THE **CAMBRIDGE** WEEKLY

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Virus week – not in stock markets

January is behind us and what a year it's already been. Investors have been bounced around from WWIII fears between the US and Iran, the formal Impeachment of the US president and the prospect of a global virus pandemic. Against this backdrop, it is not surprising that our January 2020 asset returns overview has quite a lot of red across equity markets and solid black across the lower risk bond sectors (see table at the bottom).

Yet it was only the last week of the month that led to this end result. For most of the month the tallies had been positive for equities – maintaining the somewhat extraordinary run for global risk assets since last September. Then the Coronavirus scare gripped investors and provided the reason for the more speculative end of the markets to start taking profits.

Readers may be pleased to hear that it took just the first four trading days of February to turn the tide in favour of equities once again. It must seem bizarre that stock markets recovered so swiftly from the virus scare, while the wider global public is still being bombarded with distinctly scary stories from China. Market participants came around fairly quickly to what we noted here last Friday – not only that there was not much evidence to suggest that this new coronavirus from China's Wuhan was different to most other seasonal flu viruses but also certainly not as likely to become a global emergency as had originally been feared.

So, all clear for investors then. Does this mean we go back to the previous narrative of gradually improving economic growth numbers interspersed with the occasional comedy intermezzo from Donald J. Trump and his unconventional and unpredictable actions?

Well, not so fast. By the end of the week – at the time of writing – it may have dawned on more than just us that the fear of the virus may have more wide-reaching consequences. China's decisive, if not draconian, actions to limit infections spreading further may have been lauded by the World Health Organisation, but they leave a vast number of China's workforce displaced relative to their place of work. Ironically, the Coronavirus outbreak coinciding with the Chinese Lunar New Year celebrations has meant that the virus spread much more than would have been the case during other periods when people do not travel. However, for China's economy it has so far been a blessing since factories are all but shut during this two-week celebratory period anyway. So, while the domestic and some of the international tourism sector has taken a hit, China's manufacturing sector has not – so far.

The next two weeks will be crucial, not just for China's people and economy, but the global economy at large. Should the rate of new infections not decline, then the Chinese authorities will be unable to lift the travel bans next week as envisaged. That means that factories will not reopen as planned and the global supply chain dependencies will begin to bite. Since the China Lunar New Year is a reoccurring event, manufacturers elsewhere will have held increased inventory levels in order to bridge this period – up to the end of February if they planed prudently.

We expect a return of market volatility over the coming fortnight, as the world watches with bated breath whether China returns to work or remains quarantined.

The overwhelming noise of the viral news has had many miss the fact that the other worry point for markets has quietly gone away. The US central bank – The Fed – has not ended its ongoing liquidity support as had been feared. Despite this reassurance from central bankers that market supporting liquidity conditions are here to stay for longer, another bond market monster has reared its ugly head once more: the inverted US yield curve. Only at the very short end between cash and two-year maturities, but enough to reawaken another 'fear of fear' dynamic.

We do not expect the Fed will allow itself to be bullied into straightening out the yield curve slope by lowering rates – especially as it is likely to regard the market rally that followed the introduction of its liquidity support measures last autumn as a negative not positive side-effect. With the humongous volume of government bonds at the Fed's disposal, it could aim some attention to the cash end of the yield curve and reinvest enough of maturing stock of treasuries there. This would allow for a straightening of the yield curve by slightly less conventional means.

So, the jury is out on whether the fragile balance between growth and stagnation, or disruptive bond markets and highly valued stock markets, continues and becomes more stable or whether it all morphs into even greater volatility over the shorter term.

The broad consensus is that the Coronavirus disruption will depress data flow, sentiment and put a dent into the first quarters economic progress. Against this, neither we nor the research partners we regularly discuss these matters with have changed our view, that 2020 will witness an improvement in the global economy. Indeed, the Coronavirus episode has increased our conviction that the economy will take a turn for the better, given that the Chinese leadership will now be forced to unleash a far more substantial stimulus program than had been expected for this year. Unfortunately, this may well come at the price of a one quarter delay for the pick up in global economic growth.

