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&PARTNERS

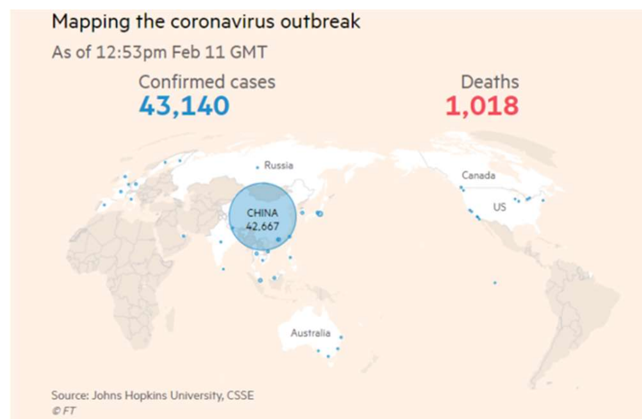
Economic Background – February 2020

Always had a vision, always had high, high hopes[1]

Financial markets entered 2020 with optimism. Geopolitical tensions had eased and there were tentative signs of a manufacturing pickup in activity that had plagued the sector and hampered the global economy for most of 2019.

Public Unrest

However, events in early January reminded the world of tensions in the Middle East. Following the US assassination of Iranian military commander Qassem Solemani, Iran retaliated by firing missiles at American bases in Iraq. With tensions heightened, Iran shot down a Ukrainian International Airlines flight, killing 176, including 82 Iranians. After authorities initially blamed the crash on a technical failure, when the truth subsequently emerged the public anti-American sentiment quickly turned on the regime. Being dubbed "Iran's equivalent of the Chernobyl disaster" by Iranian political analysts, the anger and distrust of the country's leadership is being exacerbated by economic sanctions.



Chinese authorities have also faced unprecedented levels of internal criticism following the death of Li Wenliang, the 30 year old doctor who initially alerted colleagues to the spread of a "pneumonia of unknown cause". Whilst the authorities were initially praised for telling the world about the virus it has now become clear that their initial reaction was to clamp down on the spread of news, and despite imposing severe quarantine restrictions on travel, the virus has continued to spread rapidly. To date the virus has spread to over 30 countries and confirmed fatalities of over 1,000, exceeding deaths from the SARS epidemic in 2003.

If the authorities were slow to react to the virus, the same cannot be said for its support of the financial markets. As markets reopened post extended lunar new year holiday China's central bank (PBOC) injected 1.2 trillion yuan ($174 billion) of liquidity. A 'national team' of Chinese state-run institutional investors are ready to underpin the market. The Chinese regulator has also instructed mutual funds to limit the net daily sales, ensuring the market selling is kept in check.

Coronavirus will at least have a short-term impact on the domestic and global economy. In 2003 the SARS outbreak caused Chinese GDP growth to slow by 1.4% in the second quarter of that year. With China's share of global GDP more than 4 times as large as it was in 2003, a similar slowdown today would take c.0.2% off global GDP growth. Economists forecast that first quarter growth in China will slow to 4.8% compared to the 2019 annual rate of 6.1%.

China's Importance Now And In 2003

China's Annual Consumption As % Of Global		
	2002	2019
Crude Oil Consumption	6.6%	13.5%*
Crude Steel Consumption	22.6%	47.5%*
Copper Consumption	17.8%	53.3%**
Aluminum Consumption	16.5%	57.3%**
Nickel Consumption	7.2%	53.3%**
Zinc Consumption	21.0%	48.4%**
Iron Ore imports	21.0%	64.3%*
Semiconductors Sales	5.0%	34.6%**
Smartphone Sales	11.2%***	29.2%
Personal Computer Sales	2.4%	20.0%
Passenger Cars Sales	7.3%	34.5%*

*THE DATA IS FOR 2018;
**THE DATA IS THE SUM OF DECEMBER 2018-NOVEMBER 2019.
***THIS WAS FOR CHINESE MOBILE PHONE SALES. NO MODERN SMARTPHONE YET IN 2002.

We already know that the outbreak is having a detrimental effect on retail, leisure and travel sectors, but there will also be disruptions to global supply chains. Given China's propensity to consume raw materials, oil and industrial metal prices have sold off substantially.

Grande Bargain

Coronavirus is also likely to have an impact on the Chinese property market, which was under some pressure even before the virus hit. Consumer confidence has been deteriorating throughout the US-China trade talks and property prices have moved little since China started to clamp down on the ($8.4 trillion[2]) shadow banking system. The scale of personal and corporate debt has been a bête noire for the authorities, with the PBOC remarking in November:

[1] High hopes, Panic! at the Disco, 2018.

[2] Financial Times, September 2019

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> *"The debt risks of the household sector and some low-income households in some regions are relatively prominent and should be paid attention to,"*

Since then there have been increasing concerns of defaults in local government financing vehicles (LGFVs). LGFVs have been the drivers of infrastructure growth in China for decades and have helped boost economic growth. As China's economy migrates and slows, defaults of these vehicles are a risk to the Chinese financial system and corporate China.

