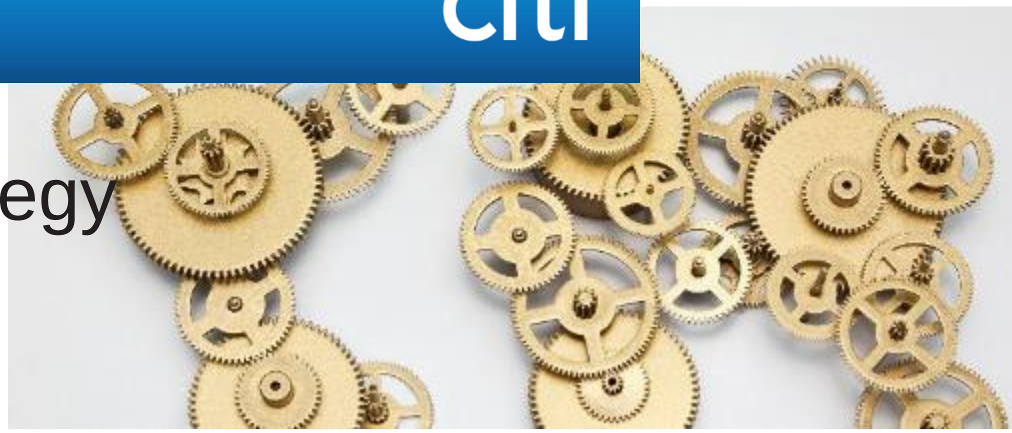
Private Bank

Global Strategy Bulletin

February 21, 2020



Expensive Defensives

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- The evolving Coronavirus shock will likely cause a first quarter economic contraction in China and cloud the underlying path of the world economy for at least a few months. In a similar way, it is pushing many asset prices away from the path of their longer-term fundamentals.
- "Defensive" bonds and certain stocks have surged in value. Similarly, so-called growth stocks have trounced value shares. Equities whose value is derived from "growth in the distant future" can't suffer from economic losses when they have little current business to lose.
- The US economy is also viewed as a relative safe harbor. The US dollar has surged on inflows to US assets. This is reminiscent of the Asian financial crisis of 1998, but the coronavirus will not likely be as persistent
- The Federal Reserve's reasonable reluctance to assume a long-lasting impact for the US economy may exacerbate market uncertainty and strengthen the USD further.
- A period of falling coronavirus fears and normalizing activity should lead to a sharp reversal of these trends. Non-US cyclicals, global financials and commodities (apart from precious metals) should rally back. Bond yields should spring back from even lower levels. When this will unfold is as uncertain as the coronavirus's impact. Like the course of the illness itself, the current trend may get worse before it gets better.
- For investors concerned with near-term volatility, shorter-term hedging may actually be more effective and less damaging to long-term portfolios than chasing current market trends.

Expensive Defensives

As discussed in our latest *Quadrant*, we continue to see a more volatile market backdrop in the period just ahead. The Wuhan coronavirus is the first new shock to the world economy of 2020. Economic activity in the first quarter will show significant negative impacts from the precautions to limit the spread of infections. China will likely see its first quarterly economic contraction in recent decades. Yet like each global health threat of the past, such *disruptions* are unlikely to mark a lasting turning point for global growth.

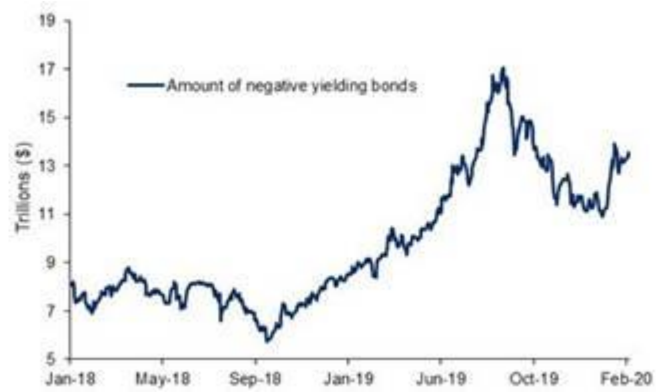
The evolving shock has distorted valuations and pushed many asset markets away from the path of their longer-term fundamentals. This impact has yet to become truly dramatic. But like the course of the illness itself, the current trend may get worse before it gets better.

The assets that are deemed immune to the economic fallout of the "COVID-19" disruption are either surging in value or in "relative value." Those most impacted have fallen (One key exception are Chinese equities, which showed the largest and earliest impact, and have rallied since early February).

What has rallied on the Coronavirus? Any bonds that are deemed "money good." As figure 1 shows, US Treasury yields have started to part ways from reliable cyclical indicators. This is in part because forward-looking investors can foresee the negative impact to global trade and industrial activity that is still ahead. Yet it owes even more to the collapse to deeper negative levels in other developed market bond yields with Japan and Europe's economies more greatly exposed to the viral impact (see figure 2).

Figure 1: US Treasury Yield and ISM New Orders

Figure 2: Negative Yielding Bonds, $Trln



Source: Factset and Haver Analytics as of February 21, 2020.

US Safe at a Distance?

Other USD assets have also benefitted on an outright or relative basis. As figure 3 shows, the relatively static US utility industry has seen shares jump 25% over the past year and 9% in the young year-to-date. US utility dividends are deemed a direct bond valuation play and should be little impacted by anything less than a severe US economic fallout. Similarly, "growth ideas of the distant future" are not particularly impacted by current economic woes. These long duration (if speculative) assets are influenced by competing credit market returns which are a falling hurdle. US growth stocks have surged past value stocks as long-duration bond yields have collapsed (see figure 4).