January 2020 asset class returns

Asset Class	Index	January	2019	2018
Equities	FTSE 100 (UK)	-3.9	17.3	-8.7
	FTSE4Good 50 (UK Ethical Index)	-4.6	13.9	-9.2
	MSCI Europe ex-UK	-2.6	20.0	-9.9
	S&P 500 (USA)	-0.3	26.4	1.6
	NASDAQ (US Technology)	2.7	34.1	6.3
	Nikkei 225 (Japan)	-1.6	15.0	-7.5
	MSCI All Countries World	-1.5	21.7	-3.8
	MSCI Emerging Markets	-5.5	13.8	-9.3
Bonds	FTSE Gilts All Stocks	4.1	6.9	0.6
	£-Sterling Corporate Bond Index	3.1	11.0	-2.2
	Barclays Global Aggregate Bond Index	0.9	2.7	4.9
Commodities	Goldman Sachs Commodity Index	-12.0	13.1	-8.5
	Brent Crude Oil Price	-15.5	17.9	-14.5
	LBMA Spot Gold Price	4.0	14.2	5.0
Inflation	UK Consumer Price Index (annual rate)*	0	-	2.10
Cash rates	Libor 3 month GBP	0.1	0.9	0.6
Property	UK Commercial Property (IA Sector)*	-0.1	-0.8	2.9

Data sourced from Morningstar Direct as at 31/01/20. * to end of previous month (31/12/19). All returns in GBP

Coronavirus, or the Fall and Rise of Emerging Markets

Despite being a few weeks into the Coronavirus scare, still very little is known about its real extent. Conflicting media reports abound: One day we hear apocalyptic news and the next we hear reports that the virus' peak is near or even behind us. The same is true for how dangerous it is - with reports ranging from 'extremely deadly' to 'not as bad as seasonal flu'. What we know for sure is that, after losing a valuable six weeks over December and January, the Chinese government has been about as responsive as it could be.

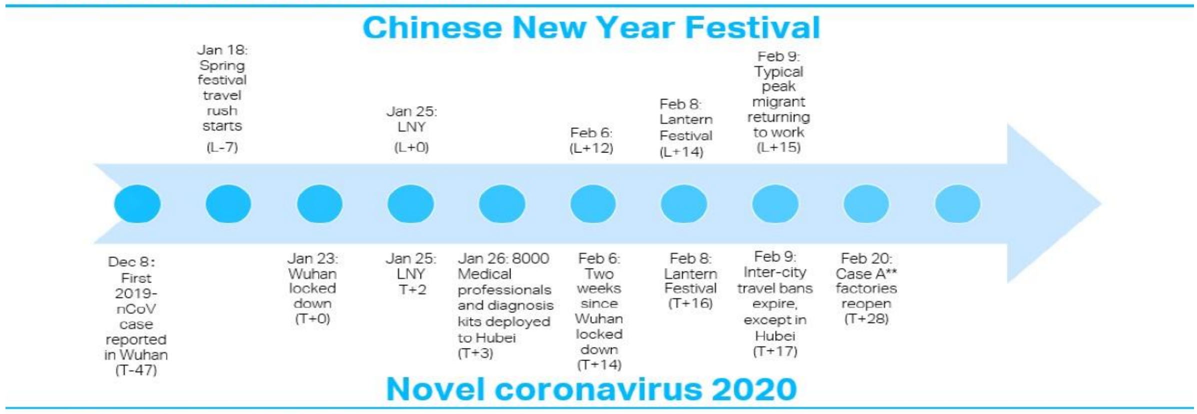
On Tuesday, President Xi Jinping declared a "People's War" on the virus – sending the message that the government's hardline approach and strict travel restrictions will continue. Authorities will defeat the epidemic at any cost, according to state media.

There is no consensus on when we will hit 'peak Coronavirus', but the bigger disturbance remains likely to be the impact on the Chinese economy. Granted, there is never a good time to have a global virus scare, but the timing of this one is definitively unfortunate. After the global economic slowdown of 2019, the first few weeks of this year were just starting to show some green shoots of recovery – in South-East Asia particularly. But a Beijing central government directive to shut down the world's second largest economy beyond the lunar new year period (effectively cancelling China's equivalent to our Christmas) has now flattened those green shoots with a steamroller.

