Global Investment Outlook February 2020

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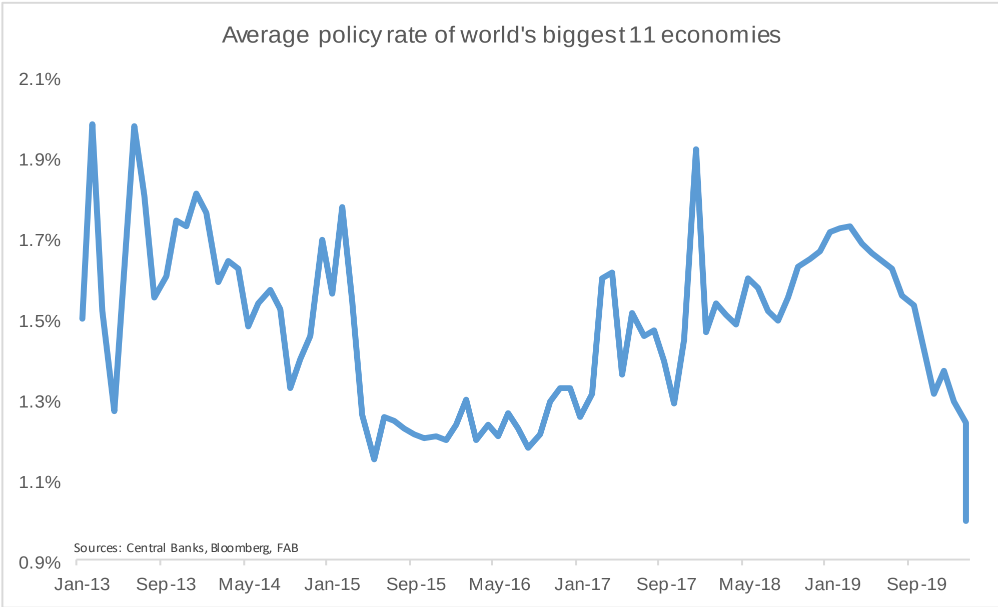
Market sell-off provides opportunity ahead of stimulus boost

"Every exit is an entry somewhere else"

Sir Tom Stoppard

- **Stimulus impact not yet priced in and could provide significant bounce in the second half of 2020.**
- **Central banks across the world cut rates and governments announce historic fiscal stimulus packages to turn around the global economy after the coronavirus impact.**
- **Economic data set to worsen going ahead as it begins to reflect the activity slowdown caused by the epidemic.**
- **Investors sell risky assets as they start to weigh the impact of the coronavirus epidemic on the global economy.**
- **Commodity prices suffer as the Chinese economy could post its worst quarterly growth figures in the Post-War era.**
- **Central banks across the world cut rates and governments announce historic fiscal stimulus packages to turn around the global economy after the coronavirus impact.**



The year started with unexpected events that shook markets, but which were initially shrugged off. Right after New Year's day, an escalation of tensions between Iran and the US caused a short-lived sell-off. By mid-January, the spread of a new coronavirus, which reminded many of the Severe Acute Respiratory Syndrome crisis in 2002-2003, tested the bulls again.

Global central banks, from the Fed to the PBOC, are cutting rates and injecting liquidity

The main impact of the new coronavirus has been in consumer behaviour and, as a result, economic activity. Because the world looks set for a downturn, the pressure on commodity prices could persist for a bit longer. Indeed, closed factories in China and cancelled travel plans all over the world are likely to take a significant toll on growth in the first quarter, and the fact that people are not going to malls will exacerbate that. However, the negative shock should be temporary.

Indeed, many asset classes began to recover by the start of February as investors realized that, in many cases, declines based on negative shocks result in favourable purchasing opportunities, especially if central banks and policymakers increase economic stimulus as a result. Investors reassessed that position in the end of February, making asset prices even more attractive.

