Investment Weekly

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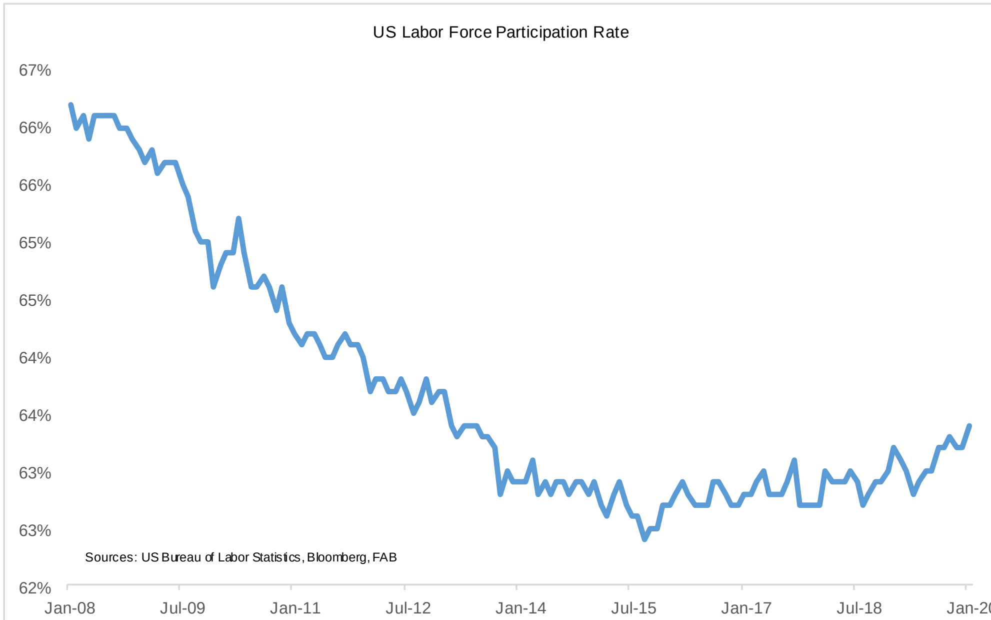
US remains strong even as virus takes toll on global economy

- ♦ **US stock market starts to price-in global economic rebound after virus fears impact the global economy.**
- ♦ **US economy appears to be growing strongly as January job creation beat expectations.**
- ♦ **Virus spread may be peaking, according to experts who modelled transmission patterns.**
- ♦ **Postponed demand from the current fear period could boost economic growth in second and third quarter.**
- ♦ **This movement could presage a spike in commodity prices in the near future, once virus fears subside.**



The US economy is again proving resilient as the rest of the world suffers under the impact of a panic caused by a new virus that originated in China. Last week, the US Bureau of Labor Statistics revealed that the American economy created 225,000 new jobs in January, 36% more than the median forecast of economists surveyed by Bloomberg.

Perhaps more importantly, the number of people in the workforce, a measure of how optimistic the average American is about getting a job, increased to 64.3% of all the people able to work. This was the highest number for the so-called 'participation rate' since 2013 and it was the main reason for a small increase in unemployment to 3.6%, though this measure remains near a 50-year low.

The Federal Reserve has been paying more attention to the participation rate as it sees the relatively low number of unemployed Americans still looking for a job as one of the reasons why inflation has fallen behind their expectations. Still, even at the current higher levels, the participation rate remains well below the average 66.5% of the 20 years before the global financial crisis. The last time the participation rate was above 66% was in 2008, which means the Fed still has a long way to go if it wants to put the US economy back into the shape it was before the crisis.

That means that the probability of a rate increase remains remote even if the US continues to create jobs at the current pace. Jerome Powell, the Fed Chairman, has repeatedly said that he believes inflation would have to run high for a while before the Fed moves rates up. He has also said that he would like the participation rate to increase.

If the probability of a rate hike is remote, the market is increasingly convinced that

Americans are getting upbeat about their economy again, but a Fed hike is probably still far

the Fed could be forced to cut rates in the next year instead. The recent outbreak of a new coronavirus in China, which has spread across the world, has only reinforced that notion.

The implied yield on the Fed funds futures due in January of 2021 is 1.18%, which suggests the market expects up to two rate cuts within a year. At the beginning of the year, that rate was 1.45%, suggesting markets expected the Fed could stay put for all of 2020. Whether the latest expectations will be confirmed or not will depend on the global economy's performance in coming quarters, and that may be better than expected. To be sure, there is little doubt that global GDP will slow down in the current quarter.