This has been evidenced by the response of capital markets. After struggling for much of last year, emerging market (EM) equities were steadily climbing throughout December and early January – with investors coming to see EM stocks as undervalued and with more upside potential relative to their developed world peers (which, in some regions and sectors, have become extremely stretched on a valuation basis). But EM shares pulled back substantially from mid-January after the Coronavirus news broke.

Chinese economic activity will take a hit during the first quarter of the year – that much is without question.

Coronavirus and Chinese New Year Timeline



Source: TS Lombard

The outlook for Q2 2020 is less certain, but even under the best scenario it is likely some effects will still be felt. But every cloud has a silver lining. As we move into the second half of the year, we are confident that the Chinese economy will rebound hard and fast. The Chinese government cannot afford otherwise.

There is already a growing resentment of the severity of the quarantine, and the perceived failures of authorities during the early days of the outbreak. The Communist Party of China relies upon the promise of growth and prosperity for the stability of its rule. While it is important for them to be seen as instrumental in defeating the virus, it is equally important to get the country back open for business.

Over the last two years, Beijing has played a delicate balancing act with the economy. Their campaign to crack down on the out-of-control shadow banking sector (think US sub-prime before the global financial crisis) and deleverage the debt-laden economy have caused a credit crunch which has hurt business and consumer demand. They have resorted to sporadic episodes of stimulus – including cutting interest rates, tax breaks and infrastructure spending – to counteract the crunch, but have always been wary of tipping the scales too far back to overleveraging.

Expect caution to be thrown to the wind for the rest of this year. A stimulus package of RMB60bn has already been promised, and there should be more where that came from. Local governments that struggled for funding last year will likely receive a big boost of special bond issuance to help pay for infrastructure projects in the latter half of 2020. In addition, planned liquidity injections from the People's Bank of China should keep credit-burdened companies afloat and financial markets swimming in cash.

Crucially, this will not only support China, but wider EMs too. Phase one of the US-China trade deal – although lacking in detail – has already set the scene for a recovery in global trade. This will benefit EM exporters, as will increased Chinese demand from Q2 through to the rest of the year. The recent fallback in oil prices is sure to hurt oil-exporting EMs in the short-term. But with an expected recovery in Chinese demand and ongoing supply constraints from OPEC and its partners, there's no reason for oil to become a new 2020 headwind. In the meantime, lower oil prices will provide some input cost relief for oil-importing EMs which, in terms of capital market impact market, should far outweigh that of the oil producers (see table below).

	% Share Of EM Ex-China Market Cap	China Exposure In Earnings
Korea & Taiwan	36.6	✓ ✓ ✓
Latin America	17.3	✓ ✓
India	11.9	
EM ASEAN	10.1	✓
South Africa	7.3	✓ ✓ ✓
Russia	6.0	✓ ✓
Persian Gulf	6.0*	✓
C. Europe & Turkey	3.0	
Others	1.8	

* In May 2020, the Persian Gulf share will rise to approximately 6.7% as Kuwait joins the EM index.
MRB Partners Inc © 02/2020

The other key component in all this is the value of the US dollar. Dollar strength has been a theme of the last two years, hurting EM businesses with dollar-denominated debt and hemming-in global trade volumes which are predominantly conducted in US$. As outlined before, we expect that trend to reverse in 2020. And while the Coronavirus impact has challenged that view over the shorter term, a strong Chinese stimulus-driven recovery in the second half of the year should make up for it.

The future still looks bright for EMs, despite viral fears. From the moves in EM equities this week – which have bounced slightly from their falls earlier in the month – it looks as though markets agree with us. After the virus passes – whenever that is – expect China and EMs to repay that market confidence.

US economy ignores tumultuous politics

Former New Hampshire governor John Sununu once remarked: "The people of Iowa pick corn, the people of New Hampshire pick presidents," The two US states are the earliest to have their say in choosing presidential candidates. But although Iowa goes first, New Hampshire has a knack for picking the eventual winning candidate. This week, after the chaos of the Iowa Democratic caucus, the US Democratic party might start telling the 'Hawkeye State' to stick to the corn.

On Monday night, voters from Iowa made their choices on who should get the chance to face-off against Donald Trump in November. But it took until Thursday evening to get the final results. What went wrong? Well, to bring the caucus process into the 21st century, party leaders let people cast their votes on a new smartphone app. That app – largely untested prior to use – ended up having multiple bugs and security concerns. What's more, the back-up phonelines Democratic officials handed out became flooded with nuisance calls after the number spread on social media and Trump supporters got a hold of it.

