Investment Weekly

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Fears of a significant global slowdown appear unwarranted

♦ Markets start to price-in the economic slowdown expected to result from the spread of the coronavirus, and as the consequences become clearer in terms of short-term dislocations.

♦ Containment measures inside China and globally could reduce Chinese economic growth by as much as two percentage points in the first quarter.

♦ We believe the rebound after the epidemic is controlled could be very strong, however, based on the stimulus measures being applied, to the extent that China could see growth at about an 8% pace by the third or fourth quarter.

♦ Investors have shed some risk assets at the margin, and bought some haven assets such as quality bonds, and gold, pending the first indications that virus spread control measures have begun to pay off.

♦ Chinese high-yield bonds are particularly sensitive to interest rates in the country and should rebound nicely in time.

♦ In the meantime, however, emerging market currencies and risk assets could suffer further as the yuan weakens and should the dollar show renewed strength.

♦ The UK officially left the European Union on 31st January; stability in sterling and large purchases of Gilts underlined the growing belief that Boris Johnson's Conservative government can bring about positive economic change, beginning in the current transition period ending on the 31st December this year.

♦ The impeachment of President Donald Trump will not be carried, helped by the Senate voting not to allow the appearance of witnesses. The 'risk-on' stance of the FAB Global Investment Outlook remains in place.

Apart from the mounting number of tragic deaths caused by the new coronavirus that originated in China, the jury is still out on exactly what the impact will be on the global economy. Given the death rate compared to confirmed cases remains relatively low (around 2%-2.5% of people infected have died so far), the toll should not be as big as it was during the Severe Acute Respiratory Syndrome (SARS) event in Asia in 2002-2003. SARS killed nearly 10% of those who contracted the disease. To put things into perspective, 10.8% of the total deaths in the first week of January in the US were attributed to

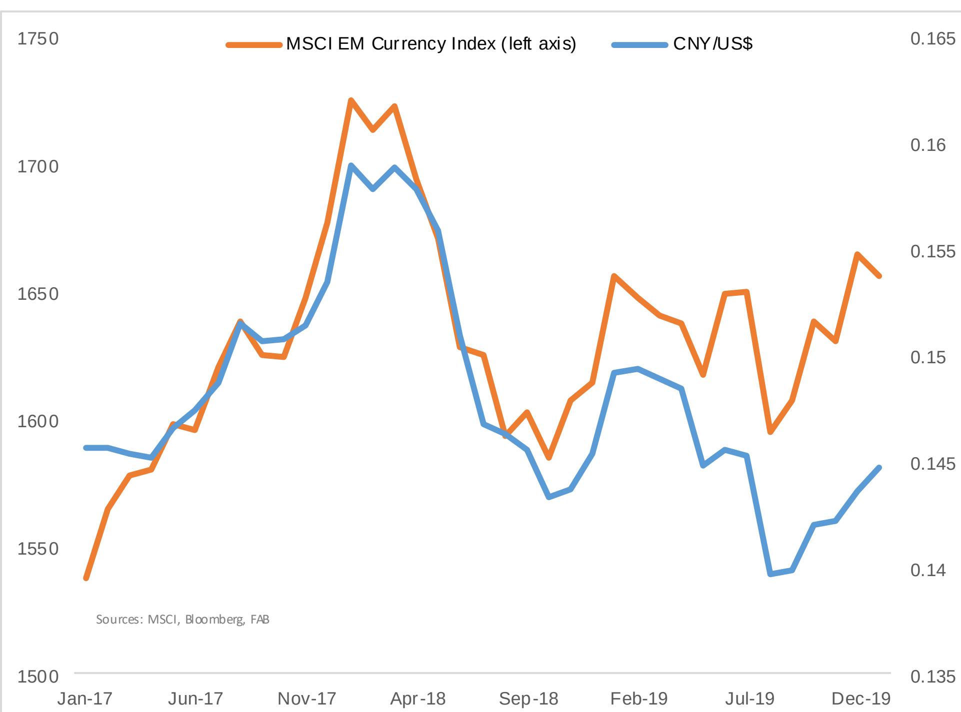
Contagion fears could have an impact on China's services sector and slow the economy

pneumonia and influenza, according to the National Center for Health Statistics. The 2012-2013 flu season in the US (a particularly bad year) saw some 56,000 people die of complications related to it, according to the US Centers for Disease and Control Prevention.

