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EXPERTS IN GLOBAL INVESTING

Q&A with Hamish Douglass

Hamish Douglass, the Chairman and CIO at Magellan, talks about the US elections, why the share market seems to be ignoring the economic damage of the pandemic and the reason China's tech giants have a bright future.

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Q: What are your thoughts on the investment implications of the US elections?

A: That obviously depends on the outcome. The polls say Joe Biden is leading the race for the White House. He's ahead in the national polls and ahead to a lesser extent in the battleground states. While Biden is the favourite, so too was Hillary Clinton in 2016. Anything could happen but the first concern of markets is the prospect of a contested result. If the presidential race is close, the losing side could dispute the outcome and markets don't like uncertainty. We should prepare ourselves for the situation where the loser doesn't concede.

While in such circumstances markets would be volatile in the short term, the longer-term investment implications of the polls could come down to the result in the senate. The Democrats are likely to hold onto the house of representatives. It's a much closer call as to which party controls the senate, now in Republican hands.

If the Democrats retain the house of reps and gain the White House and Republicans hold the senate, the long-term investment implications would probably be muted because the Republicans would block radical legislation.

But if the Democrats sweep congress and the White House, the investment implications could be far-reaching if the party removes the senate's filibuster, which gives the chamber's minor party, as long as it has 41 votes, the ability to thwart change. If victorious Democrats remove the filibuster, the party would then be in a position to install any agenda and markets might worry about radical policies becoming law.

We won't be overly concerned, however, if the Democrats end up dominating Washington. Like all parties, the Democratic party consists of factions and there are plenty of moderates in the party including Biden. They will ensure that the party's agenda is more moderate than radical.

Q: Why is there a disconnect between a battered world economy and the record-high share market?

A: Share markets forecast. Investors do this by discounting the cash flows of a business from now to Judgement Day to figure out what the stock is worth. They factor in what's happening in the next one, two, five and even 20 years. When you look at the economy, it's a static picture. It's telling you what's happening today. We could have unemployment or credit losses but that's not telling you what the unemployment rate will be in five years. So you often get this disconnect between the present and people's expectations of the future.

Still, we ask ourselves whether or not the market might be at one of its irrational phases. There's so much uncertainty yet share markets are close to all-time highs. Is that irrational? It's not because it reflects support from stimulus, especially low interest rates. The lower the interest rates, the higher the company valuations because the discounted future cash flows are higher in a low-interest-rate environment. Perhaps the biggest assumption investors are making is that with all the pharmaceutical trials underway a vaccine will be found in 2021.

Q: What happens if a vaccine isn't found in the next 12 months?

A: The longer the virus lingers in a society without immunity, the greater the strain on health systems and the deeper will be the economic damage. Markets are expecting that at least one of the trials underway will lead to an effective vaccine, and this vaccine will be rolled out widely next year. If we don't get a vaccine, or if we get one and it can't be distributed widely, the greater the risk to economies and health systems. That would probably be a major dampener for markets.

Q: Governments have ramped up fiscal stimulus. Does their rising debt matter if interest rates remain low for a lot longer?

A: It looks like governments don't think that it matters but taken to extreme it matters. Our government that was so opposed to debt and deficits is taking on extraordinary amounts of debt. And the argument is that there's no interest cost for this because interest rates are so low. It's almost free. But if we take this to the extreme, why don't we get rid of all taxation and governments just borrow the money? Of course, that isn't sustainable.

This thinking even has a name: Modern Monetary Theory. There will be a day of reckoning. Just because interest rates are super low today, you cannot assume they will always be low. And if you believe debt is free and debt has no consequences, you might as well believe in the tooth fairy. One day inflation will come back and one day interest rates will have to increase.

But this period of low rates could last for a long time. What worries me is the longer this goes on, the more politicians believe in the tooth fairy because they have relatively short election cycles. What are the restraints on them to spend the money today and believe it's a free lunch? I hope there are some rational voices at the table. I think it's been prudent for governments to be aggressive in their response in the past six months but future generations will have a lot to bear. I hope this trend does not get too much momentum.