The embarrassing omnishambles led to some near-comical speeches from the leading Democrat candidates. Amid the mayhem on Monday night, the big four – Joe Biden, Bernie Sanders, Elizabeth Warren and Pete Buttigieg – each delivered what sounded like pre-planned victory speeches, congratulating Iowans on the strong message they had delivered the nation. But what that message was, no one had any idea.

The biggest surprise of the night came from Pete Buttigieg, who in the end claimed (by a whisker) the largest vote share. In doing so, he became the first openly gay politician to top a US state nomination contest. But he finished virtually neck-and-neck with Vermont Senator Bernie Sanders – winning by just 0.1%. Trailing are Massachusetts Senator Elizabeth Warren and former Vice President Joe Biden in third and fourth, respectively. Biden, the supposed centrist frontrunner and bulwark against more left-wing candidates Sanders and Warren, tried not to sugar-coat how bad the result is for his campaign, calling it a "gut-punch". Biden can still be expected to win big when primary season heads down south later this month, but his failure in Iowa – and the contrasting success of fellow centrist Buttigieg – means the younger man has the momentum.

On the other side of America's political divide, President Trump enjoyed acquittal in the US Senate's 'trial without witnesses' impeachment process. Republicans and their aligned media outlets wasted no time claiming Trump had been completely exonerated and declaring the entire impeachment a fantasist Democrat conspiracy. Such sentiment was echoed in the President's explosive State of the Union address. Democrats, meanwhile, highlighted several perverse aspects of proceedings – including the Senate declining to call former national security adviser John Bolton as a witness to the trial. In keeping with their usual message on Trump, they labelled the current administration an existential threat to democracy.

We are happy to report that the comedy of errors and cringeworthy speeches did not phase capital markets in the slightest. US equities recovered strongly from last week's sell-off, with the S&P 500 climbing steadily higher throughout the week. This may seem a little odd given that markets continue to appear in a delicate and skittish mood. Valuation multiples have shot sky high on the back of renewed market confidence, but the global economy has yet to reward investor faith with a sustained recovery. Already this year we have seen many threats to fragile asset prices: simmering Middle East tensions, a global virus scare and now tumultuous US politics.

It is early days, but Bernie Sanders and (to a lesser extent) Elizabeth Warren both still have a decent shot at becoming the next American President. This idea scares capital markets. Trump's acquittal has helped his approval ratings and (probably) his own chances of winning in November, but it is not clear that the commander-in-chief would be much of a preferred option for US businesses. His erraticism – particularly with regards to trade – has been the key concern for the US economy over the last three years.

The fact that markets are pushing on despite all this is, we believe, down to three key factors: unambiguous signs that the US economy is reaccelerating, , the US-China trade deal and third, ample liquidity from the US Federal Reserve that looks unlikely to revert to 2018-style tightening measures anytime soon..

On a country basis, US growth slowed more than most last year (admittedly from much more impressive levels previously). But the leading indicators are picking up and are now all pointing in the right direction – particularly with regards to business and consumer confidence. This has been helped by the preliminary trade truce between the US and China. The phase one deal signed last month had very little meat on the bones, but it sent a powerful message of de-escalation. That has given businesses renewed confidence, to the benefit of the economy. In short, both markets and the underlying economy are content to do their own thing, political mayhem be damned.

But we should not get carried away. Valuation levels are still extremely stretched after a year of near-stagnant corporate earnings and it would take only minor disappointment to push equities off their perch. Bond markets may have been the ones more worried and aware of this fragility. It has gone somewhat under the radar that, since the virus scare, the US yield curve (the difference in yield between shorter and longer maturity government bonds) has started to partially invert yet again, which tends to indicate that bond investors are more concerned about the near term than the longterm. This caused investor panic when it happened last year, since an inverted yield curve has historically been a good predictor of recession.

