Holland Macro Views:

Roaring Tigers and Recency bias

If this note reads that we are universally bullish or on in anyway certain of the future that is not its intention. Our aim is to think as contrarians and challenge any biases we see that might be leading to a lack of objectivity. That there is risk and an unusual amount of uncertainty we accept. We also accept at a sub-industry level much may change, but a lasting economic slump we see as far less likely.

We find ourselves wondering if the 'wounded animal' that is the consumer in a normal recession, who takes a long time for his spirits to revive, is not replaced in Covid-19 by the 'Caged Tiger'. Maybe she will not rampage as soon as the cage is open, but if she is healthier than realised (as we believe she is) she could roar a little sooner than many might imagine. This does not imply an imminent 'V' shaped recovery, instead just that the gradient of recovery might surprise when it comes. Portfolios we think should be constructed with one eye on this eventuality and the other on downside risk that looks at balance sheet strength, market positions and resilience to a proacted slowdown.

"Danger and heartbreak dead ahead"

Seemingly many investing and economic commentators are agreeing with the lyrics of The Marvelettes 1960s song, i.e. that there is "danger and heartbreak dead ahead." It is hard to open a newspaper, Twitter or turn on the radio without someone telling you (with a reasonably high degree of conviction on their part) one of the following:

- That a second Covid-19 infection wave is a certainty
- That Covid-19 is creating a significant economic downturn that will take years to recover from
- That many who are currently furloughed will lose their jobs soon after the scheme ends
- With China/US relations now so bad globalisation will soon go into reverse replaced by protectionism
- Inflationary problems are just around the corner post all the intervention we have had (monetary and fiscal)
- The stock market is riding for a fall post its foolish rally.

We highlight below a quote from Friday 1st May FT Lex column. Not because we think it wrong but because we think it well reflects the current mood:

> *"Bullish investors should focus less on when the US economy will re-open. The real question is when US demand will recover – and how it is exposed to a second wave of infections. On nearly every measure the prognosis is grim. The current rally in stocks, like some of the presidents' medial prognostications is only tenuously linked to reality".*

Source: FT

A week later the FT used it front page to tell us that "*Britain on brink of worst recession since the great frost of 1709, BoE warns.'* If the FT acts as the expressor of the balanced view of investor concern, then CNBC is the voice-piece for our friend Mr Market "*there is no return to normal, no return, until we get a vaccine and that is not coming until next year*" – **Jim Cramer, May 4th**

The danger in data

All of this caution could of course be justified. This piece is designed just to reflect and offer some perspective. The first refection we offer is on our modern standard of living and the danger of data. While we will not question the BoE data in its comparison to 1709, we would ask readers to reflect on what a 30% GDP contraction would have felt like in 1709 vs. what it feels like today. Surely, they are same you suggest? No, we will firmly assert. Today a US consumer only uses only c.25-35% of their spending for food and shelter. Whilst we seem to have mislaid our 1709 diary, we know the standard of living then was much much worse. This is we think an important clue as to what the future might look like and warns against the hysteria such headlines can create. Today our confinement means we have been forced to cut back on the huge discretionary expenditure that 100 years of economic prosperity has given us (car repairs, haircuts, eating out, drinking out, holidays ++) . That this would result in a such sharp drop in a catch-all data point like personal consumption, or GDP is thus unsurprising.

As such does the historical comparison of this fall vs. the past really tell us much? During the 2020 collapse a very high percentage of global society has still been able to live a safe and healthy life. In addition, we also have good enough central finance (government + banks) that are providing a significant safety net to those that need it. Anyone reading just a little economic history will tell you it was not always like this. When Buffett puts up his slide of "*Don't bet against America*" too many people just think of the stock market, but that has never been his point. It is about the economic miracle that has been occurring for the last 100+ years that has created a constantly improving standard of living in America and now the world. Thus, more *discretionary* as opposed to *necessary* consumption has been made possible. Books like *Factfulness* and *Enlightenment Now* lay out the data (hard proof) behind such progress.

Interestingly such books also make it clear that it is the bad news that has always sold newspapers, never stories of 50-years of progress in medical advances or lower child mortality. In all the doom and fear we are reading about currently we find not a single article reflecting on how lucky we are to be able to withstand such an attack on our society. While we will not make light of current events, or the challenges ahead we think the scale of recent economic reversal needs to be seen against this context. The crisis/panic of Covid-19 2020 will likely be a blip in the ongoing advance of society and the wealth and wider prosperity it continues to bring.

