Investment Weekly

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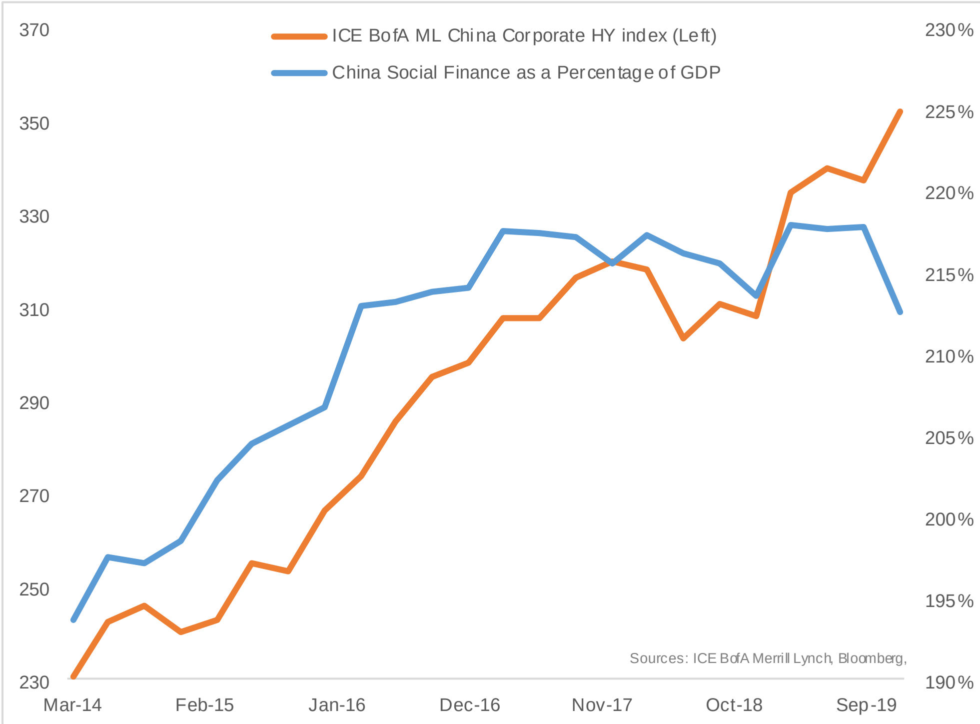
Finding value and staying invested amid high valuations



♦ Beijing pledges to do whatever it takes to get the economy back up, which could help support the values of Asian high-yield bonds.

♦ Daily number of new cases in China starts to decline and shows signs of stabilising.

♦ First batches of economic data begin to provide a picture of true economic impact of the virus.

♦ Investors take some profits as coronavirus continues to spread outside China.

♦ Fed minutes reveal that the central bank is more worried about inflation dropping than rising, suggesting it will continue to hold rates lower, or even cut them, for longer.

♦ US dollar index flirts with key 100.00 level, suggesting more greenback strength could be ahead.

Global investors are starting to have a picture of how hard the new coronavirus has hit the global economy. Data from key countries last week, as well as warnings from large multinationals provided a negative surprise to investors and prompted some of them to take profits.

However, economic data tends to be backward looking, and, yes, the global economy has been ailing from the virus. Looking ahead instead provides a very different picture and the better data that could come later in the year may increase the excitement about markets in the same way as the negative data could spook some investors now. That is particularly true about Chinese assets.

That is why the FAB Asset Allocation Committee (AAC) kept a 'risk-on' position in its latest meeting on Thursday. Members agreed that there could be a period of correction ahead, as the economic data becomes deeply negative, but that would be followed by an ebullient period with even better economic data. Hence, right now, price drops should be viewed as opportunities.

In fact, investors are probably better served finding what asset classes offer value in relation to other markets instead of thinking about what to sell.

Asian high-yield is a case in point. The Bloomberg Barclays Asia USD High-Yield Bond index currently yields 6.2%, with a duration of 2.9, while its US equivalent is yielding 5.2% with a higher duration of 3.3. Both indices have an average rating of B+, but the US High-Yield index has 8.2% of its holdings in the CCC category, the lowest rating in the junk bucket, whereas the Asian index only has 0.19%.

Chinese high-yield bonds tend to do well when Beijing is adding liquidity to its system

Over the past two years, the US high-yield index has gained 13.9%, outperforming Asia's 12.8%. This was in large part a result of the US-China trade war, and of Beijing's attempts to deleverage its economy. Now, Asian high-yield bonds may offer more upside potential and higher coupons. The performance of its underlying securities is also related to China's drive to stimulate its economy.