China had already been injecting liquidity in its local system, and more than 20 central banks have cut rates so far this year, including the financial authorities of large economies such as Brazil, Russia, Thailand and Malaysia. Not to mention the Federal Reserve, which did its first emergency rate cut since the Global Financial Crisis on 3 March. This global stimulus could still help equity and corporate bond prices to continue to gain.

To be sure, concerns about the coronavirus could sap the performance of these assets, depending on how the epidemic evolves. There could be other headwinds too. However, any economic decline is likely to be followed by a strong recovery, if not a continuation of the apparent 'melt up' seen in the fourth quarter of 2019 and the start of 2020.

Macro

- **Fear of virus impacts consumer confidence in the US and in developed nations, which could significantly slow GDP growth.**
- **Cancelled travel and shopping plans eventually could feed into business activity, creating a demand shock.**
- **Central banks are adding monetary stimulus to counter this and governments are increasing fiscal stimulus efforts.**

The coronavirus will have an impact on the global economy in the first quarter, which helps explain why commodities have sold off as the disease spread. However, the ensuing recovery may be much stronger and could reverse the losses seen in the first quarter. Still, the upcoming economic data is likely to be downbeat.

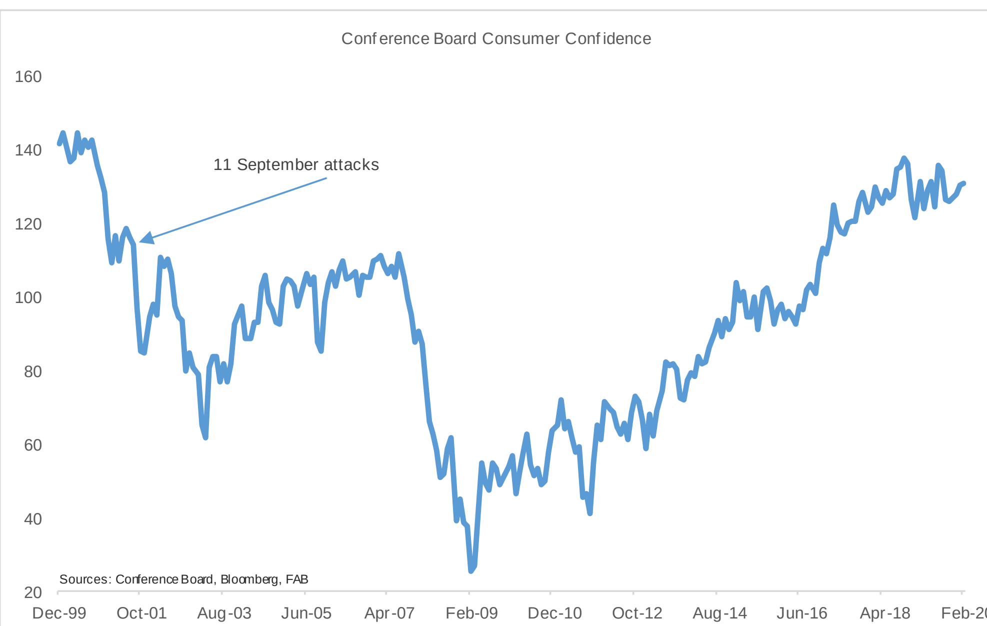
Furthermore, the psychological impact on consumers could sap demand in coming months, which then has a knock-on effect on business activity. It was, perhaps, with that in mind that the Fed cut rates suddenly in the first week of March. A sudden drop in consumer confidence, similar to the one seen after the 11 September 2001 attacks, could shave as much as half a point of growth in the US.

As for the world's second biggest economy, China, it hit the brakes for nearly a month as the country dealt with the new coronavirus. Manufacturing was halted at many factories, which extended the weeklong Lunar New Year holiday by more than two weeks in some cases.

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 nearly three percentage points of manufacturing growth, and manufacturing represents nearly 80% of the Chinese economy.

This also affects the Europe. China was the second biggest destination of European goods in 2018, according to the latest data from Eurostat, having bought 11% of all of the Eurozone's exports.

The impact of the coronavirus on consumer confidence could be similar to that of 9/11



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.

