Weekly Digest

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The Best Laid Plans…

Everything looked very simple as we entered 2020. The central case was for a gradual recovery of global economic growth, led primarily by an easing of global trade tensions thanks to the phase one trade agreement between the US and China. The wheels would receive more oil from extremely loose monetary policy, and further juice would be added by the need to rebuild inventories that had been run down in 2019. It seems fitting, then, that Burns Night and Chinese New Year fell on the same day this year, as we recall the lines from the Scottish poet's To a Mouse: "The best laid schemes o' mice an' men gang aft a-gley" (go awry). It was around Chinese New Year that concerns about the new COVID-19 virus really started to grow, and, a month on, the situation is far from resolved. Indeed, it seems to have taken a distinct turn for the worse over the weekend, with a sharp escalation of cases in Korea, Iran and Italy. There's nothing like geographical proximity to raise levels of anxiety, and European equity markets have finally succumbed to a sharp mark-down today. The game of "chicken" that I described last week has ended, for now, in one player taking evasive action.

Investors had remained remarkably relaxed until today. The evidence from previous similar outbreaks suggested that any shortfall in activity in the short term would be made up for relatively quickly, bolstered by supportive policy measures, both monetary and fiscal. Thus any immediate falls in risk assets would be recovered within a time frame that only the nimblest traders could exploit. Longer term investors would be best served by holding firm. The dam burst this morning, and it's hard to argue with the market's assessment. With several towns in Northern Italy in effective lockdown and Austria threatening to close its border with Italy, the three biggest fallers in the FTSE 100 were Easyjet, TUI and International Airlines Group (parent of British Airways and Iberia). Luxury Goods companies in Europe are also taking a battering on the view that Chinese tourists' travel will be severely curtailed, along with their spending on luxury items.

When this virus first started to make its presence felt, I wrote that the uncertainty about its effects would demand a higher risk premium, but markets, following an initial wobble, instead started to price in the recovery and the supportive valuation effect of lower bond yields. Several market indices hit new all-time highs. But there does come a point when the level of earnings starts to be questioned more searchingly, and we now seem to have reached that point. It is almost pointless to try to pin down exact forecasts for, say, the effect on global GDP. It is the trend that is important. There was perhaps an element of wishful thinking that the evidence for a recovery that was being seen in global economic data at the start of the year would be persistent, but the cracks have started to appear.

The most recent Purchasing Manager surveys, which tend to offer the timeliest indications of economic activity, have started to slip. The Services index in the US fell below 50 on Friday, as did the Composite index, indicating a contracting economy. However, it's not all gloom and doom, as Germany's IFO Business Climate survey ticked up in February.

It is becoming clearer that one of the key problems with COVID-19 is its reproductive ratio, a number defined as "R zero". The reproductive ratio is the expected number of cases directly generated by one case in a population where all individuals are susceptible to infection. Current estimates (and it is still very early days to be certain) for COVID-19 suggest a reproductive ratio of around 2.5 or even higher, meaning that it is much more contagious than seasonal flu or even the common cold. That is why it is imperative to quarantine potentially infected people. In fact, a Financial Times graphic shows that the only common viruses that are more contagious are Polio, Smallpox and Measles (which has an incredible reproductive rate of 15) – hence the development of vaccines to combat those threats. SARS is closer to 2, which is still high, but remember that the compounding effect means that even a slightly higher number creates new cases at an exponentially faster rate.

The trade off in calculating the effect of the virus is to look at the mortality rate. Measles, for example, despite being very easy to pass on, at least kills very few people. Polio (5-10% rate) and Smallpox (@30%) are much more deadly. Thankfully, the viruses with very high fatality rates, such as Ebola, MERS, Bird flu and H5N1, are less easily transmittable. You really don't ever want to catch the Marburg virus. The fatality rate for COVID-19 appears to be around 2%. So where does that leave us? It would seem highly dependent upon the Italian, Korean and Iranian authorities' ability to contain the latest outbreaks. The fact that first cases have been reported in Afghanistan, Kuwait and Bahrain this morning is not exactly helpful either. Of course, even if the virus is contained, the cost of containment in terms of lost economic activity will be felt, but, in the long run, that's a price worth paying. It certainly feels too early to "buy the dip" this time, but it also feels too aggressive to make wholesale portfolio liquidations, on the basis that we know that ultimately this outbreak will be contained, it's just a question of when.

The greatest danger is for companies that came into this with weak finances, and who might fail to survive. We tend to steer clear of such investments. This is also the point at which more defensive assets in a balanced portfolio show their worth, and we always recommend carrying a mix of government bonds, uncorrelated absolute return funds or gold, for example.

For things to get really bad, we believe that it would take another negative catalyst to emerge. That puts the onus on politicians across the world to play nicely with each other for the foreseeable future and for central bankers to keep the liquidity taps turned on. Last year was an exceptional one for balanced portfolio investors, especially when measured on a volatility-adjusted basis. What we are going through currently is no more than the normal ebb and flow of investing, however alarming it might feel – and I can't guarantee that it won't get worse, especially if more cases turn up in major developed countries.

Last week's Economic Highlights

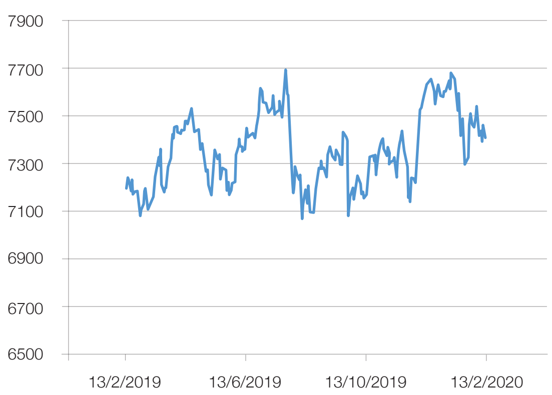
FTSE 100 Weekly Winners

Centrica	11.4%
NMC Health	10.3%
Flutter Entertainment	6.9%
Smith & Nephew	5.8%
Fresnillo	5.5%
AstraZeneca	5.3%
InterContinental Hotels	5.1%

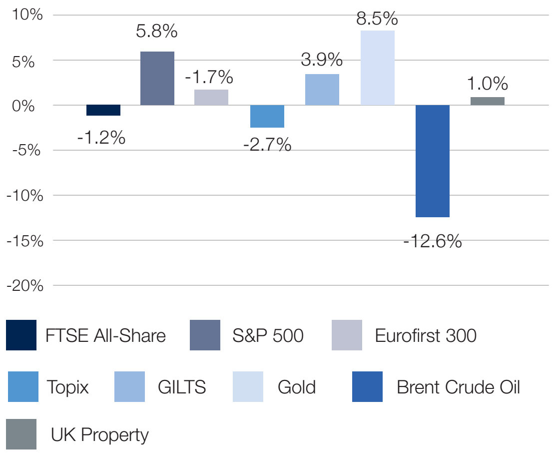
FTSE 100 Weekly Losers

Burberry Group plc	-6.4%
British Land Company	-5.4%
Imperial Brands	-5.3%
TUI AG	-5.2%
Rolls-Royce	-4.7%
Royal Bank of Scotland	-4.2%
Glencore	-4.1%

FTSE 100 Index, Past 12 Months



Year to Date Market Performance



Source:FactSet

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