CHAHINE CAPITAL
Performance Engineering

29/2/2020

STRATEGY OVERVIEW

Cuts in interest rates will not be enough to deal with this crisis

Summary

On 25 January, we asked “Is the party over?” and now it really is. It has long been assumed that coronavirus would be largely confined to China and that our healthcare systems would easily cope with contamination elsewhere. Equity markets kept on rising right up to the point where Italy announced a wave of infections and the US authorities issued a warning of their own. They then corrected violently: by 13% from their highs at the time of writing over just seven trading sessions. Declines of over 20% have historically forewarned of recession, although not infallibly. In the autumn of 2018, for example, central bank easing prevented a correction producing that result.

The biggest losers so far in the current crisis are energy stocks. They accounted for 13.5% of the MSCI World index before the 2008 financial crisis but amount to just 3.5% of the index now. Other casualties include tourism and travel (aviation, cruises, hotels, restaurants, casinos) and clothing. The auto sector was already sluggish and is exposed to supply bottlenecks even before risks of recession are factored in. The financial sector has corrected more than average because it is exposed to crisis-affected companies; in the oil sector, junk bond spreads have hit 10%. The worsening economic environment is already visible in layoffs at firms like Expedia.

As usual when recession beckons, investors have switched to safe havens such as gold and the Swiss franc. The autumn 2018 crisis started with successive Federal Reserve rate hikes, which the markets effectively succeeded in reversing. This resulted in soaring financial asset prices without any corresponding increase in wealth. The current crisis is different, as it has nothing to do with interest rates and everything to do with a real risk to economic activity. Companies that start to fail because of a lack of customers will not be revived with zero interest rates, especially as nobody is likely to lend them money. This time, conventional central bank liquidity injections will be of no help at all. Instead, cash should be given directly to those who need it to get through this crisis. Helicopter money, in other words, for consumers and businesses. The authorities in Hong Kong have already decided to issue HK$10,000 (US$1,283) to all residents aged 18 or over and are offering other direct support to both citizens and firms.

In a replay of 2018, the markets have put a good deal of faith in Fed easing. 30-year yields are down to a new low at 1.65% in America and are negative in the euro zone. The curve is pricing in three or four Fed cuts; the ECB is assessing what the long-term effects of coronavirus might be, but as we say we do not see what monetary policy can do in this situation. The supply chain is breaking in pharmaceuticals, with China unable to export the raw materials to India that end up as exported finished products. Apple, Japan and South Korea have signalled comparable problems. The chances of a rebound in corporate profits growth this year are waning fast, and the consensus estimate for US index EPS growth is down to just 5.6%. Our estimates are 1.5% without a recession and -14% with one. The American market’s CAGR implied in market prices is 0.5% with a 30-year at 1.68%, and our model is at 1.9%.

Our theoretical objective for the S&P 500 is 3,241 points, compared with 2,954 points at Friday’s close. That objective would drop to 2,992 points with a 30-year at 2%, and in a recession scenario with 1.5%, it would be 2,776 points. A long rate at 1.25% would lift it higher still. These considerations prompted us to return to the market, and we are looking to increase our equities exposure from 35% to 38% in a stepped operation: a fifth with the S&P 500 at 2,938 points (executed on Friday), two fifths at 2,850 points and the balance at 2,750 points. We are using the same strategy for Europe, using these same US thresholds.

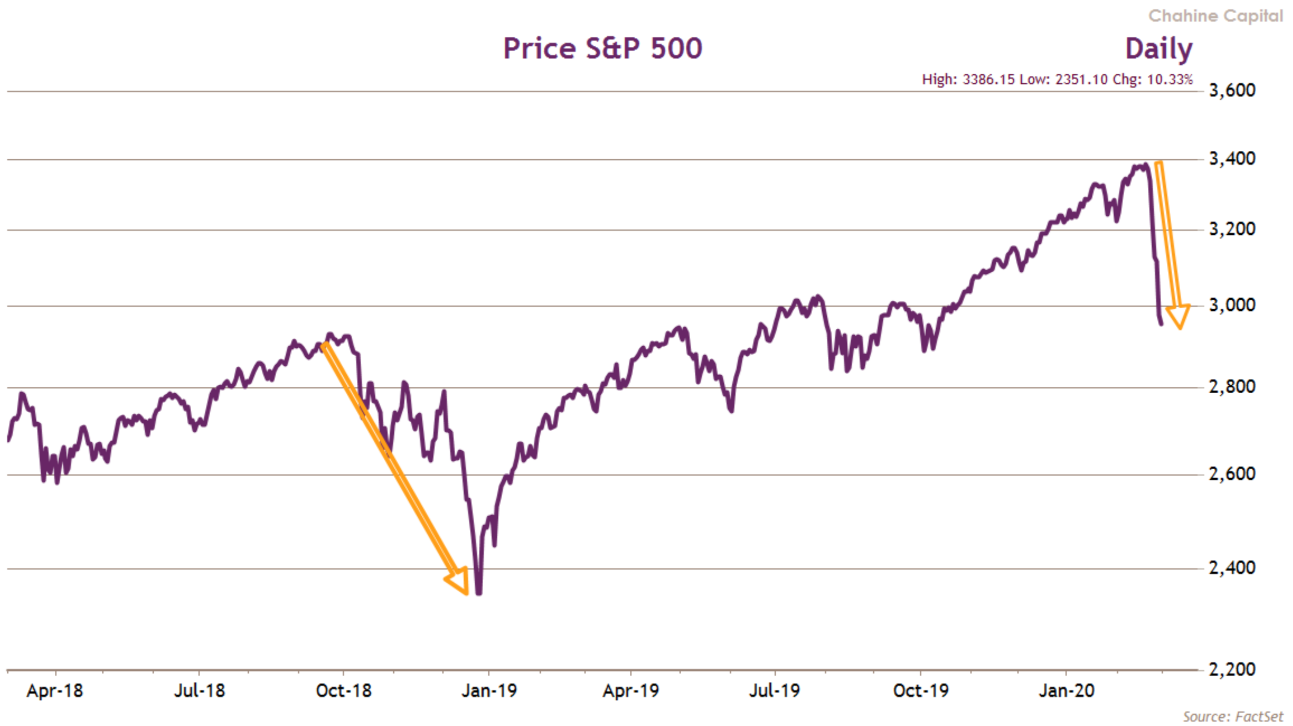
Jacques Chahine

An extremely sharp correction

On 25 January, we asked **"Is the party over?"** and now it certainly is. It has long been assumed that coronavirus would be largely confined to China and that our healthcare systems would easily cope with contamination elsewhere. Although the Chinese epidemic had been apparent since December, equities continued to rally right up until 19 February. A surge in infection in Italy and the isolation of entire cities, Chinese-style, triggered the selloff. In the USA, the Center for Disease Control and Prevention heightened investors' fears by announcing that America would have to prepare for an epidemic as well.

