MONTHLY HOUSE VIEWS

February 2020

Sidetracked by Wuhan

Macro

The Wuhan flu epidemic has led to travel restrictions for many tens of millions in China, with factories and offices extending their lunar new year holidays. The hit to growth is set to be sizable but we expect it be short-lived, with recovery likely as the virus begins to come under control. Recent business confidence surveys have confirmed our scenario of gradual stabilisation and recovery in manufacturing activity, bolstered by the “phase one” truce in the US-China trade war. With Brexit formally concluded at end-January, attention now shifts to the difficult negotiation of the UK’s future relationship with the EU.

Central Banks

We expect the European Central Bank (ECB) and US Federal Reserve (Fed) to remain on hold this year, keeping interest rates at current levels. The Fed has indicated that its Treasury bill purchases might be reduced over the second quarter, as interbank rates have come back in line with its objectives. The Peoples’ Bank of China (PBoC) might be encouraged to ease policy further to mitigate the coronavirus-induced hit to activity while several other emerging world central banks continue to cut rates in light of sluggish inflation.

Markets

G7 10-year government bond yields have slumped even lower in reaction to the coronavirus outbreak, leaving them deeply negative after inflation. Corporate bonds offer better value, although we highlight the rising risks in lower-quality issuers in the US. Rising UK business confidence and undervalued exchange rates could favour Sterling against the US dollar. Short-term flu risks can weigh on Asian and global equities but recoveries from previous epidemics have tended to be rapid – we continue to expect higher levels by year-end.

Bottom line

We maintain a preference for global equities over fixed income investments and propose keeping overall asset allocation unchanged. Although short-term risks have risen in emerging market equities, upside performance potential remains much more attractive and we suggest remaining Overweight. Abundant liquidity conditions and low financing costs combine to underpin credit (i.e., corporate and emerging debt) and we maintain an Overweight stance. Gold remains our preferred diversification vehicle in diversified portfolios, with prices underpinned by robust demand.

OUR ASSET ALLOCATION

The table below presents the latest conclusions of our Global Investment Committee

Summary house views

		Strong UW	UW	N	OW	Strong OW	Change since last GIC
EQUITY	GLOBAL EQUITY			■			
EQUITY	United States			■			
EQUITY	Eurozone			■			
EQUITY	United Kingdom			■			
EQUITY	Japan			■			
EQUITY	Emerging				■		
FIXED INCOME – SOVEREIGN	GLOBAL RATES			■			
FIXED INCOME – SOVEREIGN	U.S. Treasuries				■		+
FIXED INCOME – SOVEREIGN	U.S. Breakeven				■		
FIXED INCOME – SOVEREIGN	Bunds		■				
FIXED INCOME – SOVEREIGN	EMU Breakeven			■			
FIXED INCOME – SOVEREIGN	Gilts		■				
FIXED INCOME – SOVEREIGN	Gilts Breakeven			■			
FIXED INCOME – SOVEREIGN	JGBs			■			
FIXED INCOME – SOVEREIGN	EM Govies ($)				■		
FIXED INCOME – CORPORATE	U.S. IG				■		
FIXED INCOME – CORPORATE	U.S. HY			■			-
FIXED INCOME – CORPORATE	EMU IG				■		
FIXED INCOME – CORPORATE	EMU HY				■		
FIXED INCOME – CORPORATE	UK IG				■		
FIXED INCOME – CORPORATE	UK HY				■		
FIXED INCOME	Duration USD*			■			
FIXED INCOME	Duration EUR*		■				
FIXED INCOME	Duration GBP*		■				
FOREX	EURUSD			■			
FOREX	USDJPY			■			
FOREX	GBPUSD				■		+
FOREX	EURCHF			■			
FOREX	EM FX (vs. USD)			■			
CMDTY	Brent			■			
CMDTY	Gold				■		
ALTERNATIVE	ALT. STRATEGIES			■			
ALTERNATIVE	L/S Equity			■			
ALTERNATIVE	Event-Driven				■		
ALTERNATIVE	FI Arbitrage				■		
ALTERNATIVE	Global Macro / CTAs			■			

