Investment Views

February 2020

One flu over the cuckoo's nest

We do not doubt the devastating potential of the coronavirus outbreak. However, we do question the fevered commentary dominating media channels. The fact that no one knows how this will play out would seem to support the aggressive response of the Chinese government (and others) whilst questioning the doom-laden certainty of many talking heads.

At the time of writing (3rd February, 09:00 UK time), the 2019-nCoV virus has (officially) infected 17,485 people worldwide; 362 have died. To set this in context, SARS infected 8,098 and killed 779 during an eight-month outbreak in 2002/3. Whilst the official figures should be treated with a degree of scepticism, it suggests that this new virus spreads more rapidly than SARS but may be less deadly. The mortality rate has, to date, been very low.

To us, the next week or so is key to understanding the reach of this disease. China locked down Wuhan, in Hubei province, on 23rd January. Before then, 5 million workers had left the city as part of their lunar new year travel; the infection level of this migrant cohort is, as yet, unknown. Given that the virus is believed to express over a two-week period, the authorities have extended the official holidays to February 7th, limiting travel during the crucial fortnight (post-lockdown). By then, we should get a clearer idea of how far the initial outbreak has spread.

For what it is worth, our guess is that China is taking suitably draconian steps to contain their domestic outbreak. Well-resourced procedures also suggest that cities in developed nations have every chance of controlling the disease as it inevitably reaches their shores. Our anxiety centres on densely populated emerging market cities, where containment protocols are more porous and rudimentary. What would happen if the flu takes hold in Delhi, Dhaka or Karachi?

Turning to the economic and second order effects, it is somewhat easier to identify areas of concern. Given the disruption of the uncompromising Chinese response, there will be an inevitable slowdown in local GDP. SARS knocked 2% off Chinese growth; we suspect "Wuhan-flu" may do more damage. The global impact may also be wider. China's share of global GDP has quadrupled since 2003 (to c.

17%), with local businesses increasingly integrated into global supply chains. Wuhan is a major manufacturing hub for auto and smartphone parts that are often delivered on a “just-in-time” basis. Apple gave a vaguer revenue forecast in its earnings call last week, blaming the coronavirus; a foretaste of the corporate caveats to come.

The nascent global recovery, engendered by renewed US QE at the back end of 2019, is thus under threat. Given that political uncertainty will re-emerge as we head towards the November US Presidential election and the UK/EU December trade deal deadline, economists and equity markets were looking for improved corporate confidence, with an uptick in both manufacturing activity and investment, during the first half of the year. This narrative is obviously vulnerable. Complicating matters further, we note that the coronavirus counter-measures will impact trade, undermining delivery of the US/Sino phase 1 deal. Chinese demand for US exports, a key part of the agreement, will likely fall short.

All of this questions the relentless rise in US equities. With profits falling in all four quarters of 2019, last year’s impressive rally needs resurgent earnings to validate the move; valuations are now cuckoo. Driven by QE liquidity, the S&P500 stands at a price/earnings ratio (P/E) of 18.7 times forecast earnings. This is well above the 5 and 10 year averages of 16.7 and 14.9, respectively, and the highest since 2002. It also relies on the optimistic expectation of 10% earnings growth this year (source: Factset). Price/book and price/sales metrics are similarly stretched.

Signs of ‘irrational exuberance’ abound. After rising 135% since September, Tesla is now worth more than VW, despite its’ (loss making) 2019 output being less than 3.5% of the German behemoth (367,200 vehicles v 10.8m). In the tech space, the valuation of Apple, at $1.4 trillion, now exceeds the entire US energy sector and the market capitalisation of the Australian stock market. Cheap money continues to fuel momentum driven flows into US equity trackers funds that, in turn, bid up the largest index constituents with no thought about valuation.

As we look ahead, the path of global growth and markets has become less clear. To us there seem to be two key questions. Firstly, will the delayed impact of last year’s monetary and fiscal stimulus sustain the gradual reacceleration in global growth and a concomitant rise in company profits? Before this health scare, we had a growing conviction that this would be the case, with equity markets grinding higher during the first half of 2020. Secondly, what will be the monetary and fiscal reaction of Central Banks and Governments? Will they double down on current support, driving further flows into equity markets? In this regard, having added over $400bn to the US financial system since October, the Federal Reserve’s balance sheet flat-lined in January; are they trying to moderate their support? Interestingly, the recent market correction, whilst ostensibly triggered by the flu outbreak, coincided with this bout of Fed reticence.

For now, we sense that the authorities will continue to underpin risk taking, with any signs of economic weakness being met by further monetary and fiscal assistance. Indeed, we note that the Chinese authorities today cut rates and provided ¥1.2 trillion ($174bn) of liquidity to mitigate market volatility. This suggests that equity markets could well edge higher over the coming months although volatility and the risk of a meaningful correction will rise sharply, absent signs of a recovery in corporate profits. For now, our bias towards cheap “value” equities, US treasuries and bullion are allowing us to participate in equity upside, without too much exposure to the depths of the “risk-off” days. We see no reason to change tack.