Cancelled travel plans and more people staying at home means less driving and less demand for oil, particularly in China, the world's biggest consumer of energy.

Once the fear subsides, however, activity could accelerate beyond normal. All the cancelled travel plans are likely to be bunched up in the second and third quarter, which means more driving and flying than usual. The same goes for shopping and, by proxy, manufacturing.

The market seemed to be discounting that as stock markets were on the rise in the second week of February, with the Nasdaq and the S&P 500 touching new highs. The rally is also partly a result of record low interest rates across the world, which drives investors to seek better returns in equities and other risk assets.

However, as the potential demand shock in the west became apparent, investors began to consider whether earnings growth could take a hit this year, and US equity markets corrected in the beginning of March. The sudden move by the Fed could help reverse that, but there could be a period of weakness first.

Indeed, US equity prices have shown a strong correlation with the Federal Reserve's balance sheet in the past few years. That suggests that the price of equities and other risk assets will continue to be supported if central banks continue to create vast amounts of money. That looks likely as central banks remain concerned about deflation.

Interest Rates and Bonds

- **US Treasury yields mark all-time lows as mortgage investors seek to hedge their portfolios.**
- **Extreme valuation for US Treasuries is likely to reverse this month, however, and as fear around the coronavirus subsides.**
- **Yield premiums for corporate and EM bonds fail to keep pace and increase, though they could catch up later.**
- **The FAB AAC still expects positive returns in Asian high-yield and EM hard currency debt.**

US Treasuries saw extreme volatility and historically high valuations toward the end of February and start of March as investors in US mortgages used the swaps market to hedge the average life of their portfolios.

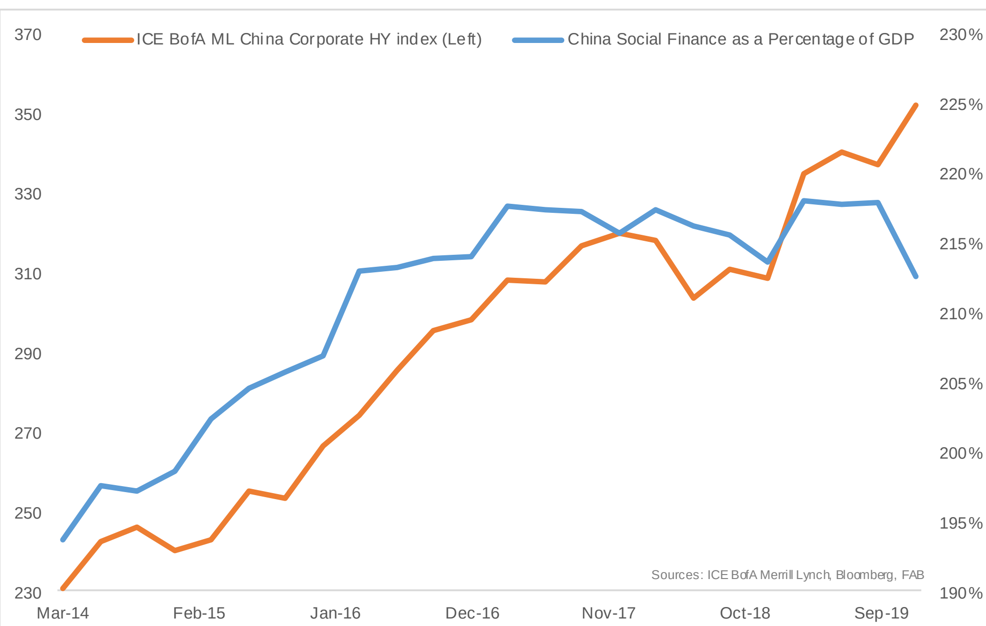
Mortgage investors (a US$9 trillion market) could have been prompted to buy more long-dated Treasuries in late February after the market changed its expectation of the direction of interest rates in the US, and as the Fed confirmed them with an emergency rate cut. The average life of a mortgage portfolio tends to be around 10 years. If the Fed cuts rates, more people refinance mortgages and that accelerates repayments, reducing the life of mortgage portfolios. To compensate for that, many of the players buy long-dated US Treasuries.