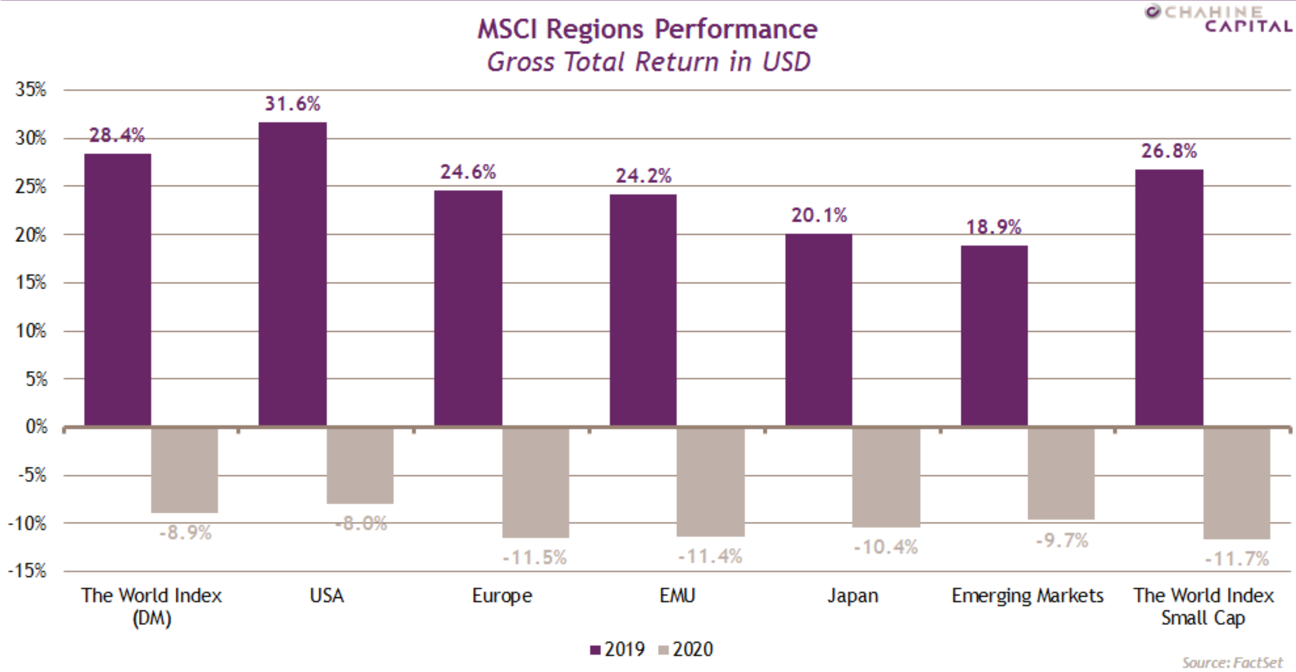
Isolation, the cancellation of all manner of public events and the spread of the epidemic across the globe have hit market confidence and created a serious risk of recession. The S&P 500 fell 13% from its highs in a matter of days; that is more than the usual definition of a severe correction (10%) but still less than the 20% associated with a bear market. The 2018 correction was worse (19.8%) but did not foreshadow recession. Historically, a correction of at least 20% is associated with subsequent recession, but not all such corrections mean that outcome. For the moment, just as in the autumn of 2018, investors are hesitating between recession and a simple correction. Similarly, they are also looking to central banks to save the day. That attitude certainly worked last time around, when the Fed eased three times in quick succession and equities surged 31% the following year. That was purely asset inflation on the back of that monetary policy decision, as corporate earnings growth was flat all year.