In simple terms, so far the new coronavirus is just marginally more deadly than the common flu. The trouble is the disease is completely new and scientists are not sure how or whether they will be able to control it. The mortality data is also very recent so it cannot yet be considered as a disease of limited consequence. The 'unknown' factor is the biggest driver of the fear that has gripped the world. 'Fear' and 'the unknown' are, however, psychological factors that can be deadly for economic growth. In fact, even Chinese academics close to the government have started to admit that the country may slow down significantly on the back of this epidemic.

On Wednesday last week, Zhang Ming, an economist at the Chinese Academy of Sciences, predicted that the coronavirus outbreak could reduce his country's GDP growth by one percentage point in the first quarter. However it is easy to see why the number could easily be even worse. People are avoiding travel and public places, such as shopping malls and supermarkets as the virus spreads. Such risk-averse behaviour has a direct impact on the economy. Retail sales probably account for about 28% of Chinese growth. In simple terms, assuming a two percentage point drop in that measure from the 8% printed in the fourth quarter to 6%, that could shave off 20-30 basis points from annualized Chinese GDP growth in the first quarter.

The broader services sector contributed more than 26% of Chinese domestic output in 2018, and that is also likely to hurt. All told, a significant slowdown in services activity could contribute to a reduction of some two percentage points in economic growth from China as a side-effect of the fear related to the new coronavirus. Considering that the Chinese economy represented nearly 19% of world GDP in 2018, according to the World Bank, such a slowdown is likely to have wider effects.



Notwithstanding the considerable human distress caused, all this doom and gloom may provide a buying opportunity in risk assets once the disease comes under control. Once fear subsides, much of the buying and traveling that did not take place during the epidemic will be seen to have been deferred rather than cancelled, and the rebound could be significant. History may be a good guide here. Chinese retail sales growth bottomed out at 8.3% in June, 2003, when the SARS crisis began to subside. It then accelerated and one year later was increasing at a rate of just under 14%, helping the Chinese economy grow by 11.5% in the second quarter of 2004.

China could add monetary stimulus after cutting reserve requirements seven times

This is likely to be juiced-up in the current year by additional monetary and fiscal stimulus from Beijing. The People's Bank of China (PBOC) had already been increasing liquidity to fight the impact of the trade war with the US, having cut the reserve requirements for major banks seven consecutive times over the past two years. The magnitude of the epidemic's potential hit to the economy, however, is likely to prompt not only more monetary easing, but also fiscal stimulus.

Markets are likely to start pricing-in that accelerated future growth as soon as it becomes clear that the disease is under control, and there is a clear tally of the damage it has caused. For instance Hong Kong stocks are currently trading at 10 times expected forward earnings, more than one standard deviation below its five-year average of 11.7 times. If the Hang Seng index was just to return to its average P/E, it would rally more than 10%. While there could be political factors still overhanging Hong Kong, it remains a conduit into China for foreign investors, and the upside for Chinese and Hong Kong stocks could be significant once the current sell-off is over.

Chinese high-yield bonds are also likely to benefit from the stimulus and a medium-term economic rebound. About two thirds of these bonds are issued by property developers. Sales in the sector have slowed down over the past two years as Beijing engaged in a deleveraging campaign and attempted to curb property price appreciation. This, along with the slower growth derived from the trade war, has weighed on the asset class. The latest coronavirus outbreak has added to the sector's woes, as sales offices and showrooms were closed across China in the past two weeks, translating into weak expected first quarter sales for property developers. If the PBOC loosens its monetary policy further, this is indeed likely to have a positive impact on the valuations of Chinese high-yield bonds. Property developers often work in tandem with local governments to develop entire communities. Any news that Beijing will be loosening leverage limits on provinces and cities to spur growth will likely be to the advantage of developers. However until such welcome measures arrive, Asian high -yield bonds will probably remain subdued. The Bloomberg Barclays Asia USD High-Yield index is down nearly 0.5% in the past two weeks, since the coronavirus came to the forefront. China represents about 57% of this index. The index could correct further before the rebound starts, though.

