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Markets in Quarantine

Highlights:

- **February was a tale of two halves in global markets. For the first half they proceeded upwards in the US – reaching new heights and seemingly unphased by presidential politics, but in mid-February Apple stock was hit by fears of the impact that Coronavirus would have on its production, and this proved to be a canary in the coalmine. It turned out that the literal quarantining of China due to the virus, and then the spikes in evidence of its global spread was the exogenous shock that would rob markets of all of their year to date gains, and then more.**
- **Europe and the Euro remain on the back foot as the Coronavirus disruption enhanced already weak economic data. The Euro reached a 33 month low against the USD**
- **Other politics took a back seat. Post Brexit-day on January 31, a sweeping reshuffle of Boris Johnson's cabinet saw the departure of Savid Javid, Chancellor, and a raft of new faces, sparking a rally in Sterling on expectations of new fiscal stimulus. This was shortlived, however, as fears of a new cliff-edge, and no deal, were stoked by the Prime Minister's rhetoric.**
- **In the US the primary process saw a narrowing of the Democratic field and a sharpening of the divisions within that party. President Trump, seemingly vindicated by surviving his impeachment trial, had been taking a victory lap, which ended in a triumphant mass rally with Prime Minister Modhi in India. That was quickly eclipsed, though, by the Coronavirus crisis, when an apparent bungling of his administration's initial response drew widespread criticism and fears of lack of readiness.**

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Current macro snapshot

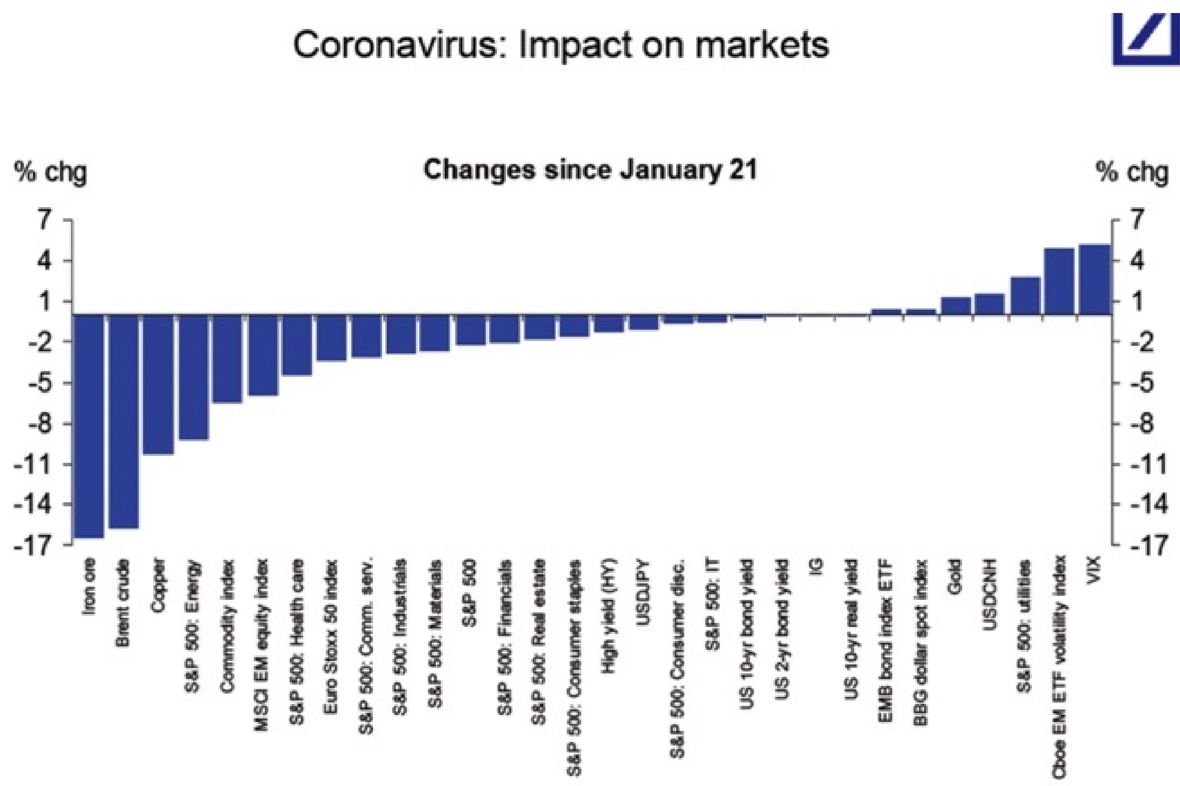
Coronavirus, We don't know what we don't know.