The Uxbridge English Dictionary

By way of light relief, we revisit the Uxbridge English Dictionary; published by Penguin, it is a worthy addition to any guest bathroom. For the uninitiated, the Dictionary was born out of the long-running BBC radio program “I’m sorry I haven’t a clue”. During the comedy show, contestants are asked for alternative definitions to well-known words. We share a few below:

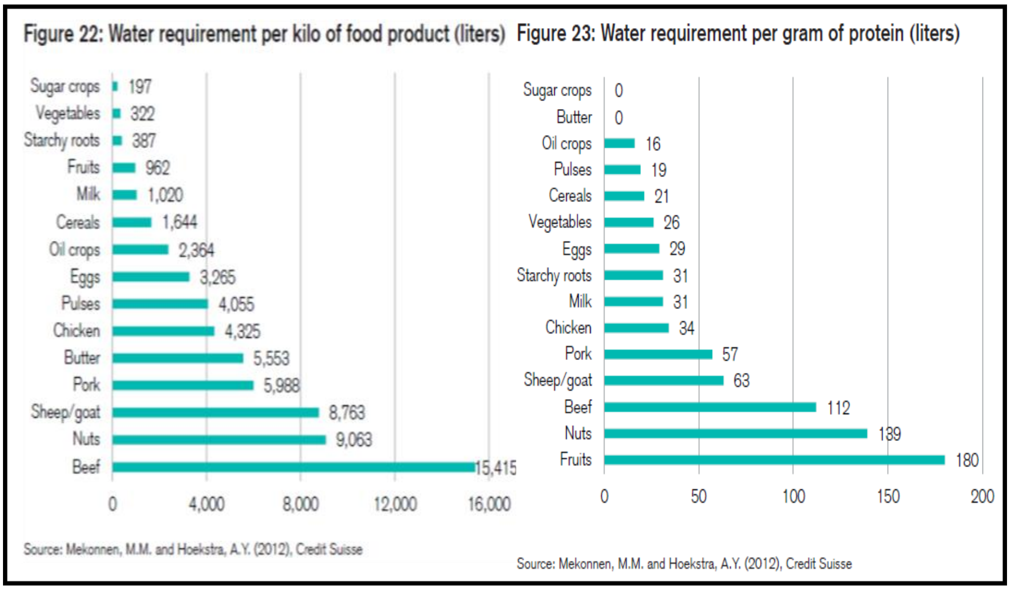
Canapé	A Scottish inability to settle bills
Negligent	A man who wears lingerie
Lamb shank	Sean Connery’s sheep drowned
Inferno	Don’t wear mink
Norway	A Geordie expression of surprise
Onesie	What the Queen calls a selfie
Knee pads	Scottish turnip commercials
Non dom	A defective contraceptive

Water as a theme

We have been exploring water as an investment theme; it’s current uses and the growing supply/demand imbalance. Scarcity is evident in many places, from the western US to Asia, Africa and the Middle East. Access to plentiful, clean water is an increasing challenge and could well be the genus of social disquiet and political friction as we move through the coming decades.

Food production is a major stressor. As real incomes and wealth increase, calorie intake rises. To illustrate the point, according to the WHO, since 1964 developing nation calorie intake per head has risen from 2,054 to 2,850; a 39% increase. Looking forward, the UN Food & Agriculture Organisation expects global food demand to rise 60-100% by 2050.

In the charts below, the litres of water used to produce a kilo of certain foods (left chart) and a gram of different proteins (right) is clearly illustrated. The stats make unhappy reading for beef farmers and those that enjoy a steak. The charts are taken from a comprehensive research report, published by Credit Suisse.



Policy Matrix Summary

The matrix below is a summary of our current outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high level guide on where we stand at this time.

6-12 Month view	Overall	Equities	Bonds	Alternatives
+	Alternatives Cash	Asia Latin America Gold Miners China A Shares UK mid-caps	Inflation Linked Emerging Market	Uncorrelated Strategies Gold
–	Equities Bonds	European US Technology	UK European Japanese Corporate High Yield	

Market Performance

All performance numbers show % changes except for bond yields which show yield changes.

	31 Jan 20	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.3206	-0.4%	2.0%	0.7%
CHF	1.0380	0.5%	2.4%	3.2%
AUD	0.6692	-4.7%	-2.9%	-8.0%
JPY	108.3500	-0.2%	0.3%	-0.5%
EUR	1.1093	-1.1%	-0.5%	-3.1%
BOND YIELDS (10 yr)				
UK	0.52	-0.29	-0.10	-0.69
US	1.51	-0.41	-0.18	-1.12
Germany	-0.44	-0.25	-0.03	-0.58
Australia	0.95	-0.42	-0.19	-1.29
Japan	-0.07	-0.05	0.07	-0.07
EQUITIES				
US. S&P 500 (USD)	3,225.52	-0.2%	6.2%	19.3%
UK. FTSE 100 (GBP)	7,286.01	-3.4%	0.5%	4.6%
FTSE Europe Ex UK (local)	285.92	-0.9%	3.3%	15.8%
Japan. Topix (JPY)	1,684.44	-2.1%	1.0%	7.5%
China. Shanghai Comp (RMB)	2,976.53	-2.4%	1.6%	15.2%
HK. Hang Seng (HKD)	26,312.63	-6.7%	-2.2%	-5.8%
Australia. All Ords (AUD)	7,121.20	4.7%	5.1%	19.9%
FTSE Asia Pac ex Japan	547.06	-3.7%	1.8%	4.0%
FTSE World (USD)	657.47	-1.0%	4.6%	14.4%
FTSE World (GBP)	739.46	-0.5%	2.7%	14.2%
COMMODITIES				
Oil (WTI)	51.56	-15.2%	-4.4%	-5.6%
Gold	1589.16	4.7%	5.0%	20.3%

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