	Positioning	*Duration
O/W	Overweight	Long – 7-10 years
N	Neutral	Intermediate – 5-7 years
U/W	Underweight	Short – 3-5 years

EQUITIES	
United States	Demanding valuations should limit the upside for US equities this year. We remain Neutral.
Europe	We keep a Neutral exposure to European equities given the combination of an improving macro backdrop and supportive monetary and fiscal policy.
Eurozone	As elsewhere, euro zone equities have seen selling pressure as worries about Wuhan flu have gained momentum. However, Business confidence data have improved. We remain Neutral.
UK	As Sterling could rally this year, we expect smaller companies to outperform their larger brethren.
Switzerland	Swiss equities have demonstrated resilience. However, the Swiss franc has strengthened on safe-haven inflows. We suggest a Neutral stance.
Japan	Japanese equities may struggle during the Wuhan flu outbreak. However, the phase one truce should benefit Japan. We are Neutral.
Emerging (EM)	Provided that the epidemic comes under control, we favour Emerging equities to developed markets as valuations and earnings growth expectations are more attractive.

FIXED INCOME	
Sovereigns	Sovereign short-term yields will remain low, anchored by accommodative monetary policies. Improvements in the global economic environment should push long rates slightly up.
Duration*	We prefer intermediate maturities in the US and keep a defensive stance on longer-dated sovereign bonds globally. In the near-term, 10-year US rates can provide some diversification against volatility spikes.
Inflation-linked	Given limited downside risks and attractive valuations, we remain Overweight on US inflation contracts (“breakevens”).
Investment Grade	Spread are tight and unlikely to compress further. The additional yield provided by Investment Grade bonds is the main factor underpinning our Overweight position.
High Yield	We remain Overweight on eurozone High Yield bonds (HY), but downgrade to Neutral the asset class in the US given the fragile fundamentals of lower rated segments and tight spreads.
Emerging debt (in € and $)	We keep our Overweight position on Emerging dent given supportive fundamentals and attractive valuations.

CURRENCIES	
EUR/USD	On a purchasing power parity basis, the euro remains cheap against the USD, limiting its downside. We expect that the euro could be boosted late in 2020.
GBP/USD	Sterling should be supported by several positive factors and is undervalued. We expect it to rise to between $1.35 and $1.40.
EUR/GBP	As negotiations on future relations between the UK and the EU start, we don’t expect major moves over the coming months.
USD/JPY	The yen’s prospects remain limited given negative prevailing yields and moribund growth. All in all, the USD/JPY should remain range-bound.
EUR/CHF	Any sustained weakening in the franc against the euro will need a confirmation that the Wuhan flu outbreak has been contained. We remain Neutral.
Emerging	We expect the dollar to weaken and emerging currencies to appreciate later this year,

ALTERNATIVES	
Hedge funds	Our preferred areas remain in Event-Driven and Fixed Income Arbitrage.
Gold	Although news that the Wuhan flu is coming under control could spark a short-term retracement, we maintain our Overweight stance as fundamentals remain positive.
Oil	We see Brent prices back in a $60 and $70 per barrel range by year-end.

Source: SGPB, 31/01/2020
* Duration: short = 3-5 years, medium = 5-7 years, long = 7-10 years
HY = High Yield bonds (higher return but greater risks), IG = Investment Grade bonds (higher quality but lower return)

ECONOMIC OUTLOOK

Short-term hit to activity

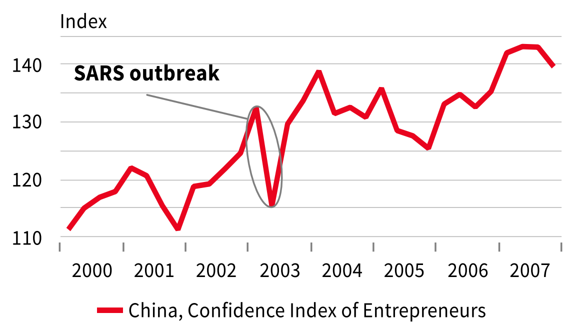
When analysing geopolitical tensions or viral outbreaks, a sober reflection of historical data is often a better indicator of what comes next than frenzied theorising. History would suggest the Chinese economy will suffer a slowdown in the wake of the Wuhan flu outbreak, but that markets will likely rebound in short order.