The world's second biggest economy, China, has hit the brakes for the past two weeks as the country deals with the spread of the new coronavirus. Manufacturing has been nearly halted, which extended the week-long Lunar New Year holiday by up to two weeks.

To put it into perspective, manufacturing output grew 5.3% in February of 2019. Were it not for the Lunar New Year in that month, output was expected to have been 6.1%. Hence, if last year's 10-day closure reduced manufacturing output by 0.8 of a percentage point, the three-week closure of this year could shave off as much as three percentage points of manufacturing growth. Since manufacturing represents nearly 80% of the Chinese economy, that is a big bit for GDP growth.

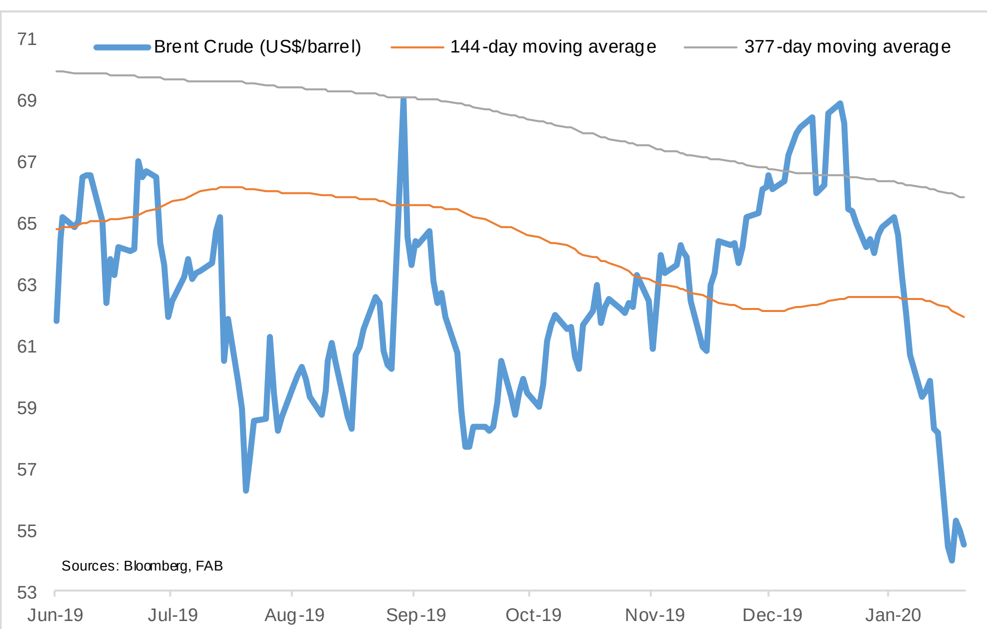
This also affects the European economy. China was the second biggest destination of European goods in 2018, the latest data available from Eurostat, having bought 11% of all of the Eurozone's exports. Germany, Europe's largest economy, is particularly sensitive to what happens in China, since the Asian country is its main export destination. Among the main products that the Chinese buy from Germany are cars and machinery, which are likely to be particularly impacted by the lower activity.

The services side will suffer even more as travel and shopping in malls has pretty much halted in the country. This is where other parts of the world economy can suffer too. Japan is one of the most popular destinations for Chinese tourists, with some 8.4 million of them having visited the country last year, spending more than 13 trillion yen (US$13 billion) while there. France is also set to feel the pinch as the country received 2.2 million Chinese tourists in 2018.

Canceled travel plans and more people staying at home means less driving and less demand for oil, particularly in China, which is now the world's biggest consumer of the product.

That helps explain why Brent crude prices dropped 6.3% last week, adding to what is already a 20.2% drop for the commodity so far this year. The move lower has prompted OPEC members to talk about making further cuts to output, which would make sense given that demand is really likely to slow down in coming weeks.

The recovery of oil prices could be even sharper once the global economy rebounds



The trouble becomes how to implement such cuts, given that many of the group's members have already implemented painful cuts. The one country that still has significant ability to cut is Saudi Arabia, however, that could take a significant toll on its economy, which is already ailing from the lower output and depressed oil prices of the past couple of years.

The country had just started to show signs of recovery, with growth data of the third quarter showing that the non-oil part of the economy grew at the fastest pace in five years. That recovery probably continued in the fourth quarter but could be hampered in the first quarter of this year as a result of the global slowdown. The effect could be exacerbated if the country is forced to cut oil production further to shore up oil prices.