An unusually sharp correction

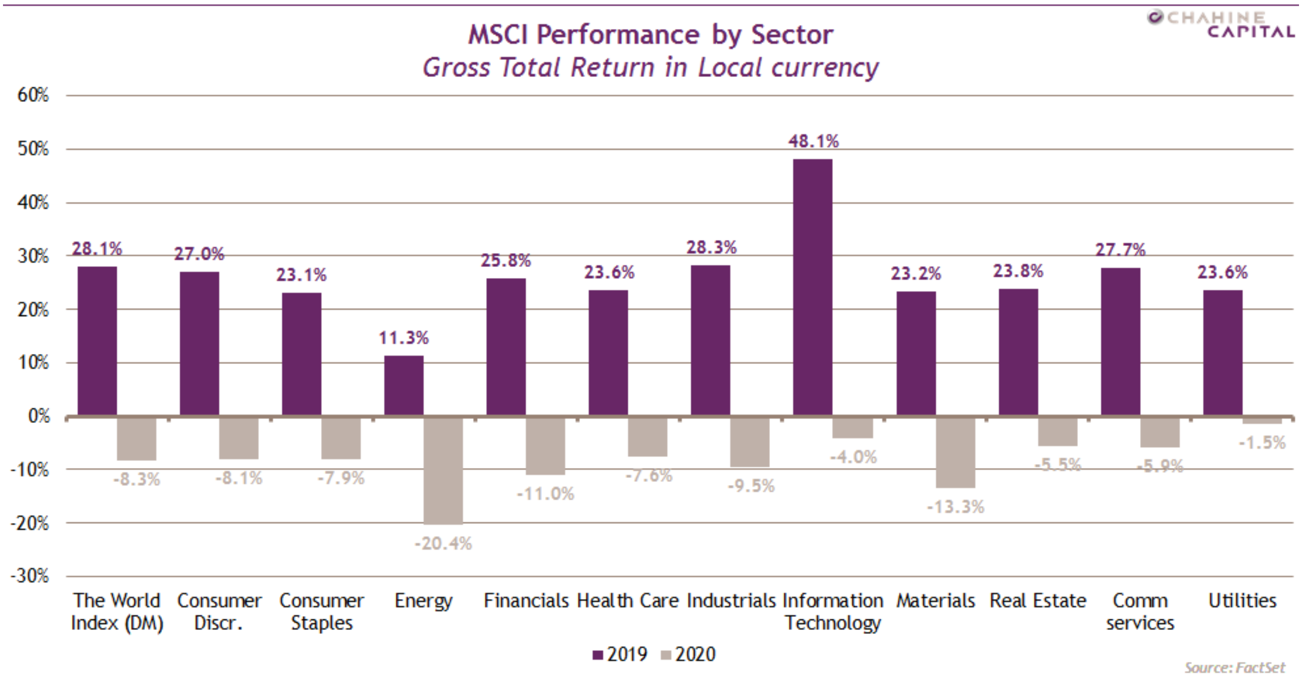


The correction may have been less severe than the 2018 move, at least so far, but it has been swift. The market shed 13% of its value in seven straight sessions, including 4.4% in a single day. This shows that there are few players brave enough to buy on the way down. All sectors have been affected, with a degree of nervousness around financials in particular.

Equities slide into negative territory for 2020



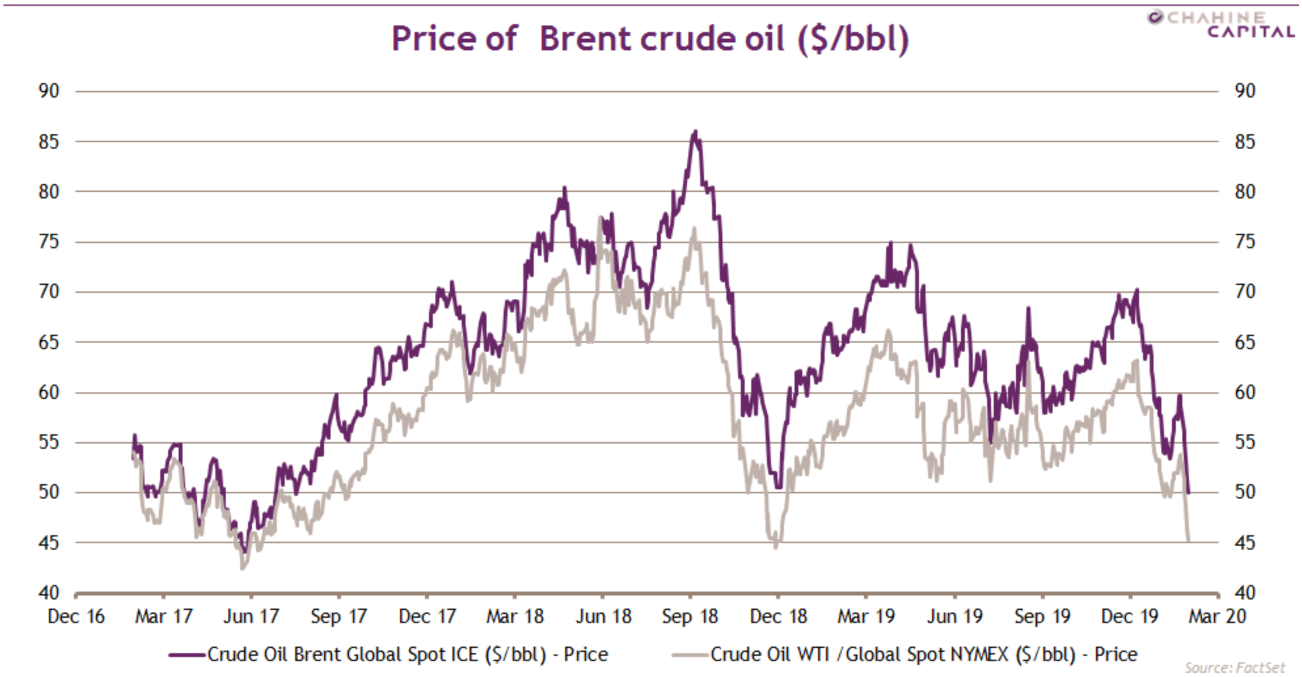
Energy and basic materials in the hot seat



The first economic victims of the crisis

As China is the world's biggest importer of oil and raw materials, oil prices started to tumble as soon as it became clear that the Chinese had a serious problem on their hands. They accelerated to the downside in February, with WTI dropping from a recent high at $63 per barrel to $45/bbl, and although that equates to a 28% correction it is still less dramatic than what we saw in the autumn of 2018, also to $45/bbl. The oil futures curve is rising slightly, offering a glimmer of hope of a return to stability. The CRB commodity price index has never come anywhere near its 2008 highs.

Oil prices back to their lows



The MSCI World index is 8.6% lower than it was at the start of the year, and some sectors have suffered more than others. Energy is down 25% and its share of index capitalisation is just 3.5%, compared to 13.5% at the end of 2007 (oil prices were above $100/bbl at that time). Other poor performers are tourism and leisure stocks, affected by the spread of the coronavirus outside China. The pictures of a deserted San Marco in Venice speak volumes for the gravity of the situation. Royal Caribbean Cruises, TUI and Carnival Cruise are all down around 40%, for example. Airlines are down between 20% and 30%. Maritime transport, casinos and hotel chains have been hit just as badly. In the USA, companies selling Chinese or Asian-made clothing and accessories, such as Calvin Klein, Ralph Lauren and Tommy Hilfiger, have been undermined by the closure of factories in China and neighbouring countries. All these firms are down more than 30%. The rare companies holding up well include names like Netflix, which can expect to benefit from self- or imposed isolation.

