which estimates thus far have only fallen 7%. Price-to-book value multiples have contracted from 3.2x at the beginning of 2020 to 2.3x. While this is less expensive, it is still not cheap, especially when compared to 2009 where the P/B multiple fell to 1.2x.

Within the sector, the Airlines industry (-46%) unsurprisingly has been the hardest hit since the coronavirus outbreak began with demand for its services coming to a near halt. With the market anticipating a knock-on postponement in demand for new aircraft, Aerospace manufacturers (-38%) were the second poorest performing group. This is a severe retrenchment in market value for the airline industry and compares to the 2001 downturn that saw the shares drop 48%. We expect governments to support portions of both industries, albeit at the expense of current shareholders.

By way of contrast, Rail, Marine and Air logistics have held up well on a relative basis as demand for their services are less volatile in this situation.

Along with the operational disruption affecting significant parts of the sector, we have also seen stress in debt markets; resulting in those names with high debt levels and potential liquidity issues being punished.

Figure 23
COVID-19 vs GFC Performance (US$)*



Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.
* COVID-19=21/02/2020–31/03/2020. GFC= 31/10/2007–28/02/2009.

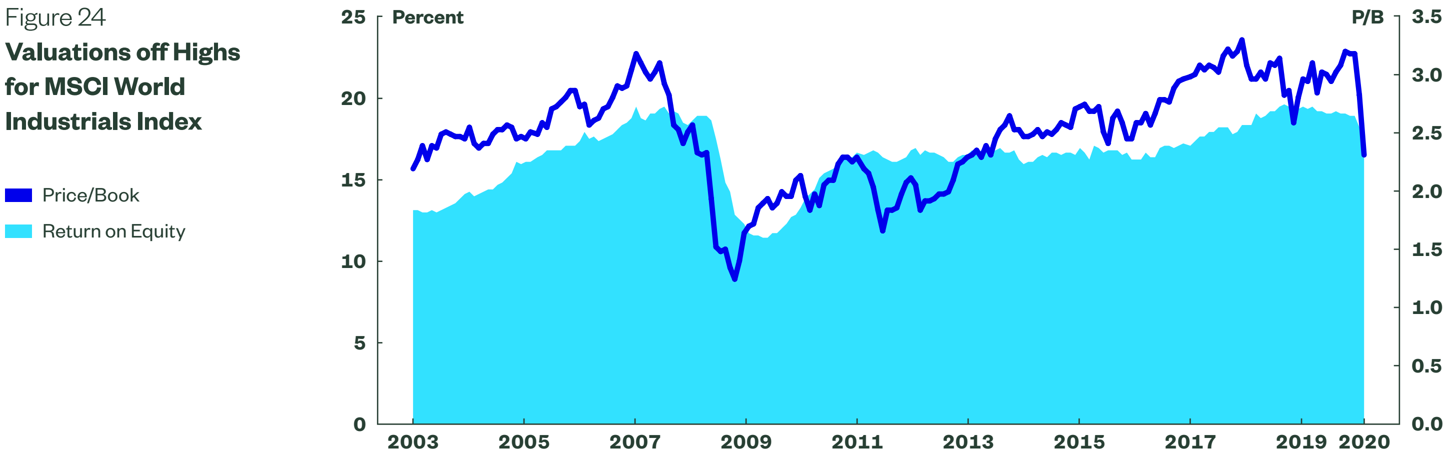
Valuation

The sharp sell-off has contributed to a decline in valuations that had been above their long-term averages heading into this crisis (Figure 24). The sector's reduced P/B multiple of 2.3x at the end of March represents a significant contraction since the start of the year and compares in a moderately favorable manner with the 10-year average P/B multiple of 2.6x (Figure 24).

Within the sector we are also seeing P/B valuations well below historic medians across a range of subsectors; this has helped create a diverse opportunity set for us as value investors.

Ultimately, though, finding cheap opportunities still requires a high degree of selectivity.

Figure 24
Valuations off Highs for MSCI World Industrials Index



Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.

Opportunity

We initially focused on our holdings, stress-testing their operations to be confident they ought to be in a strong position when this shock period passes. We then sought to unearth new opportunities and test the attractiveness of our current holdings against them.

Airlines valuations are now approaching previous trough levels (Figure 25). Over the long term, we expect air transportation to continue to grow. Moreover, with the industry having consolidated in recent years and delivered on improved operational efficiencies, we have been reviewing their capability to withstand a downturn. We believe there are attractively-valued businesses that will make it through this crisis and reward investors over the longer term.

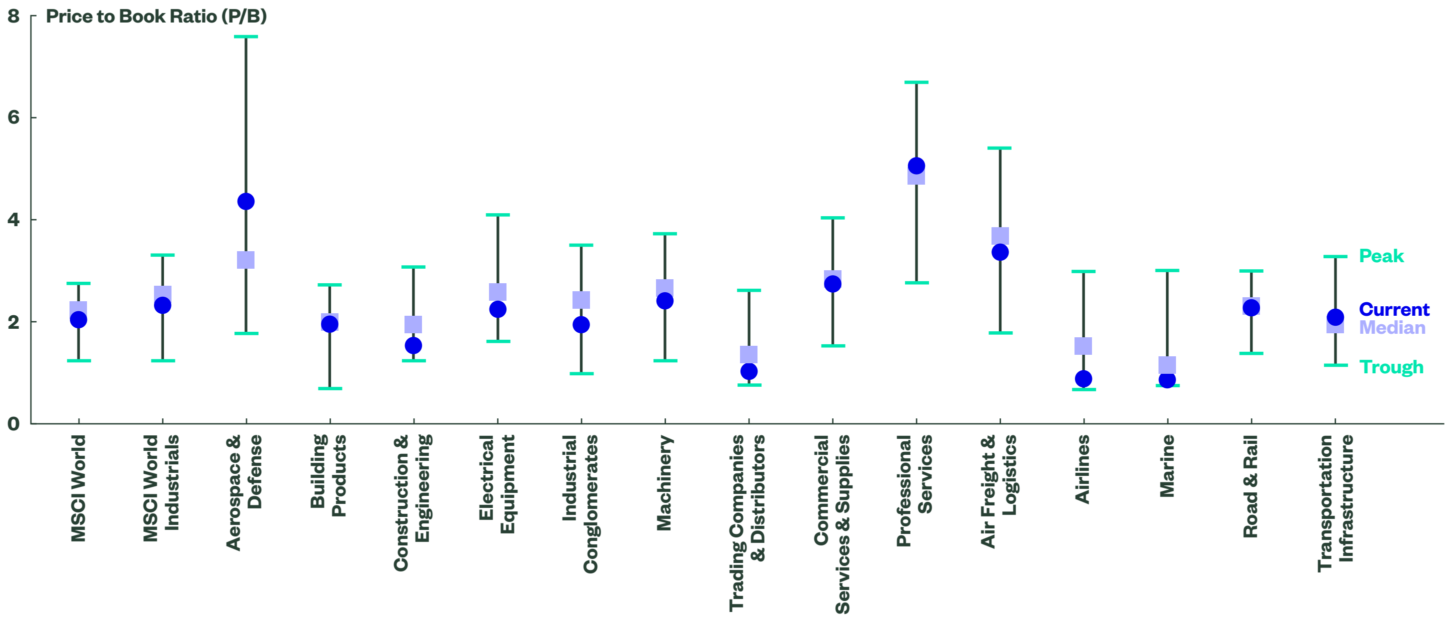
We have looked to take advantage of some indiscriminate selling in early-cycle names, such as staffing companies. We are also spending time assessing aerospace names where valuations may present us with an attractive entry point. Beyond that, we see this sell-off as holding the potential to test our existing holdings against what we view as being the best-in-class names in the sector (which typically have had valuations that were prohibitive prior to the pandemic).