Hunting high and low

When situations like this occur in our investing careers, we have often found it best to look for insight in two places. Among the wisest and among those who live all around us.

In seeking the views of the wise we have read and listening intently in recent weeks to those such as Buffett, Gates, Sam Zell and Howard Marks to mention just a few. From such wisened voices we hear caution and an honest and open reflection that the outlook is extremely uncertain. Their caution is mainly with reference to the danger of the virus returning or the uncertainty for the economic recovery that follows. Each however is normally upbeat on a longer-term basis.

Their views continue to give us much to reflect upon and lead us to realise how trying to forecast the future is almost futile in such an environment. Howard Marks most recent memo, *Uncertainty* is truly excellent in that regard. We think it one of his best.

https://www.oaktreecapital.com/docs/default-source/memos/uncertainty.pdf

The second source of insight as to the way of the world comes to us from those all around us. This is where we think investors could look to to better understand what might happen next and whether it is what is expected by markets and individual company share prices.

Recency Bias + Fear gauges

As we mulled the risk that was Covid-19 in February we found ourselves increasingly uncomfortable packing bags and squeezing onto flights for half term holidays. In hindsight these holidays were perhaps the Chuck Prince/Citigroup moment for western consumers who were still dancing as the music still played. Cleary the medial situation then deteriorated quickly, and policymakers' warnings were heeded and obeyed by the wider population.

As we seek to analyse markets and economies during such times it is important that we can hold differing thoughts or sentiments at the same time. We can be empathetic; we can be understanding as to why people make feel the way they do. But importantly at the same time we need to be objective. The average person in global society is always busy. Busy with their day job, marriage, children, mortgage ++. This makes them far too busy to question all the information they are given daily. As such they rely heavily on their animal instincts ('system one' as Kahneman put it). This tells them to behave like all those around them but to watch out for occasional danger.

In February half-term western populations' peers and leaders were giving them no reason to worry. A dramatic change in command from those they respect in a crisis enforced a huge change not only to individual's activity levels (as desired), but also importantly to personal fear gauges (which went from 'zero' to 'red alert'). Once all our peers followed suit the reason for this caution was re-enforced in us all. The 'recency bias' and 'social proof' that told all in January and February they were safe now tell us in April and May they we are not. The neighbours that would have hated you if you cancelled their skiing holiday in February now don't even want to go to the garden centre. This is recency bias. (We state again these are not criticisms just psychological observations).

It is the now required reversal of consumer psychology away from fear and safety towards more normal behaviour that is causing some experienced investors to express uncertainty over what will happen next – **We totally agree.** Getting a mother to send a child back to school just by telling her that the child is a 1000x less likely to die from Covid than an old person is no easy task. The only words she hears are 'school' and 'die'. In time however lower perceived risks and peer behaviour will ensure a return to normality

Wounded animal or caged tiger?

Whilst a wide variety of data all point to a massive economic impact, individual discussions throw up alternate views:

- There are many self-employed or small businesses who have been able to carry on without too great an impact who will also receive grants and self-employed compensation

- There have been steeper falls in consumption in parts of the UK that would normally be considered better off, i.e. more recession resilient (a recent survey showed Brighton and Oxford as examples)
- A recent Danish survey showed the biggest proportionate fall in spending occurring amongst the wealthy and elderly (i.e. the opposite of a normal recession)

These latter points we think interesting and possibly illustrative of a wider economic phenomenon which we will call the 'caged tiger'. In a normal recession the average worker/consumer could be thought of as a wounded animal. Poor job security, higher credit costs and lower housing wealth create an environment that is hard to break out from. Animal spirits take some time to recover as job prospects improve and a little more disposable income enables greater spending. Whilst this scenario might well describe a proportion of workers during the current environment it does not describe all (far from it). There are a great number whose job prospects are still secure, whose main source of wealth (their house) has not fallen in value and whose credit costs have not risen.

Enforced recession – Easier or harder to recover from?

But these normally affluent spenders are being stopped from spending at all. The result has been an unusually high spike in the savings ratio reported at end of March (we expect it to be very high in June qtr.). These are what we will call the caged tigers, those who would love to be far more economically active and frankly spend. The scale of the savings even ordinary families have made during this lock down period are significant. A quick look at the breakdown of US Personal Consumption Expenditure (PCE) by household shows that 51% of it in 2019 was spent on housing/healthcare/food/energy and finance. But arguably almost everything else has not been able to be spent in the last 8 weeks. The citing of Oxford and Brighton in the UK as two areas seeing the biggest falls in consumption is notable. The wealthier in society have the greatest disposable income so spend more on discretionary items and services. That the normal recipients of these services (say a hairdresser) is feeling the economic pain is clear. But that the spender is better off is also an under reported fact. A wider benefit for all is the cost of travel. Many people have sizable transport (to work/ school++) costs. That these are running at almost zero is a boost to many household budgets.