Another wider - but almost certainly temporary - impact the virus is having is on emerging market currencies. Given the importance of China as a buyer of raw materials from some of the world's largest developing nations, when Beijing catches a cold other emerging markets suffer too. Over the past three years, the yuan has had a 74% correlation with the MSCI EM FX index. It is no wonder, therefore, that emerging market currencies were under pressure since the virus emerged. The MSCI EM FX index has dropped some 0.8% in the past two weeks. The offshore yuan, meanwhile, is down 1.7% in the same period, having touched the key rate of CNH7/US$ on Thursday. The movement in the Chinese currency could be stemmed once authorities come back to work following the Lunar New Year. Either way, Chinese financial bodies and companies can be expected to support the markets, heavily if necessary.

However, the move for other emerging market currencies may have a bit further to go, as foreign exchange traders tend to reduce risk across the board when a major trading pair moves as sharply as the yuan has. The initial targets have been the Chilean peso and the Russian ruble, two currencies heavily associated with commodities, i.e. copper and oil respectively. The Thai baht has also been under pressure given the importance of Chinese tourism for the Thai economy.

The move could extend to other EM currencies in the short-term, especially those that offer higher yields and are seen as more fragile, such as those of Turkey and South Africa. Again, fear and technical triggers are the drivers for this move, so it may take some time before a measure of calm returns. During this period it may be difficult to pick up emerging market assets denominated in local currencies. Still, once the sell-off is done the rebound for the asset class could be very strong.

The downside move in the Chinese yuan has also had an impact on the euro and the Australian dollar, given that the Eurozone and the Australian economies are increasingly tied to the Chinese economy. This has helped the US dollar index breach key technical resistance, and it spent most of last week trading above its 200-day moving average. Any further dollar strength would be detrimental to the US economy as it would dampen inflation (since imports get cheaper) and economic growth (because a stronger currency increases the trade deficit). That prospect was being priced into the market as the implied yield on Fed fund futures due in January, 2021, moved down to 1.16%, suggesting investors were increasing their expectations of a rate cut this year.

The Federal Reserve, however, gave no indication that it would make any moves this year in a policy meeting that ended on Wednesday. The central bank kept interest rates unchanged as expected, and signaled no change ahead. Chairman Jerome Powell did, however, leave a suggestion that the Fed could consider being more aggressive to bring inflation to 2%. They are also following developments regarding the coronavirus very closely, and given the importance of Chinese economic growth to global growth and markets. Given that, and the secular hurdles in the way of higher inflation (technology and demographics have helped keep prices in check), it appears the Fed is more likely to cut rather than hike rates in the near future.

