Perspective

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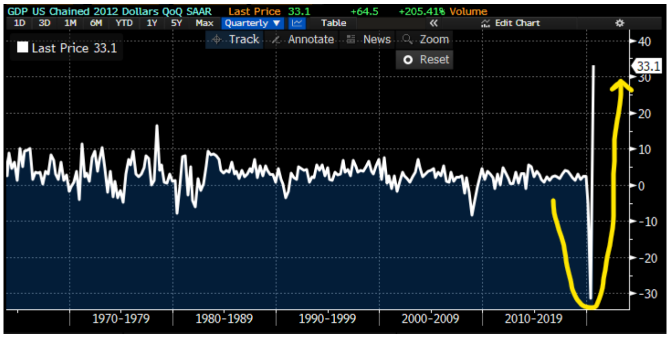
The Election Edition – Tactical hedge protection in place as the pandemic surge worsens ahead of the US election.

INVESTMENT FOCUS - ELECTION & COVID-19

While the North American economy has delivered a "V" shape recovery (see the graph of US GDP on this page), COVID-19 infection rates have taken on a Thornmark-style "M", with the second and subsequent peaks higher than the first - . Higher peaks are a desirable investment outcome, but not so for virus transmissions!



COVID-19 infections are surging as voters head to the polls for a highly contested US election. In this issue of the Perspective, we discuss the economic and market implications of the pandemic and election outcome. Thornmark's tactical strategies are designed to navigate the risks and opportunities, smoothing the path to long-term investment gains.

ECONOMIC REBOUND INTACT

The global economic pain from the pandemic was intense and severe. The economic decline, and recovery, were the most extreme ever. US quarter-over-quarter GDP declined more than 30% in Q2, before rebounding as much in Q3. Other indicators show similar rebounds – initial jobless claims, unemployment rate, ISM indices, factory orders, industrial production, etc. Canadian economic data demonstrates the same dramatic declines and rebounds, as does most of the world. Encouragingly, China, the pandemic's epicenter, which implemented rapid and draconian containment measures, is now the world's most robust major economy. Investment markets, as they usually do, lead the economic rebound. Some indices, like the S&P 500, have rebounded into positive returns for the year. Most developed markets, after dramatic rebounds from the March lows, remain in negative territory for 2020.

COVID'S SEASONAL SURGE

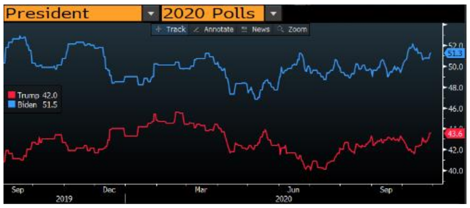
As expected, the SARS-CoV-2 virus is having a seasonal fall rebound. As temperatures drop in the northern hemisphere, virtually all regions, with the notable exception of China, are seeing dramatic increases in infections and hospitalizations. Regions have different pandemic response strategies. While it is difficult to know which are "best", there generally seems to be a more surgical and economic friendly approach than during the "first wave" in February and March. Combined with better treatments and the prospect for vaccine approval around year-end, we expect lower mortality rates during the COVID-19 "winter wave'.

US ELECTION

Trump expected an easy economic path to re-election in a highly contested election. However, a questionable pandemic response, or lack thereof, seriously undermines Republican prospects.

Elections are unpredictable. We didn't learn this from 2016 alone; it has always been the case. Therefore, despite Biden leading a Blue Wave in the polls (see election poll graphics on page 2), the outcome remains an unknown event that will affect North American financial markets. However, we conclude that either a Blue Wave or a split congress with a Biden presidency will be good for stock markets.

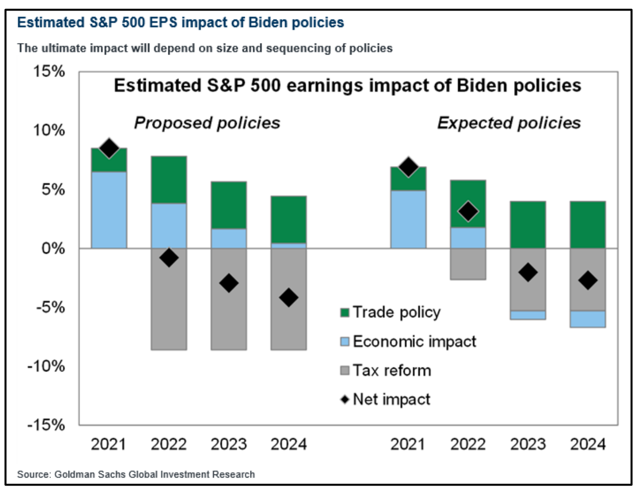
As shown in the lower graphic on page 2, courtesy of Goldman Sachs, their analysis suggests a Blue Wave would positively impact stock market earnings during 2021 and 2022. Other credible research comes to a similar conclusion, as do we at Thornmark. On the flip side, if Trump is reelected, markets will cheer further deregulation and tax rates remaining lower for longer.



Therefore, we do not see a negative election outcome on the stock market in the year ahead. Out outlook supports the recent stock market reversal and more gains over the next couple of years.