The news trickling out about the Coronavirus has indicated its growing intensity, but there remains considerable doubt about the accuracy and comprehensiveness of the information provided. The virus, now named COVID-19, has officially caused over 3,000 deaths out of a reported 81.000+ cases, and

an abundance of global caution has led to a cessation of air travel between China and the rest of the world and a protocol of 2 weeks quarantine for exposure. A steady number of isolated clusters have now cropped up globally, sparking panic in some cases such as locally in Brighton, UK.

Parallels have been drawn to the disruption caused by SARS in the region in 2003, but a key difference is that the deaths and impact from that were smaller at the time, and at that time China represented only 7% of global GDP v. close to 20% now. The impact of the virus on markets was originally described as a "wild card" and it is already clear that the disruption to the global supply chain (particularly for tech manufacturers and the auto sector) will be severe. Apple in the US just announced that the virus outbreak would cause it to miss its Q1 revenue target, and this sent shivers through markets as they expected more of the same. Chinese GDP itself is expected to show negative growth in Q1 and maybe even Q2. But while for the past few weeks this was surmised to be a temporary disruption that would result in a reversion to the mean after markets reopened it now appears that a return to normal cannot be forecast. The sheer uncertainty of the problem is continuing to wreak havoc.

The chart below from Deutsche Bank research indicates the chilling impact that the announcement of the spread of the virus had after it was announced (this chart was as of mid-February):



UK's Brexit Journey

It has been a somewhat confusing time for signals from the UK economy as while in January data suggested that a rate cut was likely by the Bank of England, it later emerged that January produced the strongest manufacturing and service data in over a year and the fifth highest month on month reading since 1998. This, coupled with an indicator of strong property prices (Rightmove index) and strong job figures, did point to a bounce back in sentiment following the certainty conferred by the December election result. As trade negotiations unfold and the impact of the latest cabinet reshuffle becomes clear, the UK economy seems likely to remain a volatile mix in 2020. The FTSE in particular has been

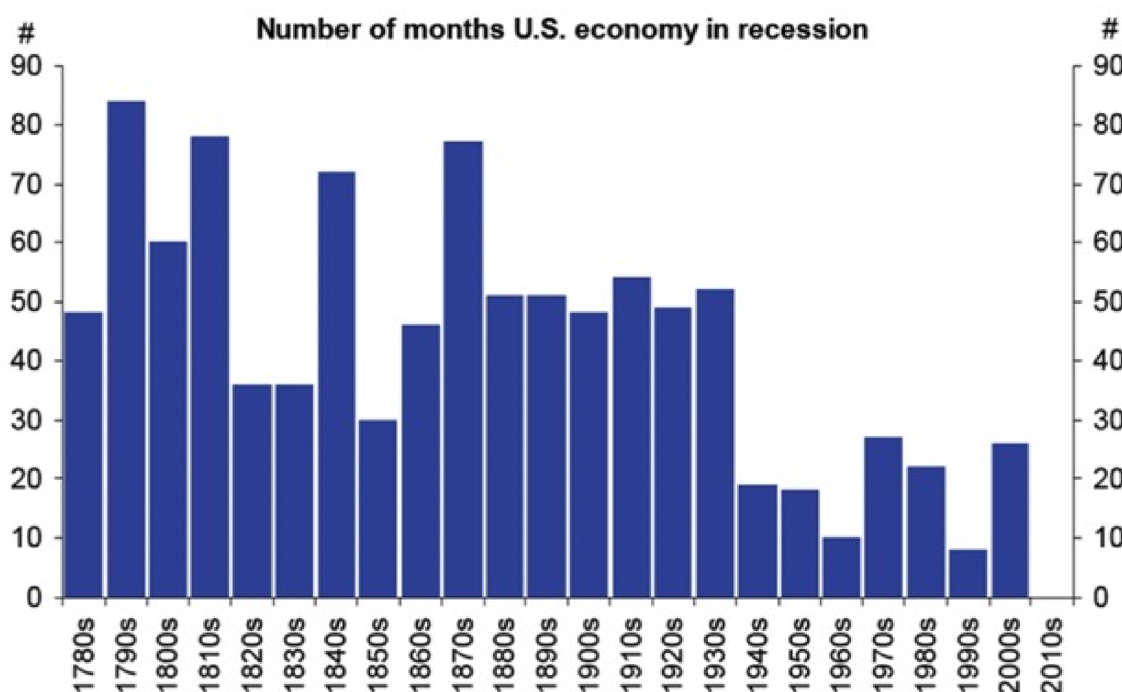
badly affected by the Coronavirus correction in markets – losing 9.7% in February to be close to -12.75% for the year to date.

US Presidential Politics – another wild card?

