Investment Weekly

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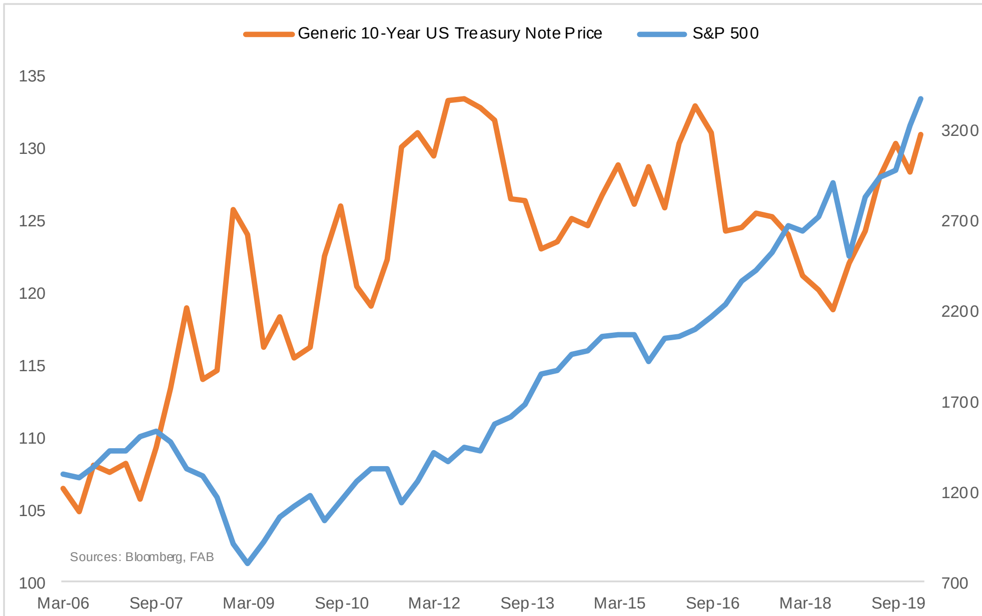
Stimulus drive spreads across the globe, boosting risk assets

- **Bonds and stocks moving higher together as markets realize that monetary stimulus is likely to continue across the world.**
- **While the ECB and BoJ may have limited ability to cut rates, EM central banks still have plenty of room for easing.**
- **At least 13 central banks across the world have cut rates so far this year, with many more expected to follow.**
- **Earnings growth could be muted this quarter, but analysts expect a strong economic rebound later this year.**
- **International Energy Agency forecasts the first quarterly drop in oil demand in more than a decade, but OPEC cuts and slowing shale production could reverse oil price decline later this year.**



A glance at market activity in the past two weeks suggests that bond and stock investors are living in different worlds. The yield on 10-year US Treasuries is close to some of the lowest levels in history, yet interest rate futures are suggesting the Federal Reserve could cut rates twice in the next 10 months. Meanwhile, the S&P 500 and the Nasdaq Composite indices have both reached new records.

Usually, equities and bonds do not move in tandem, since lower bond yields tend to foreshadow slower growth, and stock investors like to see the economy accelerating. However, sometimes they do move together, and that is usually when central bank stimulus is pushing all asset prices higher. That may be part of the reason why this is happening again.

Markets seem to be increasingly convinced that the Fed will have to join other central banks in easing monetary policy further this year.

Indeed, Fed Chairman Jerome Powell's testimony to the US Senate Banking Committee last week only reinforced some of those beliefs. The central banker said that "low rates are not really a choice anymore, they are a fact of reality." He also added that if there is a significant downturn, the Fed could be forced to use quantitative easing tools, given its limited ability to cut rates further. "We will use those tools," Powell said. "I believe we will use them aggressively," he added.

The comments dismissed budding fears that the central bank could stop expanding its balance sheet, which it started doing in September. The Fed is expected to soon decide whether it continues to buy some US$100 billion a month of short-term Treasury bills. The program has added

Thanks to the Fed, both bonds and stocks are moving higher regardless of the economy

US$422.7 billion of liquidity to the US since the start of September. The added liquidity helped fuel a 2.6% devaluation of the US dollar against its major trading partners in the fourth quarter.

It also helped spur further gains in the stock market, which has shown an increased correlation to the Fed's balance sheet in the past three years. Hence, in many ways, whether the Fed continues to inject liquidity into the US financial system has become more important for stock markets than whether the economy will continue to grow and fuel earnings growth.