The decade of extraordinary monetary policy we have just come through makes yield curves difficult to read, but just as the fear of the Coronavirus has become the bigger issue than the death toll of the virus itself, alarm at an inverted yield curve is often worse than inversion itself. The Fed is unlikely to fight this fear with another rate cut, however. It is now just as concerned about overheating capital markets as it is about overheating economic conditions. An equity market rally without any underpinning growth in earnings should convince the rate-setters to hold their current course until they see clear signs of economic deterioration. The economic data supporting that view is just not there at present.

The Fed may have other tricks for combating yield curve inversion, however. Given the size of its balance sheet, and the sheer volume of maturing bonds they have to reinvest all the time, its bonds dealers may focus the 'hose' of their reinvestments at the short maturity end of the market, which should straighten that yield curve fairly quickly.

In summary, even though the US economy now has enough steam to stop markets sweating the small stuff, extended valuations leave equities in a fragile condition. The tech and growth-driven US stock markets will only be able to outperform the rest of the world if global economic growth remains at pedestrian levels. Any meaningful recovery in global trade would see other regions offering better upside potential. Moreover, any meaningful deterioration would leave US valuation levels looking even more precarious than they do now. We continue to have conviction that growth will rebound and stabilise, with no recession on the near-term horizon. However, given it is yet unclear whether the global economy will at long last reach 'escape-velocity', we are "comfortably uncomfortable" to play it safe and stay fully invested in the US stock market, given its track record of beating the rest when real economic growth is scarce.

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10th February 2020

Global Equity Markets

Market	FRI 15:59	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7457.3	2.4	171.3	→	→
FTSE 250	21470	1.5	326.5	→	➚
FTSE AS	4146.1	2.2	88.6	→	→
FTSE Small	5981.9	1.5	86.0	→	⬀
CAC	6016.7	3.6	210.3	→	➚
DAX	13495.6	4.0	513.6	→	➚
Dow	29198	3.3	942.1	⬀	➚
S&P 500	3336.5	3.4	111.0	⬀	➚
Nasdaq	9425.6	4.8	434.1	➚	➚
Nikkei	23828.0	2.7	622.8	→	⬀
MSCI World	2416.5	3.2	74.1	⬀	➚
MSCI EM	1102.4	3.8	40.0	→	→

Top 5 Gainers

Company	%
Evraz	12.2
Smurfit Kappa	10.2
TUI	10.1
Prudential	8.4
easyJet	8.0

Top 5 Decliners

Company	%
NMC Health	-41.4
Micro Focus Int'l	-24.6
Hargreaves Lansdown	-7.1
Imperial Brands	-6.8
GlaxoSmithKline	-4.8

Currencies

Pair	last	%1W
USD/GBP	1.294	-2.0
GBP/EUR	0.847	-0.9
USD/EUR	1.10	-1.2
JPY/USD	109.79	-1.3
CNY/USD	7.00	-0.9

Commodities

Cmdty	last	%1W
Oil	54.76	-5.8
Gold	1566.4	-1.4
Silver	17.67	-2.0
Copper	255.5	1.5
Aluminium	1737.0	0.3

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.6	0.1
UK 15-Yr	0.8	0.1
US 10-Yr	1.6	0.1
French 10-Yr	-0.1	0.0
German 10-Yr	-0.4	0.1
Japanese 10-Yr	-0.0	0.0

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	4.7	18.9	13.4	13.3
FTSE 250	3.7	24.6	15.1	14.3
FTSE AS	4.5	19.9	13.6	13.4
FTSE Small	3.4	201.2	-	13.9
CAC	3.0	21.6	14.9	13.5
DAX	3.0	25.6	14.6	12.5
Dow	2.2	20.8	18.4	15.0
S&P 500	1.8	22.2	19.2	16.0
Nasdaq	0.9	28.9	24.0	18.1
Nikkei	1.9	19.3	18.4	17.1
MSCI World	2.3	21.1	17.7	15.3
MSCI EM	2.6	15.3	13.1	11.9

UK Mortgage Rates

Mortgage Rates	Dec	Nov
Base Rate Tracker	2.53	2.50
2-yr Fixed Rate	1.45	1.44
3-yr Fixed Rate	1.56	1.58
5-yr Fixed Rate	1.69	1.69
10-yr Fixed Rate	2.61	2.61
Standard Variable	4.28	4.28

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

For any questions, as always, please ask!

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The value of your investments can go down as well as up and you may get back less than you originally invested.

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