ELECTION OUTCOME RISK

While the economic and market outlook for the year ahead is positive, it is not without risk, particularly in the short-term around election day. An increasingly polarized and militant Republican base is threatening election integrity and reprisals if Trump is not reelected. For months now, Trump has pushed conspiracy theories to his base about the accuracy of the 2020 election results. With zero evidence, he complains about an effort to "steal" the election through the use of mail-in ballots. In Trump's own garbled words: "Well, we're going to have to see what happens. You know that. I've been complaining very strongly about the ballots. And the ballots are a disaster. ... We want to have -- **get rid of the ballots and you'll have a very trans- -- we'll have a very peaceful -- there won't be a transfer, frankly; there'll be a continuation**. The ballots are out of control. You know it."



As a result, there are concerns that, should he lose, Trump will try to hang on to control and that his militant base will intimidate voters and act violently to their leader's loss.

We assess the risk of post-election violent conflict as low. We would not be surprised if there are some localized conflicts, but should Trump lose, once the election is settled, an orderly transition of power is expected. However, Trump is erratic and unpredictable, so we could be wrong. Our tactical strategies are designed to address this and other risks.

TACTICAL RISK MANAGEMENT

We remain optimistic that stock markets will continue to trend higher in the year ahead. However, as discussed above, there are event risks with COVID-19 and the US election, to name a few. To combat these risks, fiscal and monetary policy remain accommodative.

To navigate these risks, we modestly increased cash for some dry powder in the event of an election sell-off. We continue to focus on companies benefitting from sustainable changes in consumer and corporate behaviour. Lastly, and most significantly, derivative overlay strategies are designed to limit downside risk. Index put options protect roughly 50% of the portfolios from doomsday COVID and/or election scenarios. Net of all tactical strategies, the unhedged stock exposure of the Thornmark Investment Funds ranges from only 20% to 30%. This extraordinary protection is intended to protect portfolios against significant downside, while maintaining upside opportunities from underlying portfolio securities.

To capitalize on upside surprises of a smooth election transition and/or credible vaccine developments, we continue to tactically add longer-dated call options to enhance performance in rising markets. Our puts extend from November through March of next year, while the call options extend to June 2022. These strategies should yield less volatile performance with a positive relative performance skew, regardless of market direction.

SECURITY COMMENTARY

Many companies will flourish in the post-pandemic new normal. We discuss a few here. Garmin, the smart watch maker, benefits from socially distanced home fitness and outdoor activity trends. Its industry high 20% growth in watches should continue with its new solar features that extend battery life by days and its leading reviews in niche bike, hiking and running trackers. Its Tacx indoor bike trainers continue to be sold out despite the company doubling its production capacity this year, with a backlog that extends through November. Street estimates, however, assume the 15-18% revenue growth rate over the past three years decelerates to 10%, and consensus estimates are still down 4% since February. It has been underfollowed by major brokerages, and management guidance was pulled at the start of COVID, but will likely be re-instated soon. With EPS growth of 20%, it deserves to close the gap to Apple at 32x, which is only growing EPS at 10%. Our $125 target assumes the P/E re-rates from 19x towards the higher end of its historical range of 24x, for a potential return of 26%.

Covetrus (CVET) enable vet clinics to move their in-house pharmacy business to a digital platform. Prescriptions represent 20% of a clinic's revenue, and the majority have no e-commerce capability, which has been an issue accelerated by COVID. CVET is the largest provider with a platform of payment processing, inventory management and delivery. It is also the largest distributor of medical supplies. Pent-up demand from fewer visits this year and the growth in pet owners should accelerate its growth.

Meanwhile, 2021 EBITDA estimates haven't changed since February. It needs to rebuild trust after large earnings misses in 2019 post its IPO and a CEO change. New management has been more conservative with targets, and channel checks by analysts show that its distribution business is regaining lost share. EBITDA estimates deserve to be 10% above consensus based on the software division, maintaining its 4-year CAGR of 38%. Valuation should re-rate higher with software contributing 35% of sales in 2022, up from 1% of sales in 2018.

Comparable SaaS companies trading at EV/EBITDA multiples above 25x, compared with CVET at 17x. Our target is $29 is based on an 18x multiple for a total return of 19%.

TPI Composites produces 20% of the blades used in wind energy turbines. Its engineering expertise and manufacturing history have led to the Turbine OEMs outsourcing blade production to TPI and bankrupting independent competitors. This advantage only increases as blade lengths grow over 75 meters long and are installed in more challenging service locations. Global wind energy installations should accelerate above the 5-yr CAGR of 12% with energy costs on par with natural gas and more social awareness by corporations and government. Europe's new green deal should increase the annual capex spend on renewables by 50% in the EU and Joe Biden's potential Climate plan should double the US annual spend. TPIC should outpace the industry growth given its US footprint (and US domicile) that will benefit from the US nationalism trend that Biden/Trump are pushing. Meanwhile, the street estimates only 12% future revenue growth for TPI. Stimulus may take time to flow to TPI, but its EV/EBITDA should trade at the high end of its historic 6-11x EV/EBITDA range. Our target is $45 based on an EV/EBITDA of 10x on F22, or 59% above the current price.

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