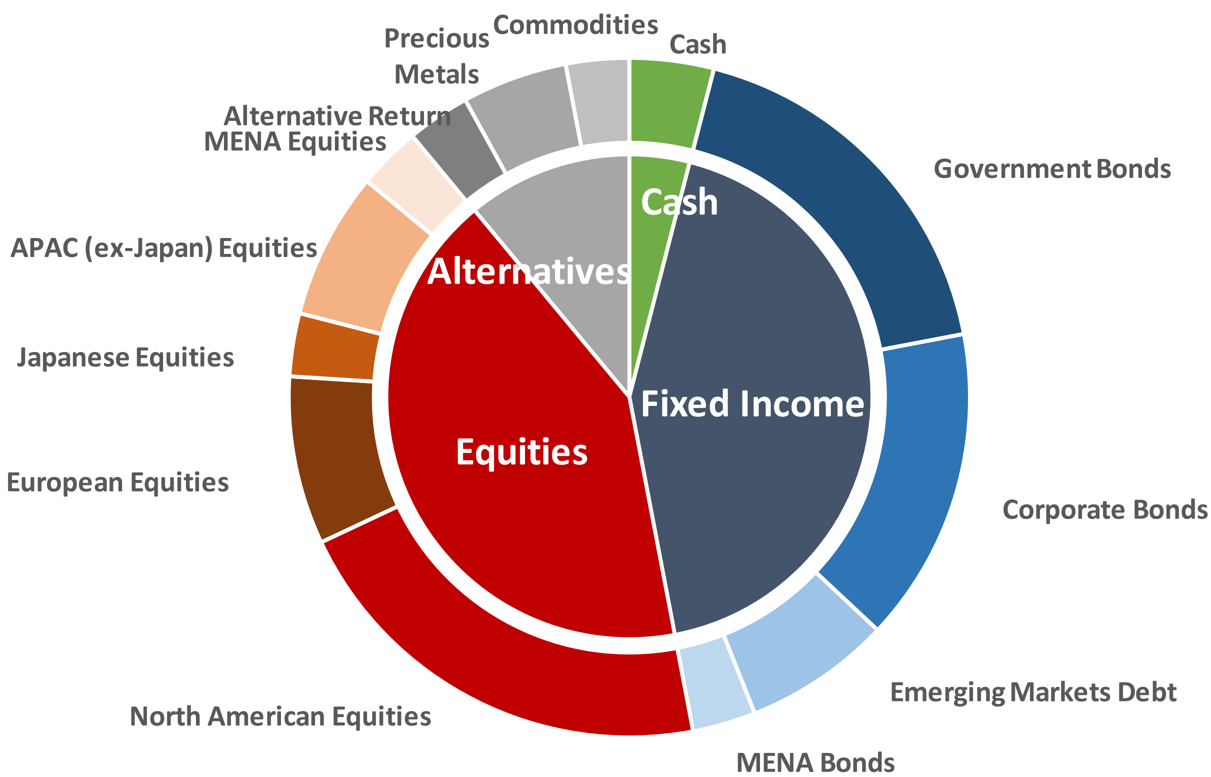
Elsewhere in emerging markets, the Indian Budget for the financial year 2021 was published. In essence it is designed to enhance fiscal discipline through a lower estimated fiscal deficit for the next year. The move to reduce personal tax exemptions is aimed at simplifying the tax regime while increasing tax receipts. The removal of the dividend distribution tax is expected to reduce tax provisions for companies. The increase in government capital expenditure will be part-funded by $30 billion-worth of divestments, perhaps challenging given the historical undershoot. The budget lacked major initiatives regarding NBFCs (Non-Banking Financial Corporations) and real estate,

Haven demand has pushed the dollar index above its 200-day moving average

and given that expectations for better government-funded growth did not materialize, the Indian markets were disappointed.

Lastly, and within our own MENA region, there were positive economic developments for Jordan. Last Thursday agreement was reached between the Jordanian authorities and the IMF on a $1.3 billion four year aid package. The government at the same time announced a very carefully-worded budget, interpreted as being realistic, and sensitive to the economic plight of the average citizen. The aid package should assist the local authorities in realizing their reforms, and enhance the overall outlook for the country, and helping it cope with the absorption of millions of Syrian refugees in recent years. The IMF forecasts Jordanian GDP growth at 2.1% in 2020, increasing to about 3.3% in the coming years. Current public debt stands at $40 billion, or approximately 92% of GDP. Despite various concerns, since the start of the year Jordanian government debt has been a regional stand-out performer, and debt yields have tightened aggressively (by 25-30 basis points) across the curve.

Current Tactical Asset Allocation



Asset Class	Positioning	Detail
Cash	Neutral	After allocating more cash to investment grade corporate debt
Fixed Income	Overweight	Moving to slightly overweight after adding overweight to EM dollar debt and corporate investment grade bonds
Equities	Overweight	Rotating US exposure to defensive stocks
Alternatives	Underweight	However, overweight on precious metals specifically

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