Markets are still indicating that the Fed could cut rates again this year. With the coronavirus epidemic slowing down the global economy and the US dollar strength, there is a possibility that markets are proven right.

As for Europe, the European Central Bank could cut rates this year, and it will probably start to purchase more than the €20 billion of bonds every month that it was buying when the year started, which limits the downside potential of European government bonds. In fact, the Eurozone is likely to be pushed into more stimulus as its economy slows in the first quarter as a result of the slowdown in China.

Yet, the ECB would prefer the yield curve to steepen, as this would support European banks. To achieve that, the ECB could buy more bonds with shorter maturities and encourage governments to issue more bonds with longer maturities, given the resistance to even lower short-term interest rates. Monetary stimulus could also find further support due to mounting political tensions, especially in Italy, which could trigger a rise in Italian yields. Finally, Europe's continuous move into negative territory is making Japanese government bonds more appealing.

Asian high-yield bonds are highly sensitive to interest rates in China, which are dropping



Recently corporate bonds, and high-yield in particular, have suffered as investors reassessed growth forecasts. That could reverse as central banks continue to add historic amounts of liquidity into the system. This market also faces rising defaults thanks to the large portion of the market comprised of energy companies, which are ailing amid low oil prices.

Hard currency high-yield bonds in emerging markets, however, still seem to offer value, particularly in comparison to the US. Within that bucket, Asian high-yield looks particularly attractive.

The Bloomberg Barclays Asia USD High-Yield Bond index currently yields 6.5%, with a duration of 3, while its US equivalent is yielding 5.9% with a higher duration of 3.5. 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 in the junk bucket, while the Asian index has 0.19%.

To be sure, investment-grade debt has provided good returns in periods of volatility. It has also performed well so far this year as investors went into the asset class amid heightened geopolitical risks and fears of a global slowdown thanks to the coronavirus epidemic. The 30-year US Treasury, for instance, rallied 19.2% between 31 December and 4 March.

The 10-year US Treasury bond yield is expected to trade in a range of 1.3%-1.9% this year. Towards the upper end of this range investment-grade bonds should be considered for purchase. The likely tendency is for this yield to trend lower, but it could move higher later this month.

Equities

- **Stock markets correct as investors reassess earnings expectations in light of a global slowdown.**
- **While there may be a bull market correction, low rates across the globe and fiscal stimulus could make earnings growth accelerate next year.**
- **Energy and materials are the most beaten up sectors, while financials start to grapple with lower rates.**

The FAB Asset Allocation Committee (AAC) in an emergency meeting recently reduced its exposure to global equities as the Committee assessed the impact of the fear related to the coronavirus on earnings growth. That said, the Committee remains neutral on US stock markets.

By 4 March, the S&P 500 was trading at 15.6 times the current Bloomberg consensus of US$192.82 earnings per share of the index in 2021. Given the global monetary and fiscal stimulus being unleashed in response to the coronavirus, the market could trade up to about 19 times earnings. The question, however, is whether analysts will revise their earnings forecast for next year.

If the expectations for 2021 stay where they are, the S&P 500 could rise to 3,663, or a rally of 21% from the 3,003 at which it was trading after a sell-off on 4 March. Plus, encouraging signs came from the full year and fourth quarter earnings reports too. Much of the index's future path will be determined by the first quarter earnings.

Still, historically, the most profitable phase of a bull market is the final one, which the market could be entering. With low rates and low inflation the 'long cycle' thesis remains intact. A continued 'melt-up', therefore, looks possible, after this short-term correction on the back of fears related to the coronavirus. In such a scenario, investors would benefit from remaining invested for the time being.

Furthermore, the markets seem to be assuming that Trump will be re-elected, which is assumed to be positive for risk assets. That stance, however, risks generating volatility if the Democrats choose a left-wing candidate and this person appears to have a good chance of ending up in the White House. In that case, investors may start to price in the probability of higher taxes and some hostility against large corporations. That could prompt a correction, but this is likely to be quickly reversed as long as the Fed continues to inject liquidity into the system.