In addition, we are considering the broader implications of how a crisis like this will impact companies' capital allocation decisions. Companies that were already considering how to address supply chains in a challenging trade environment may now accelerate such initiatives where possible — including increased penetration of automation across general industry. Any such reorganization of the global supply chain is likely to drive a significant capital investment cycle, i.e. a multi-year tailwind for capital goods companies.

Oil and gas has been a significant pillar of demand for the industrials sector. With cyclical and structural pressures growing, we are making stringent assessments of companies' ability to thrive without that demand — not least in the Construction & Engineering sub-sector.

Finally, we are assessing defence names caught up in the sell-off. While spending on major programs may be deferred by government, we do not expect a slew of cancellations. As such, we are looking for value opportunities within the sector.

Figure 25
P/B Valuation Range (MSCI World Industrials)
Jun 2003–Mar 2020



Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.

Sector Snapshot
Consumer Discretionary

Ciara Lynch
Research Analyst

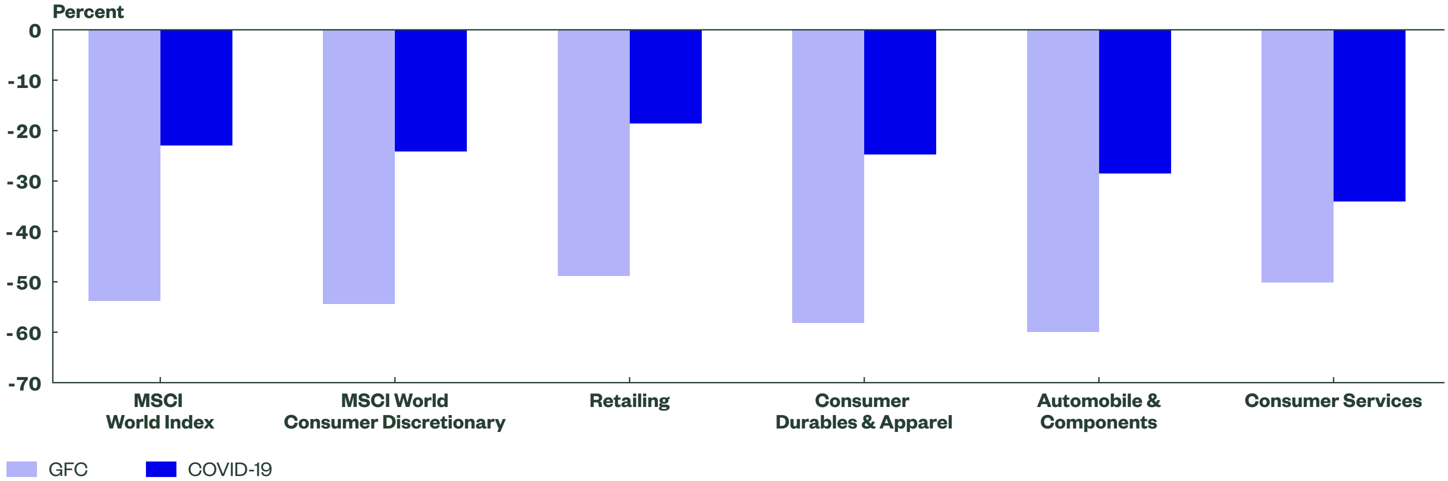
With the spread of COVID-19, consumer businesses from hospitality to retail have faced a transformed landscape that has seen hotels, restaurants and stores close and consumer spending hit amid soaring unemployment. But, not all parts of the sector are as heavily impacted.

The Consumer Discretionary sector has performed largely in line with the overall market, with the MSCI World Consumer Discretionary index falling 23.7% in the opening quarter of 2020. However, performances by geography and subsector are less uniform in nature, with Europe and America harder hit than the Asia Pacific region and industries most exposed to the virus's impact experiencing the sharpest declines (Figure 26). Sector valuations have declined, with price-to-book valuation multiples falling from 3.4x at the beginning of the year to 2.6x currently, still well above the levels reached in 2009.

Within the Discretionary sector, consumer services (hotels, restaurants, cruise lines), unsurprisingly have been hardest hit (-33.7%) as restaurants and hotels closed and cruise lines stopped sailing. Close behind are automobiles (-28.6%), even though they entered this crisis on already-low valuation levels. Durables has performed similarly to the sector (-24.3%). Retailing has been relatively less affected (-18.1%), owing to the large weighting of Amazon, which is navigating through this crisis relatively unscathed from a share price perspective.

Figure 26

COVID-19 vs GFC Performance (US$)*



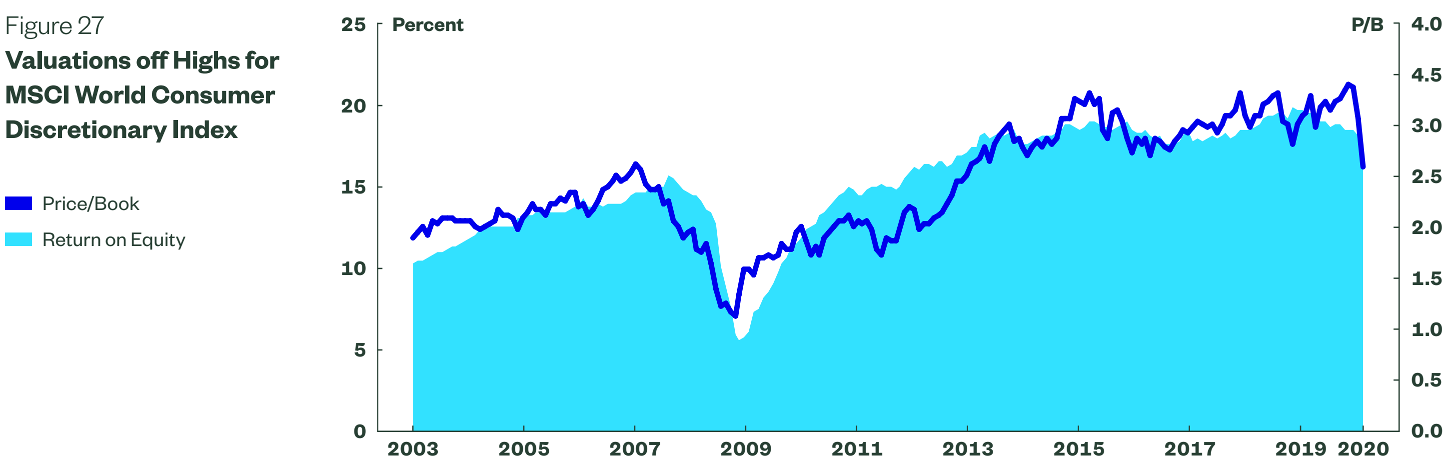
Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.
* COVID-19=21/02/2020–31/03/2020. GFC= 31/10/2007–28/02/2009.

Valuation

Looking at the overall sector, it is difficult to make the case that valuations are particularly attractive. Returns peaked over a year ago and valuations remain elevated on the basis that returns continue to fall; the price to book ratio for the sector is 2.6 times, close to a seven-year low.

Figure 27

Valuations off Highs for MSCI World Consumer Discretionary Index



Source: State Street Global Advisors, MSCI. Past performance is not a guarantee of future results.