In this election year, US politics is even more polarized than ever, but also entirely unpredictable. The democratic party's primary process got off to a farcical start as the Iowa caucus results were delayed and then deemed inaccurate, although they did clearly give the lead to, jointly, Bernie Sanders and newcomer Pete Buttigieg. While self-described Democratic Socialist Sanders is feared to be poor for markets, there is less certainty about any of the moderate candidates or Mike Bloomberg. As of March 2 the field had narrowed further with Pete Buttigieg, Amy Klobuchar and billionaire Tom Steyer exiting the race after a decisive victory for Joe Biden in South Carolina. Against this backdrop, an emboldened President Trump is continuing his post impeachment victory lap, stepping up his aggressive tweeting and engaging in a White House shuffle of his own, removing anyone who testified against him at the impeachment proceedings.

Recession watching

To add to some of the recession analysis of the previous overview, Deutsche Bank has shown that this was the last decade free of a recession since 1776!



This unusual occurrence is a blend of the elongated slow but mediocre recovery from the recession that hit at the end of the previous decade as well as, maybe, the impact of artificial stimulus from trigger happy Central Banks. It would suggest that the time is nigh for some kind of reckoning, though, and as noted above, perhaps the Coronavirus has already been the exogenous shock that has dealt this.

Individual Asset Class Performance

- Equities

- Fixed income

Equities: From Wild Card to Global Pandemic

January was a fairly torrid month in global markets, with only the tech heavy US index eking out a positive return at +2%, while the S&P ended the month – 0.16%. This would not normally be remarkable if it were not for the fact that all of the gains for January were erased in a single day – January 31. This provide to be a harbinger of things to come as February started out ebullient, then led to the entire year's gains being erased (and much more) by month end. By month end the S&P had lost 8.4%, leading to a -8.56% return for the year. The tech-heavy NASDAQ seemed to have more support, losing 6.4% for the month and being now down 4.5% for the year. The Dow lost 10% for February and is now down 11% for the year. For the S&P it was the worst week since 2008.

In January, the FTSE 100 lost 3.5%, while the German DAX lost 2% and the CAC 40 (France) lost 2.9%. A mediocre growth figure of 0% for Germany and 0.1% for the Eurozone as a whole in Q4 did little to lift spirits regarding Europe's stubborn inability to emerge from a quagmire of economic weakness. With the unexpectedly high incidence of Coronavirus in Northern Italy Europe became ground zero for the ex-China spread of the virus and markets moved in tandem. As already noted the UK FTSE lost 9.7% in February to be close to -12.75% for the year to date. The Eurostoxx 600 lost 8.5% to be down 9.7% year to date, while the CAC 40 lost 8.6% to be down over 11% year to date. The greater hit taken by the FTSE is due to the higher incidence of metals and mining stocks in the FTSE, which have been particularly badly affected by fears of a protracted slow down and the disruption in China.

As might be expected, Asia also had a terrible start to the year with many markets remaining closed after the traditional Chinese New Year closures in February. This unprecedented extension led to distortions in valuations and although markets have now largely reopened it is too early to assess the true impact of the closures and Coronavirus on market performance. In January, the Hang Seng index in Hong Kong lost close to 7%, while the Korean Kospi was down 3.6% and the Nikkei in Japan down just under 2%. The Hang Seng was actually relatively flat in February as it is now down only 6.75% for the year. All markets fell drastically in the last week – the Kospi lost 8%, the Hang Seng 4% and the Nikkei 225 over 10%. Early indications in March are that markets are rebounding in response to commitments by central banks to inject stimulus.