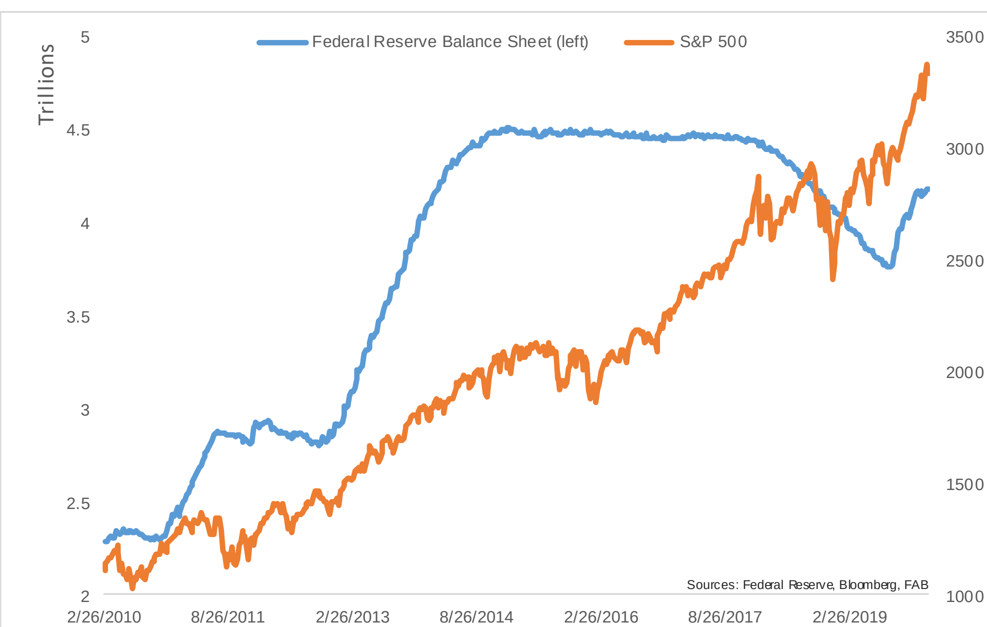
Emerging market stock markets also look poised for a good year as central banks cut rates, with 13 of them having done so by the second week of February. Much of their performance will be hinged on China's recovery from the coronavirus scare in the first quarter. The government seems committed to putting the country's economy back on track and that should help boost all other developing markets. Whether this perception of an impending recovery will start being priced into emerging assets in this quarter or after it may depend on the economic data.

The risk for foreign investors when it comes to emerging markets, however, is the pressure on local currencies from an appreciating US dollar. Local governments also may feel compelled to let their local currencies depreciate as global inflation remains relatively low and as the yuan is likely to depreciate in coming months as a result of stimulus in China.

As for Europe, the region's economic and political scene continue to look relatively depressing. UK equities could offer a bright spot, especially domestic earners. The FTSE 250 index, dominated by midcap companies focused more on the local market, is trading at a PEG (price to earnings to growth) ratio of 0.57. To be sure, some Brexit risks remain, although the British pound looks to have stabilized.

Japanese equities remain a value-trap, despite relatively attractive valuations. The country, however, reported annualized negative growth of 6.3% in the fourth quarter and this could translate into fiscal stimulus. Such stimulus could support the country's markets but much of their performance will depend on the trajectory of the Japanese yen – the Nikkei 225 index has a negative 38% correlation with the yen over the past five years.

US stocks have benefited from stimulus in the past decade and that is likely to continue



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Commodities and Gold

- **Fears of a global slowdown because of the coronavirus make commodity prices plunge.**
- **While short-term outlook may be cloudy, monetary and fiscal stimulus could increase demand for raw materials in the second half.**
- **Gold re-establishes its bull trend as retail investors get more excited about the yellow metal and as lower global rates make it more attractive as an investment.**

For the past decade what happens in China has the biggest impact on commodity prices, given that the country remains the biggest consumer of raw materials. In that sense, it is no surprise that the Bloomberg Commodities index has dropped 7.8% between 17 January, when investors became more aware of the coronavirus epidemic, and 4 March.