What an epidemic means for business

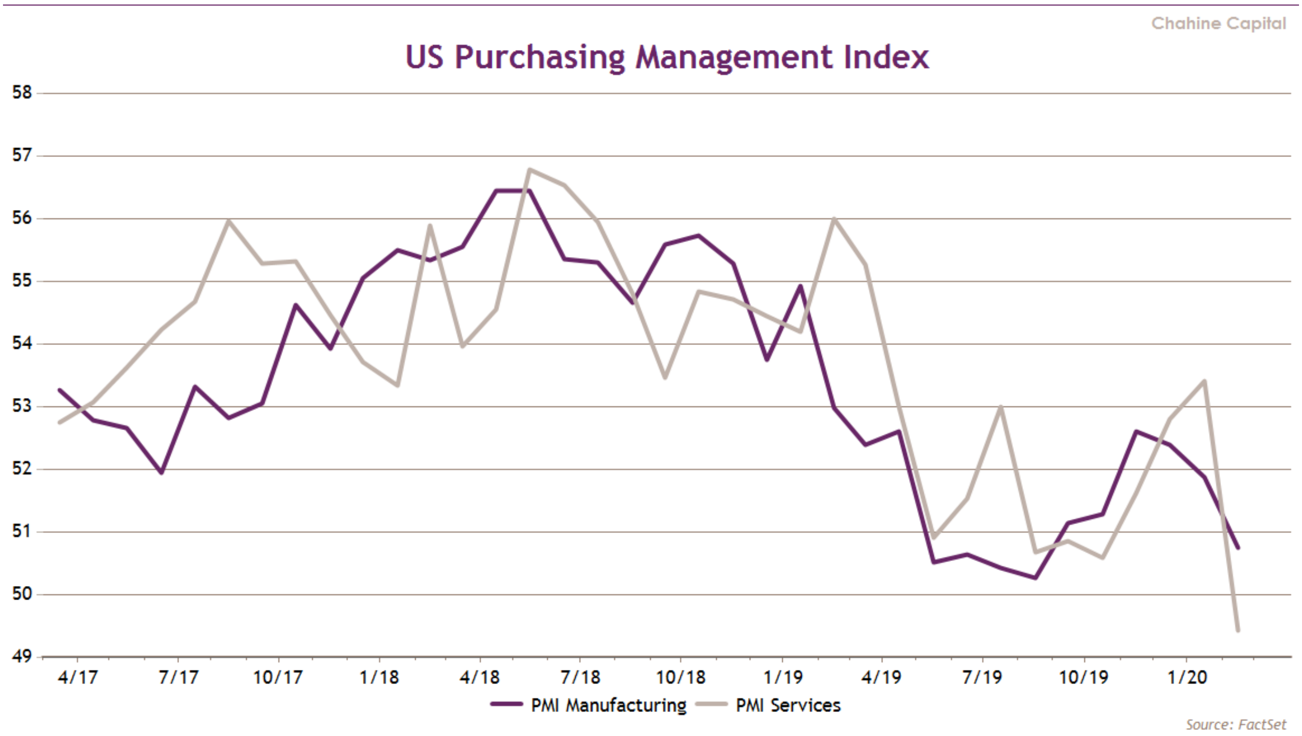
Although the coronavirus outbreak is still in its infancy outside China, economic damage is already evident in self-isolation and the cancellation of trade fairs, business trips, sporting events and other public gatherings. Countries like Italy depend heavily on tourism, and of course the leisure and tourism sector worldwide is suffering or about to. Many of its companies will have to slash their payrolls; Expedia has laid off some 3,000 employees. Breakdowns in supply chains originating in China and other Asian countries will bring Western firms to a standstill, triggering redundancies and – for some – default on outstanding loans. Anecdotally, the US builder Toll Brothers cites a lack of electrical components from China as the reason for completion delays.

In this environment, investors seeking security are bound to be less willing to finance companies and take up bond issues. Pressure is building on the junk bond market, where soaring yields for debt issued by the more fragile companies are becoming attractive for investors looking for high returns. Financial difficulties among companies and individuals will affect banks, which is why their share prices have corrected by more than the market average. Citigroup and Bank of America are down 20% and Wells Fargo is down 25%. Some European banks are even more affected – RBS in the UK is a case in point – but the big groups are in the same situation as the Americans.

Breaches in the supply chain and fears of recession have dropped auto industry share prices by 15-30%. Chinese car sales have turned lower, while European sales have slipped from an annual 16.5 million vehicles to 14.3 million. Renault is now capitalised at less than €8 billion.

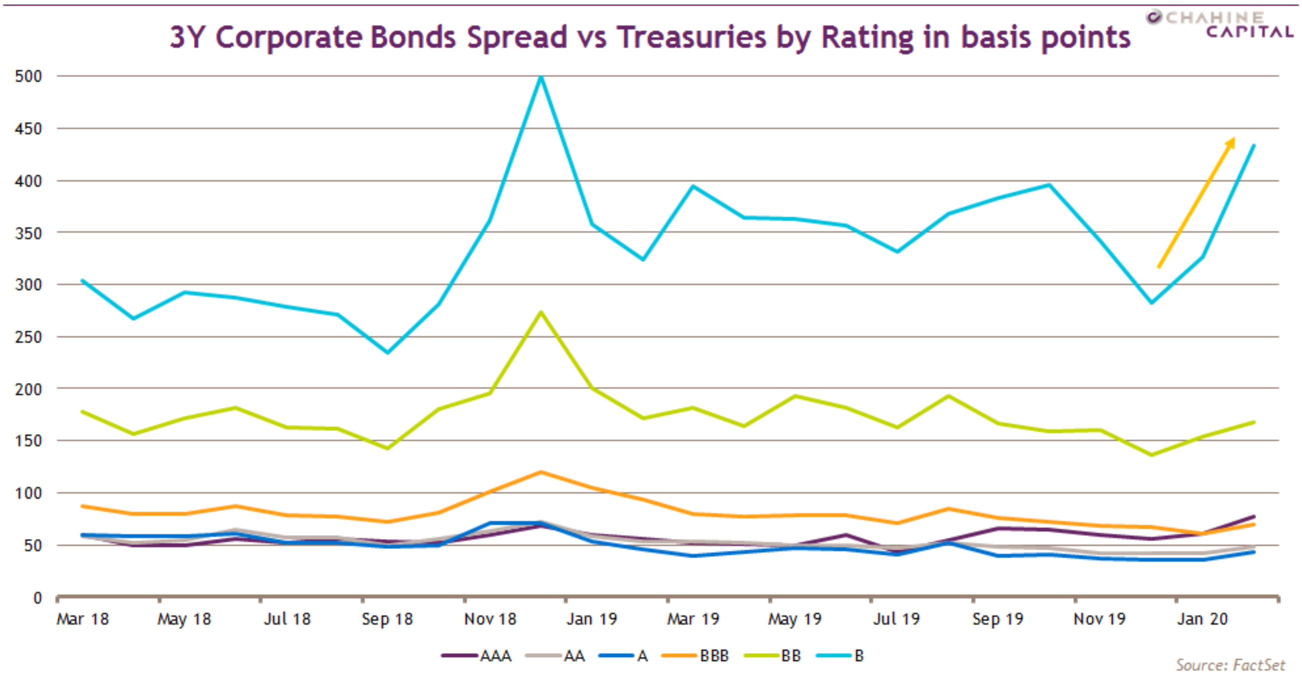
The first macroeconomic indicator pointing to a contraction in activity is the US PMI, which fell below the 50 mark in February. There has not as yet been any corresponding trend in Europe, and we should remember that this indicator often conflicts with the ISM series.