Investors are coming to terms with the idea that the world's second largest economy will probably see first quarter growth come at the lowest in at least five years. Stock markets, however, focus on the long term and earnings estimates for 2021 have actually been on the rise as analysts consider that the recovery after China controls the new Coronavirus could boost growth significantly towards the end of this year, and even through some of next year. Expectations for earnings growth for the S&P 500 in 2021 have risen to 11.4% last week, from less than 10.5% in November, according to Bloomberg.

In fact, assuming that the S&P 500 ends the year at 19 times the expected US$193.3 per share earnings that analysts estimate for it, the index would close the year around 3,672.7, or 8.6% higher than the record 3,380.16 at which it closed on Friday. The index was trading at 19.4 times the expected earnings for the next 12 months on Friday, slightly higher than the 17.8 five-year average.

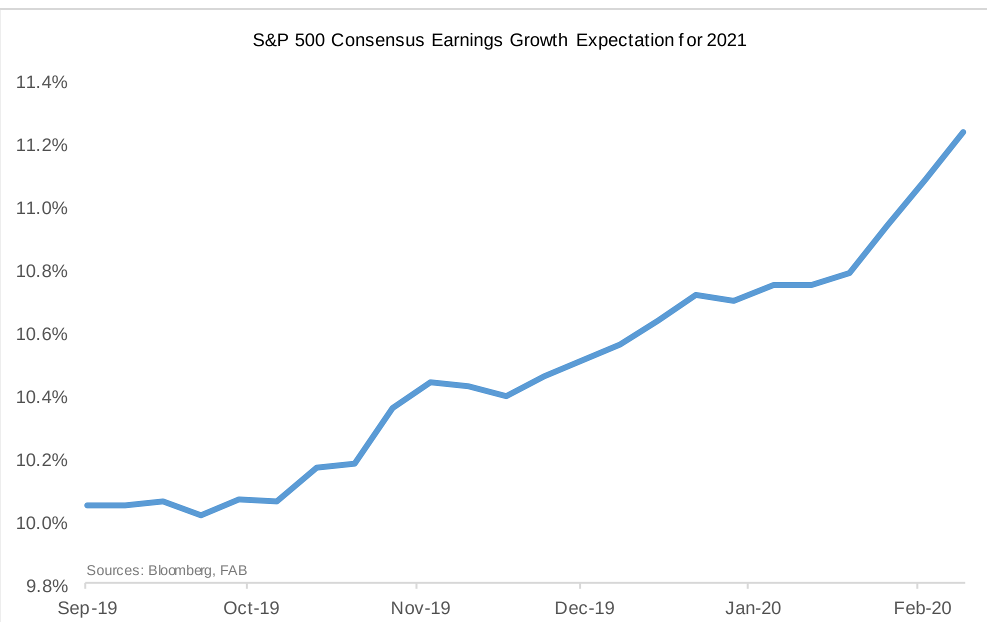
Much of that rally will depend on an economic recovery, itself predicated on how much stimulus China throws into its economy — and there are signs that the country will spare no effort to recover from the impact of the Coronavirus.

Last week, Chinese leader Xi Jinping appeared to reiterate that, saying China has “the ability and confidence not only to defeat the epidemic, but also to accomplish the set goals and tasks for economic and social development.” The country had a stated goal of growing at least 5.8% this year. This will have to be achieved even as this quarter growth will be lacklustre at best.

If China grows, say, 4.5% officially in the first quarter, it would have to accelerate to more than 8% year-on-year growth (assuming a mild acceleration to 5% in the second quarter) by the third quarter to reach that 5.8% goal. If the country does print an 8% quarter, it will expand at the fastest rate since 2012. That would be particularly helpful for Europe and some other Asian countries, such as South Korea and Australia, which depend heavily on China for their own economic growth.

The situation in Europe is particularly dire as the bloc was already slowing before the coronavirus impacted manufacturing in China. Last week, Eurostat revealed that industrial production in the Eurozone dropped 4.1% year-on-year in December, the worst such drop since 2009. That number preceded the impact of the coronavirus on Europe, which has China as its second largest export destination. Investors will get a better read of how deep the pain will be this week from economic data in a few places.

Analysts seem to be expecting that an economic rebound will boost US earnings in 2021



Export orders data from Taiwan, which is a key part of the supply chain for Chinese manufacturing, is due on Thursday and will offer a better gauge of how severe the factory stoppage in China was. Economists expect the measure to fall 7.3% year-on-year but the drop could be much steeper. Another measure of the actual impact of the coronavirus outside of China will come in the German ZEW current situation survey, which is set to be released on Tuesday.

