Sparinvest

Monthly comment by
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CLI rebound dominated start of the month

As previously mentioned, the OECD's Composite Leading Indicator (CLI) has bottomed out, and for the first time in almost two years, it is now rising. Moreover, the turning point in connection with the November CLI went hand in hand with the announcement of a soaring December figure for U.S. building permits. The 3-month change in building permits is at the highest level since 1983 and will have a relatively strong impact on the CLI figures for the next couple of months, so the tide has definitely turned.

The market responded in the form of a steep rise in equity prices at the start of the year. In the first half of the month, the MSCI World (EUR) increased by as much as 3.7%, and long-term yields rose to the highest level since July. However, the news of the outbreak of coronavirus hit the market on around 17 January. This virus is assumed to have originated in a relatively unregulated and unhygienic market for, inter alia, live food, in Wuhan in China.

So far, the coronavirus has been less deadly than the SARS virus that hit China in 2003. On the other hand, it seems to be spreading faster and more easily despite numerous safety precautions introduced by the Chinese authorities, who seem to be surprised at the large number of people infected or possibly infected.

Market focus on the coronavirus

The equity market fell back as the number of people infected or killed by the coronavirus rose, and ultimately the MSCI World (EUR) yielded a return of only 0.7% in January. Long-term yields dived again, and the yield on eg a 10-year German government bond fell by 25 basis points. Likewise, the yield curves flattened considerably in both the US and Europe. On the first trading day in February, Chinese equities (Shanghai Composite) dropped by a full 8%.

The reason why the markets respond relatively strongly to the virus outbreak is that the economic impact of the outbreak is highly uncertain. On the one hand, data from 13 previous epidemics since 1980 shows that the effects have, on average, been positive over 1-, 3- and 6-month horizons – i.e. equity markets have actually risen after an epidemic. Although there is some variation for all three horizons, it is remarkable that annualised returns tend to be higher than the equity market's annualised long-term return after a global epidemic.

On the other hand, there may be some randomness linked to the above observation as most incidents have occurred during or just before a major upswing in the equity market. Furthermore, most of the epidemics have arisen or had the strongest impact in EM countries, which, given the limited size of their economies, have had no notable impact on the world economy or the global equity markets.

China's share of the world economy is around four times higher than when China was hit by SARS in 2003

Hence, as the coronavirus has mainly affected China, it should be taken into account that China's share of the world economy is around four times higher than when China was hit by SARS in 2003 (incidentally, that was also a coronavirus and is also believed to have originated in a Chinese food market).

The primary reasons why SARS did not have a stronger impact on the economy were not only that the number of new cases peaked after a few months, but also that Chinese factories did not shut down during the epidemic. Given that the current coronavirus seems to be more infectious, it is easy to imagine that the Chinese authorities would respond by shutting down parts of the Chinese industrial sector. This is also, why both the China-dependent Australian dollar and the price of oil have fallen steeply in the wake of the virus outbreak.

In my assessment, the rapid spread of the virus will compel the Chinese authorities to shut down parts of the Chinese industrial sector a few days into February and ask people in the relevant areas to stay at home and indoors as far as possible. When the number of new cases begins to stagnate or fall, the authorities will probably ask the factories to open again, so that the economy may take a Y-shaped path.

The People's Bank of China (PBoC) is reacting

It looks as if the Chinese central bank shares the view of the risk to the Chinese economy in particular. At any rate, the PBoC chose to pump some 300bn yuan into the Chinese banking system via repo rate cuts in January. This came after the PBoC had already reduced the reserve ratio requirement for Chinese banks from 13 to 12.5 in early January. The cut means that Chinese banks will be able to lend more money, which will support the economy over the next six months or so.

Impeachment is fizzling out for the Democrats

In the U.S., the impeachment process is ending as the Senate has already made a decision on whether or not to allow more witnesses in the case against President Trump. There was some uncertainty as to how many Republican senators would vote in favour of more witnesses, but in late January it turned out that there were not enough senators who would break the Republican ranks. This meant that the Republican majority in the Senate could immediately decide whether to remove President Trump by impeachment – and, not surprisingly, the result was a swift "no", which also eliminated part of the noise surrounding the process.

In my assessment, the Democrats' weak witnesses and lack of proof throughout the process have benefited the President, so that his supporters and, not least, the important independent voters are now leaning even more towards Donald Trump in the forthcoming presidential election.

The primaries (in which the two parties nominate their presidential candidates) have now started, and as I write this, there is considerable uncertainty as to which Democratic candidate received the highest number of votes from the delegates in Iowa, where the first primary was held. Recently the bookmakers have had better and better odds for Bernie Sanders, who is a left wing Democrat and would presumably be the worst outcome seen from a market perspective. However, Bernie Sanders would probably be unpalatable to many centre voters, who are not buying his agenda of substantially higher taxes, cancellation of student debt, Medicare for all and more regulation.

U.S. politics has supported the equity market for the last month

So my overall assessment is that the development in U.S. politics has supported the equity market for the last month and that the weakening seen in the last two-three weeks has been almost wholly related to the coronavirus.

Industrial output cycle still improving – but slowly

As previously mentioned in recent months, the industrial output cycle has bottomed out. Our models for industrial output and order intake both show that we can expect fairly strong acceleration over the next 12 months – in the Eurozone and in the U.S. This is now also being reflected in the European and U.S. PMI and ISM values, which were somewhat higher than expected at the start of February.

As I see it, a positive outlook for the industrial sector over the next 12 months will increase President Trump's prospects of re-election. It was the declining industrial output in the important swing states in late 2016 that made it possible for Donald Trump to win over dissatisfied Democrats. It may well turn out that strong industrial output in the final phase of the election campaign can convince the same voter segment that President Trump has actually made a difference for them – even if it is largely attributable to the inertia of the industrial output cycle.

Equity allocation

Regional momentum and volatility indicators (MomVol) have risen slightly and remain very high and above the threshold value of 0.6 at end-January, for which reason we can expect robust equity markets in February, other things being equal. The OECD leading indicator for the entire OECD area has now begun to rise having fallen almost continuously for two years.

Obviously, the outbreak and rapid spread of the coronavirus is a major uncertainty factor in relation to risk exposure decisions in the current market. The significant media exposure of the virus and the circumstance that most market participants have now presumably accepted that the virus may have a strong, but – it is hoped – temporary impact on especially the Chinese economy reduces the probability of more negative surprises linked to this virus.

Therefore, despite the – admittedly – strong uncertainty surrounding the coronavirus, I still recommend that investors overweight equities and risky assets relative to their long-term target allocation in the near term.

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