China is the biggest component of Asian high-yield indices, comprising 56.3% of the Bloomberg Barclays measure. Within that, nearly two thirds of the constituents are Chinese developers. Developers tend to be highly leveraged because of the nature of their business, borrowing to buy land and build apartments, and then sell them.

Homebuilders are hence very sensitive to monetary stimulus since lower interest rates tend to reduce their leverage costs and increase their profits. That is why the S&P Homebuilding Sub Industry index rose nearly 52% in 2019 — as the Fed cut rates the industry benefited.

In a similar fashion, Chinese homebuilders could benefit from the monetary stimulus that Beijing is unleashing to turn around its economy after the coronavirus shaved off as much as 3 percentage points of the country's first quarter GDP growth. And for anyone who currently doubts that China will do just that, the central government sent a clear message on Saturday.

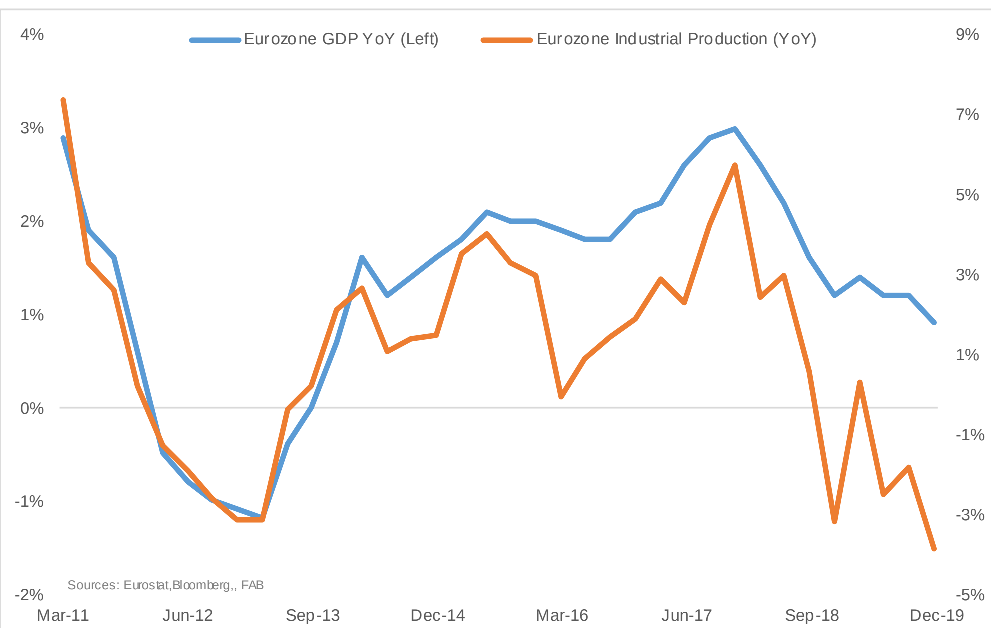
Liu Guoqiang, the Governor of the People's Bank of China said yesterday that the country will release more liquidity into the financial system by adjusting the requirements for banks to qualify for lower reserve requirements. In simple terms, Chinese banks will have to set aside less cash with the central bank for every dollar they lend. Mr. Liu also said that benchmark deposit rates may also be adjusted to further increase liquidity.

On the fiscal side, the Politburo, China's main policymaking body, announced that fiscal policy will be more proactive and that construction projects will be accelerated to revive the economy. This decision also favours Chinese homebuilders, as they often marry home development with major infrastructure projects.

Indeed, data suggests that part of the reason why Asian high-yield bonds have underperformed their western counterparts over the past two years has been China's deleveraging campaign. Since December 2016, when the loans outstanding reached two times the country's gross domestic product, Beijing has curtailed new loans and kept the number steady.

This naturally coincided with a rising number of defaults (which, however, still are a much smaller percentage of bonds outstanding than in the US). Hence, a reversal of that policy by way of new leverage would benefit Asian high-yield bonds as defaults stabilize and leveraged companies do better.

European data for the first quarter looks set to be particularly disappointing



To some extent, the argument of more stimulus ahead supporting riskier assets extends to the rest of the world and underpins the FAB AAC's decision to remain risk-on. Again, though, there could be some adjustment of asset prices ahead as investors realize the true extent of the global slowdown caused by the coronavirus.

The first snapshot of the size of the impact came from Taiwan. The country's export orders fell 12.8% in January compared to the same month last year, the steepest drop since February 2013. More than 40% of Taiwan's exports are to China as the company produces chips and hardware that are then assembled in places such as Shenzhen or Guangzhou and exported to the rest of the world. Hence, the drop in export orders provides a glimpse of how intense the manufacturing slowdown in China has been.