Both measures are likely to paint a sad picture of the world economy and the upcoming releases will probably bring little solace. The silver lining (and the one markets seem to be grasping), however, is that this opens the door for more stimulus everywhere. In places like Germany, a potential recession as the ruling Christian Democratic Union grapples with challenges to its grip on power could be the trigger missing for a much-needed round of fiscal stimulus.

Elsewhere, emerging market central banks are finding the perfect excuse to loosen monetary policy in the current situation. Financial authorities in developing nations still have room to cut rates, unlike the Eurozone and Japan, where monetary stimulus rates seem to have reached the limit of its power to boost growth. Indeed, the stimulus is spreading and since the start of the year 13 central banks, mostly in developing countries, have reduced interest rates. As the year progresses, many more are likely to do the same.

That means that the same dynamic that has been seen in the US over the past year, when bonds and stocks moved higher together, could now spread to emerging markets. The only issue there, however, is that lower rates in these countries could mean weaker currencies.

That helps explain why the FAB Asset Allocation Committee (AAC) has been bullish about EM bonds, but has limited its overweight position to hard currency notes. These securities benefit from lower rates in the home countries of these issuers since it becomes cheaper for companies and governments to borrow in their local currency, reducing the supply of bonds internationally.

The greenback, by the way, has benefited from the recent global economic slowdown. The dollar index has rallied 2.8% since the year started as investors sought safety.

While the Chinese yuan has a very small weight in the dollar index, it may be among the main reasons why the US dollar is rallying. On average, returns on the Chinese currency have had a 42% correlation with those of the euro, and a 36% correlation with the British pound over the past five years. These two currencies are the main drivers of the dollar index.

In other words, the yuan has become an important driver of the direction of the dollar index by proxy. That may be bad news for emerging markets because the yuan is likely to depreciate from here. The reason for that is simple: as China increases liquidity at home to counter the impact of the coronavirus, it will cut rates and add fiscal stimulus, two measures that normally translate into a weaker currency. If the yuan depreciates further, it will push the dollar higher and will help push the depreciation of EM currencies.

That makes investment in local currency-denominated assets tricky but this could be good for the overall economy of developing nations. A weaker currency means cheaper exports and higher liquidity onshore, both of which accelerate economic growth.

That faster growth, however, takes some time to come through, and first, for these economies, comes higher inflation as the cost of imported goods soars. Among these foreign purchases often is oil.

That poses a serious issue for the commodity given that developing nations (China and India in particular) are the main source of demand growth for oil.

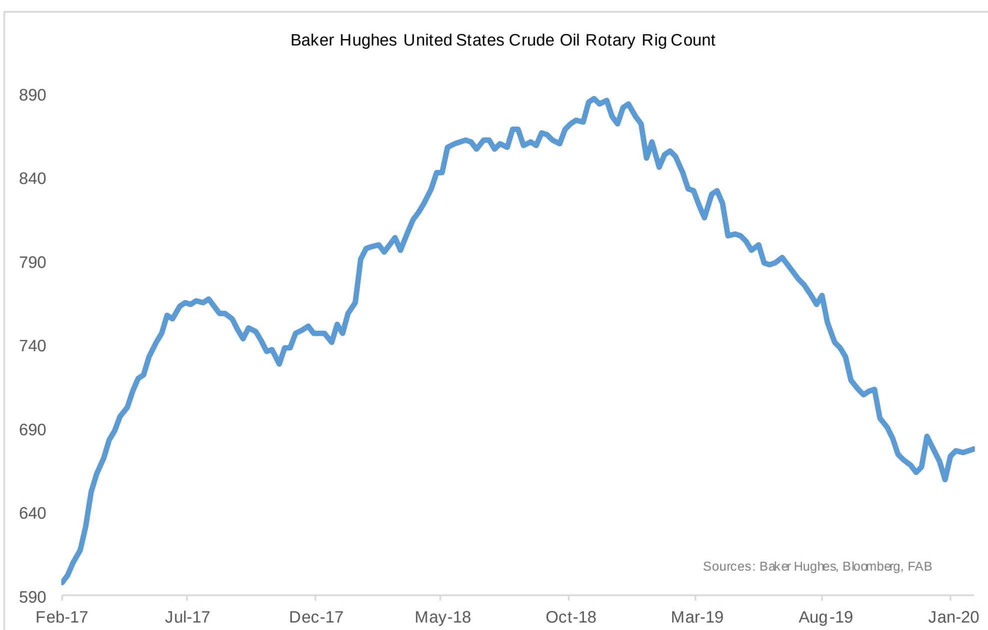
That is partly why the International Energy Agency (IEA) last week predicted the first quarterly drop in demand in nearly 10 years. The IEA said on Thursday that it sees demand dropping by 435,000 barrels a day this quarter. The estimate came days after the US Energy Information Administration (EIA) estimated that the coronavirus could reduce demand for petroleum and liquids by 880,000 barrels a day this quarter.