An early warning of contracting US output



The flight to safe havens has driven junk bond spreads from 300 to 450 basis points; in the oil sector, they have jumped 10% to 1,000bp in recognition of the plight of smaller shale oil producers. No such pressure is evident on higher-quality bonds (issues rated BBB or better), where spreads over government bonds remain very low.

Severe pressure on junk bonds



Lower interest rates are no remedy

As usual when recession beckons, investors have switched to safe havens such as prime government bonds, gold and the Swiss franc.

The autumn 2018 crisis originated in successive Federal Reserve rate hikes that drove the 30-year Treasury yield to 3.43% and threatened economic growth. The market's correction forced the Fed to execute a policy U-turn, and by easing right through 2019 it helped lower the 30-year yield to 2.2-2.3%. This resulted in soaring prices for asset prices and real estate, however.

As the present crisis has nothing to do with interest rates, the real risk it poses to economic activity cannot be removed by rate cuts. Even zero interest rates do nothing for companies failing for a lack of customers. In any case, it is hard to see who would lend at this point. Note that Fed liquidity injections last year did nothing to boost activity: they simply raised the value of assets already held by the super-rich. In our view, conventional monetary policy measures such as liquidity injections would be no help at all. Saving Private Ryan will require direct cash payments to those that need it to get through this troubled period. Our regular readers will be aware of our recommendation to issue 'helicopter money', which would be far more effective than lower interest rates. This is hardly wild theory: the Chinese appear to have grasped the point by reducing taxes and social security contributions, introducing help for households paying their rent and encouraging banks to reschedule debt at reduced interest rates. Stronger medicine may be in the pipeline.

The Hong Kong authorities have gone a step further: all residents aged 18 or over are to receive HK$10,000, the equivalent of US$1,283, as part of a HK$120 billion package aimed at countering the coronavirus effect. Taxes on individuals and businesses will be reduced and credits to SMEs will be guaranteed. Social security benefits for families will be increased.

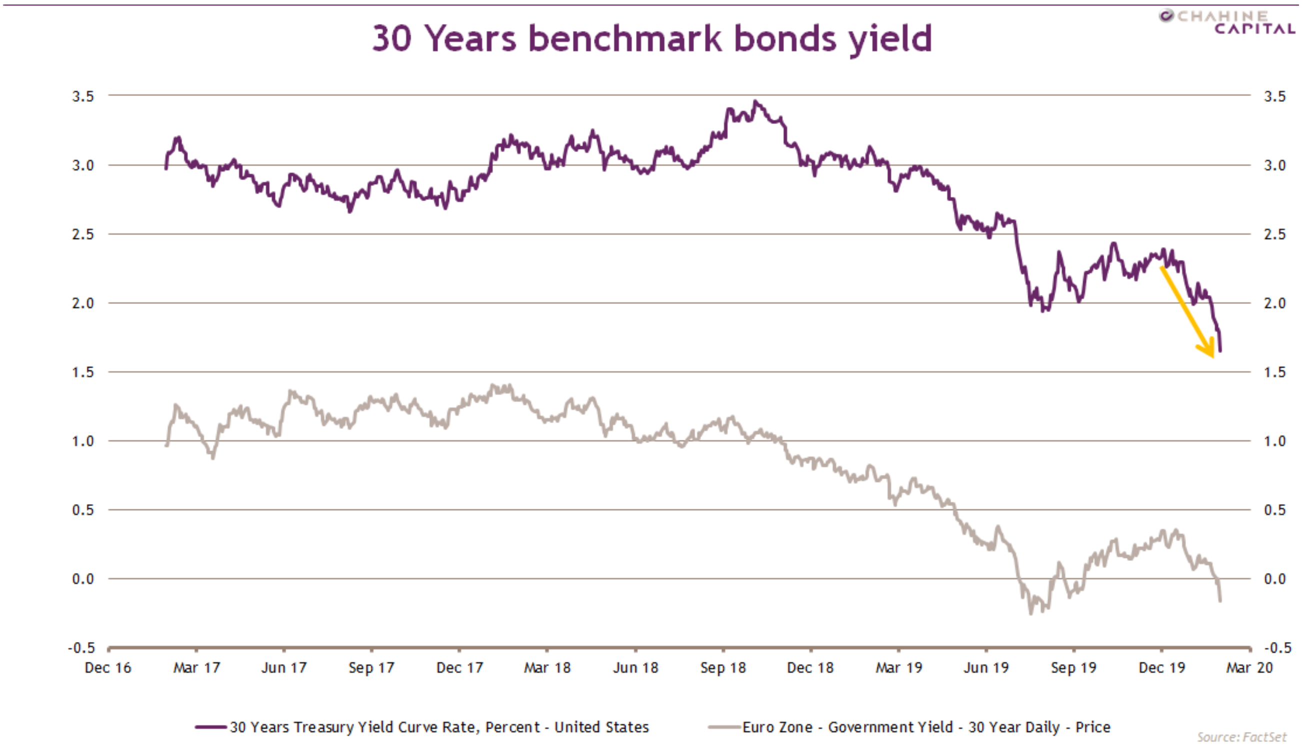
It remains to be seen whether governments closer to home will cope with the crisis, which apart from the speed of its spread offers no clues to how it will end. There is some hope from China, where the number of new infections appears to have declined, but opinion is divided on what that really means. Activity has picked up in state energy, transport and telecoms companies, but it remains depressed among SMEs. The PMI hit a new low in February – it is was stronger during the financial crisis – and forecasters expect a 4-6% contraction in GDP in Q1.