The first month of 2020 has seen a number of tail risks emerge. First, markets were convulsed by the spike in geopolitical tensions between Iran and the US, which led to an initial knee-jerk "risk-off" reaction before investor fears dissipated rather quickly. Then, towards the tail-end of January, the fear of the Coronavirus gripped markets. Given the epicentre of the outbreak is in China – a critical pillar of the global economy – theory suggests the virus can slow China's growth, and therefore have second-order effects on markets.

The theory is logical. However, as the inimitable Yogi Berra said: in theory there is no difference between theory and practice; in practice there is. Similar viral outbreaks (i.e. SARS in 2003; Swine Flu in 2009; Avian H7N9 Flu in 2013; Ebola in 2014) followed quite a standard market pattern. After the first registered case abroad, global equities sold off sharply over the next few weeks. Conversely, US Treasuries – the ultimate safe-haven asset – rallied. However, in each case, equity markets then recovered in rather short order while bond prices gave up much of their gains. Historical market precedent is rather clear: these episodes tend to be storms-in-teacups, and best "looked through" for those investors with time horizons beyond a few months.

Can this time be different? Of course it can. China is the world's second largest economy based on market prices, and the biggest in purchasing power parity terms. Anecdotally, we know this outbreak has caused 70,000 cinemas across the country to shut; the international coffee chain Starbucks has closed 2,000 of its Chinese branches; Toyota has temporarily halted car production. There is no denying there will be a negative economic impact. One useful proxy of the scale of the impact comes from the 2003 SARS epidemic, which some estimates suggest cost the Chinese economy about 1 percentage point of growth. However, the impact was short lived and China went on to register 10.0% growth in 2003, 10.1% in 2004 and 11.5% in 2005 as the economy reaped the benefits of its recent membership of the World Trade Organisation.

In 2003, confidence rebounded quickly



Source: SGPB, Macrobond, 31/01/2020

However, there are other important considerations. This time, the Chinese administration swung into action almost instantly, and the World Health Organisation has praised China's handling of the outbreak. Authorities appear very transparent in their dissemination of information, quite different from the cover-up of SARS which was heavily criticised. This may well partially explain why the cases of the current coronavirus outnumber the infections during the entire SARS outbreak of 2002 and 2003. Moreover, preliminary figures suggest the new coronavirus is far less likely to result in death than SARS, which killed 1 in 10 infected patients.

China has been decelerating for over a decade as the economy transitions from high export-driven growth to greater reliance on domestic demand. While this year might be worse than originally expected, it does not signal a dramatic new paradigm. The slowdown may also be offset by slightly better than forecast growth in the developed world in 2020 as the stagnation in manufacturing appears to have stabilised, and crucially, has not spread to the wider services sector. Moreover, it is prudent to remember that slowdowns can last for years, and the premium from risk assets tends to be positive during this phase of the cycle.

Bottom line. When analysing "new information" such as geopolitical tensions or viral outbreaks, a sober reflection of historical data is often a better indicator of what comes next than frenzied theorising. History would suggest the Chinese economy will suffer a slowdown, but markets will likely rebound in short order should this virus follow the path of similar previous outbreaks.

FIXED INCOME

Prefer Corporate and Emerging debt as a source of additional yield

We do not expect significant returns this year from fixed income. Government bond yields are unattractive and modest upward pressure on long rates should build as the economic scenario improves. While credit spreads (the difference in yields over sovereign bonds) are tight and unlikely to narrow further, corporate bonds can still provide some additional yield ("carry") in a low rate environment.