Our best guess is that in the coming days and weeks the door of the tigers' cage is opened and she is encouraged to come out. That her first steps will be cautious ones we think is both likely and understandable. However, where our view differs from others maybe is that we think once the tiger (consumer) has found her feet she could well roar once again one day. The debate for us is not the 'if' but the 'when'. A lengthy delay we accept can have knock-on consequences.

Don't bet against Capitalism

Buffett's favourite slide "*Don't bet against America"*. said differently could be restated as "don't bet against the global worker/consumer". Capitalism's attraction is that it enables via personal effort an accumulation of income that is greater than need, meaning that luxuries in life can be aspired to and ultimately afforded. This desire to work hard to improve one's position in society is deeply ingrained in human psyche –and increasingly popular across the globe. This economic desire we still feel is 100% intact. For many the recent stop in their spending has not been out of a need to spend less but being forced to spend less. Thus, the recovery in such spending could be steep.

NB: The effect has not just been on service items like gyms and hairdressers but on large parts of spending on durable goods also; Autos, furniture and clothing are 10% of PCE. That we will for a period spend less in sectors like transportation/hotels and dining (10% of PCE combined) is clearly a new fact of life for a while, but importantly that might free us up to spend more elsewhere. Might we instead improve the home we have been stuck in for 2 months, or have a little more to cover rent/mortgage costs/bills? **That the Covid-19 crisis creates economic change we agree, that it creates an inevitable economic catastrophe we are far more sceptical of.**

Western arbitragers and the wealth effect

If the global aspiring worker is the one of the important cogs driving the capitalist machine another is the interest-rate arbitrageur. There will be those that do not even know what that word means, but who are engaged in the activity. What we mean by this is the activity to look at the cost of debt and compare it to the cost of a property asset you can finance with that debt. For many decades this was just an activity for the uber wealthy, but recent years have made it a mainstream activity (in UK + US). The result is constant refinancing of existing mortgage debt or use of new debt for buy to let/speculate purposes. Clearly this process is also mirrored in the commercial property sector. All the while central bankers are prepared to step in as the FED did in March and all the while the forces we are fighting are deflationary ones with our ever-lower interest rate weapons then the role of arbitragers (both professional or amateur) will continue. What do they bring to society? Well some will say a speculative bubble in asset values. That may one day be true (and we all still await that reckoning) but in the meantime they are one of the conduits that passes on the wealth effect in just the way central bank actions desire.

Exactly when these two cogs – cog 1 (consumer animal spirits) and cog 2 (interest rate arbitragers) are again working strongly in unison to drive the economy we do not know. But underestimating their combined power has been an error of many a bearish investor in the past. This is not a predication of an imminent recovery. Far from it. Just an observation of powerful drivers that investors are unwise to bet against for too long.

Virus views and second comings

We found a recent virus data point interesting from an unusual source. For light relief from the daily news we picked up an old book from the bedside (Tipping Point by Malcolm Gladwell). In reading we found no light relief at all as Chapter 4 was on "epidemics"! In looking at tipping points Gladwell had looked at pandemics. He noted an important point in the 1918 Spanish flu, i.e. that the reason it came back with such vengeance in the fall of that year was that the virus itself had mutated quite significantly over the summer to become a much more dangerous disease.

We thought this was interesting because everything we have heard about Covid-19 is that so far it has mutated very little. Indeed, that is why, whilst vaccine producers cannot move fast enough when asked they express to be fairly sure on being able to tackle the disease in time for exactly that reason. I.e. it does not mutate too much. Whilst we realise the danger of the amateur virology role, we think such insights can help balance the debate away from despair to occasional hope. Admitting that we don't and cannot know is important however as the quote below illustrates:

> *"I've studied this stuff at university, done analysis for decades, written several NHS guidelines (including one for infectious diseases) and taught it to health professionals.* ***That is why you don't see me making any coronavirus forecasts****…"*

Medical Statistician Robert Grant/Oaktree letter

Nothing to fear except…

If ever there was a time for psychology to have a strong place in policy making or investing it is now. For us it is not the GDP falls or the lack of rents paid to landlords in April or May that worry us greatly. It is the fear that now sits inside a billion people's heads. This fear has been successfully created by policymakers, unwinding it is the 'opening-up' challenge. We stated in March that investors needed to be careful not to bring the personal emotion that would influence their home life into their investing decision making. That is still true.