A slump in long rates

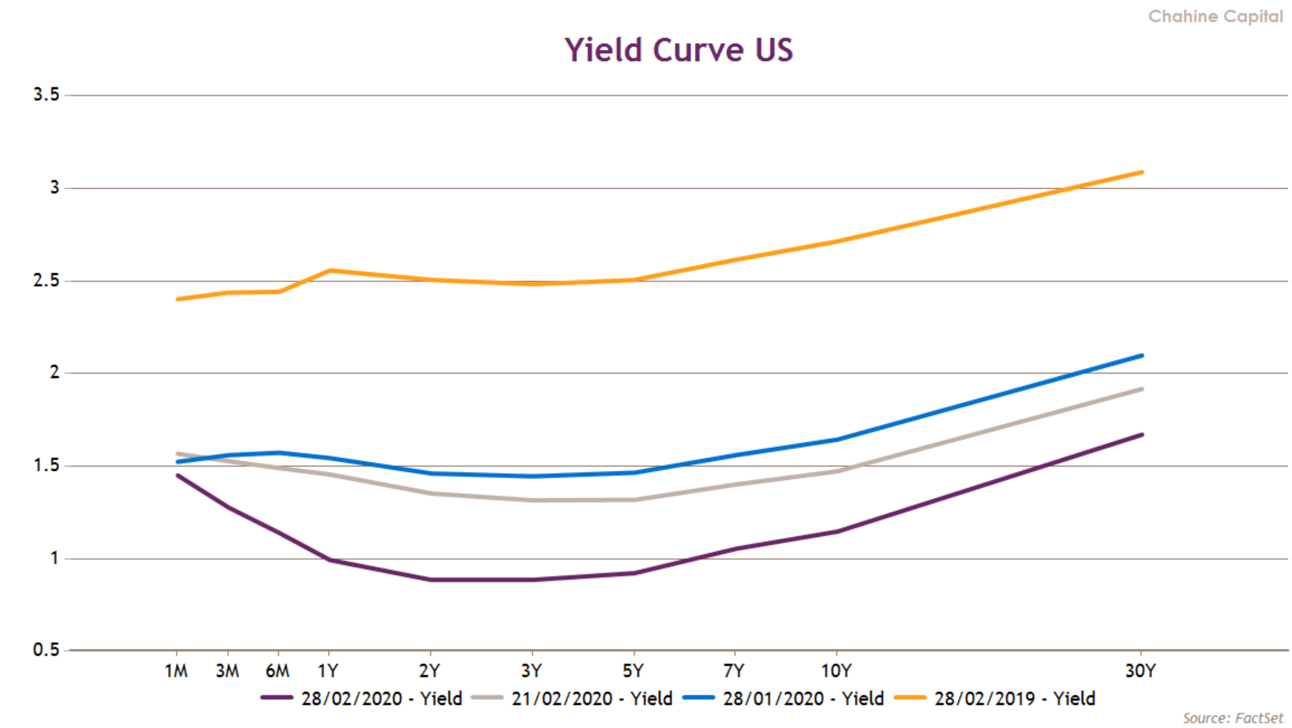
Investors have put a great deal of faith in Fed rate cuts. It is as if they expect a rerun of the events of the autumn of 2018. 30-year yields have dropped to record lows at 1.65% in the USA and into negative territory in the euro zone. The US curve is pricing in several cuts from the Fed, which says it is ready to execute them. Two or three cuts are likely between now and June, and some commentators expect 50bp in March. There could be a surprise move decided outside the usual meeting calendar. That said, the Fed knows just as well as we do that monetary policy is not much use against the coronavirus. Factories cannot produce anything without raw materials, and consumers stuck at home are in no mood to spend.

The ECB is sitting on the fence for now and wants to see whether the crisis could have long-term implications for growth and inflation. It is something of a baptism of fire for Christine Lagarde, who will need imaginative solutions to the situation. Given that negative interest rates do not seem to be doing anything, we hope that she takes a close look at helicopter money instead.

Long bond yields shift even lower



More easing priced into the US curve



The tighter interest-rate differential between the euro zone and USA has nudged the single currency higher, from a low at $1.08 to $1.1047.

The market looks to upcoming data

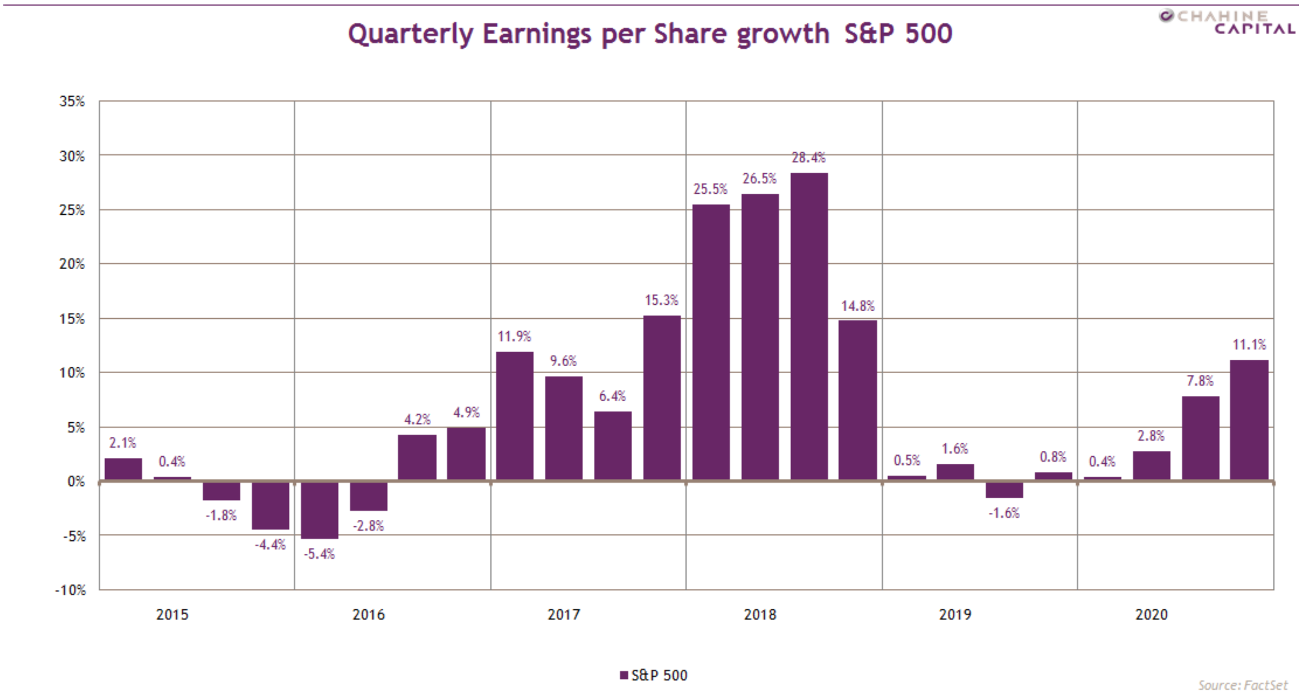
It is too soon to estimate the effect of the crisis on growth at national or world level. The consensus forecasts we have are irrelevant, as they are on hold without any impact of the epidemic taken into account. As it happens, the 2020 growth forecast had already been shaded down, from 2.66% to 2.57%, and the number for 2019 is down to 2.69% (local currency terms, not PPP). The IMF is on 2.9%, compared with 3.6% in 2018. The macroeconomic picture looks much the same, as there are few releases for February. The next big release will be Friday's US employment figures. CPI inflation is running at 2.5% in the USA, or 2.3% ex-food and energy. The Fed's favoured PCE deflator has picked up to 1.7%. In China, a 20% jump in food prices in the wake of swine fever and supply chain problems has lifted the inflation rate to around 5%.

