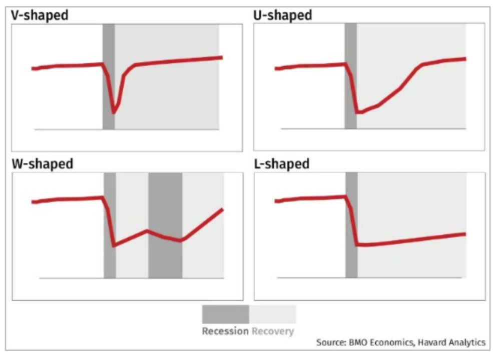
Perspective

Economies Will Recover from the Pandemic, but What Shape Will it Resemble – V, W, U, L, Nike Swoosh?

Daniel L. Bain
Chief Investment Officer and CEO

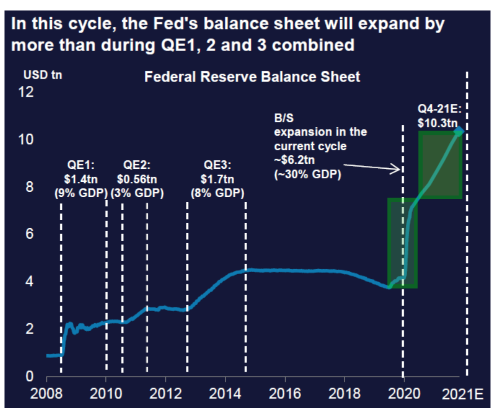
WHAT SHAPE WILL THE RECOVERY TAKE?

There might be no bigger financial question now than the form of the pandemic's economic recovery. Without broad agreement on what the letters mean, there is intense debate over the shape the recovery will resemble - V, W, U, L, etc. (some even add the Nike "swoosh" to the list).



Our expectation of a V-shaped recovery would see North American GDP growth returning to pre-recession levels by the end of next year. The recovery will be faster than from the 2008 Credit Crisis, but it will still be 18 months before growth returns to pre-pandemic levels. Yes, even a V-shaped recovery takes time.

Although there is no precise definition of recovery shapes, they generally resemble the letters as shown in the graphic on this page. And if history is a guide, the faster an economy or market declines, the quicker the recovery. Since the first quarter economic and market declines were the fastest on record, it was reasonable to expect a rapid rebound. That's precisely how North American stock markets unfolded. In a four-month round trip, the markets recovered most of their losses. And there is a myriad of reasons to expect the trend to continue.



ECONOMIES ARE REBOUNDING AROUND THE WORLD

Economies around the world are rebounding; and North American stock markets roared back from March lows, as they continue to discount future economic improvements. With global equities up almost 40% since late March, there is healthy skepticism that market levels might now exceed underlying fundamentals. This concern is expressed by investors' conservative positioning, in the financial press, and client conversations. Paradoxically, investor conservatism helps set the markets up for a contrarian and continued move higher. Conservative positioning means there is cash on the sidelines looking for an opportunity to enter the markets.

At Thornmark, we assume modest fall/winter second wave of COVID infections this, increased use of face masks (finally), broad SARS-CoV-2 immunization in North America by mid-2021, and ongoing fiscal and monetary policy stimulus. As pent up demand builds, consumer spending will rebound next year even while businesses respond more cautiously, meaning it will take longer for employment to reach pre-COVID levels than stock markets.

BALANCING RISKS & OPPORTUNITIES

The economic debate will rage on. Despite our optimism, we acknowledge the risks. The economy could falter on geopolitical instability, an extended and intensifying pandemic, or a US presidential election debacle (such as a leadership/policy shift, or a contested outcome). In the face of these risks, central bankers promise to do everything necessary to protect the economy. The US Fed, for example, deployed roughly $4 trillion of stimulus in only two months. As Morgan Stanley shows in the second chart on page 1, during the Credit Crisis, it took six years to muster $4 trillion of relief. At the same time, skepticism has professional and retail investors conservatively positioned with lots of cash on the sidelines. Adding to the cash stockpile is the billions of dollars being raised by companies taking advantage of cheap credit and capital. By some estimates, there is $75 trillion of liquidity, looking for investment opportunities. Still, we can not ignore the risks.

To navigate these risks, Thornmark is fully invested, with a tactical focus on companies benefitting from sustainable changes in consumer and corporate behaviour. We are using derivative overlay strategies to limit the downside, but also to enhance the upside, should the markets rally on news of a credible vaccine. We do this by adding shorter-dated put options (which provide downside protection) and buying longer-dated call options (which help us participate in a rising market). Our puts extend into November, offering some protection against a COVID second wave, a breakdown in US-Chinese trade progress, and the US presidential election.

SECURITY COMMENTARY

Many companies will flourish in the post-pandemic new normal. We discuss a few here.

GoodFood Market Corp. (FOOD), the Canadian meal kit and grocery delivery company is an e-commerce company that is gaining substantial and sustainable new business in an environment of lock-downs and social distancing with restaurants effectively closed. The quality, low waste, and convenience mean people will continue using GoodFood services, even after the pandemic. Sales have accelerated to $250 million during the pandemic, and are expected to grow more than 20% for the next couple of years as penetration expands. Margins will also improve with scale, increased delivery density, and automation. A price/sales valuation is reasonable, given FOOD's early-stage growth phase. Our $8 price target is 1x 2022 sales per share, for a total return of 75%. The company is a takeover candidate as a strategic asset to grocery stores, so there is upside to our target.

Medical equipment company Thermo Fisher (TMO) is well-positioned to benefit from the tsunami of COVID testing and vaccine research. TMO manufactures equipment used in pharma R&D (including expensive genetic sequencers used in vaccine research), distributes personal protective equipment (PPE), and supplies 25% of the chemical reagents used in COVID lab tests. Critical stockpiles of testing and related equipment dwindled before the pandemic. In the pandemic wake, countries will be well-stocked for the foreseeable future, a boon for Thermo. Testing services will be elevated during the 2020/21 and future flu seasons, given the need to identify COVID outbreaks and to quickly distinguish COVID from other seasonal illnesses. Health care deliveries in March were delayed by China, resulting in greater domestic demand for TMO products. Historically, TMO traded around 24x P/E, but now deserves a premium given improved growth prospects. We project a two-point multiple expansion to derive a $450 target, for a 1-year total return of 24%.

Lastly, who doesn't love a pet? Well, lots of people that didn't have pets found love during the pandemic. Pounds, breeders, farmers, and activist shelters are virtually empty (yeah). But with pets, invariably come vet bills. While we love our pets like family, we all cringe at unexpected medical bills. But we'll do anything to take care of our furry loved ones. That's where Trupanion (TRUP) comes to the financial rescue, as North America's largest provider of pet insurance. Their business has surged during COVID, and will remain elevated, creating an annuity for Trupanion, since customer turnover remains low. With its software platform installed in over 5,000 vets/hospitals, TRUP dominates the competitive environment with superior policies and fast reimbursements. Sales have grown over 20% for the past 19 straight quarters and will likely continue. Only 1.5% North American pet owners carry insurance (compared for example to 25% in the UK), so growth potential is substantial. Comparable companies trade around 8.7x EV/2021 sales. While TRUP deserves a discount due to its lower EBITDA margins, the current 65% gap is excessive. Our $76 target is based on a 4.3x multiple, inline with a 50% historical discount to tech peers, for a projected total return of 78%.

David Bain

THORNMARK ASSET MANAGEMENT INC.

Office: 416.204.6200
Toll-Free: 877.204.6200
Email: info@thornmark.com
Website: www.thornmark.com