Another signal came from Apple Inc. The maker of the iPhone saw its stock fall 1.8% on Tuesday after it said that it may not meet its revenue targets this quarter because production of its flagship products was taking longer to resume in China due to the coronavirus.

While Apple is giving global investors more up-to-date information, most of the data being released is backward looking and has a significant lag. This means that for the next two months, the economic numbers out of Asia are likely to be dismal.

Europe may provide even more disappointing surprises. The Eurozone was already showing signs of a marked slowdown in December and that is likely to be exacerbated as a result of the growth slowdown in China. Industrial production in the Eurozone, for instance, had dropped 4.1% in December, the worst drop for the measure since 2009, in the aftermath of the Global Financial Crisis.

The next release for that data point is in March, when the extent of impact of the coronavirus will become apparent. The same pattern of past data slowly showing a dire economic situation is likely to be compounded. The few forward looking data points surfacing provide what is still a preliminary picture.

For instance, in Germany, Europe's biggest economy, the February ZEW Current Situation survey released last week was at negative 15.7, much worse than the already negative 10 that economists had forecast. Germany's January manufacturing numbers will only be known in the second week of March.

This stream of negative backward looking data could spook investors at times, as it seems to have done on Friday, when a measure of US business activity pointed at an economic contraction and prompted a 1.05% drop in the S&P 500.

Again, however, such economic data is likely to spur more monetary and fiscal stimulus, which would help boost growth later this year and push asset prices higher. Germany is a good example. The country narrowly averted a technical recession (two consecutive quarters of a shrinking economy) last year after its GDP fell 0.2% in the second quarter.

A positive 0.2% third quarter recovery staid the hand of some of the country's politicians who were pushing for an aggressive fiscal stimulus package. However, the country did not grow in the fourth quarter and is likely to see another quarter of contraction and, perhaps, a technical recession by the second quarter.

All that comes ahead of national elections next year and as the Alternative for Germany (AfD) party has gained increased popularity, threatening the power of Angela Merkel's Christian Democratic Union in several provincial polls. Mrs. Merkel has also said she will not run for reelection and does not have a clear successor, further complicating the picture. France also faces a similar situation.

All this suggests that Europe is very likely to see a round of fiscal stimulus later this year as the incumbent parties try to boost their local economies to slow the political gains that nationalist (and sometimes Eurosceptic) parties are making. The European Central Bank could also further expand its asset buying program to increase liquidity and help stimulate the economy, in a very similar fashion to what the PBOC is doing.

All this global easing may force the Federal Reserve to join in and cut rates this year, or at the very least create a permanent window of liquidity to replace its current repo operations. Fed fund futures currently imply that the central bank could cut rates twice before January.

Apart from the impact of the global slowdown on the US economy, the strength of the dollar will play an important part in determining whether the Fed confirms these expectations or not. The dollar index was trading on Friday at 99.262, very near breaching a key resistance of 100, which has not been tested since April 2017.

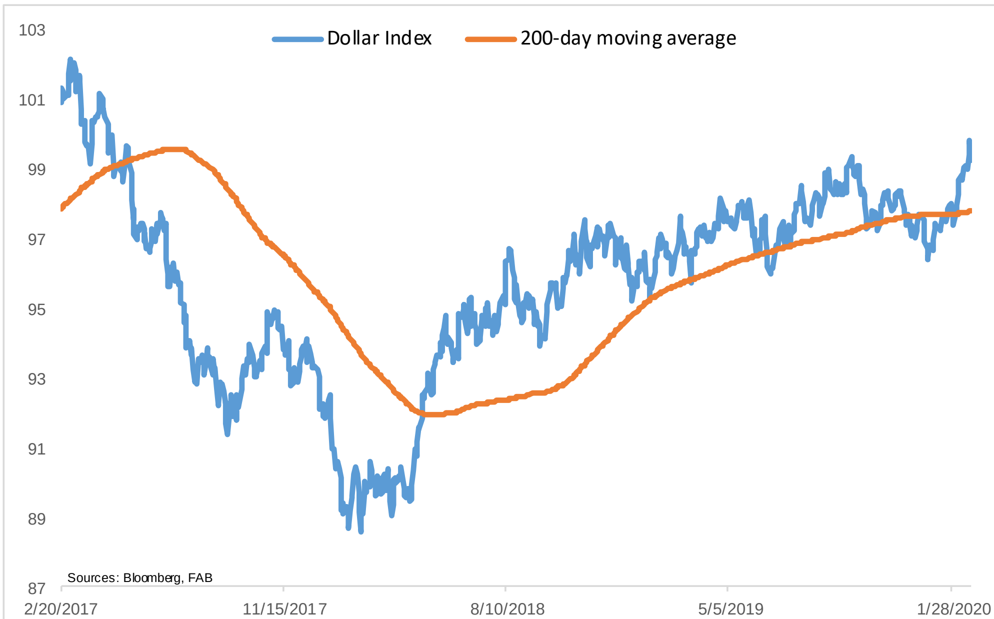
With Europe and China unleashing massive monetary and fiscal stimulus, there is reason to believe the dollar could continue to appreciate.