Supply chain problems can lead to competition for alternatives. For example, China is a major supplier of the raw materials for pharmaceutical products, with India one of its biggest clients. Indian firms are starting to run short of drugs like Paracetamol and components of antibiotics. The electronics and auto sectors are highly dependent on Chinese-made parts, and Apple, Japan and South Korea are already in difficulty because of it. Similar situations will arise if and when Italy and Germany run into problems exporting their products.

Waning chances of a rebound in earnings growth

Several companies have announced that their Q1 earnings will not be as high as they had previously indicated. We expect others to follow. Profits forecasts were being revised lower even before the coronavirus effect and they can only go one way from here. Q1 and Q2 estimates have been slashed and analysts are left hoping for an improvement in the second half of the year. The consensus estimate of US earnings growth in 20202 has dropped from 8.6% a month ago to 5.6%; we are pencilling in 1.5% on the assumption of no recession, with a 7% rebound next year. PERs are looking more reasonable since the correction: the US market is priced at 17x 2020.

Fading hopes of higher profits



Market valuations depend on the scenario

Our risk premium model can work with any number of different scenarios. It tells us straight away that the US market is pricing in an 8-year CAGR of 0.5%, down from 3.8% last month, reflecting the drop in the 30-year yield from 2.18% to 1.68%. This CAGR implies a recession in profits. Our own modest hypotheses give us a CAGR of 1.9%, down from 2.7% last month.

If we assume an average GDP growth rate of 1.5% over the period (i.e. including recession at some point) plus a reduced inflation rate of 1.5%, we still get to a CAGR of 3%. This means that the market is really very pessimistic, which is inevitable at this stage. Under or base scenario, our year-end objective for the S&P 500 is 3,241 points, compared with Friday's close at 2,954 points. Last month our objective was 3,051 points; the difference is amply justified by a slump in long yields that outweighs the deterioration in profits growth.

This scenario also implies a return to a degree of normality after a few months without a recession in the meantime, however. A crisis that keeps people at home for weeks on end would presumably have a 'ketchup effect' at the end, when consumers rejoice and embark on spending sprees. The Casino Sands director in Macao certainly thinks so. But a recession at the end of the crisis should not be ruled out either, and we have run the model with a 14.3% drop in profits this year plus a 7.6% rebound in 2021. Goldman Sachs is also looking at a 13% decline. In those circumstances we would expect the 30-year yield to ease to 1.5% or even 1.25%. The CAGR would drop to -0.7% and our new objective would be 2,776 points (higher with 1.25%).

Recessions create fear, and the ensuing irrationality can create opportunities for alert investors. Given that the market is already pricing in recession and long rates at 1.25%, we have decided to allocate 3% of our assets to raising our equities exposure. This investment is a three-stage affair: 20% of it has been done with the S&P 500 at 2,938 points; a buy order for 40% has been left at 2,850 points; and the balance is to buy at 2,750 points. If there is no recession, the move could pay off handsomely. If there is a recession, the market will offer even better buying opportunities: corrections always go beyond reason. We would then have to wait until after the recession to assess our strategy's success.

Readers will know that we have recommended underweighting equities (35% for a 40% benchmark) ever since the 2,914 points recorded on 29 September 2018, which we then saw as a cycle high. Our new strategy is cautious, as the additional 3% is averaged in at lower and lower prices. Alternative strategies depend on the investor's own comfort zone, but either way it seems likely that long rates will stay low for a good while yet. 'Interesting' times…

Opportunities for a cautious return

S&P 500 - Valuation end 2020 except implied scenario *CAGR Compounded Annual Growth Rate from 2019*	30 Years Gvt bonds				
	1.25%	1.50%	**1.68%**	2.00%	2.25%
Mild recession: -14.3% in 2020, 7.6% in 2021 - CAGR -0.7%	**2 970**	**2 776**	2 649	2 448	2 308
Implied Scenario CAGR 0.5% over 8 years	3 333	3 118	**2 979**	2 756	2 601
Base scenario: 1.5% in 2020, 7% in 2021 - CAGR 1.9%	3 635	**3 396**	**3 241**	**2 992**	2 820
Current Index S&P 500			**2 954**		

Europe is as vulnerable to the coronavirus as anywhere, and already weak economic growth is liable to falter again. The auto and luxury sectors have been marked down heavily. Imagination will be required of policy makers, as even more negative interest rates make no difference to anything. Generous social security regimes relative to the USA could help cushion the blow, however. Companies closed 2019 with flatlining earnings and we assume the same again this year, assuming no recession. Low interest rates make assets with secure cash flows very attractive, and that covers carefully selected real estate and utilities. European equities will of course continue to track Wall Street and we suggest using the S&P 500 signals just mentioned for re-entering the market, focusing on stars outside the major indices.