Figure 3: S&P 500 Utilities, Tesla and Virgin Galactic

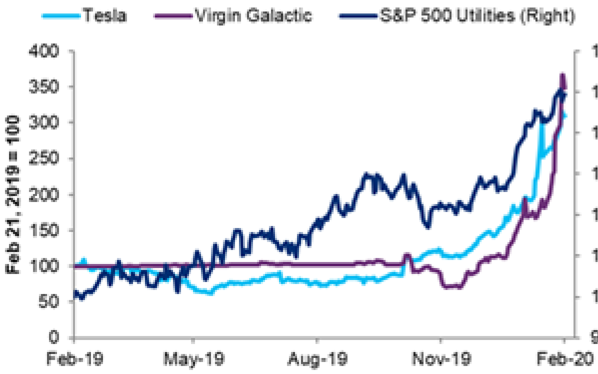


Figure 4: Russell 1000 Growth Vs Value vs US Yield Curve

Source: Factset and Haver Analytics as of February 21, 2020.

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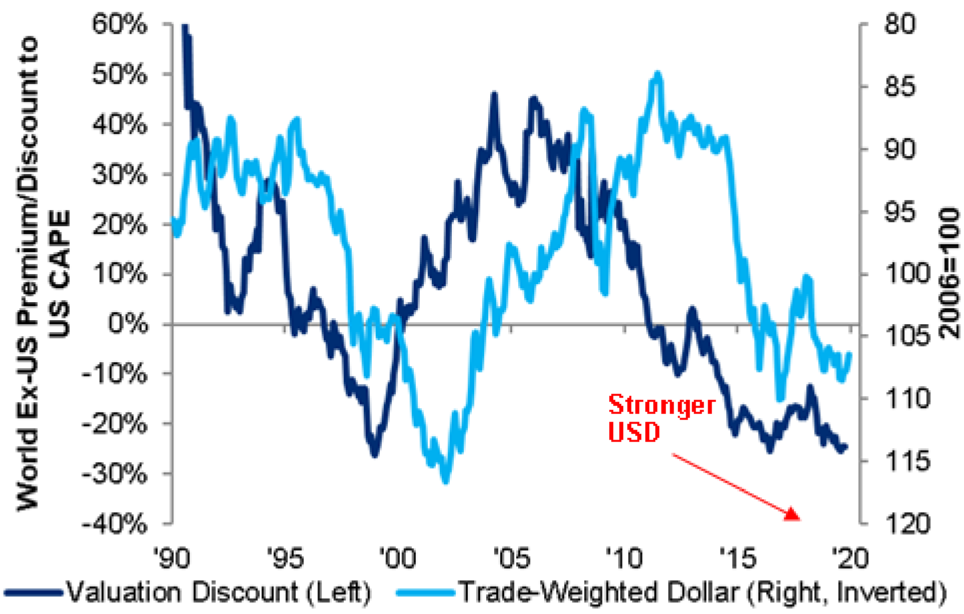
The surging US dollar is a signal of the “safe haven” inflows into US markets. Gold has unusually rallied at the same time, benefitting from falling real US interest rates. This is all somewhat reminiscent of 1998, when South East Asia’s GDP contracted 13% and US shares surged. However, the Asian financial crisis was a more lasting economic slump than past pandemic threats. The Asian crisis also *drove* a massive US valuation premium. Such a US premium now *already* exists after last year’s massive US stock market outperformance (see figure 5).

Figure 5: US Trade Weighted Dollar vs Non-US Equity Valuation Discount to US



Note: CAPE is the Cyclically Adjusted Price to Earnings ratio. Source: Bloomberg, Thompson Reuters, Factset and Haver Analytics as of February 21, 2020.

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Meanwhile, European shares could fall on the coronavirus impact given the region's stronger trade ties to China. These equities could lose value over the short-term. Yet core European government bond investors are *guaranteed* to lose money over the longer-term if they hold their negative-yield bonds to maturity. At higher prices, they lose even more.

A period of falling coronavirus fears and normalizing activity should lead to a sharp reversal of these trends. Non-US cyclicals, global financials and commodities (apart from precious metals) should rally back. Bond yields should spring back from even lower levels. When this will unfold is as uncertain as the coronavirus's impact. In the meantime, as we noted in Quadrant, equity markets should look to past short corrections around global health concerns averaging 8%.To date, equity markets have been far more calm overall, instead shifting to ever more **"expensive defensives."** Shorter-term hedging may actually be more effective and less damaging to long-term portfolios rather than chasing such trends.

Monetary Policy – Important Background Issue, But Not a "Virus Antidote"

Finally, most central banks will play a limited role, if any, in offsetting the economic effects of the coronavirus shock. Credit easing steps in China (fiscal support) for small firms is crucial to help bridge a gap amid lost sales. This can stem "second order" negative shocks from insolvency.

For the US, the Federal Reserve is understandably yet to judge whether any negative fallout will persist long enough to be material. The long lags in impacting economic activity make monetary policy a relatively ineffective short-term palliative tool. Yet the Fed's restored self-confidence – anchoring short-term US yields at a high level on a global scale – actually exacerbates the near-term market disorders we have just illustrated.

Unfortunately, some illnesses must simply run their course.