Q: Some people are concerned about the return of inflation. What's your view?

A: We think we're in a period of low inflation for an extended period of time. We had a massive long economic recovery from 2009 and we didn't see any evidence of inflation. And there's a whole series of reasons why that occurred. We have excess capacity in the world's system. Many advanced countries have ageing populations, which leads to increased savings in society. Productivity has been rising. We're probably facing an extended period of low inflation.

But that doesn't mean we're always going to have low inflation. Policymakers could do reckless things in this environment, particularly with monetary policy. If inflation were to come back, it would be bad for markets if central banks responded by raising interest rates. While we think we're in a low-inflation world for a while yet, we're thinking about what could change that view and whether we might need some inflation protection in our portfolio over the longer term.

Q: What are the consequences of this lower-interest-rate and lower-growth environment?

A: Income and profitability and equity returns will grow more slowly in aggregate and that's going to be a difficult environment for share investors to navigate. They need to be selective to find reliable growth.

Q: Trade tensions are rising between China and the US. Does any decoupling between the pair reduce the appeal of your positions in Chinese technology businesses Alibaba and Tencent?

A: We're interested in investing in businesses we think can grow at attractive rates in the next 10-plus years. Yes, this is a difficult target to meet. We're in a low-growth world but Chinese consumption is likely to grow strongly in the next 10 to 20 years. We don't think tensions and any decoupling between China and US will lessen the consumption story in China. This theme is why we own Starbucks, which has a promising business in China, and Estée Lauder, which produces luxury goods that appeal to the Chinese.

Our investments in the Chinese technology platforms Alibaba and Tencent play into the China consumption story. They're incredible businesses sitting at the intersection of what's happening in the digital economy in

China. But these stocks are not coupled with the US; they don't have big businesses there. So notwithstanding the Chinese-US tensions, we're comfortable holding Alibaba and Tencent. There are risks with these stocks. But they're probably more domestic regulatory risks and other risks associated with China rather than risks linked to the decoupling from the US.

Any decoupling would likely hurt US brands operating in China rather than the Chinese tech giants but at the moment there is no threat from this angle for our investment in Starbucks and luxury-goods stocks.

Q: What's your medium-term outlook for the FAANG versus the BAT stocks (Baidu, Alibaba and Tencent).

A: It's an interesting way to frame the question but I don't regard it as one versus the other. These stocks are different and are subject to different risks. What they have in common is that these platforms are highly advantaged businesses and most (except Baidu) have the most powerful business models we've literally seen since the railroad barons of 100 years ago. There are strong network effects in place and they're light in terms of their capital usage, outside of Amazon. I call this 'capitalism without capital'. It is truly extraordinary. The FAANG stocks of Facebook, Amazon, Apple, Netflix and Google are global plays, ex-China, with ecommerce, digital advertising, cloud computing and entertainment. The big Chinese tech platforms are even broader than the FAANG stocks, including gaming, videos and music. They're into payments, financial disintermediation and local services like delivery.

But these companies will attract the attention of regulators in different ways. The most pertinent question is: What are the risks? We want to buy these stocks when we think they're priced at less than what we think they're worth after taking their risks into account.

Q: How concerned are you about the regulatory risk surrounding the technology companies in the global portfolio?

A: Large monopoly businesses always attract the attention of regulators. This is happening with the two US platforms in the portfolio: Alphabet that owns Google; and Facebook. Amazon and Apple face the same scrutiny but we don't own these stocks.

Even though Alphabet and Facebook are large platforms, they are different business models and the regulatory risks they face are different. Alphabet's risks are more around anti-trust or anti-competitive issues; that it favours its services. Facebook's issues are around the responsibility for the content it carries on its platform.

We do huge amounts of due diligence on the risks attached to different companies, particularly in Europe and in the US. The helpful thing is these risks are visible. There's a lot of public debate. Investors are not going to wake up one morning and find that a law they have never heard of before has been imposed. That's not how the legislative process works. We think these companies are attractive investments despite their risks.

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MC214