Oil was hit particularly hard, with Brent crude dropping nearly 18.4% in the period between 17 January and 4 March. While energy prices recovered a bit in early March, the short-term outlook remained cloudy as the world slows down.

In February, the International Energy Agency (IEA) in February said that the first quarter would see demand dropping by 435,000 barrels a day, the first quarterly drop in more than a decade. The US Energy Information Administration (EIA) also estimated that the coronavirus could reduce demand for petroleum and liquids by 880,000 barrels a day this quarter. Both agencies are likely to further revise lower their demand forecasts this month, in light of a slowdown in Japan and Europe.

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 on track to make an even bigger cut, of up to 1 million barrels/day, as it met in March.

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.

ETF holdings, a gauge of retail investor demand for gold, have been increasing significantly

Tensions in Libya have also curtailed production there, taking more than 1.2 million barrels a day out of the market. Ultimately, it may be up especially to the oil-producing nations of the Gulf Cooperation Council to curtail supply to bring the market back to balance.

Other commodities may not see such a quick reaction on the supply side of the equation and, hence, will remain under pressure for the coming months, especially as economic data provides a clearer picture of the actual impact of the coronavirus on the Chinese economy.

That said, assuming China continues to push stimulus into the economy, commodities could bounce back strongly. Metals may do particularly well if the stimulus increases construction activity in China, as it is likely to do.

Gold, meanwhile, is taking a different route. The yellow metal has worked well as a volatility hedge and the recent bout of uncertainty pushed the price up, even as the dollar strengthened – though in the very long term gold tends to move in the reverse direction of the US dollar.

In February gold prices also overcame a key technical hurdle as they sped past the US$1,600/oz level, trading up to 1,646.7 by 25 February. That confirmed the metal's uptrend this year, though gold prices could still correct as uncertainty around the impact of the coronavirus fades.

Perhaps key sign that there is potentially further strength ahead for gold prices is the recent interest from retail investors. Gold ETFs bought 2.5 million ounces of gold between 31 December and 25 February. That tends to be a bullish sign.

As a result of this prospect, the FAB AAC increased its allocation to gold to 6% in the balanced portfolio in an emergency meeting on 3 March.

Currencies

- **Dollar temporarily reverses a strengthening trend as investors unwind carry trades amid expectations of more Fed rate cuts.**
- **Strength of the euro and the Japanese yen, however, could prompt even more monetary easing in Japan and the EU.**
- **Emerging market currencies fail to get tailwind from dollar weakness as local central banks continue to cut rates and governments pump stimulus and increase deficits.**

The year started with a few key trend shifts for currency markets that could reverberate through other asset classes. The most important of these was renewed US dollar strength. The rapid succession of unexpected events in the first month of the year (Middle East tensions followed by the coronavirus epidemic) brought investors back to the safety of the US currency and reversed a three-month period of weakness for the greenback.

That, however, was reversed in the end of February, as expectations of more Fed rate cuts prompted investors to unwind carry trades and weakened the dollar.

In the last week of February, the euro saw its steepest appreciation against the US dollar since 2016, while the Japanese yen rallied the most in nearly two years.

Both Japan and Europe rely on exports for growth, and if their currencies rise, their products become more expensive. To be sure, much of the move in both currencies also bears the hallmarks of a technical move. The expectation of a rate cut in the US probably prompted many investors to unwind their carry trades, through which they borrowed in euros and invested in higher-yielding US Treasuries.

The yen, meanwhile, is seen as a haven currency and many investors buy it to protect themselves against sell-offs such as last week's. Hence, demand for the currency rises when volatility increases.

In simpler terms, there is reason to believe that some of the moves in the two currencies could reverse in a couple of months. However, in the meantime, they compound the problems that Europe and Japan already have as a result of the slowdown in the Chinese economy because of the Covid-19 virus.

