TORELL & PARTNERS

Economic Background – March 2020

Don't stop thinking about tomorrow[1]

Global equity markets fell sharply at the end of February as the impact of the rapid spread of the Coronavirus (Covid-19) became apparent.

As at 19 March there are over 200,000 confirmed cases, of which there have been 85,000 recoveries and unfortunately nearly 9,000 deaths. 37% of the cases are in China, with significant infections around the globe particularly in South Korea, Italy and Iran.

Uncertain Impact

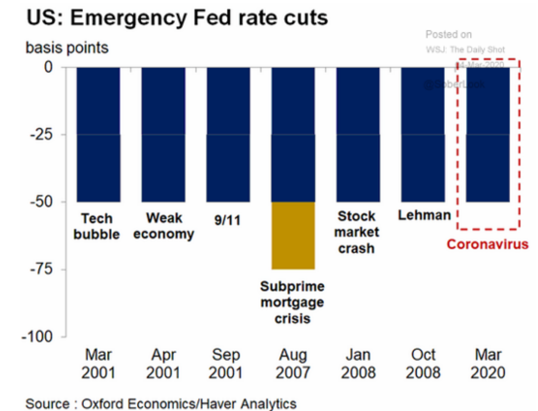
No one knows what the impact on the global economy will be, or how long it will last but the most likely scenario is that the disruption will extend into the second quarter of this year.

We have seen a sharp slowdown in China's economy and many governments and central banks have committed themselves to significant stimulus and liquidity to help offset the economic impact of the virus.

The latest data we have supports the view of a sharp decline in activity in China. Companies across all sectors have reported on the damaging effect that the travel restrictions are having. February's Services PMI data is the first reduction in China's service sector on record. The virus has affected new orders and exports fell sharply but it has also impacted labour supply. Global Manufacturing has contracted also during this month, with global trade falling at its fastest pace since April 2009. China, which accounts for an estimated 25% of global manufacturing activity and is at the heart of the global supply chain, is severely disrupted. The Organisation for Economic Co-operation and Development (OECD) forecast that global economic growth would fall to 2.4% from its previous estimate of 2.9%. A more prolonged disruption would lead growth much lower. As cases continue to grow in Europe and the US, finance ministers and central bank governors of the G7 met and reported they are 'ready to take action' and promise to use 'all appropriate policy tools' to stem the coronavirus epidemic.

Stimulus

The Bank of England have reduced interest rates to 0.1% and the UK government have announced a wide range of fiscal measures to help the economy and people in need, with more promised. In the US the House of Representatives initially proposed an $8bn spending package intended to combat the spread of Covid-19, but this will be dwarfed by the $1.3 trillion package of measures being discussed in Washington. In this package of measures it includes the idea of direct cash transfers to Americans, to help with the current cash shortfall. The US Federal Reserve initially employed an emergency cut to the Fed Funds rate by 0.50%, then subsequently cut again by 1% to leave the US interest rates at 0.25%. The People's Bank of China have already taken some action cutting rates, injecting liquidity and enacted targeted measures to smooth cash flow disruptions to business and consumers.



It is reported that Chinese government entities have 110.5 billion yuan ($16 billion) in coronavirus funding to spend, of which 65% has been spent. The ECB have announced a €750 billion bond buying programme. In Italy, where the economy was already shrinking prior to the coronavirus outbreak, the government announced a plan to inject €3.6bn into its economy to try and mitigate the impact of the virus. Canada and Australia have cut interest rates and the IMF is ready to provide $50bn in emerging financing for countries stricken by the coronavirus outbreak.

[1] Fleetwood Mac, Don't Stop, 1977.

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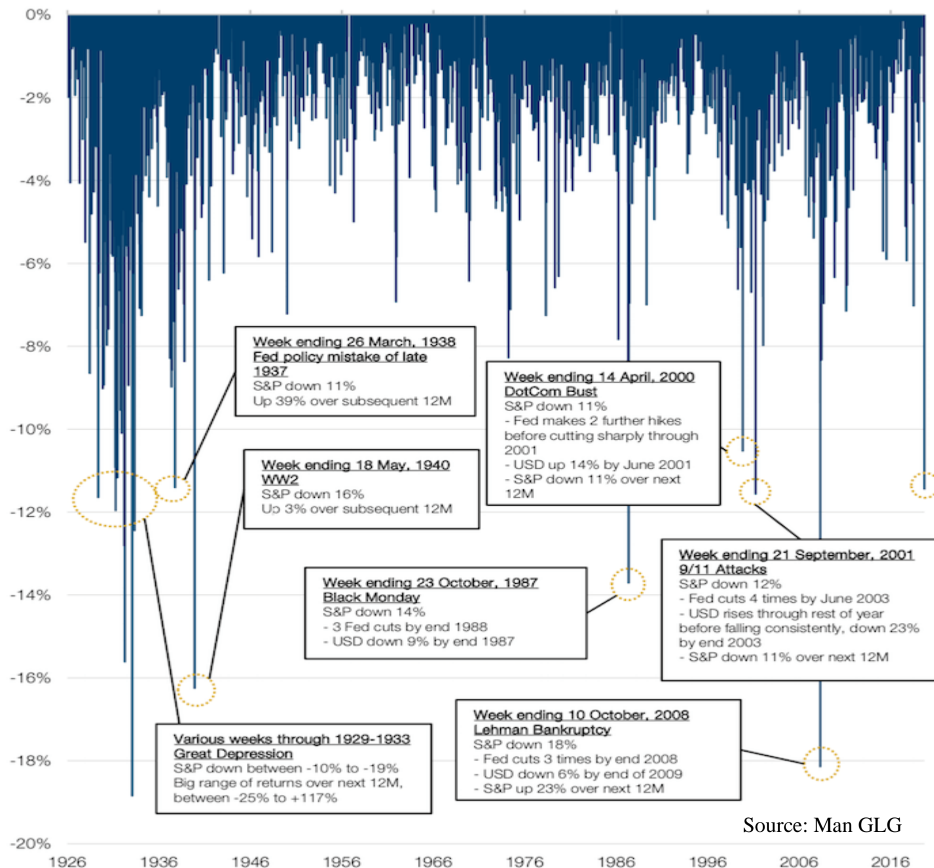
Much of this slush of stimulus is designed to ensure that liquidity constrained companies are not faced with a cash flow crunch, not to stop the proliferation of the virus. The virus will have an economic impact, how long it lasts will depend upon public and corporate policies.