However, aggregate sector valuations hide a very different picture at the subsector level. Valuations for the Durables and Retailing subsectors still seem elevated compared to the global financial crisis; Retailing has been buoyed by the relative resiliency of Amazon and its large weight in the subsector; the situation is very different for other Retailing components, such as the department store subsector where the sell-off has been severe. In the Consumer Services subsector, valuations for hotel and restaurant stocks are getting closer to 2008 levels.

The experience of auto stocks during this downturn is markedly different than in the last recession, having reached the same valuation end-point but via an alternative path. Auto valuations had achieved relatively high valuations in 2007 (P/B ~ 2.0x) and then de-rated through 2008 to briefly hit P/B lows of ~ 0.8x. Coming into the current crisis, valuations were already very depressed (~ 1.0 P/B) and have quickly de-rated to 0.8x P/B. However, balance sheets are in better shape than they were heading into 2008.

Opportunity

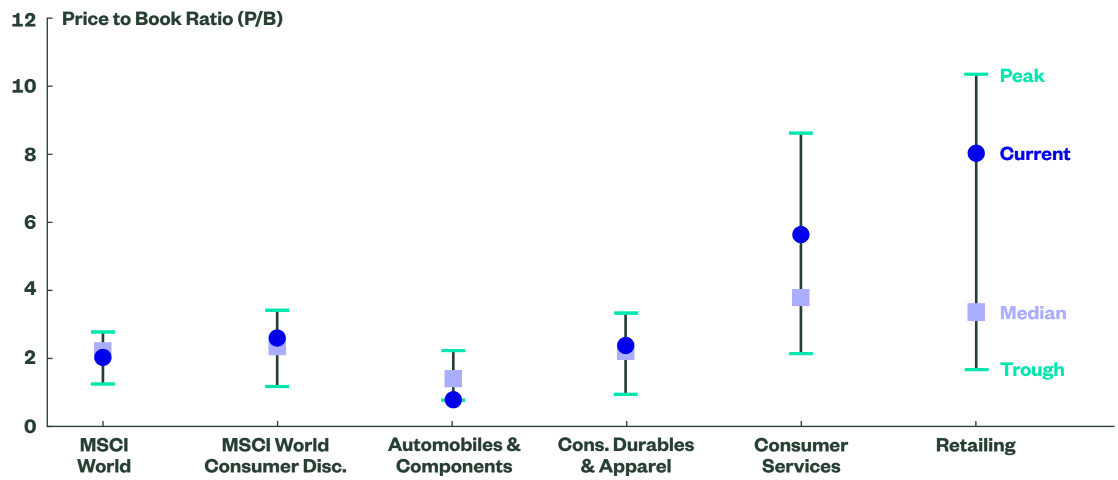
Elsewhere, we are beginning to see some interesting opportunities in the hard-hit Consumer Services subsector. Companies exposed to eating out — restaurants, caterers — experienced sharp share price declines, while hotels have also tumbled. We think these businesses will continue to be severely interrupted in the near term, with mandated shutdowns across most of their operations, with the hotel industry also hampered by people's aversion (and inability) to travel. However, once the environment begins to normalise, we expect people to resume eating out and stay in hotels, underpinning a recovery for these companies.

That being said, we are mindful to watch for structural change: will the enforced working-from-home regularize its use over the longer term, with a consequent impact on corporate caterers? Could the increased use of virtual meetings hit corporate travel and conferences, thereby affecting hotels?

The rapid sell-off has created some idiosyncratic opportunities that we are seeking to exploit. The aforementioned fall in auto sector valuations to GFC trough levels (Figure 28), coupled with the stronger balance sheets of our autos holdings, have reinforced our belief in the names we own. Similarly, after completing our stress-tests we now see tremendous value in some of our consumer durable holdings.

Valuations of hotel and restaurant companies have typically put these names beyond our reach. With this beginning to change, we will assess the potential opportunity here, while being mindful of having sufficient margin of safety to allow for any delay in the recovery of demand.

Figure 28
P/B Valuation Range (MSCI World Consumer Discretionary)
Jun 2003–Mar 2020



Source: State Street Global Advisors, MSCI as at 31/03/2020.

Sector Snapshot
Consumer Staples

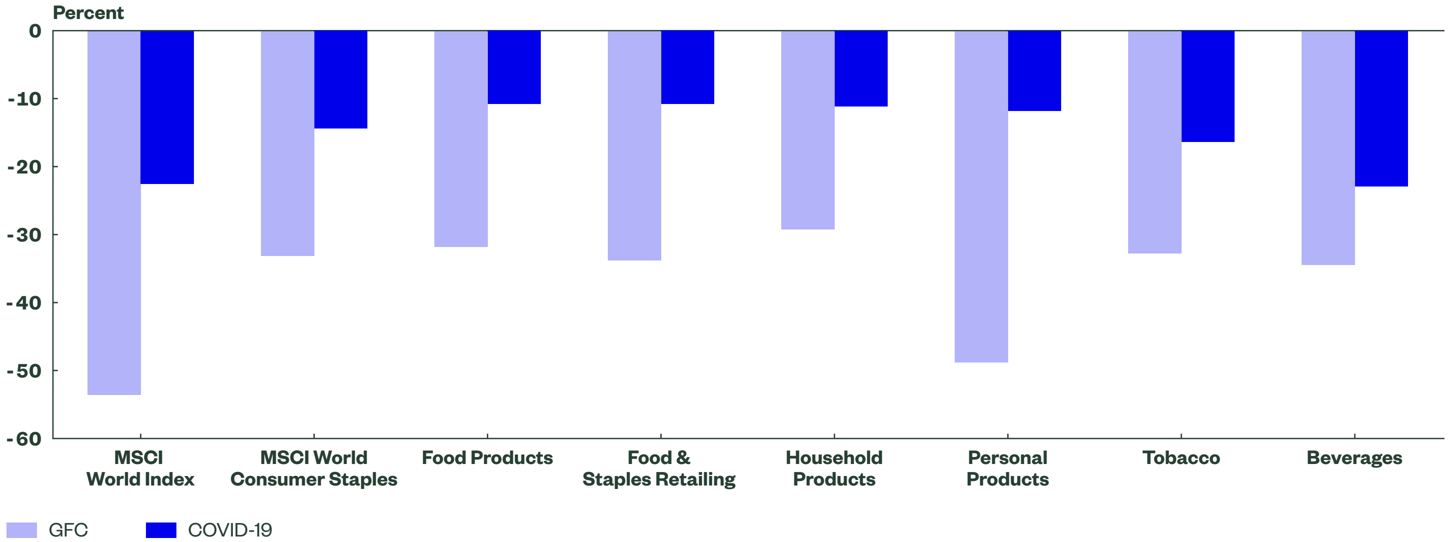
PJ Davies
Research Analyst

The earnings streams of staples companies are typically less impacted than others during downturns, which makes them an attractive option for investors seeking more "defensive" assets. However, already high valuations mean that many stocks in the sector remain expensive despite price falls.

The defensive qualities typically associated with the Staples sector have been on show since the downturn began in earnest; it has fallen only 14% in a market down 23% since 21 February. Only the Healthcare sector has proven more resilient. The experience in the GFC was similar: in that period, the overall market fell 54%, but Staples dropped only 33%.

