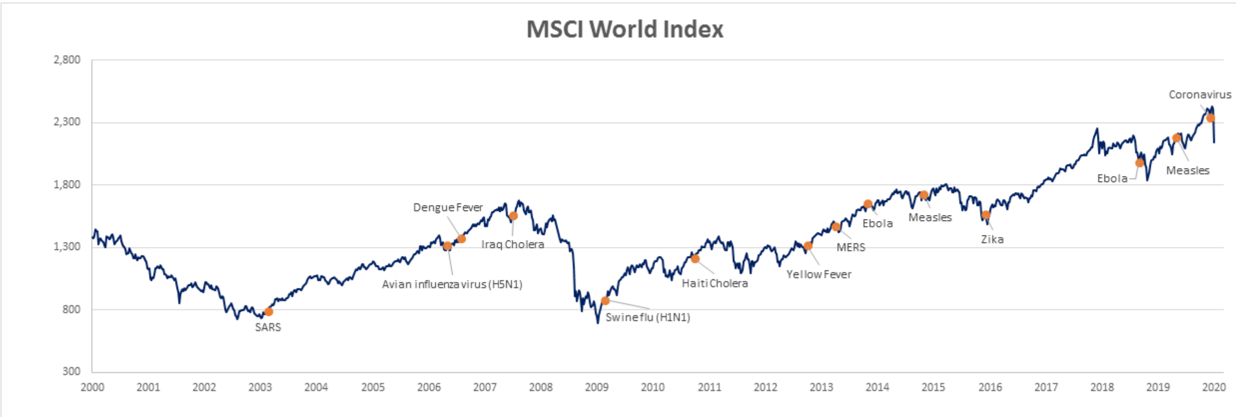
Creating Value through Innovative Financial Solutions

LC Monthly Investment Memo : February 2020

The Coronavirus (COVID-19) is yet to be tamed. Cases continue to spread, now rapidly outside of China and neighboring countries. Large numbers have been reported in Europe and the Middle East with South Korea, Italy and Iran have come into the forefront in terms of the rate of infection spreading. South Korea raised the country's infectious-disease alert to the highest level after a multi-fold increase in cases. Iran has the largest number of deaths (>65) outside of China. Infections in Italy topped 2000+ as emergency measures have been implemented. All countries are placing heavy travel restrictions to contain the spread. If travel restrictions and supply chain disruptions continue, the impact on global growth could be more widespread. The initial numbers coming out of China points in this direction, with the latest factory PMI plunging to record low of 35.7, well below market estimate of 45.

While China's stimulus had kept the markets resilient for most part of February, markets tanked on 24th February (Monday) with the Dow Jones plummeting more than 1,000 points to close 3.6% lower and the S&P 500 dropping (-3.4%) - the most since February 2018. Investors flocked to the safety of government debt, pushing the yield on the US 10-year Treasury bond down past its record low (2016 post-UK referendum low of 1.318 per cent). The risk-off mood sent gold up to a fresh seven-year high ($1688/ounce) on safe-haven buying and VIX levels jumped to above 25. Oil plummeted more than 4% on intensified growth concerns, and industrial commodities were also hit. Credit spreads also widened globally with emerging markets taking the brunt of the hit. This marked the start of market meltdown due to Covid-19 with pressure building up for concerted effort by policy makers across the world to cushion this fall. Leaving his earlier rhetoric of a resilient US economy, the Fed Chairman Jerome Powell has now said the virus "poses evolving risks" to the U.S growth and signaled the central bank is prepared to cut rates if necessary. At time of writing, the Fed responded to this pandemic through cutting rate by 50bps and the market expected a similar cut by end of the year. Other Central Banks are following suit with rate cuts and stimulus packages being unveiled.

The most imperative question remains whether the Covid-19 outbreak will recede, or it will morph into a pandemic and its effect on the markets at large. Historically, the reaction of the markets to such virus outbreaks has been short lived with a subsequent V-shaped recovery, driven by pent-up demand having accumulated in the intervening period as shown by the chart below which shows the MSCI World Index through the different crisis.



Source: LCPL, Bloomberg

Having said that, one needs to be cognizant that that China's share of the world economy has been growing through the recent years and it has the potential to disrupt global markets more severely than in the past. For instance, China's share of global GDP is currently at 19% (2019) as compared to the SARS outbreak in 2003 when it was less than 5%. It is also worth mentioning that post the Global Financial Crisis of 2008, Central bank policy has been more accommodative leading to prolonged period of low rates.

Going forward, if the number of new confirmed cases declines and the efforts by policy makers have the much-desired impact, investors are likely to look through the plunge without much casualty. While the US and Eurozone economies may be moderately affected, the temporary hit on Asia could be stronger due to supply change linkages with China. Though substantial, the impact on Chinese growth should be short-lived with rebound in economic activity and policy support. However, this event could also lead to some fundamental changes. Could India be a beneficiary of China's woes with some global factories moving (diversifying) there? Donald Trump's recent visit to India and the already strained relations between US and China adds to this potential possibility.

For Investors to tide over these uncertain times a more cautious approach is warranted. As mentioned in our January outlook, we continue to favor strategies which offer low or no correlation to traditional asset classes offering strong risk-adjusted returns like relative value/arbitrage strategies. For equity and fixed income investments, quality remains key. While we cannot rule out further disruptions to global markets if the virus continues to spread rapidly outside China, investors can start accumulating repriced assets on dips but in a phased manner, keeping a watch on how further news unfolds.

The uncertainty of COVID-19 is putting upward pressure on high yield/emerging market spreads. A pullback in liquidity is being seen which may lead to issues in refinancing and increase default rates. Also, the risk of potential downgrade looms especially in the energy sector. An acceleration of downgrades and defaults in the energy sector could dampen sentiments for the global high-yield market as a whole. In view of this, we favor Investment Grade (IG) credits as they will be more resilient in a bear market. We also suggest avoiding long duration as we feel that benchmark yields have compressed sharply due to risk off behavior and an expected recovery could potentially lead to losses driven by a reversal in rates. Within the High Yield space, we still have a stronger preference for bank AT1 papers given their relatively higher spread pick up and stronger credit fundamentals.

With the equity markets at all-time high it looks vulnerable to short-term bull market correction. Within equities we favor quality stock picks of companies that have strong fundamentals (high profitability, growth, predictable cashflows and good corporate governance). We also would suggest investors to avoid sectors that are cyclical (travel, transportation, retail) or are highly sensitive to commodity prices (I.e. Oil and gas, metals and mining). We prefer sectors like healthcare, utilities, e-commerce and consumer staples amid the ongoing uncertainties in the market. Considering the entire world has been impacted by the COVID-19 and the world is a much more inter-connected place than ever before, we prefer a globally diversified play rather than regionally focused. As it is difficult to time the market and predict the future course with certainty, a diversified portfolio that includes quality names with reasonable allocation to non-correlated strategies (that is non-directional with markets) should continue to be part of an investors core portfolio. Opportunistic trades should be used tactically to enhance overall portfolio return. This is the essence of our Investment philosophy to deliver stable risk adjusted returns over the full business cycles.

Yours Faithfully,

The Lighthouse Canton Team