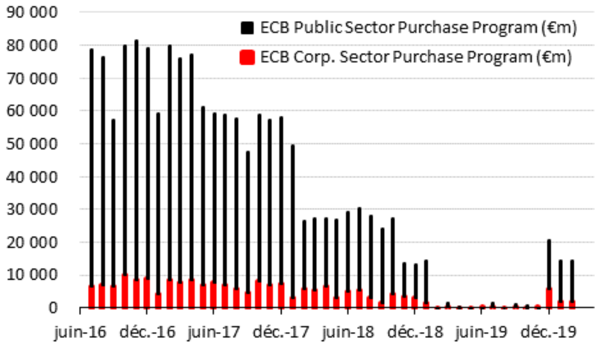
Sovereigns

US. The bar for Fed rate changes this year is set high: after three rate cuts in 2019, additional easing is unlikely at this stage, while rate hikes are improbable in such a fragile environment. As a result, short rates will stay anchored at current levels. At the long end of the curve, rates should start to rise as manufacturing activity recovers, but only marginally given modest inflationary pressures. In the very near term, however, long rates can provide some diversification against volatility spikes on coronavirus fears.

Eurozone. As the ECB eased last year in response to global trade and investment headwinds, the 10-year German bund yield rebounded from record lows. However, mounting fears about the coronavirus outbreak have pushed rates down again. While we expect industrial activity to recover in due course, we don't see inflation accelerating markedly. The ECB will keep interest rates unchanged and asset purchase policies in place. In this context, we find little value in core countries' long rates and prefer peripheral bonds given the support from central bank buying and muted political risk.

UK. Mixed economic data has kept monetary policy uncertainty high, as illustrated by the swings in market expectations for rate changes. While the Bank of England (BoE) finally left rates unchanged in January citing a rebound in business activity surveys and household confidence, inflation has weakened and Brexit uncertainty will not disappear entirely. We expect BoE to keep rates stable, with long yields moving slightly higher.

Resumption of ECB asset purchases should keep rates low and support credit markets



Source: SGPB, Bloomberg, 31/01/2020

Credit

US. Times of moderate economic growth are usually favourable for credit markets. However, corporate bond spreads already look rather expensive and offer little potential for further tightening. Moreover, balance sheets have deteriorated as this cycle has matured. As we do not anticipate a downturn in the economic outlook, we believe US credit markets remain attractive compared to government bonds, mainly for their "carry". We maintain our Overweight view on the higher quality Investment Grade (IG) sector but reduce to Neutral our stance the more fragile High Yield (HY) segment.

Eurozone. We continue to expect credit to outperform government bonds. As in the US, this will be mainly due to carry rather than any tightening in corporate spreads, which are already low. Improving economic conditions should enable an extension of the credit cycle and keep default rates low. Moreover, the ECB's accommodative stance will provide additional support, both in the form of low-for-long rates and via their corporate bond purchases. We therefore maintain our Overweight position in both the IG and the HY segments.

UK. Despite multiple delays in approving the Brexit Withdrawal Agreement, credit spreads continued to tighten throughout last year with IG now close to cycle lows. With the start of the transition period, we expect uncertainty to linger around the advancement of EU/UK negotiations. However, reduced fears of hard Brexit, the low interest rate environment and improving global growth should support credit markets. We maintain our Overweight view.

Emerging Market (EM) debt

The ongoing coronavirus emergency may weigh on emerging markets in the near term. However, looking further ahead, fundamentals remain supportive for EM debt – valuations are not particularly expensive, global trade and investment are set to improve, monetary policies in both developed and emerging countries remain accommodative and the US dollar is expected to weaken. We therefore maintain our Overweight stance.

EQUITIES

Sidetracked by Wuhan

In the near term, market sentiment is likely to be dominated by the unfolding Wuhan flu epidemic. However, previous instances have tended to see sharp corrections in equity markets followed by recovery once the outbreak begins to come under control. Accordingly, we suggest maintaining Neutral exposure to equities given the combination of an improving macro backdrop and supportive monetary and fiscal policy.