Precedent

In the last week of February, the S&P 500 Index fell 11.4%. The scale and speed of the fall is not without precedent. Since 1926, there have been 15 other instances where the US



Source: Man GLG

benchmark was down 10% or more in a week. As you can see from the chart, many of the previous instances are remembered by their notoriety. This was a broad-based sell off, across all sizes of companies and styles, where earnings and valuations are ignored. There is no pattern of what to expect next from markets, except it is likely to be volatile.

> *"Of the 15 instances (excluding today) where the S&P 500 Index fell more than 10%, six experienced further negative performance over the subsequent 12 months and nine were positive. The worst-case scenario was -25%, the best +117%."*
>
> *MAN GLG*

In the first two weeks of March the S&P 500 index fell by a further 19%. Markets are in panic mode, however we will see dramatic price moves occurring on the upside and downside during times like these, so attempting to trade in and out of markets for a long-term investor is a) hard and b) fraught with the danger of being whipsawed. What markets and more importantly investors need is time and patience. It is easy and often wrong to take a knee jerk reaction.

Markets can fall further from here and we will never be able to call the bottom, however for those with an intermediate to long term outlook investing in equities became more attractive over the past few weeks. With the monetary and fiscal stimulus coming into the system, once the worst is over markets are likely to return to their growth profile.

Conversely government bond markets do not appear attractive to a longer-term investor. The US 10 year government bond yield has halved since the virus took hold, falling from 1.6% to 0.8%. The US 30 year yield is at 1.4%. German 10 year government bonds are near all time lows of -0.7% and the UK 10 year government bond yield is at 0.3%. Through a combination of monetary easing policies and fear, government bond yields are extraordinary and frankly ridiculous.

Momentum works both ways

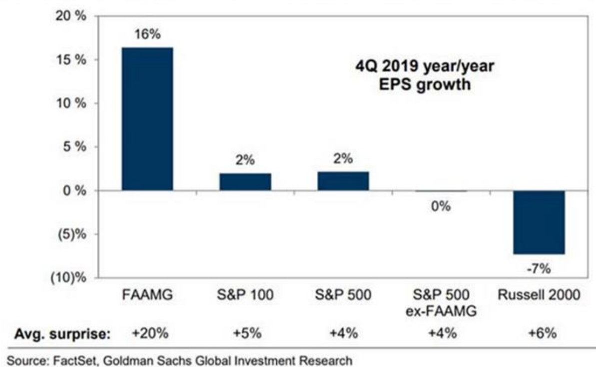
There are almost 3 million stock market indices in the world, 70 times more than there are public listed stocks. Passive investing and the rise of the ETF has caused product providers to create more "investment solutions" for willing investors. From country, sector and theme specific to size and style, there's a solution. Since the financial crisis $3.5 trillion has been allocated to ETFs. In quarter 4 of 2019 $145billion was placed into equity ETFs, these

investors tend not to be valuation sensitive and have helped to underpin the strong growth in the technology sector.

To be clear we are not anti-passive investing, we believe they are valid strategies to be used at the right time, but we are cautious as to their effectiveness in times like these. We can see that there is a continuing divergence of market valuations between different regions and styles of companies and that in some cases the valuations appear extreme.

> *" ... most bubbles, if not all, are characterized by the unquestioning acceptance of things that have never held true in the past; of valuations that are dramatically out of line with historic norms; and/or of investment techniques and tools that haven't been tested."*
>
> *Howard Marks, Mastering the Market Cycle*

In the 6 weeks prior to the equity market falling, the inflow into global technology funds was at an all time high of $6.4 billion, buoyed by the giants of the technology sector's strong performance and earnings growth during 2019. The most (over)employed position of fund managers is in US Large Cap Technology. With strong earnings results in Q4, FAAMG (Facebook, Apple, Amazon, Microsoft and Google) stocks outperformed the S&P 500 considerably. Excluding the FAAMG's, the S&P 500 achieved 0% growth in earnings and earnings from the small and mid-cap Russell 2000 index fell 7% over the past year. The market carried on regardless, with the S&P 500 reaching an intra-day high of 3394 on 19 February. As selling takes hold and human behavioural traits take over from rational thinking, earnings and valuations will be ignored for now.



In the coming weeks and months earnings forecasts for the rest of the year will likely be revised down. Q1 earnings calls will be closely watched. Given current sentiment, it is hard to imagine more multiple expansion this year, even with central banks cutting rates further. Reports that the virus becomes contained are likely to provide investors with comfort that the worst is behind us, until then volatility (and animal spirits) will rule.

Whilst the Coronavirus will have a significant impact on global economies for some time we believe this disruption will pass. Containment techniques, the development of vaccines and herd immunity will slow the spread of the virus and economic growth will return. As long term investors we try to look through the short term disruption. What is important is to assess absolute valuations of assets, your objectives and your time frame for investing. It always feels hard to do at the time but we try to…

> *"Be fearful when others are greedy and greedy when others are fearful"*
>
> *Warren Buffet*

Chris Davis
Chief Investment Officer

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