Weekly Digest

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John Wyn-Evans
Head of Investment Strategy

More Of The Same

As if to prove that any prognostication by me or any other investment strategist can only be the best effort to settle on the most probable outcome across a range of possibilities, the events of last week produced a couple of notable surprises. They both relate to the subject matter of the last two Weekly Digests, and so forgive me if there is an air of repetition about today's edition. (And I also offer apologies in advance for the fact that both the coronavirus and the US Presidential election are likely to dominate proceedings for a while yet.)

Turning first to the coronavirus, the element of surprise came not from the evolution of the virus itself, but from the reaction of financial markets. Although, thankfully, we restrained ourselves from hitting the panic button when the virus was first reported, by no means did we expect the leading benchmark equity indices in both the United States and Europe to hit new all-time highs within a couple of weeks, which is precisely what they did last week. Is this a sensible reaction or dangerous complacency?

Pretty much everything that happens in financial markets can be rationalised, especially on a post hoc basis, and this episode is no different. As we initially concluded, investors have been conditioned to look through any current disruption and loss of earnings to the return to normal once the virus is contained. This makes eminent sense. Equities are "long duration" assets, meaning that the profits, cash flow and dividends that they generate are expected to endure for many years, even decades. One method of determining the "net present value" (i.e. what it's worth today) of an asset is to tot up all future cash flows or dividends and to discount them back to the present. Using this methodology, the loss of a quarter or two of profits isn't going to make much of a dent to valuation in the context of forty or fifty years of future growth. And just to add a little icing, the discount rate, usually defined by the long-term bond yield, has also fallen in the last few weeks, which, arithmetically, drives up the net present value.

These factors have been particularly helpful for "Growth" stocks. Not only do they fall into the "long duration" category, but they also tend to have high, sustainable margins as well as high returns on investment. This makes them even more (positively) sensitive to a falling discount rate. Meanwhile the "Value" sector, which is currently dominated by the Energy, Industrial and Banking sectors, fares less well on that front. Not only that, but the former two sectors are deemed to be more at risk in the short term from demand destruction and potential supply chain disruption.

So what happens next? I think it would be dangerous to lower one's guard just because everything has gone well so far. Sentiment will almost definitely take a hit when individual companies start to report exactly how much this epidemic will cost them, especially when costs turn out to be a lot stickier than revenues. No doubt the market has already tried to sort out the wheat from the chaff. Oil majors, cruise companies, purveyors of luxury goods and the owners of casinos in Macau, for example, have seen their shares underperform. But the key driver will be the extent of the spread of the virus. The good news is that the daily rate of growth of cases in China appears to be declining, and the spread of the virus outside China has been relatively limited. But there is no shortage of epidemiologists warning that this could be the calm before the storm. To be brutally honest, nobody has the definitive answer, and so we deem it premature to make wholesale changes to our investment strategy. Trimming the sails should be sufficient for now. But should the virus become more widespread in other countries, one would expect an aggressive containment response from governments and health authorities, which would exacerbate any short-term downturn in economic activity. We continue to believe that our preference for companies with strong balance sheets and the ability to compound high returns over long periods confers a degree of resilience on portfolios, but it is almost inevitable that there will be some corporate fatalities amongst less financially sound companies.

Turning back to the US Democratic primaries, my assertion last week that the candidate to face Donald Trump in November's election would almost definitely be a septuagenarian was blown apart by Pete Buttigieg (38) winning the Iowa caucus, albeit by a small margin from Bernie Sanders. The other big surprise was that the recent front-runner, former Vice President Joe Biden, was pushed down into fourth place behind Elizabeth Warren. That result is going to make tomorrow's New Hampshire primary even more interesting, and really puts the pressure on Biden to deliver a good result in South Carolina at the end of the month, a state where he has been leading the polls consistently, especially amongst black voters thanks to being Barack Obama's number two.

And this is all before Michael Bloomberg enters the race on "Super Tuesday", March 3rd. With as many as five or six (if you add Amy Klobuchar) candidates splitting the vote, it remains eminently feasible that the Democrats arrive at their convention in July with no clear winner. If history is a guide, that uncertainty would tend to increase market volatility owing to the uncertainty about who Trump would ultimately face and the potential policy shifts that could occur. The latest poll I have seen reports that Bloomberg has the best chance of unseating the president, and markets would take that outcome reasonably well. Trump himself has weathered the impeachment storm and seemingly enhanced his standing with the electorate if the latest approval ratings are to be believed. As the incumbent, the odds favour him winning again, to some degree because he can orchestrate policy and the news to his own benefit. The market seems to be relatively happy with the thought of another four years of Trump, although his jokes about eight or twelve more years are a touch unsettling given what "strong-man" presidents have done to change limits in, for example, China and Russia. However, nobody is entirely sure what he will do in a second term, which raises its own degree of uncertainty.

Last week's Economic Highlights

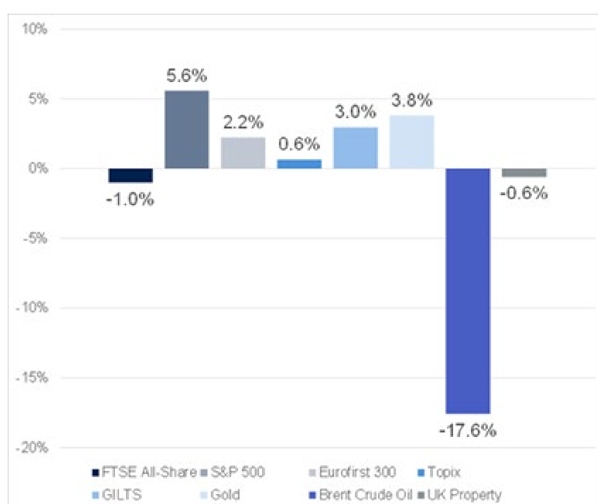
FTSE 100 Weekly Winners

Evraz	12.7%
Smurfit Kappa	11.7%
TUI AG	10.9%
Ferguson	9.4%
easyJet	8.4%
Prudential	8.1%
Scottish Mortgage IT	7.8%

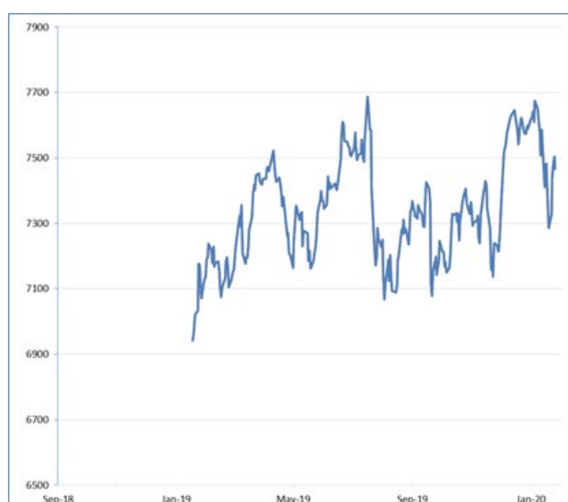
FTSE 100 Weekly Losers

NMC Health	-45.8%
Micro Focus	-24.7%
Royal Mail	-9.8%
Hargreaves Lansdown	-7.0%
Imperial Brands	-6.1%
GlaxoSmithKline	-4.7%
BT Group	-3.7%

Year to Date Market Performance



FTSE 100 Index, Past 12 Months



Source:FactSet

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