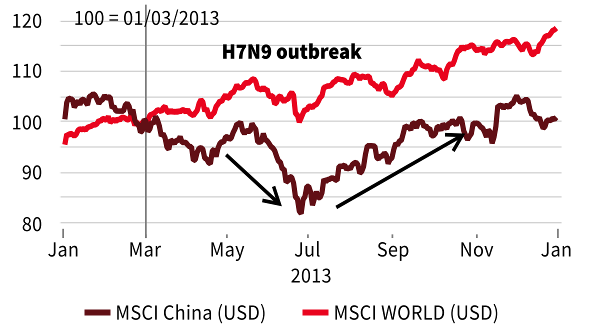
US. The rapid emergence of the coronavirus epidemic has taken the shine off the strong start to the year for US equities, despite the trade war truce and a strong start to the fourth quarter earnings season with three-quarters of reports so far outperforming expectations. As highlighted in our macro outlook, the outbreak's impact on economies and markets is likely to prove intense but short-lived. Nonetheless, valuations remain demanding which should limit upside for US equities this year.

With net profit margins still well above their 10-year median and under pressure from rising wages, we continue to prefer more defensive sectors such as Consumer Staples and Utilities. Indeed, the only Q4 earnings disappointment so far has come from the cyclically-sensitive Materials sector. We also highlight the attractions of companies – known as the Dividend Aristocrats – which have demonstrated the ability to grow their dividends consistently over time.

Eurozone. As elsewhere, euro zone equities have seen selling pressure as worries about Wuhan flu have gained momentum. Business confidence data, on the other hand, has registered some improvement from the lows reached last autumn and job markets remain robust. As in the US, Q4 earnings reports have beaten expectations in the main and the consensus expects a bounce in earnings of around 9.9% in 2020 on top-line growth of 3.2%.

We continue to expect that a pick-up in activity this year will favour more cyclically-sensitive sectors like Consumer Discretionary and Industrials, where analysts forecast double-digit earnings growth for 2020. Financials have long been shunned by investors given the pressure on Banks' net interest margins from negative rates on their ECB deposits. However, the launch late-2019 of a tiering mechanism should go some way to mitigate their impact and the sector is aided by a 5.1% dividend yield.

In 2013, recovery was rapid



Source: SGPB, Macrobond, 31/01/2020

UK. Business confidence has recovered rapidly after December's decisive election victory for the ruling Conservative party. As highlighted in our currency analysis, sterling could rally this year as the government now pushes through fiscal stimulus plans to bolster growth, especially in the regions. However, with some 70% of FTSE 100 turnover generated overseas, we expect smaller companies – which are more domestically-focused – to outperform their larger brethren.

Switzerland. As the coronavirus outbreak has unfolded, the Swiss franc has strengthened on safe-haven inflows, which is often viewed as a negative for this market, given the high proportion of international earnings. However, Swiss equities have demonstrated resilience thus far, perhaps because the market is dominated by a number of high-quality global leaders in rather defensive sectors like Healthcare and Consumer Staples.

Japan. Given their heavy exposure to Asia-Pacific, Japanese equities may struggle during the Wuhan flu outbreak. However, the market looks attractively-valued versus long-term trend earnings and analysts are forecasting a return to profit growth this year after 2 years of declines. In addition, the phase one truce between the US and China should benefit export-sensitive economies like Japan. Moreover, the government's fiscal easing plans should bolster domestic growth.

Emerging Markets. As illustrated in the chart, previous outbreaks of new flu strains have led to corrections in EM equities, notably in China, before markets begin a sharp recovery as it becomes clear that the epidemic is coming under control. Moreover, we expect the Chinese authorities to step up stimulus measures to help mitigate the near-term impact of travel restrictions and factory closures. Furthermore, emerging markets trade at a discount to valuations in the developed world, despite better expected earnings growth. Given these factors, we suggest keeping a moderate Overweight stance on EM equity markets.

Past performance should not be seen as an indication of future performance. Investments may be subject to market fluctuations, and the price and value of investments and the income derived from them can go down as well as up. Your capital may be at risk and you may not get back the amount you invest.