Coronavirus impact on China property sales

Hong Kong listed 'China Evergrande Group' (the largest real estate developer in China and electric vehicle manufacturer) provided further evidence of stretched financial models when it announced it was raising a further $2 billion from debt markets. The cost of this debt is eye watering as it is being raised with a yield of between 11.5% and 12%. Prior to this capital raising Evergrande had outstanding debts of $118 billion and a 12-month trailing interest cost of $8.7 billion, (the largest on the planet excluding financials). The good news is that the company has historically earnt enough to cover the interest expense, primarily by selling property as the yield it appears to generate on its properties is c1%. Unfortunately, Evergrande had the slowest sales growth since 2012 last year and reports are that discounts of over 10% could be had. When property only goes up in value and there are buyers the business model can work for a time. If prices fall and buyers disappear, due to over indebtedness or fear, the model falls over very quickly. In February it announced that sales had decreased by 6%, it has put on hold 1,460 developments and closed 1,040 sales offices until at least 20 February. Ironically, could it be the coronavirus that Chinese authorities failed to halt in its early stages be a tipping point for its credit markets?

Fortune telling

Currently we are witnessing some remarkable movements within equity markets, especially within the technology sector. Apple Inc., the multinational technology company has a market capitalisation which is greater than the 30 largest stocks in the German market (including BMW and Volkswagen). Tesla Inc., the electric car (and energy generation and storage) company, has had a parabolic price move. The share price has moved from $170 per share last May to over $900 per share more recently. These are perhaps the most extreme examples, but there is a definite bifurcation in the market between perceived quality growth stocks and those that are not. What is driving the most recent expansion in growth stocks? 'Value' style fund managers believe that the market is front running central banks, anticipating a fall in bond yields. But also, that there could be more technical factors at play. Sentiment has improved more recently with reports of an increase to equity flows. These flows are likely to have gone into momentum strategies and funds that have done well over the preceding last few years, reinforcing the "success" of investing into expensive growth companies.

Tesla share price

Source: Refinitiv

Terry Smith's Fundsmith Equity fund was the best-selling 'active' fund in 2019, due in part to its excellent long-term performance (+25.6% in 2019). The £19.8bn fund cemented its status as the UK's largest fund in 2019 and performance is up over 5% in the first 5 weeks of 2020. Mr Smith's investment strategy is to globally:

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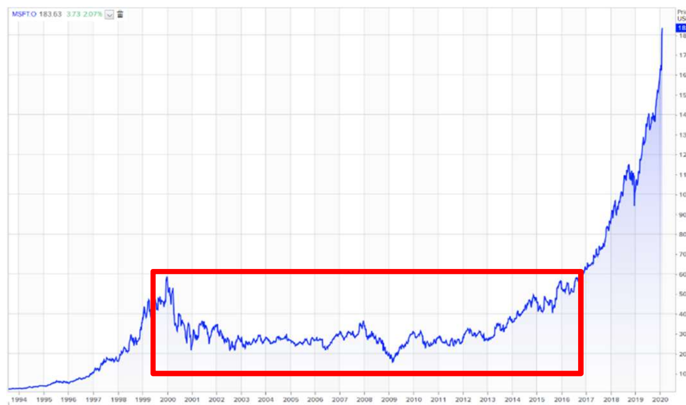
- Buy good companies
- Don't overpay
- Do nothing

In his recent letter to investors Mr. Smith questioned why you wouldn't invest alongside such luminaries as "Bill Gates (Microsoft), the Bettencourt family (L'Oreal), the Brown family (Brown-Forman), the Walton family (Walmart) and Bernard Arnault (LVMH)?" Whilst we have some sympathy with this view, it does depend upon the price you pay – as per Mr. Smith's second strategy point. Even the best quality companies have failed to provide equity investors with a capital return. The period of 1999 – 2013, produced very little in the way of capital gains for the share prices of Microsoft, L'Oreal, Walmart et al. Indeed, for Microsoft it didn't retake its 1999 high until late in 2016. Since then well …

Microsoft share price



Source: Refinitiv

It has been an amazing period for quality growth companies, but to believe that valuations don't matter or that one method of investing will outperform forever would appear brave. No one thought that the valuation disparity that existed in the 1999 tech bubble would return or be exceeded, but today's metrics are very similar.

Schroders publish an excellent 'The Value Perspective' blog. A recent post reminds us that in August 2000 Fortune magazine identified 10 companies that encompassed "four sweeping trends that we think have the potential to transform the economy". The magazine consulted a panel of stock pickers and reduced the selection to 10 stocks covering the "lightning-fast changes in communications networking, the brave new world of entertainment, the 'boomerization' of financial services, and biotech's coming of age". The names in this portfolio: "Nokia, Nortel, Enron (yes, that Enron), Oracle, Broadcom, Viacom, Univision, Schwab, Morgan Stanley and Genentech. A decade later, only one company would prove to be in positive territory while two had been wiped out entirely."

It is perhaps unfair to select this set of names, but it does highlight the point that just buying the 'best' and doing nothing, is not necessarily the right thing to do all the time. To be clear, this is not what Terry Smith does either. This year he has sold out of 3M due to doubts surrounding management capital allocation decisions and Colgate as "we grew tired of waiting for an effective growth strategy to emerge.".

In the portfolios we construct we select managers with different styles and strengths that complement each other and provide a balance. We are wary not to over diversify for diversifications sake, but to partner with management teams we trust to look after our client's capital over the medium to long term.

Chris Davis
Chief Investment Officer

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