Further quantitative easing or even more negative rates in Japan and Europe could stem the appreciation of the two currencies. Hence, the BoJ and the ECB could be expected to announce new easing measures soon.

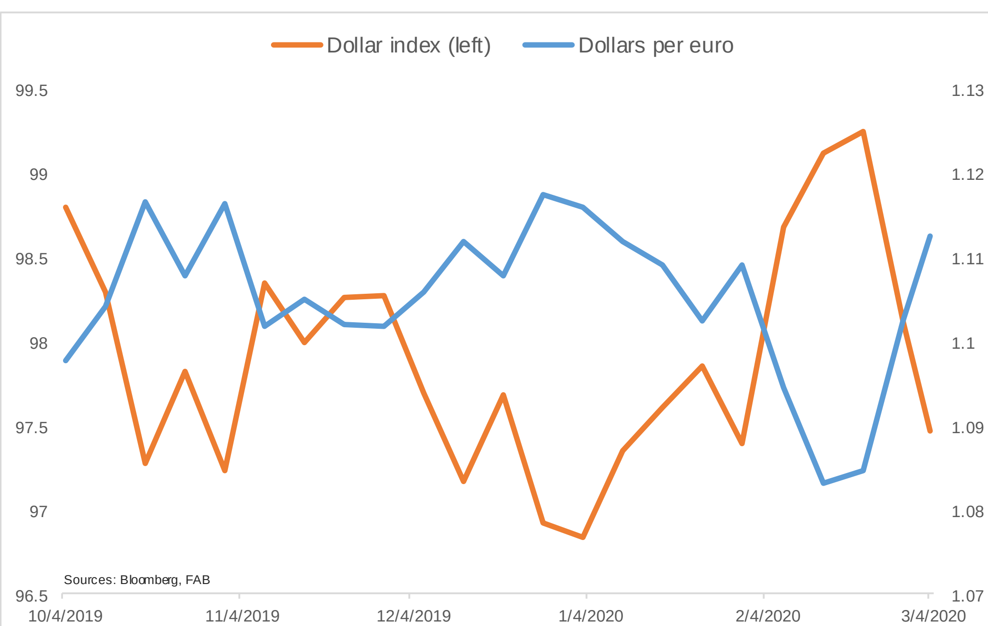
While a weaker dollar would normally translate into stronger emerging market currencies, that has not been the case. The sell-off in risky assets also hit EM and the round of stimulus from central banks and governments in developing nations could further weaken their currencies.

Besides, the Chinese yuan is likely to weaken further as Beijing pumps increasing amounts of fiscal and monetary stimulus into its local economy. The weaker growth and lower rates in China would also normally lead to a weaker currency. Beijing could manage the fall so it happens slowly, but a weaker currency would help restart activity in the second and third quarters and is likely to be part of the strategy for the country to overcome the fallout from the virus.

A weaker Chinese economy is likely to weaken the economies of Europe, Australia and other G-10 countries which have important weights in the dollar index. Hence, that could spell more dollar strength for the time being. To be sure, as previously noted, the dollar index is near a resistance level and could correct before resuming its uptrend. As long as the yuan continues in a downtrend, EM currencies are likely to remain under pressure.

As for the Swiss franc, it continues to act as a haven currency, rising when volatility spikes. It acted similar to the dollar in the latest sell-off, however, and weakened slightly. That movement seems to have been the result of margin calls, similar to what happened to gold in the last days of February, and is likely to be reversed in the near future.

