February 3, 2020

Overview

US equities finished January with contrasted performances. The S&P's 500 was down .04%, while the Nasdaq Composite finished up 2.03% over the same period. The Russell 2000, meanwhile, was down a sharp 3.21%.

Internationally, all indices were down with the S&P's EPAC BMI (developed economies) weakening 2.39% and the emerging market MSCI EM index down 4.66%. The threat to global economic growth that the Coronavirus epidemic presents explains all of this negativity.

The chart of the S&P's 500 below illustrates how much of a market turnaround took place following the first announcement of the epidemic, on January 19 in China. The vertical line marks the date of the announcement.

The S&Ps. 500 was up over 3% by that time, pushed by the Phase 1 agreement on trade signed by China and the US earlier in January. That positive momentum has since been lost.

As is often the case when investors are surprised by an economic or global event of some magnitude, US treasuries rallied (rates down), the USD went up vs. other currencies, Small Caps underperformed vs. other equity sectors and emerging market equities sunk. The second part of January offers a perfect example of what an investor's "flight to quality" reaction means.

In January, our client portfolios hovered between .03% and -.99% A portfolio consisting of 50% ACWI (World Equity Index ETF) and 50% AGG (US bond aggregate proxy) rose .47% during that period. This is a good proxy for most of the portfolios under Fleurus' care.

As a reminder, the equity allocation in our clients' portfolios ranges currently from 30% to 70%, depending on risk profiles.

Market developments

January was a month rich in developments, sometimes unexpected ones. First came the killing of an Iranian general in a US drone strike in Iraq on January 2. The seniority of the man within the Iranian establishment caused equity markets to swoon until a rather mild Iranian response allowed them to gain their composure, once again.

By January 10, a good US unemployment number for December, the imminent signing of the trade "truce" with China and robust retail sales numbers propelled equity indices forward, stateside and internationally. The first relatively good corporate earnings announcements by January 16 helped the advance further.

As indicated earlier, all of this stopped and then reversed with the announcement, in China, of a new strain of flu on January 19. Reminiscence of the SARS epidemic in 2003, and its economic impact on China in particular, started troubling investors to the point where a significant global "de-risking" of portfolios started.

A good illustration of this "de-risking" movement is shown in the below chart. As a result of the massive US treasury purchases that have taken place since January 19, the US yield curve is once again inverted (yellow rectangle below).

The previous inversion, in the summer months, was reversed in the Fall as a result of the Federal Reserve's (FED) three interest rate reductions from July to October. With interest rates as low as they currently are, the FED has very little room left to maneuver. Let's hope that this inversion is temporary. A rapid and successful resolution of the Coronavirus epidemic would likely reverse it, all things equal otherwise.

Tilts and Allocations

Last month, I indicated that the chances of a reversal in momentum away from US equities and in favor of international ones were increasing. With this in mind, I started buying non-US equities during the first two weeks of January, marginally adding to our international exposure. Specifically, I added to our German exposure on the assumption that the trade truce between the US and China would benefit German industry.

It did, for about one week… and until the pandemic fears surfaced. Since then, the perceived risk of a significant slowdown in China (a major export market for German industry) has caused German equities to fall in sympathy with Asian equities. However, I feel that it is too early to reverse this early-January investment decision.

On the other hand, as market fears were gripping investors and the selling gathered steam in the waning days of the month, I decided to reduce our emerging market exposure by about one third. With no visibility regarding the possible resolution or control of this global flu epidemic, I felt that it was a prudent move to make. China and other Asian countries in their sphere of economic influence account for about 30% to 40% of most emerging market indices. VWO, our emerging market ETF, has a 35% exposure to China and Taiwan. I may sell more of it if the situation deteriorates further over the next ten days.

It is not in my “investment DNA” to sell when everybody does, on the contrary. Except that, on occasion, the herd is right.

Judging whether we are in such a situation is difficult. Should the epidemic continue to expand with no end in sight and China continue to quarantine its citizens, the economic impact could be serious and reverberate globally. On the other hand, a resolution along the lines of SARS, seventeen years ago, could see most equity losses reversed in a matter of weeks, absent another meaningful economic or geopolitical development. That said, it is good to remind oneself that China’s role in today’s global economy is much larger than seventeen years ago. Its share of global economic output has quadrupled since.

I will give myself a bit more time to decide which way to go.

Concluding Remarks

US economic data has been good since the end of the year. As previously indicated, the unemployment number for December (3.5%) was strong. It included a decent wage rise component (+2.9% for 2019). Retail sales numbers for December were also better than expected. In late January, the University of Michigan indicator of consumer confidence rose again.

Against this positive US economic backdrop stand a few global headwinds. Major among them is the current flu epidemic.

While I think that the probability of a significant market drop is small, it is undeniably increasing. Another global political or economic event, added to the uncertainty caused by this flu epidemic, could flip investor psychology from neutral/negative (where I think it currently stands) to negative/negative. Before moving potentially to panic (liquidation) with the help of deteriorating economic indicators.

In this fluid environment, investors need to be particularly nimble and to stand ready to de-risk their portfolio rapidly if needed. But they need to do so with a plan in hand.

In other word, try to identify NOW what exposures you would want to reduce should the situation deteriorate further and rapidly.

Thank you for your trust,

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