When we drill down into the subsectors, the best relative performer has been Food Retailing, which reflects people switching restaurants for supermarkets (Figure 29). Household and Personal Products (e.g. cleaning products) have also held up relatively well, as has the Food Products subsector. One notable contrast with the GFC experience lies in the performance of Beverages and Tobacco — last time, these performed very much in line with other subsectors, but this time round they have fared much worse. Beverages came into this crisis with very high valuations, and some of the companies are highly leveraged, while Tobacco is also more highly leveraged than heading into the GFC. On a regional basis, Asia Pacific has fallen less than the Americas or Europe.

Figure 29
COVID-19 vs GFC Performance (US$)*

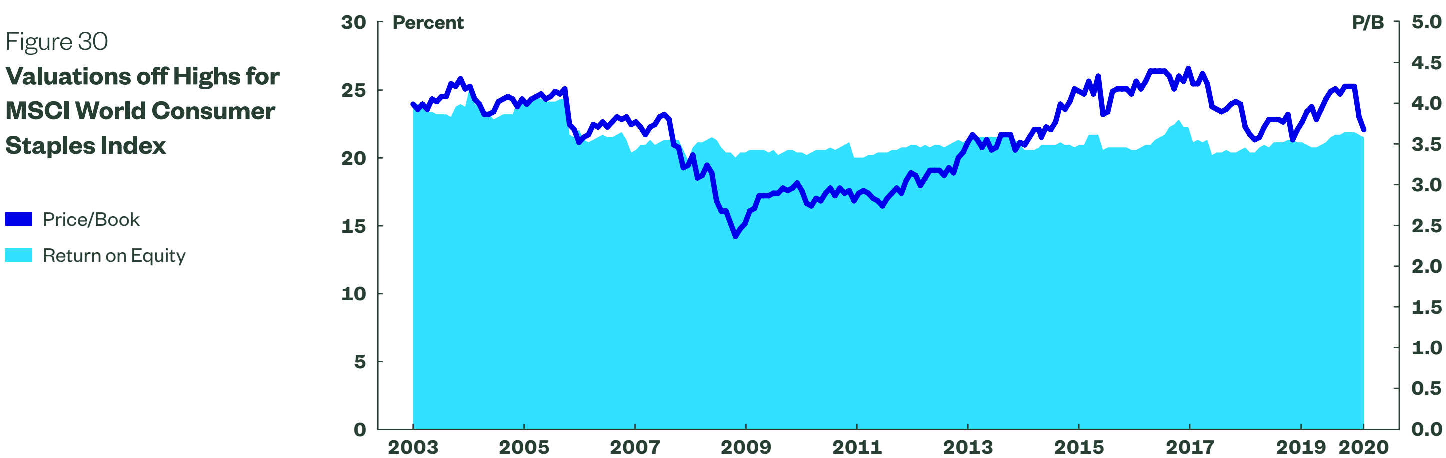


Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.
* COVID-19=21/02/2020–31/03/2020. GFC= 31/10/2007–28/02/2009.

Valuation

Having peaked in 2016/17 at a lofty 4.4x price to book (P/B), sector valuations have been drifting down since (Figure 30). Following the recent fall, they are now at 3.7x which is not far off where they stood at the beginning of the financial crisis 12 years ago. In other words, the sector is far from cheap even now. In the GFC, earnings across the sector only fell about 12% but there was a significant derating; P/B fell to 2.4x. Return on equity (ROE) has been fairly stable, but this measure is actually lower than it was before the GFC, making it even harder to justify the high current valuations. Finding value in Staples has proven difficult, and it would take a significant further fall for the sector, as a whole, to become attractive to value investors.

Figure 30
Valuations off Highs for MSCI World Consumer Staples Index



Source: State Street Global Advisors, MSCI. Past performance is not a guarantee of future results.

By subsector, Tobacco stands out as different having peaked at very elevated valuations three years ago; its valuation levels were well below the lows of the GFC heading in to the COVID-19 crisis. The other subsectors remain at historic median valuations, except for Household and Personal Products which are still significantly above median (Figure 31).

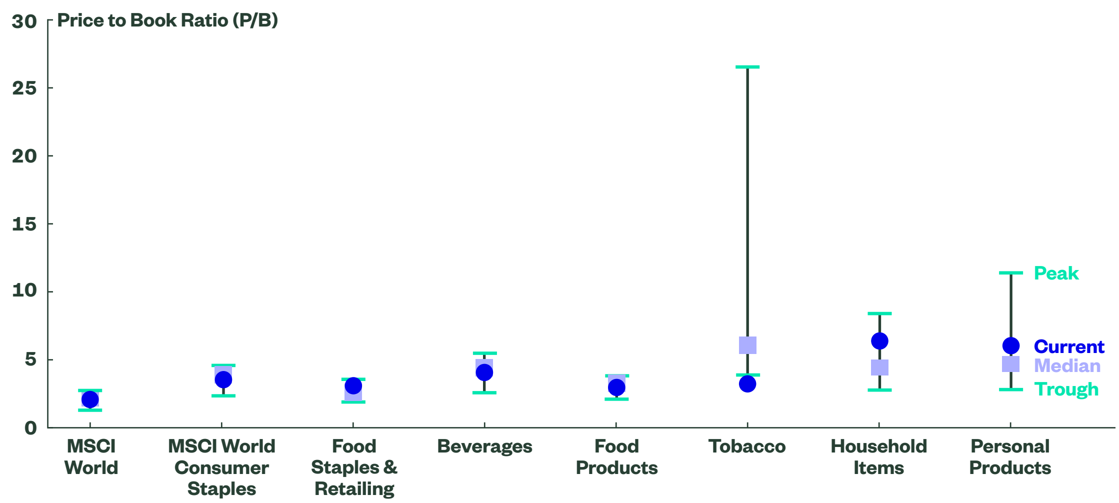
Opportunity

The Staples sector as a whole has not de-rated to the same extent as the rest of the market, which means that many high-quality companies remain far too expensive to be considered good investments. However, we know these companies well and will be ready to invest should prices change dramatically.

Elsewhere in the sector, some stocks are now reaching valuation levels which merit further investigation. Beverage companies have been relatively hard hit, thanks to the closure of bars and restaurants around the world. While some of the major players have very stretched balance sheets, leaving them in danger of having to raise capital, others are very high quality international branded businesses that should come through the current crisis without too much damage.

Another hard-hit subsector is the suppliers of food to restaurants. These companies will suffer not just from reduced sales in the short term, but from customers looking for extended payment terms or failing to pay at all. As with everything we look at, a strong balance sheet is vital, and no more so than in the coming weeks and months of uncertainty.

Figure 31
P/B Valuation Range (MSCI World Consumer Staples)
Jun 2003–Mar 2020



Source: State Street Global Advisors, MSCI as at 31/03/2020.