The dollar has weakened as investors priced in lower rates and slower growth in the US



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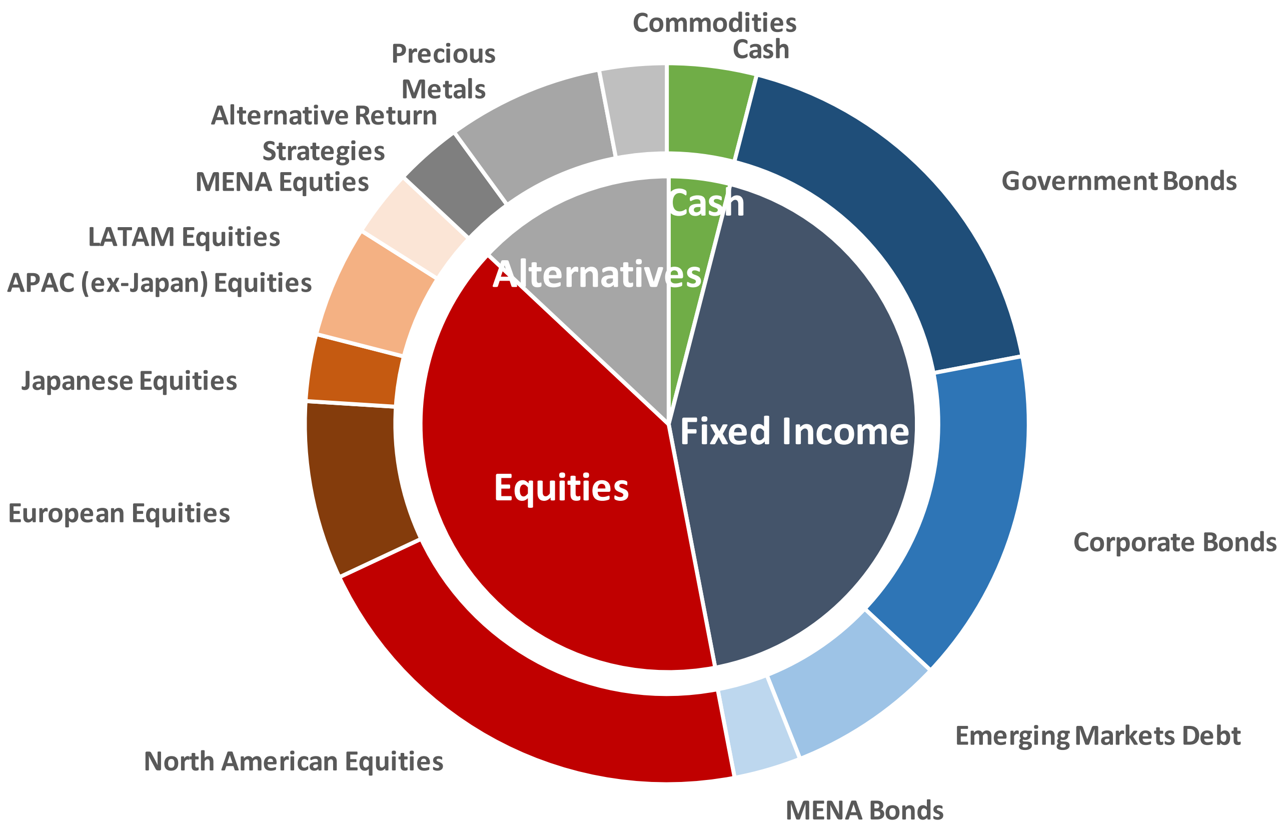
Current Tactical Asset Allocation



Strategic Asset Allocation - 29.02.2019

	Conservative		Balanced		Growth	
	Portfolio	Benchmark	Portfolio	Benchmark	Portfolio	Benchmark
Cash	5%	5%	5%	5%	5%	5%
Fixed Income	70%	70%	40%	40%	10%	10%
Equities	10%	15%	40%	40%	65%	65%
Alternative Investments	10%	10%	15%	15%	20%	20%

Notes: 1 - Performance shown is for our model portfolios and is not a composite of the performance of actual client mandates. While our goal is that each client mandate will closely mirror the holdings and performance of our models, client account performance may, and does, vary according to several factors. 2 - The performance of the model portfolios is calculated gross of management fee, and brokerage charges, if any. The performance for 2014 is calculated based on the Tactical Asset Allocation at the time. 3 - Inception date is 31st October, 2013.

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