Newsletter
February 2020

INDEX House View

As the new year's first month of trading goes by, it seems clear that much of investors' reflections should focus on two themes: the coronavirus' effect on global growth and the evolution of central bank intervention in the US.

Coronavirus

The present virus is a close relative of the SARS virus emerged in 2003-2004. One of our team members spent some time in Hong Kong and studied the timeline of the 2003-2004 pandemic. Two elements are of fundamental importance in any contagious outbreak: quarantine and vaccine. In the SARS case, quarantine happened considerably later that with the coronavirus, although it is hard to believe the Chinese government either has everything under control or is truthful about contagion numbers – cases more than tripled in some weeks. An effective quarantine system stops contagion, but doesn't stop deaths. In the quest to develop a vaccine, the solution came in sight in late 2003 when coordination began among laboratories in Europe, US and East Asia (Hong Kong and Singapore) – in the end, a university laboratory in Hong Kong won the race. Usually, vaccines safe enough to be used on humans take a considerable amount of time to be approved by health authorities and available to the public; in the SARS case it took 20 months, while in the present case we found a credible estimate in 12 months made by the Oslo-based Coalition for Epidemic Preparedness Innovations, which enjoys US$750 million of international funding. It is also plausible such timeframe has shrunk thanks to technologic advancements in medicine in the past 17 years.

Despite the usual uninformed commentaries and misinforming media reports, we found little difference between the current coronavirus development and SARS's. We therefore expect that effects on the global economy will be not as severe as some investors think, especially on Chinese securities. As of today, the epidemic is confined to mainland China and Hong Kong, which suggests that investors think only domestic consumer spending should be affected. In our eyes, this is a perfect buying opportunity of a long-term fast-growing economy that will only be temporarily affected. In the meanwhile, airlines, luxury, casinos in Macau, transports, logistics and perhaps construction will feel some pressure. However, should consumer spending be affected beyond our expected horizon, great companies will be had at even a greater discount.

Evolution of US central bank intervention

Central banks in Japan and Europe have been resorting for some years now to monetary and fiscal policies that are effectively killing whatever economic growth is available. It is only natural that business and industry at some point in history plateau in any developed economy. Usually technologic innovation and new generations produce a new economic push, but today's negative or zero rates allow corporations with dwindling growth to continue weak businesses thanks to cheap leverage. These businesses would simply collapse in a competitive market and without cheap leverage. As if it were not enough, large and medium banks in both Japan and Europe have gradually failed in their first mission – more so Europe than Japan – i.e. to distribute capital from those with an excess to those in deficit (70% of companies in the US and Europe are small to medium enterprises, which usually are badly served by large commercial banks). Despite two global financial crises, they also refused to clean up those corporate non-performing loans that have zero chance of being repaid – the average Italian bank's NPL book lasts for 50 years – on the basis of unsustainable business models. In the meanwhile, leverage has become so large in the fiber of developed economies that the number of companies whose operating cashflow does not cover interest expense is rising fast. In this environment, the cure has been to monetize debt, i.e. the central bank temporarily purchases commercial banks' loans or bonds and gives away cash. This injection of liquidity sustains banks for some time.

Facing stable consumer inflation the FED has opted to keep rates stable or decrease them should deflationary forces emerge. To maintain stability in the financial system, the FED has also started monetizing debt. By continuously buying bonds, bond prices are maintained high while bond yields are kept low. This is perpetuating the low interest rate environment and will eventually lead to zero or negative yields, exactly as it happened in Japan and Europe, which have both have been living for years with almost zero consumer inflation, economic growth and negative yields.

This is the game authorities are playing to avoid the bankruptcies of an increasing number of inefficient, over-leveraged companies. Sequentially, rising debt cost would initially reduce corporate earnings across the board, then increase defaults first in high yield companies and eventually drive weaker but stable businesses into bankruptcy.