Sector Snapshot

Communications Services

Bob Allen
Research Analyst

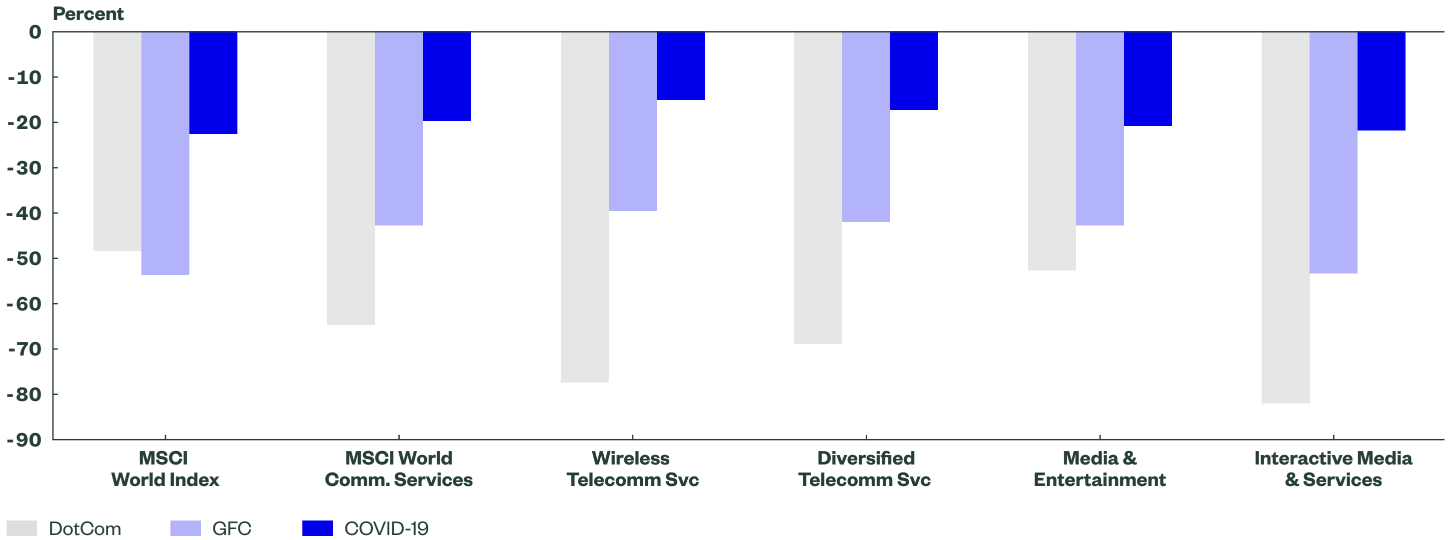
With huge numbers of people confined to their homes to help contain the spread of COVID-19, demand for telecoms and other online services has grown, while advertising spend has dropped. Has the market for these services, and what they're worth, fundamentally changed?

In a short period of time — from 21 February to 31 March 2020 — the Communications Services sector recorded a decline of 20%. In the historical scheme of things, it's worth noting this compares with a 43% fall during the GFC and an even greater slump of 65% in the Dotcom crash of 2000–2002 (Figure 32).

Within this broad sector, defensives such as telecom providers and home entertainment software developers have outperformed. This clearly reflects the market's view that, with so many adults and children stuck at home, the broadband connection and gaming console were likely to represent a new important tier in a 2020 version of Maslow's Hierarchy of Needs.

At the other end of the performance spectrum have been the advertising and broadcasting sub-industries within the Media group. Business marketing and advertising spending, as well as individuals' spending on consuming media outside the home, was expected to fall off rapidly during the stay-at-home period. On a regional basis, Japan was a notable outperformer, while Europe was a laggard.

Figure 32
COVID-19 vs GFC Performance vs DotCom(US$)*

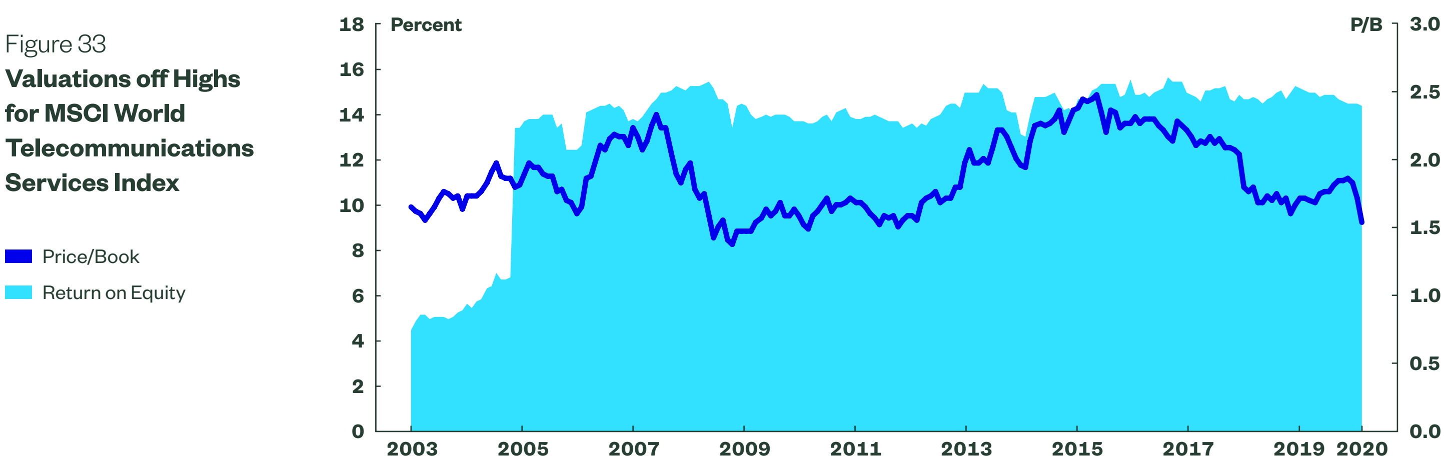


Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.
* COVID-19=21/02/2020–31/03/2020. GFC= 31/10/2007–28/02/2009. DotCom=31/03/2000–30/09/2002.

Valuation

For the Communications Services sector as a whole, it is difficult and potentially misleading to think about current sector valuation levels relative to history due to the significant change in the sector's composition in 2018. Prior to 2018, the corresponding MSCI Sector contained only Telecommunications Services, which is now a sub-industry within the enlarged sector. Therefore, we believe the analysis we have done of individual industries is more informative. The long-term price to book ratio and ROE for Telecommunications Services illustrates a sub-industry that was not expensive relative to history entering this crisis in January. However, almost all other industries in the sector were at a premium to the levels at which we began the GFC and to their historical medians; although still some way off the massive multiples being paid in March 2000.

Figure 33
Valuations off Highs for MSCI World Telecommunications Services Index



Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.

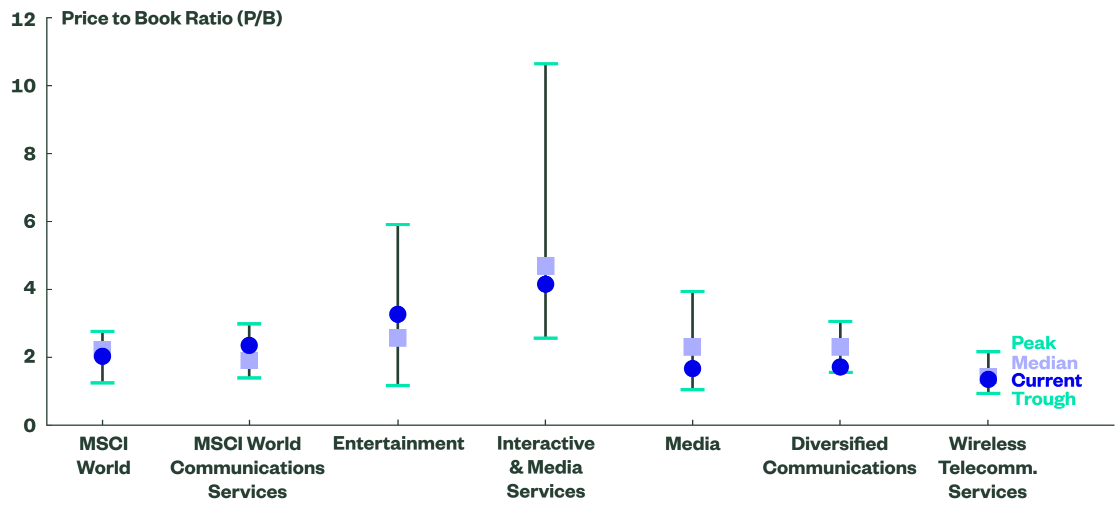
In the year to date, we have seen a modest rotation at an industry level as valuations for Wireless and Diversified Telecoms have moved to be in-line or at a modest premium to the sector. The Media, Diversified Telecoms and Wireless Telecom industries look modestly cheap in absolute terms, as well as relative to their own history (Figure 34). The Interactive Media industry appears cheaper than it has for most of its relatively short but expensive history. Given its recent outperformance, the Entertainment industry still looks expensive in absolute terms and relative to its own history. For example, Netflix continues to trade on over 60 times forward earnings.