CURRENCIES

Currency volatility remains low

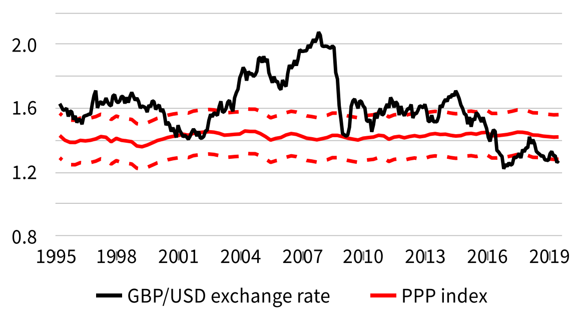
The Coronavirus impact on currencies is likely a short-term phenomenon, with exchange rates set to revert to fundamentals soon with the Chinese yuan firming back below the 7-level.

Dollar Index. While the US dollar has long been supported by structurally higher rates and faster GDP growth – and safe-haven flows of late given the Coronavirus – its strong upward rally over the last two years has probably come to an end. Momentum has likely shifted given the Fed's last three changes were to cut rates and it is effectively back in quantitative easing mode. Moreover, while the US dollar enjoys unrivalled dominance as a global reserve currency, the government's annual deficit, now at 5.5% of GDP —by far bigger than any other developed economy – is worrying.

EUR/USD. The ECB and the Fed are both expected to keep policy settings very easy this year, with rates steady at current levels. However, with core inflation at 1.3% at end-2019, and unemployment of 7.4% – the lowest since May 2008 – economic conditions do appear to be improving, limiting further downside for the euro. Furthermore, driven by Germany, business sentiment in January hit a five-month high, signalling an end in the manufacturing gloom that marked the end of 2019.

GBP/USD. Following dovish signals from some Bank of England policymakers in January, markets had priced in a high probability of a rate cut in January. However, the BoE kept its base rate steady at 0.75%, and Sterling rallied back above the psychologically important $1.30 level. Indeed, with domestic clarity on Brexit resulting from the recent general election, a powerful fiscal stimulus program and low unemployment levels, the BoE is unlikely to cut rates unless there is significant worsening in the economy. Sterling reflects few of these positive factors and is undervalued – we expect it to rise to between $1.35 and $1.40.

The British pound looks attractive against the dollar



Source: SGPB, Macrobond, 31/01/2020

USD/JPY. The first month of 2020 has seen a number of tail risks materialise – first, geopolitical tensions between Iran and the US, then the Coronavirus – which has supported the safe-haven yen. However, barring "risk-off" flows, the yen's prospects remain limited given negative prevailing yields and moribund growth. Indeed, the USD/JPY as traded in an extremely tight range of between ¥106 and ¥110 for most of the past two years. We don't expect that to change any time soon.

EUR/CHF. The Swiss franc has also benefited from safe-haven flows, which have pushed the franc to its highest level since Q1 2017. Previous strong rallies like the one since November have been stemmed by Swiss National Bank (SNB) purchases of foreign currencies. We would expect FX intervention to remain the SNB's preferred tool, given its reluctance to follow suit when the ECB cut rates last September. However, any sustained weakening in the franc against the euro will have to wait for confirmation that the Wuhan flu outbreak has been contained. We remain Neutral. .

EM currencies. EM currencies should benefit from higher relative economic growth and easier Fed policy settings. Indeed, with government bond yields much lower across the developed world at the start of 2020 than 12 months ago, hard-currency EM sovereign yields above 5% are attractive. Moreover, low inflation should enable many EM central banks to ease policy, further bolstering growth prospects. As the dollar weakens later this year, we would expect emerging currencies to begin their recovery, though idiosyncratic risks remain high in countries such as Argentina or Turkey.

USD/CNY. After strengthening below the 7-mark versus the US dollar to start 2020, the Coronavirus outbreak rapidly plunged it above the psychologically-critical level in late January. History would suggest the Chinese economy will suffer a slowdown. However, the Chinese administration swung into action almost instantly, and the authorities appear very transparent in their dissemination of information. The yuan will likely rebound in the next few weeks, dropping back below 7, should this virus follow the path of previous outbreaks in terms of containment.

