Creating Value through Innovative Financial Solutions

January has turned out to be an eventful month. Rising tensions between Iran and US in the Middle East, with missiles being fired and a commercial plane being shot down, kept investors on their toes at the turn of the new year. This, however, quickly turned into a non-event, when signs of easing political risk between the US and China started to surface. With the US retracting the "currency manipulator" label from China ahead of the signing of a Phase 1 trade deal, this statement was enough to push the S&P 500 to a fresh record high of 3,337 points on 22nd January.

More recently the outbreak of the new Coronavirus, which reported as many as 7,711 cases worldwide (and growing) according to W.H.O and set to potentially become the largest threat in years for global health, does not really seem to scare investors with European and US stocks still within 3% of their recent high. With China contributing to almost a third to global GDP growth, we think that the market has somehow significantly underestimated the potential disruption that such a virus could have on corporate earnings in 2020. While travel agencies, retailers (shopping malls), hotels, airlines and commodity producers are the obvious victims associated with this pandemic, increasing numbers of working population being quarantined or confined at home would also ultimately result in lean production lines (with scarce inventories). While mandating 16 cities in China (as of today) to be put under quarantine is probably a prudent action to prevent further spread of the virus, this also presents a large disruption to the productivity of the economy this year. Something China does not really need at the moment, with 2020 GDP growth forecasted below 6% for the first time by the World Bank.

Endless Quantitative Easing and balance sheets expansion by Central Banks have maintained rates artificially low globally. What started as a good intention post the Great Financial Crisis in 2008 is slowly turning out to be a “golden trap” for investors. Excluding the 10 corporates with the widest spread, High Yield credit spreads have reached its lowest since 2006. With the average corporate leverage level being higher today compared to ten years ago, investors have never been more poorly compensated for the risk taken holding bonds. Judging by the fact that the yield of the US 10-year Treasury is quickly dropping to 1.56%, it is now about 25bps from its historical low (1.31% in July 2016). Should rates continue its descent, fixed income portfolios are likely to show continued good performance this year.

While this is good for bond holders in the short term, this could be problematic in the long-term. Why is that so? Firstly, it "superficially" reinforces the sentiment that everything is fine in the economy despite weaker financials; And secondly, it means that new issues will be yielding lower going forward, and potentially negative in few years' time as is already the case in many of the developed countries (e.g. Japan, Germany, Switzerland).

The same complacency is observed in equities, whose prices are supported by lower cost-of capital as opposed to higher margin and/or better growth assumptions (save few technology and healthcare stocks). The picture is even more difficult to read as the concentration has never been so high in recent history. For instance, the top 5 stocks on the S&P500 (namely Apple, Microsoft, Facebook, Google & Amazon) accounted for 26% of the index market capitalization gain last year. What is more concerning is that higher prices are being supported by higher multiples rather than stronger fundamentals. As an example, Apple's EV / T12M EBITDA ratio, which measures the dearness of a company relative to its cash-flows, has doubled from 7x in December 2018 to 14x in January 2020 – a phenomenal jump over a short period of time. In the hunt for yield by equity investors, this lowering of expectations of "quality" stocks is never good news in the long term.

With many equity indices worldwide still reasonably close to their 5-year highs, the extent or magnitude of disruption caused by the Coronavirus pandemic seemed to be significantly discounted by investors. On the contrary, we think that the underestimation of the risks posed by this pandemic could be dangerous especially after considering the likely resurfacing of US-China trade tensions later this year preceding the Phase 2 negotiations and reporting of weak macro data in China, India, Europe, and UK indicating slowing growth. That said, while we can present the most sensible cause-effect arguments based on textbook theories, the post-GFC market has more than once proven itself to be unpredictable and not always sensible. For instance, the threat presented by the Coronavirus could very well turn out to be a non-event in the coming weeks and valuations will still look expensive by historical standards, or it could knock off several points from GDP in China and de-facto to the rest of the world hence increasing the pressure on weak balance sheets (high yield bonds) and high multiples (equities).

With these two possible scenarios in mind, strategies which offers low or no correlation to traditional asset classes which have exhibited consistent strong risk-adjusted track records across multiple market cycles will have the higher likelihood of surviving in such unpredictable market environment, and hence should be a staple in any investor's portfolio. Such strategies include trade finance, and relative value/arbitrage. For investors looking for equity-related strategies, despite the current average valuation of the stock market being highly inflated relative to its fundamental, we still see value in managers who are true bottom-up, fundamentally-driven stock pickers in generating alpha, although such investments should be viewed with a longer-term horizon.