That said, there is a significant chance that once there is a clear sign that OPEC will cut output further oil prices could rebound. And they could also rally strongly in the aftermath of the virus, together with a global recovery that make the current environment conducive for adding risk to portfolios.

In the case of oil, OPEC tends to take time to react to changes in the supply-demand dynamics, as is being seen right now. While this has translated into a steeper drop right now it could have the opposite effect later.

All the canceled travel plans of the first quarter are likely to be bunched up in the second and third quarter, which means more driving and flying than usual. This could see the current oil surplus quickly turn into a deficit, one that OPEC may be slow to fill. In simple terms, oil could see a significant rally in a couple of month.

The same is true for the global economy. All the factory orders that have been delayed because of the coronavirus are likely to kick in together once the disease is controlled, creating a very strong rebound. Chinese tourists are also more likely to travel after the disease is contained as those who can afford it may feel even more compelled to get out of their country.

This expectation alone would be enough to suggest that the global economy will rebound in the second and third quarter and grow faster than average. Add to that the potential fiscal stimulus that the coronavirus is likely to kick off and there is a cocktail for a very strong recovery.

China is widely expected to cut interest rates further from here but the country is also set to roll out fiscal stimulus of an order not seen since the global financial crisis. The effect of such stimulus takes some time to be felt in the economy but once it hits it could be very significant.

In 2008, when China introduced a record amount of US$586 billion, that package boosted growth by about three percentage points, according to economic studies made afterward. While the effect was temporary, there is no doubt it was very significant.

This time Beijing has already started to move, having injected US$22 billion in liquidity in the local banking system and asking banks to delay repayments of loans. Much more is likely to be announced once the country gets over controlling the spread of the coronavirus, which is its main priority now.

Markets have started to discount the prospect of so much stimulus and of an acceleration of global economic growth in the second and third quarters of this year, which helps explain why the S&P 500 breached another record last week.

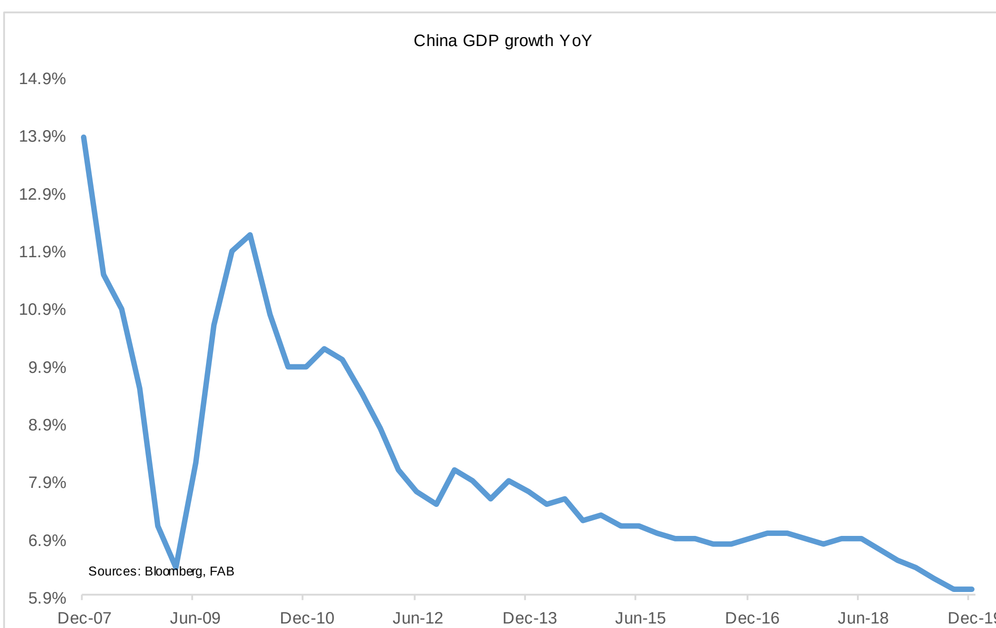
The bigger opportunity, however, may be in emerging market assets, which have already been the worst-hit by the trade war between the US and China last year and are now suffering more than others from the virus outbreak. The MSCI Emerging Markets index is still down nearly 5% since the coronavirus outbreak went global, in mid-January.

The index, however, has started to recover, having rallied 2.7% since the start of February. Much of that was thanks to a recovery in Chinese stocks. The Shanghai market initially plunged when it reopened after a two-week lull due to the Lunar New Year and the coronavirus containment measures. It started to rally last week, though, as investors priced in the stimulus announced and forecast more to come.