ALTERNATIVES

Gold shines on spike in risk aversion

Once the Wuhan flu epidemic begins to come under control, we would expect oil prices to recover and gold – where we remain Overweight – to give back some of its recent gains. Among hedge fund strategies, our preferred areas are in Event-Driven and Fixed Income Arbitrage.

Commodities

Oil

The coronavirus outbreak has pushed oil prices sharply lower as investors have reacted to the impact of travel restrictions and slower growth in China on demand for fuel. In addition, fears of armed conflict in the Gulf have faded in recent weeks as the US and Iran have avoided further escalation of tensions, thereby reducing the risk premium in crude prices. Moreover, US oil output has continued to increase since year-end, reaching an all-time high of 13.0 million barrels per day and ensuring plentiful supply.

However, demand has tended to recover quite rapidly after previous flu epidemics have begun to come under control and travel curbs have been lifted. In addition, OPEC has already suggested additional output cuts to prop up prices, given the drag from lower prices on many members' budget balances.

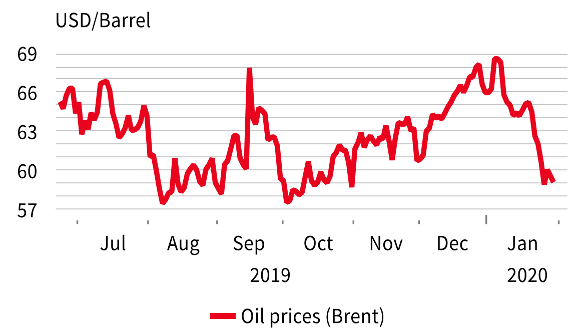
All in all, we see Brent prices back in a $60 and $70 per barrel range by year-end.

Gold

The safe-haven qualities of gold bullion have come to the fore in early 2020. After spiking in the wake of US-Iran tensions, prices then strengthened again as news of the coronavirus outbreak broke, reaching almost $1600 per ounce, the highest level since early 2013. This illustrates gold's importance as a diversification instrument for portfolios, especially those with higher exposure to risky assets.

In addition, investor demand for gold ETFs has been robust – inflows reached $19.2bn last year, triggering purchases of some 400 tonnes (t) of gold and taking aggregate ETF holdings to 2,900t by year-end, the highest ever. Central banks have also been active in adding gold to their reserves – aggregate 2019 purchases of 650t were the second-highest in the last 50 years – led by Turkey, Poland, Russia and China.

Wuhan flu has had a large impact on oil prices



Source: SGPB, Macrobond, 31/01/2020

Although any news that Wuhan flu is coming under control could spark a short-term retracement, we maintain our Overweight view.

Hedge funds

Long/Short (L/S) Equity

With risk aversion rising since the start of this year, the dispersion in returns between individual stocks has tumbled, making life difficult for L/S Equity fund managers. This has encouraged many to scale back their sensitivity to market direction, which suggests they may struggle if markets rally on any news the coronavirus epidemic is coming under control.

Event Driven

With fewer large M&A operations at present, deal spreads – the difference between the prices of predator and prey – have declined which suggests a period of slow returns in Merger Arbitrage. However, opportunities still look attractive in Special Situations where returns depend more on idiosyncratic catalysts than the Wuhan flu outbreak.

Fixed Income Arbitrage

With stretched valuations and rising risks in US High Yield markets, L/S Credit funds should stand to benefit given their ability to hedge exposures. This also means that managers achieve their returns with lower volatility than long-only HY funds. Fixed Income Arbitrage represents another attractive source of diversification and returns.

Global Macro / CTAs

The strong upward swing in equity markets last year encouraged trend-followers (known as CTAs) to add to positions, leaving them vulnerable to the recent reversal in momentum. Moreover, many traders had scaled back exposure to fixed income as yields rose, thereby missing out on January's rally. Opportunities look better for EM-focused discretionary Global Macro funds.

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Tour Société Générale
17, Cours Valmy
75886 – Paris Cedex 18
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