The EIA, however, noted that it expects OPEC to cut production by another 500,000 barrels a day from March to May as it reacts to lower oil prices and weaker global demand. The group was expected to announce a cut as early as this week but failed to reach an agreement for an emergency meeting. It still is expected to reduce output when it meets next month.

Apart from OPEC, US shale oil producers are also very sensitive to price changes and could start reducing production as a result of the recent drop in oil prices. The number of active rigs in the US has already been falling since the start of 2019 and could drop further. This supply can come back pretty quickly once oil prices rise, but that is only likely to happen once the initial economic shock of the coronavirus passes. Ultimately, it may be up especially to the oil-producing nations of the Gulf Cooperation Council to curtail supply and help bring the market back to balance.

That could mean more bond issuance from the region as these countries increase spending to boost their economies while seeing less revenues from oil. Higher deficits may also mean a more limited ability to help some of the countries in the region which may be in need of help, such as Lebanon. On Friday, the country's top officials decided to ask for the help of the International Monetary Fund as they face the repayment of a US$1.2 billion bond maturing in March.

US shale oil output could start declining from here, as evidenced by fewer active rigs



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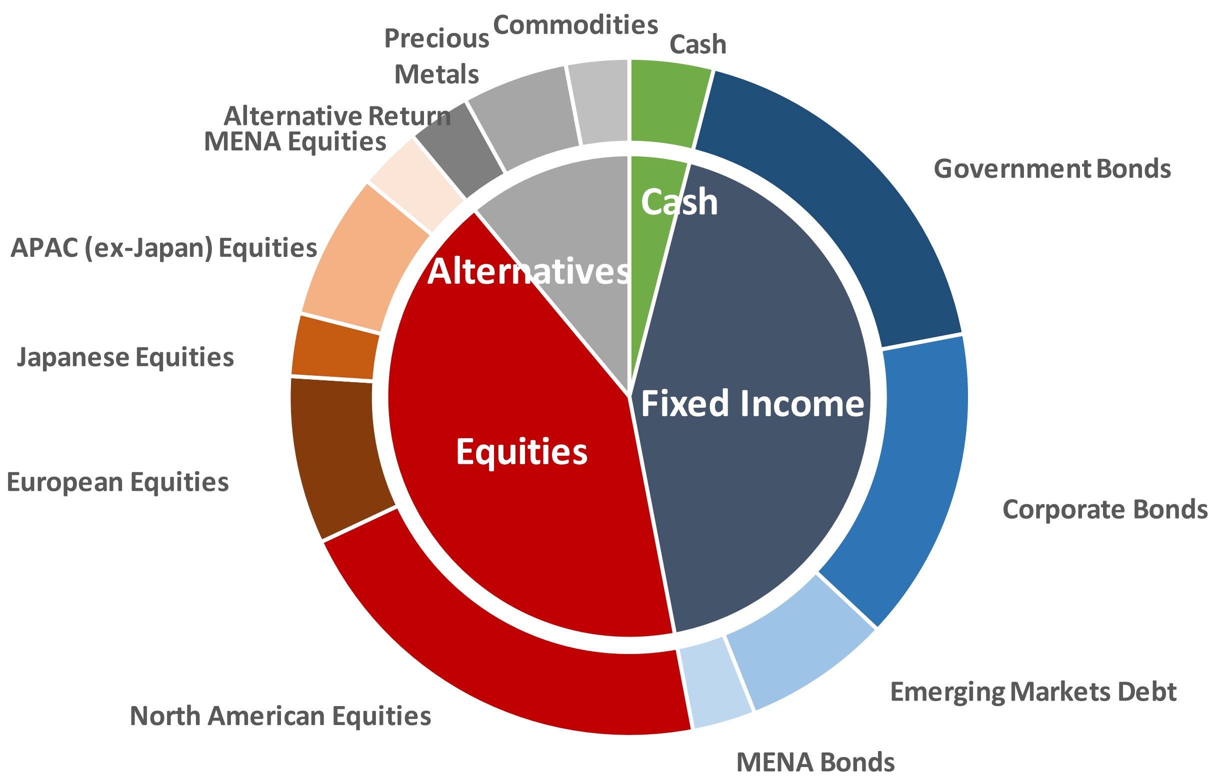
Current Tactical Asset Allocation



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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