Opportunity

The Communication Services sector is far more diverse than the previous Telecommunications sector, with constituents ranging from the venerable AT&T to the juvenile Snap; and so the impact of the ongoing crisis will be similarly diverse. Some short-term trends, such as the huge increase in online gaming, are clear but there are many interesting questions about the longer term to be contemplated. Will an extended period of "lockdown" in many countries engender habits in media consumption and telecommunications usage that will survive upon release? Will the sort of curated content associated with traditional media gain in perceived value and allow for some pricing power or volume recovery? What will it mean for "net-neutrality" and the ability of carriers to control traffic flows over their networks, as well as their ability to charge?

Having stress-tested our existing positions, we are returning to the search for value; opportunities to buy stocks that are cheap relative to their through-cycle long-term earnings power and that have the strength to get to a "normal" year. We anticipate that a market such as this may offer us greater opportunity to unearth value.

Figure 34
P/B Valuation Range (MSCI World Communications Services)
Jun 2003–Mar 2020



Source: State Street Global Advisors, MSCI as at 31/03/2020.

Sector Snapshot
Energy

Lisa O'Sullivan
Research Analyst

The Energy sector's close relationship with economic cycles makes it particularly sensitive to sudden downturns — especially when accompanied by over-supply. In such scenarios, companies with the strongest balances sheets are typically best-placed to weather stormy conditions.

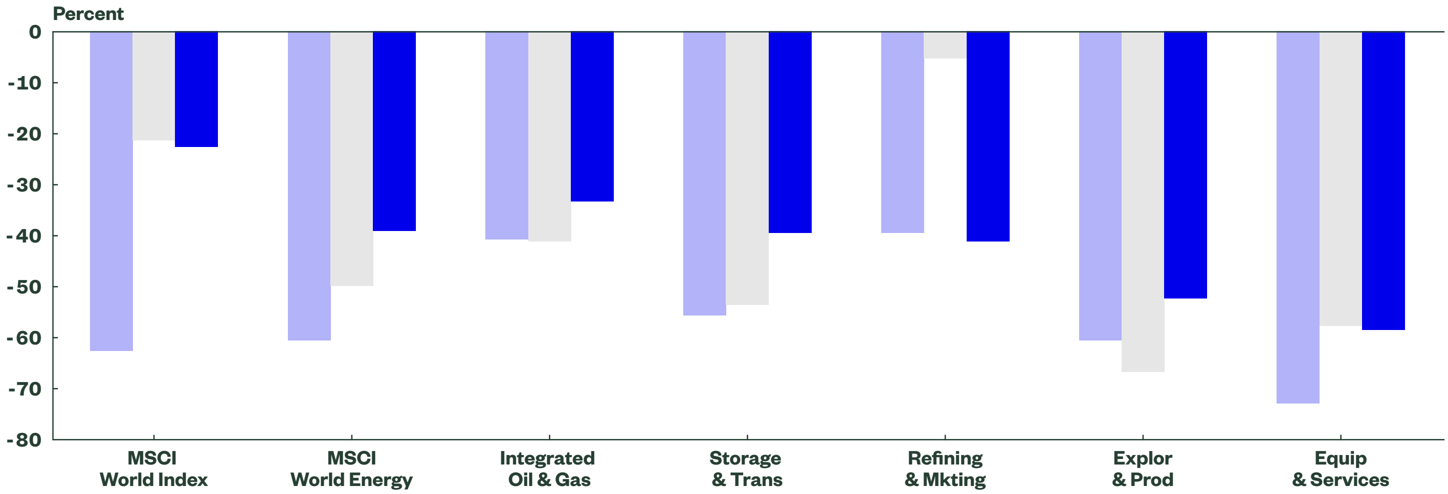
Energy has proved the poorest-performing sector during the COVID-19 driven market downturn. The virus's negative impact on oil and gas demand has been exacerbated by the breakdown of the OPEC+ supply negotiations in March 2020. Since the onset of the COVID-19 crisis, the sector is down 39%; this brings the total year-to-date fall to -45%, which is close to the decline seen over the 2014 to 2016 oil supply crisis (Figure 35). As transportation accounts for more than 50% of oil consumption (aviation accounts for 8%), the COVID-19 related travel restrictions have massively reduced demand. Together with the increased supply resulting from the collapsed OPEC and Russia (OPEC+) negotiations in March, Brent crude oil prices fell below $30 per barrel from $66 at the beginning of the year.

While earnings expectations have partially reflected the collapse in price and slowdown in demand, we anticipate earnings falling further from current levels. Energy company earnings will likely fall below levels recorded in the 2014–2016 period — the last time oil prices fell below $30/bbl. While oil and gas companies have reduced production costs significantly over the last six years, refining and chemicals businesses will not be as supportive to earnings in 2020.

The typically defensive refining industry has not been as resilient as in previous cycles. The 2014–2016 drop was driven by a supply shock — this was negative for Exploration and Production (upstream) operations while Refining and Chemical (downstream) operations benefited from lower oil input costs and the demand improvement from reduced oil prices. In contrast, the 2020 crisis is both a supply and demand shock to an industry already suffering from oversupply. This environment is negative for both upstream and downstream operations.

Energy Equipment and Service companies have been the hardest hit in this crisis. Historically, oil and gas companies reduce capital spend and focus on operational efficiencies in periods of low prices. This reduces the impact of the price decline on cash flows and oil and gas company returns. This cycle is no different in that international oil companies announced average capital expenditure reductions of 20%, while US shale oil firms are making deeper cuts. This is a blow to the Equipment and Service companies already suffering from overcapacity.

Figure 35
COVID-19 vs GFC vs Oil Supply Crisis Performance (US$)*



Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.
* COVID-19=21/02/2020–31/03/2020. GFC= 30/06/2008–28/02/2009. Oil Supply Crisis=23/06/2014–20/01/2016.

Valuation

Leading into this crisis, Energy Sector valuations were already under pressure from the post-2014 oil supply crisis and long-term demand concerns relating to the transition to low carbon energy. Sector valuations, as measured by Price-to-Book, have corrected to levels below the recent troughs of the 2008/09 GFC and 2014–16 crisis; they are now back to the level of the 1985–1986 period when OPEC/Saudi Arabia increased supply after six years of attempting to manage the supply/demand balance.