To learn about the likely behaviour of others we can reflect on our own feelings. When have we felt the most fearful in the last 8 weeks? We would suggest it was at the initial point of lockdown when the true scale of events dawned on us all. After that life at home has been calmer and importantly, we felt safer. Other more fearful times for some might be when they needed to take public transport or found themselves in busy supermarket.

Our point is that our greatest fear comes at the point of change. Thus, it is logical that now societies are beginning to be opened many are fearful (Ref: the criticism of leaders announcing even gradual openings – these views are driven by fear). This we think is our caged tiger in action – the longer she has been locked up, the more careful her exit of the cage will be. One day soon (hopefully) social proof and recency bias will turn the full 360 degrees and tell us it is safe to return (almost) to normal. That things will be different we accept, but we humans are a resourceful bunch. We repeat that we see changes by industry as very likely, but not lasting economic catastrophe.

Whatever it takes

The economic fear many are expressing often only includes what we know today. An example being the worry of mass redundancies once furlough schemes expire. However, with policymakers having acted swiftly up to know it is highly unlikely they will stand by and watch such a mass unemployment event unfold. We expect this economic recovery to be the fiscal equivalent of Mario Draghi's 'whatever it takes'. Whilst we have already had huge stimulus measures, we fully expect more if they are necessary. Policy makers are very fortunate that such a crisis occurs against a backdrop of super low interest rates. Additionally, and many will find this heard to accept, maybe we are lucky to find ourselves globally governed by policymakers who are market facing and whom seem set to at least try to make the right stimulus decisions.

In addition to existing policies there is much more that can be done to nurse an economy/society back to life - to tempt our tiger out of her cage if you will, when the time is right. A few UK examples would be to reduce housing stamp duty or extend 'help to buy'. But there are many at a micro level too. Were the virus risk to be seen to have passed by say September a government that wanted to encourage travel/reward the population could allow all children to be taken out of school for two weeks in the 2020/2021 academic year for a holiday without penalty. Covid-19 has been an unprecedented event, the policy responses to it are likely to continue to be equally unprecedented until they have 'worked'.

Maybe we are safer than we believe

While there may be political spats at a global level, doctors and researchers are co-operating like never before. Additionally, much data is being shared with wider populations. Thus, were a second infection wave to come we will be given good warning of it and we/our leaders can adapt accordingly. In short, we now know what to look for. An analogy could be the tsunami in Thailand in 2004.

Few globally knew what the warning for a tsunami (the retreating tide) meant, but many millions in coastal areas worldwide now do. 100 years ago, that information/knowledge to help avoid future catastrophe was not able to be shared. Today it is. This is happening at impressive speed with the global tackling of Covid-19.

But less useful information is shared also. Information that re-enforces the feeling that you currently have. Thus, those worried about a terrible second peak of infection or the fear of venturing outside can find data re-enforcing their current view. On Monday 24th February we were taking Covid-19 very seriously indeed, but CNBC on in the background of our office was not. They were finding and sharing the information that backed their view they then had. Now they are doing the same with todays current starting point. The view we see often reflects the direction we chose to look in.

In short

Whilst we realise the folly in fighting biological uncertainty, we are still contrarian investors at heart. We know that to find the value we seek we will need to have a different view from that which prevails, but that also our view has to be right (eventually). This is hard to do in the face of current uncertainty.

Much is made of the strength of the recent stock market rally, but for depressed value sectors still in heavy bear market territory the wider market rally means little. Mr Market is maybe just doing his job differentiating between the probability adjusted winners and losers. It just so happened that the ‘winners’ were already big companies and the ‘losers’ smaller, hence ‘the market’ performance in aggregate tells us little.

We concede that a wider long-lasting pandemic *could* tip more economic dominos over, spreading the damage further. That is why we are looking for businesses with recovery potential yes, but ones with an asset backing and/or a very strong market position that should ensure their survival. This is not in case the tiger roars sooner that all expect, but in case she is forced to stay in her cage for longer. Margin of safety comes in different forms, often it is in the price we pay. Today it is in the resilience and survival time a company will have.

Put us down as cautious optimists, but ones that like to point out and try to profit from biases when we see them.

With best wishes

Andrew & Mark **firstname@hollandadvisors.co.uk**

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Contact: Holland Advisors London Limited
2nd Floor, Berkeley Square House
London
W1J 6BD

Tel: (0)871 222 5521
Mob: (0)7775 826863
www.hollandadvisors.co.uk

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