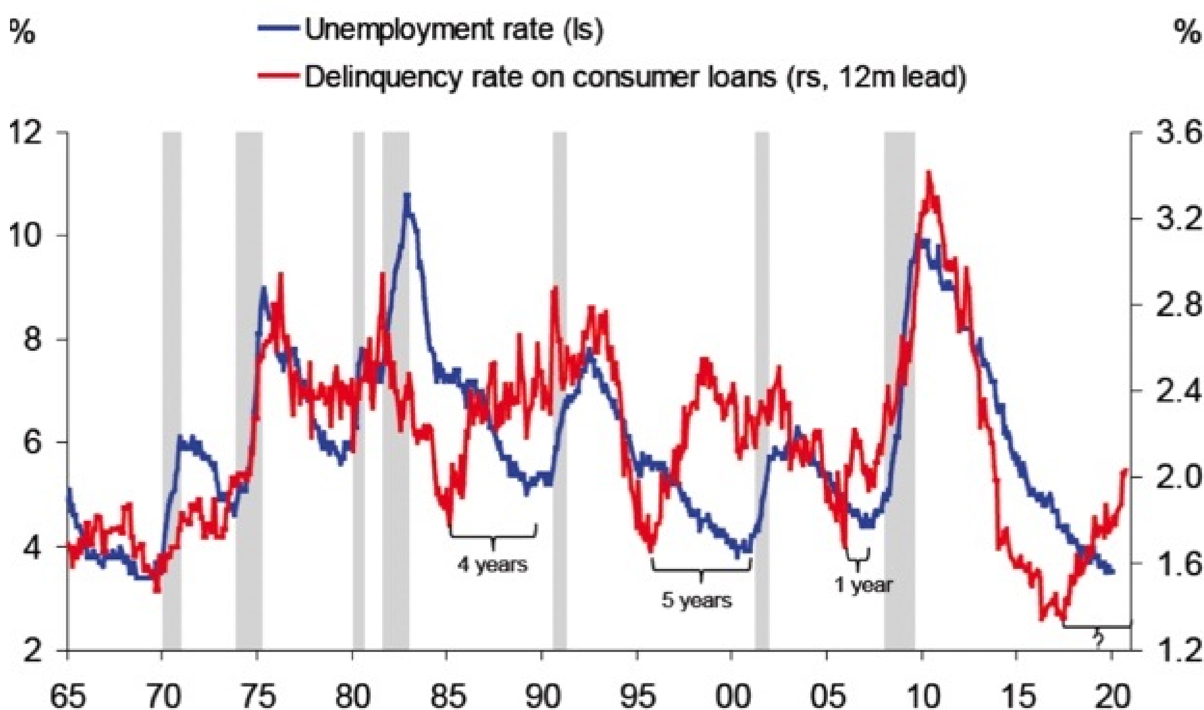
As noted above, Apple was one of the first companies to forecast an impact on its first quarter revenues from Coronavirus and there is likely to be a dramatic uptick in the number of companies reporting this. This is perhaps the most significant development to watch in coming months.

Fixed Income/Credit: shelter from the storm?

Despite the unsettled start to the year, bonds recovered from a lack lustre January to eke out around a more or less flat return in February. While the US Fed is currently still "on hold" in terms of interest rates as of the end of January, it is monitoring that situation in light of global market exposure to the Coronavirus. Elsewhere the ECB may be forced into stimulus action by the anaemic economic indicators there, while the Bank of England was rumoured to be considering a cut too as part of a post-Brexit day stimulus. The hint of concerted central bank stimulus in Asia now suggests that these stimulus measures will become a reality. Given the apparent collapse in demand for certain goods and services it is likely that this will be needed to stem the bleeding and inevitable pain for many small businesses.

To return to a theme we have raised before, which is the potential for cracks to appear in credit, the chart below shows a weakening of consumer credit in the form of increased delinquencies. This is quite a notable trend upwards since 2017 or so and it is interesting that it has been accompanied by

nothing but a decline in the US unemployment rate, which now remains at record lows. Again, the data is never fully satisfactory in this respect, as the unemployment rate is a crude figure that does not measure the impact of the gig economy and the decline in wage growth. We would again state that it is important to monitor these indicators as the economic recovery starts to age.



Outlook

So where do we go from here?

It has been an action-packed first two months of 2020. At the end of 2019 we highlighted the post-election Brexit developments, the US impeachment process and aftermath as well as the cracks in credit as areas to watch. To this we would now add the following:

- **Getting to the bottom of and predicting the endgame for the Coronavirus** With the development of a vaccine as much as one year away, we are very far from a sense of control over the spread of the Coronavirus and a first concern may be knowing the scale of the problem. The impact of the effective quarantine of the 20% of the world's GDP and the major knock on effects in terms of supply chains and global demand from China (as well as the notable impact of no Chinese tourism) will be impossible to predict and there is also likely to be some denial among governments wishing to spin things positively. The shock absorbers available to offset this exogenous shock are in short supply although some central banks have headroom to make cuts and create stimulus.

- **Cracking the European growth puzzle** European economic data continues to be mediocre and the region seems to be battered by every negative geo-political development from trade

rhetoric to Coronavirus fears to Brexit related uncertainty. A zero-growth headline masks positive indicators such as that the unemployment rate is at the lowest level in Europe since 2000. 2020 will be a testing year for all markets so this might not be the year to tell whether the region is permanently "stuck" or can emerge as an independent story amid the global noise. Investor sentiment can take on a life of its own and changing the outlook for Europe may require shifting a dominant narrative, which will take skill and finesse. So far, these skills are in somewhat short supply

- **Watching and waiting in US politics** Now that the democratic field has meaningfully narrowed and President Trump is experiencing a crisis in his presidency that is not a partisan one, there is much to watch and that could possibly change in the weeks ahead. With the democratic field likely split between a revolution (Bernie Sanders) and a restoration of the pre-Trump norms (Joe Biden) the direction of the nation is looking to be a binary one, if there is not "more of the same" under President Trump. The level of rhetoric and intensity of emotion on either side may render this a far from typical election cycle. Watching and waiting is the name of the game.

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March 3, 2020