Traditional economic theory suggests that when a country's budget deficit increases (as is the case when there is fiscal stimulus) the currency comes under pressure. Similarly, falling rates in one country versus another should result in the depreciation of that currency. Hence, for China and Europe, the double whammy of fiscal and monetary stimulus is likely to result in a weaker euro and yuan.

That in its turn would translate into a stronger dollar (and perhaps weaker emerging market currencies). If the greenback is stronger, US exports become more expensive and are likely to drop.

That, in its turn, has a negative impact on growth. Imported goods become cheaper too, which means inflation slows. In fact, the main contributor to the US fourth quarter growth was an improvement in net exports and that is likely to reverse this quarter. Lower inflation and lower growth are a recipe for Fed rate cuts. So, if the dollar continues to strengthen, the Fed might just have to give in and cut rates.

The dollar could continue to appreciate as Europe and China increase stimulus



Sources: Bloomberg, FAB

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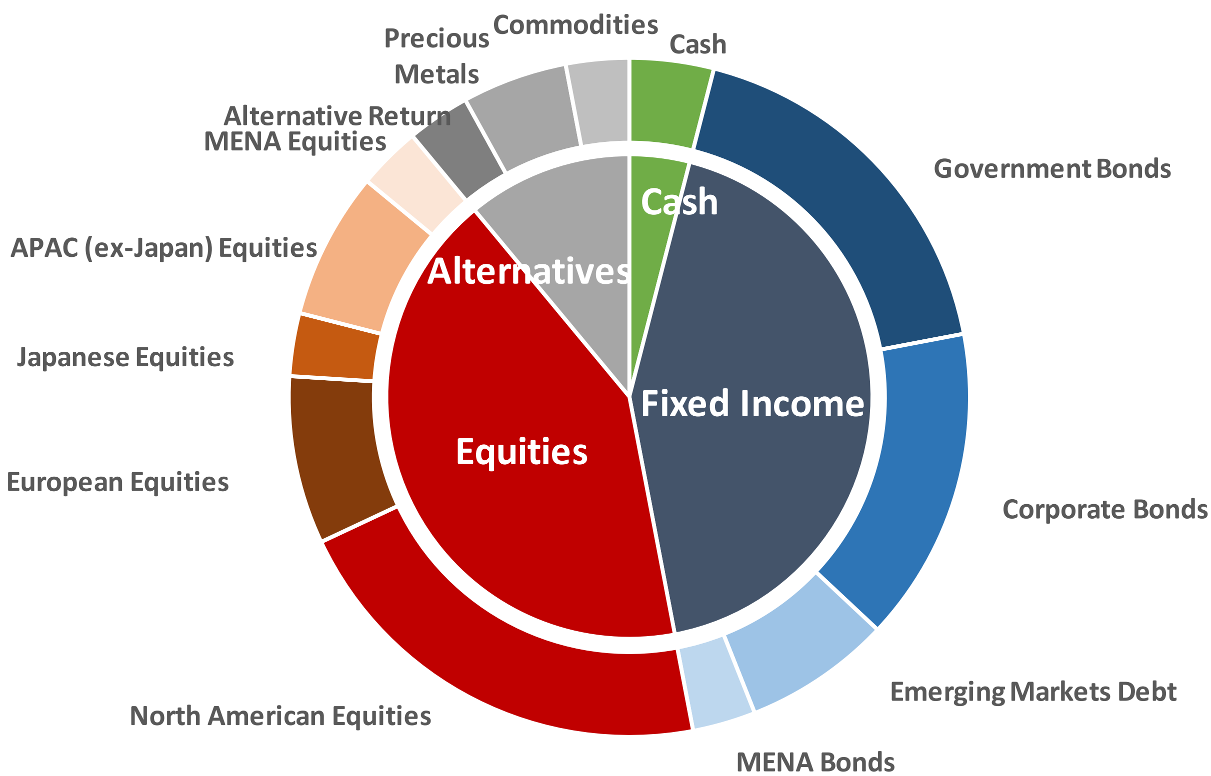
Current Tactical Asset Allocation



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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