Figure 36
Valuations off Highs for MSCI World Energy Index

Price/Book
Return on Equity

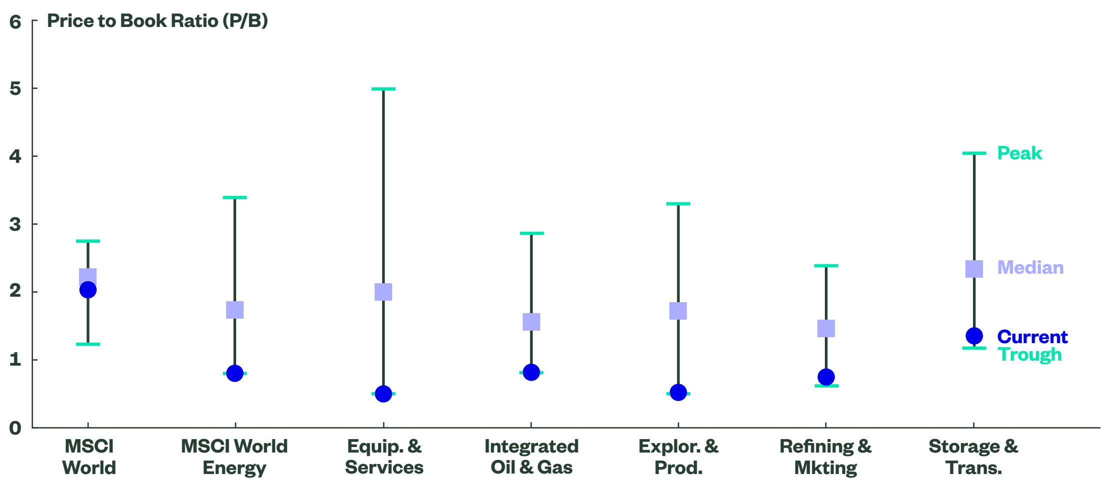
Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.

While the demand environment is certainly worse today, with prices below cash costs for a significant percentage of production, we expect a supply response from non-OPEC producers. For example, the number of rigs drilling for shale oil in the US has declined, lowering US shale production outlook for the next 18 months as natural decline rates come into effect.

Opportunity

We have stress-tested the balance sheets of our holdings — we are comfortable that they can withstand the current low prices and survive into the next stage of the cycle. We have established that the companies we are invested in are attractively valued when we factor in the current headwinds facing the energy market. We are now looking for new investments that compare favourably to our existing holdings by focussing our research on those companies trading on low valuations, as measured by metrics such as Enterprise Value per barrel of oil reserves. Also, these companies should have strong balance sheets and low-cost assets with the flexibility to reduce both operating and capital costs further.

Figure 37
P/B Valuation Range (MSCI World Energy)
Jun 2007–Mar 2020



Source: State Street Global Advisors, MSCI as at 31/03/2020.

Sector Snapshot
Materials

Owen Dwyer
Research Analyst

The sensitivity of many parts of the Materials sector to economic cycles ensured it has been among the poorer performers in 2020 as the COVID-19 impact hit. But the sector is diverse and the investment opportunity potential varies by industry.

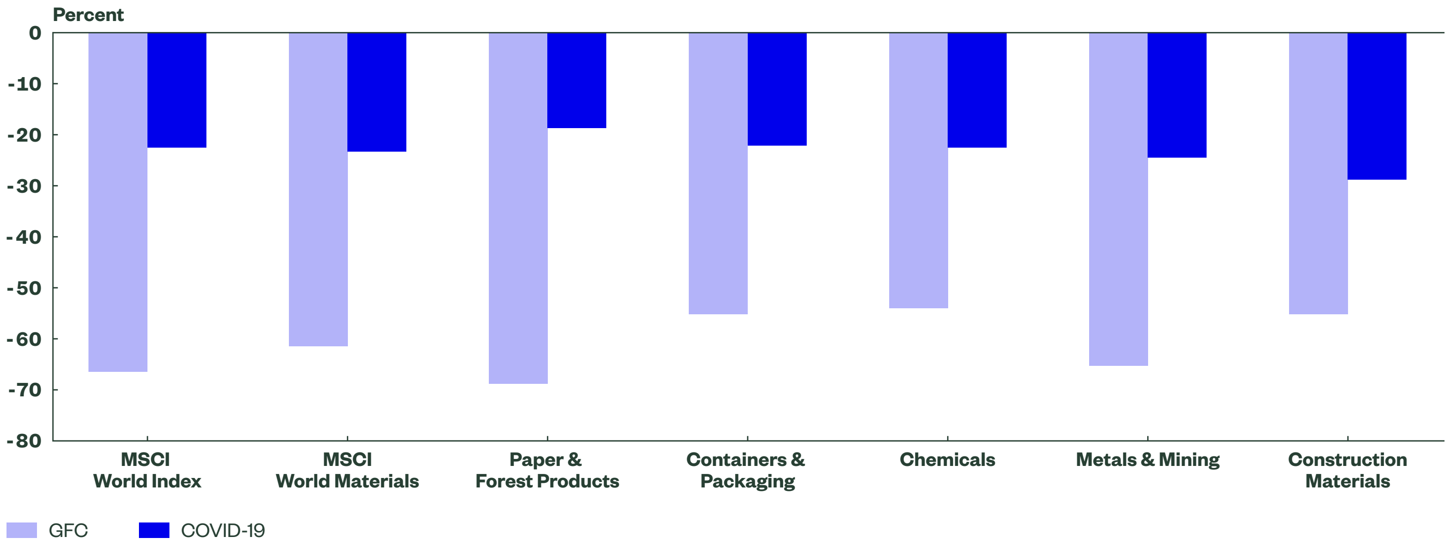
Materials is amongst the sectors hardest hit by the COVID-19 outbreak and was one of the first to be hit as China — a hugely important source of demand — succumbed earliest to the effects of the virus. Overall though, post the end-March bounce, the sector's decline in the opening quarter amounted to less than half the 60% drop seen during the GFC (Figure 38). Within subsectors, those industries with high fixed asset intensity, such as Construction Materials and Metals & Mining, have fallen the most, while those seen as more defensive, such as Paper & Packaging, have held up better. Meanwhile, among Chemicals, expensive but high return specialty firms have hardly fallen, while commodity names (e.g. fertilizer companies), almost regardless of the durability of end markets, have fallen heavily.

We believe what we have seen so far are first order effects as the market moves to price in the immediate demand shock, with the apparent expectation that a sharp recovery then ensues. We can see this by the extent stocks have fallen relative to the GFC, the extent of earnings downgrades (15% for Materials year-to-date versus 70% in the GFC) and still extended valuations relative to trough for the overall sector.

What doesn't yet look to have been factored in is the sheer scale of the economic shutdown across the globe, the destruction of savings and the how long a recovery will take once the various lockdowns end. Moreover, it doesn't appear as if markets have factored in the deflation across cost curves caused by a combination of the demand shock, inventory builds and of course much lower energy costs allied to weaker emerging market currencies.