MSCI EMU - Valuation end 2020 except implied scenario

CAGR Compounded Annual Growth Rate from 2019	**30 Years Gvt bonds**				
	0.25%	0.50%	**0.45%**	1.00%	1.25%
Depression scenario: -20% in 2020, 2% in 2021 - CAGR -10.2%	**108**	**100**	102	88	82
Implied Scenario: CAGR -8.4% over 8 years	131	122	**123**	107	101
Base scenario: 1% in 2020, 5% in 2021 - CAGR -5.8%	154	143	**145**	**124**	**117**
Current Index MSCI EMU			**123**		

Conclusions

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Main ratios for markets and sectors as of 28/2/2020 (in local currency)

Data as of 28/02/20	Weight vs MSCI World	Perf 2020	Perf 2019	Weighted P/E 2021	Weighted P/E 2020	% Wted EPS Chge 2021	% Wted EPS Chge 2020	% Wted EPS Chge 2019	Div Yield 2020	Revision vs M-2% Fiscal 21	Revision vs M-2% Fiscal 20
MSCI The World Index	**100.0%**	**-9.20%**	**25.30%**	**14.3 x**	**15.8 x**	**10.7%**	**4.6%**	**0.7%**	**2.66%**	**-0.9%**	**-1.5%**
MSCI USA	62.3%	-8.30%	29.20%	15.5 x	17.4 x	11.9%	6.1%	0.3%	2.08%	-0.4%	-1.0%
MSCI Japan	8.2%	-10.74%	15.70%	11.7 x	12.8 x	9.7%	6.8%	-12.0%	2.84%	-0.8%	-1.4%
MSCI EMU	13.5%	-9.68%	21.78%	12.0 x	13.2 x	10.2%	6.6%	0.6%	3.80%	-0.3%	-1.1%
MSCI Europe	24.5%	-9.90%	22.20%	12.4 x	13.5 x	9.1%	4.4%	4.0%	4.03%	-1.1%	-1.7%
MSCI Europe ex Energy	23.1%	-9.04%	23.83%	12.7 x	13.9 x	8.9%	3.9%	6.0%	3.79%	-1.1%	-1.4%
MSCI Austria	0.1%	-14.46%	13.38%	8.1 x	8.8 x	8.9%	9.0%	-21.6%	5.01%	-1.5%	-2.2%
MSCI Belgium	0.5%	-19.01%	19.36%	12.0 x	13.0 x	8.3%	2.0%	10.8%	4.05%	-1.4%	-0.4%
MSCI Denmark	0.8%	-2.42%	28.95%	19.4 x	22.3 x	15.1%	5.9%	-4.3%	2.05%	-1.4%	-2.5%
MSCI Finland	0.4%	-4.81%	8.28%	14.7 x	16.4 x	11.2%	1.5%	-0.6%	4.29%	-1.3%	-1.2%
MSCI France	5.0%	-9.90%	26.10%	12.6 x	13.8 x	9.3%	7.7%	4.4%	3.62%	0.0%	-1.4%
MSCI Germany	3.4%	-10.44%	20.09%	11.3 x	12.8 x	13.3%	8.5%	-3.3%	3.42%	-0.8%	-1.2%
MSCI Great-Britain	5.2%	-12.81%	11.30%	11.3 x	12.1 x	7.3%	3.4%	-4.9%	5.22%	-1.2%	-2.0%
MSCI Ireland	0.1%	-5.30%	25.63%	14.9 x	16.4 x	9.6%	3.4%	-10.4%	2.25%	-1.9%	-2.2%
MSCI Italy	1.0%	-6.77%	25.49%	9.7 x	10.5 x	8.2%	5.6%	3.5%	5.12%	0.8%	0.1%
MSCI Netherlands	1.6%	-9.45%	26.85%	14.2 x	16.1 x	13.3%	7.4%	-8.0%	3.09%	0.3%	-0.1%
MSCI Norway	0.4%	-10.95%	8.26%	11.1 x	12.5 x	13.4%	15.5%	-11.1%	5.68%	-0.4%	-1.8%
MSCI Spain	1.3%	-8.26%	9.85%	10.8 x	11.3 x	4.6%	1.8%	6.1%	5.22%	-0.7%	-1.5%
MSCI Sweden	1.0%	-5.52%	24.47%	13.9 x	14.7 x	5.7%	-18.7%	67.8%	3.84%	1.8%	3.0%
MSCI Switzerland	3.4%	-7.27%	27.22%	15.2 x	16.4 x	8.4%	8.2%	9.8%	3.30%	-0.7%	-0.4%
MSCI Europe Consumer Discretion	3.1%	-13.05%	30.01%	11.9 x	13.3 x	11.7%	10.0%	-8.4%	3.15%	-1.9%	-3.5%
MSCI Europe Consumer Staples	3.5%	-8.31%	22.38%	15.7 x	16.8 x	7.3%	4.7%	10.7%	3.39%	-1.8%	-2.0%
MSCI Europe Energy	1.4%	-21.90%	3.55%	8.5 x	9.5 x	11.4%	10.5%	-14.7%	7.87%	-1.2%	-5.0%
MSCI Europe Financials	4.1%	-12.05%	17.49%	8.8 x	9.3 x	5.9%	-1.9%	14.5%	5.85%	-0.7%	-0.7%
MSCI Europe Health Care	3.3%	-5.06%	28.40%	14.8 x	16.4 x	10.8%	5.8%	9.6%	2.97%	-1.0%	-0.8%
MSCI Europe Industrials	3.3%	-9.97%	32.02%	14.4 x	15.9 x	10.6%	5.5%	7.8%	2.97%	-1.1%	-1.1%
MSCI Europe Information Technol	1.5%	-5.43%	36.00%	17.8 x	20.7 x	16.6%	15.8%	5.4%	1.47%	-0.4%	-0.7%
MSCI Europe Materials	1.6%	-14.44%	21.39%	12.6 x	13.8 x	9.3%	9.7%	-11.8%	4.22%	-1.8%	-2.2%
MSCI Europe Real Estate	0.3%	-7.95%	18.93%	15.2 x	15.5 x	2.0%	-3.3%	-23.4%	4.85%	-2.4%	-0.6%
MSCI Europe Communication Serv	1.2%	-9.67%	0.60%	12.0 x	13.5 x	12.2%	2.6%	0.3%	4.89%	0.1%	-1.8%
MSCI Europe Utilities	1.4%	4.83%	24.29%	15.3 x	16.1 x	5.7%	3.5%	23.2%	4.63%	-0.5%	-0.7%

Benchmarks source iShares ETF - Data as of 28/02/2020