Chinese high-yield bonds are perhaps the area most likely to see a positive outcome of the current tragic situation. About two thirds of these securities are issued by property developers. Sales for the sector had 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 that has derived from the trade war has weighed on the asset class.

The coronavirus has added to the woes, as sales offices and showrooms were closed across China in the past two weeks, which could translate into weak first quarter sales for property developers.

China grew 3 points faster after the stimulus of 2008, it could do the same in coming quarters



Few industries are as sensitive to monetary policy as homebuilders, though. So, if the PBOC loosens its monetary policy further, it is likely to have a positive impact in the values of Chinese high-yield bonds. Besides, these companies often work in tandem with local governments to develop entire communities. News that Beijing would loosen leverage limits on provinces and cities to spur growth are likely to also work in favour of developers.

More construction is likely to increase the demand for many other commodities, particularly copper and steel, which are often associated with new building activity.

The expected economic slowdown from the panic associated with the coronavirus had already pushed the price of an ounce of copper to the lowest in more than two years. Once the virus is under control and the economic rebound becomes apparent, this drop could reverse quickly, particularly since output has not been growing fast enough to meet higher demand.

While there still is some pain, the virus spread could soon start to reverse, particularly as the weather gets warmer. Once that happens, the recovery, particularly in emerging markets, could be as swift and violent as its recent drop.

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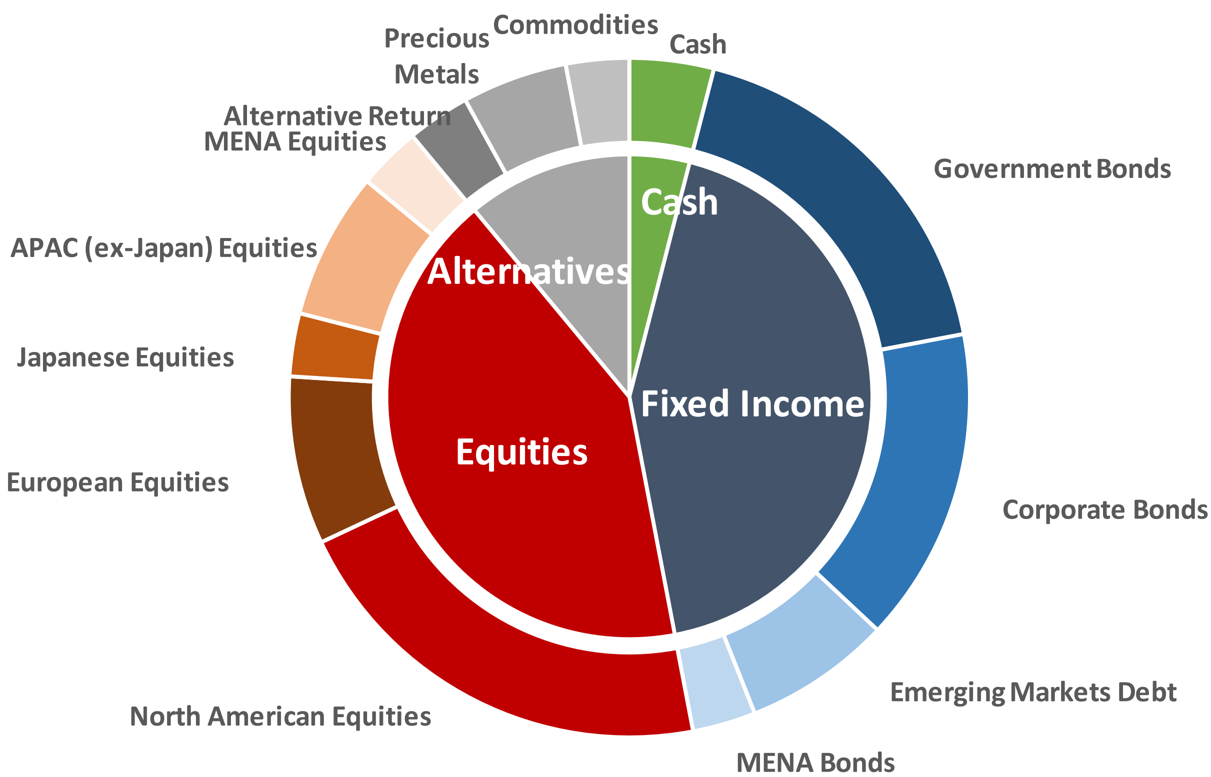
Current Tactical Asset Allocation



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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