Figure 38

COVID-19 vs GFC Performance (US$)*



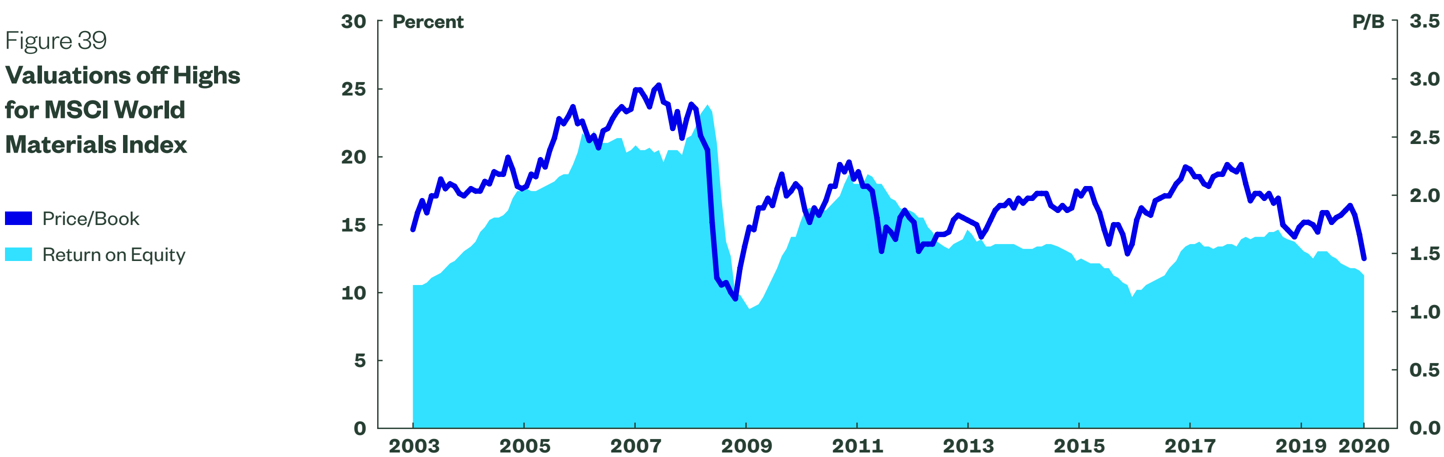
Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.
* COVID-19=21/02/2020–31/03/2020. GFC= 3/05/2008–23/03/2009.

Valuation

Overall, the sector is valued below mid-cycle, but well above trough (Figure 39), levels and with some significant variations (Figure 40). On a regional basis, valuations in Asia Pacific Materials are already at trough levels, while interestingly, North America is closer to historical trough levels than Europe, albeit with a higher base. Within the various subsectors, Construction Materials (particularly in Europe) are close to trough levels, while Packaging and Paper remain at mid cycle levels.

Figure 39

Valuations off Highs for MSCI World Materials Index



Source: State Street Global Advisors, MSCI as at 31/03/2020. Past performance is not a guarantee of future results.

From a valuation perspective and given the scale of sell-off, Construction Materials looks amongst the most interesting subsector to us (Figure 40). Balance sheets are generally robust, liquidity is decent, the sector has consolidated and the industry is highly cash-generative in a downturn.

The Metals and Mining sector has sold off heavily, as would be expected in the current environment, but there has been significant dispersion within this space. Gold miners have out-performed in 2020 (with shares typically slightly higher), but valuations remain well below median levels. Among base metals producers valuations have fallen to close to trough levels for some companies. Interestingly, bulk commodity producers have held up relatively well so far; we believe this to be driven by continued steel output in China, even during the lockdown, and anticipation of another large-scale fiscal stimulus.

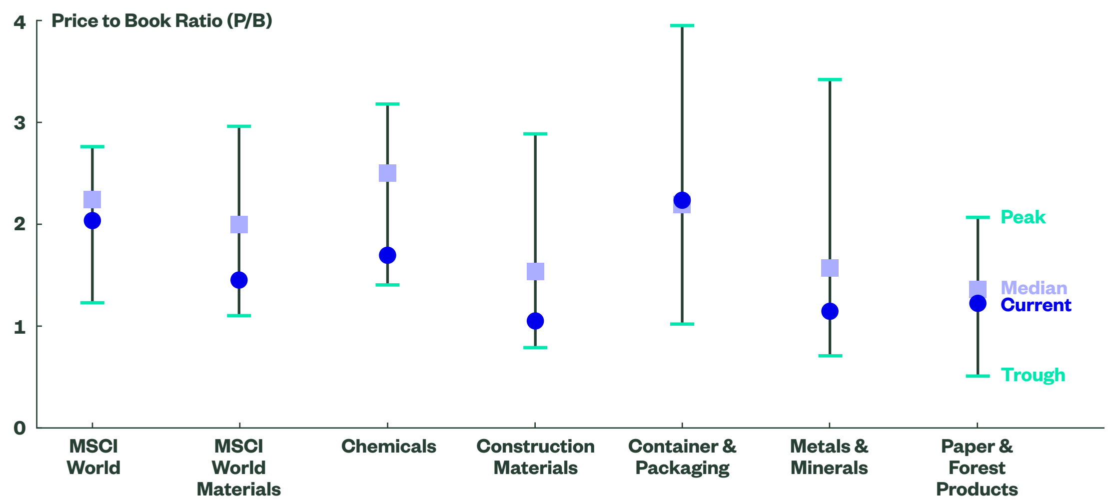
Within Chemicals, defensive staple-type companies where demand is likely robust (e.g. fragrance manufacturers, food ingredients) have re-rated both in absolute and relative terms. Commodity producers, in contrast, have de-rated and valuations are starting to look more interesting. The situation, however, is complicated by the collapsing oil price allied to significant petrochemicals capacity coming on stream in 2020 and 2021.

Within the Paper and Packaging space, valuations have held up well. The challenge for the subsector from here will be the combination of long-awaited new supply. allied to the impact of lower industrial production on demand, as we progress through Q2.

Opportunity

The current dislocation has thrown up a number of opportunities that, in our view, should benefit when demand and economies stabilizes; we are actively examining these companies. Before that happens though, we have stress-tested our portfolio for a GFC-type demand collapse where global industrial production drops by high single digit levels for FY 2020, with a gradual recovery into 2021 — we are happy that our holdings could withstand this level of activity collapse. Should activity levels drop below this for a prolonged period of time, the associated risk increases; we are looking to ensure we own companies that can withstand even this worst-case scenario.

Figure 40
P/B Valuation Range (MSCI World Materials)
Jun 2003–Mar 2020



Source: State Street Global Advisors, MSCI as at 31/03/2020.

About State Street Global Advisors

State Street Global Advisors serves governments, institutions and financial advisors with a rigorous approach, breadth of capabilities and belief that good stewardship is good investing for the long term. Pioneers in index, ETF, and ESG investing and the world's third-largest asset manager, we are always inventing new ways to invest.

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Glossary

Price-to-earnings ratio (P/E) A valuation metric that uses the ratio of the company's current stock price versus its earnings per share.

Earnings per share (EPS) A profitability measure that is calculated by dividing a company's net income by the number of shares outstanding.

Price-to-book ratio (P/B ratio) A valuation metric that compares a company's current share price against its book value, or the value of all its assets minus liabilities.

Book Value The net asset value of a company, calculated by total assets minus liabilities.

GFC The global financial crisis, or GFC, refers to the period of extreme stress in financial markets and banking systems between mid-2007 and early 2009.

Organisation of Petroleum Exporting Countries (OPEC) 13-member group of oil exporting nations founded to manage supply and coordinate pricing.

Return on equity (ROE) This measures the rate of return on the ownership interest (shareholders' equity) of the common stock owners. It measures a firm's efficiency at generating profits from every unit of shareholders' equity.

Margin of safety A principle of investing in which an investor only purchases securities when their market price is significantly below their intrinsic value.

Growth In style investing, a strategy that focuses on companies that have the potential to grow their earnings at a high rate.

Value In style investing, a strategy that focuses on companies that may be priced below intrinsic value.

Barrel of oil reserves The estimated quantities of oil which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under current economic and operating conditions