In a world where balances are pushed to the limit by authorities themselves, our investment work must then focus on the same variables authorities are trying to control, chiefly consumer inflation. We had to arrive to the conclusion that neither inflationary nor deflationary forces of meaningful magnitude are to be found today. In the past, strong unbalances accumulated specifically in the financial system of the US economy until they burst, bringing everything else down. Granted that US authorities might have a too short-term approach to consumer price movements, as of today there is no ground to say that consumer spending and demand in general are on the verge of either spiking or falling. This is understandable as interest rates remain low and US consumers can infinitely re-finance their growing debt. Needless to repeat, the elephant in the room is debt itself.

We remain cautious and prefer to have an allocation to gold, high quality/rating bonds with a global economic exposure, selected USD-denominated emerging debt and only the most evident buying themes out there, i.e. China.

For further details, please contact:

INDEX & Cie Limited
Index Tower, 20th Floor, # 2001
Dubai International Financial Center
PO Box 507069, Dubai, UAE
www.indexcie.com

Tommaso Leodari
Chief Investment Officer
Email: tl@indexcie.com

Disclaimer

The information herein contained, including any opinions and any terms and conditions presented (the "Information") has been prepared and distributed by INDEX & Cie Ltd. (the "Asset Manager"), and is directed at, and related financial products or services are only available to wholesale clients (non-retail customers) who qualify as either Professional Clients (as defined in DFSA's Rulebook, Glossary Module ("GLO") or Market Counterparties (cf. GLO) under the Rules (cf. GLO) enacted by the Dubai Financial Services Authority ("DFSA"). This document is being furnished to the intended recipient solely for information purposes and no other Person (cf. GLO) shall act upon the Information. Any investment carries its own risks; the investor must be aware of the risks posed by an investment (cf. GLO) and is fully responsible for the risks incurred. The Information is not and cannot be understood as impartial investment research. The Asset Manager does not guarantee the accuracy or completeness of the information and the opinions expressed herein are the Asset Manager's opinions at the moment they are conveyed only and are subject to change without prior notice. The Asset Manager is not under any obligation to update or keep current the Information and the opinions expressed herein. Neither the Asset Manager nor any of its officers directly responsible for the Information (or a close relative - cf. GLO - of the latter) have a financial interest or material interest that relates to any on the investments herein recommended or suggested, nor the Asset Manager either, as far as the Asset Manager is aware of, any Asset Managers associate (cf. GLO) owns (unless stated otherwise elsewhere in this document) 1% or more of the total issued share capital of any of the Issuers (cf. GLO) mentioned herein. The Asset Manager does not act as a corporate broker to any of the Issuers (cf. GLO), although one of the Asset Manager's associates may act or have acted as such. The Asset Manager has not undertaken any corporate business with or for any of the Issuers over the past 12 months, nor has in the pipeline any future relevant corporate finance business initiative involving the latter, nor is a market maker (cf. GLO) in any of the investment recommended. None of the Issuers herein mentioned has a material shareholding in the Asset Manager. This document cannot be reproduced, in whole or in part, in any form or by any means, without the Asset Managers specific authorization and any distribution of the information on behalf of the Asset Manager is strictly prohibited. Neither this document nor any copy hereof may be sent or taken or transmitted into or distribute, directly or indirectly, in any jurisdiction other than the Dubai International Financial Center. Any failure to comply with this restriction may constitute a violation of the laws of the jurisdiction where the document is being redistributed. This document does not constitute or form part of, and should not be construed as any offer or sale or subscription of or solicitation of or invitation to make any offer to purchase or subscribe for any financial products or services and neither this document nor any part of it shall form the basis of or be relied on in connection with or act as an inducement to enter into any contract or commitment whatsoever. The Asset Manager does not accept any kind of liability for losses or damages which may arise from the use of this document or its contents, nor for the unlawful reproduction and/or redistribution of the same. The Asset Manager is duly licensed and Regulated by the DFSA.