Equity Research; Where is the downside?

COLLINS SARRI STATHAM INVESTMENTS

Research Report

Report Date

2nd March 2020

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Key Risks to Price Target

Not applicable

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Where is the downside in UK equities?

The extended sell-off in global equities in 2020 is on everyone's minds.

2020 is an open book for perceptions, expectations. Investors want to familiarize with themes / winners over the "20's" decade.

But what we have so far, is an obvious hangover from 2019 and a confidence problem. Markets are wobbling due to the lack of positive catalysts and the spread of the fatal Covid-19 flu virus crimping global GDP growth.

A brief recap. When 2019 started, investors were expecting the US Federal Reserve to maintain and possibly lift the Federal Funds rate. Investors were positively surprised by 3 Fed rate cuts. A key reason for global markets outperformance in 2019, was the path of US monetary policy. But 31 December 2019 looks like a *fin de siècle* moment, the end of a decade where US blue chips tripled in value.

US Dow Jones Industrial Average

source:www.macrotrends.net

It now seems that global equity markets lacked positive catalysts going into 2020, US equities were expensive, and looking to correct prior to Covid-19 arriving.

Fatal flu viruses are not a "black swan" event. We have c. 100 years of modern medicine / experience to deploy. But regardless of investor familiarity, markets were not pricing in Covid-19 at the start of 2020.

There is inherent complexity involved in pricing in a supply/ demand shock of this nature. This is due to known unknows i.e. length/ spread of virus globally, resulting change in consumer behavior, impact on key economies and commodities, the timing and impact of counter-measures, off-sets.

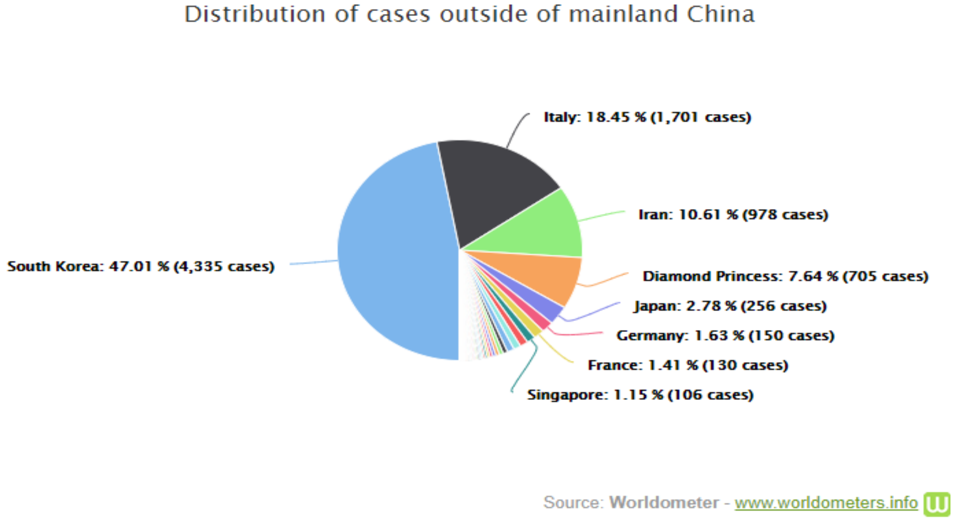
"If Kuwait sold carrots".

If China were not the world's second largest economy, if its 6% annual GDP growth was c. 2%, if it were not the world's manufacturing base, if the timing of China's recovery from Covid-19 were not crucial, then investors' reaction to Covid-19 would have been restrained.

In any crisis it is tempting to play the 'blame game', China's exotic animal food markets where animal parts are sold untreated, the Chinese Communist party apparatus (that slows down the transmission of bad news), Premier Xi Jinping's attempted coverup, social media, the global media. Was it ever realistic to expect the virus to be contained inside of China?

Investors are not epidemiologists. We are still at the stage of intelligent guesswork that will improve with better data flow, more accurate forecasting and eventually fact-based decision making. But it is possible that investors are over-reacting and possibly panicking. What reasons can I draw on to support this view?

The spread of Covid-19 outside China has so far been limited to a handful of countries / entities. This also suggests virus control measures are working.



Chinese assets have outperformed in global sell off?

After a controversial and slow start, the Beijing government has now taken substantial and effective measures to contain Covid-19 spread. Those measures are slowing the reported case growth and spread, one telling statistic is 90% of the 3,000 global fatalities have been in Hubei province in central China.

Confidence in Chinese equities was initially shaken by the Covid-19 virus (-8% 4th February 2020) but Chinese indices have stabilized and recouped the bulk of their losses.

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Global Indices over February 2020

INDICES					
Name	Last	Chg. (%)	Perf. 1W (B.)	Perf. 1M	Perf. 3M
Dow Jones Industrial	25,409.36 DL	-1.39%	-9.13%	-10.07%	-8.54%
Nasdaq 100	8,461.834 DL	+0.30%	-6.80%	-5.89%	+1.84%
US SPX 500 Index	2,987.75 RT	+2.46%	-7.44%	-7.55%	-4.04%
UK 100 Index	6,725.05 RT	+1.56%	-5.68%	-7.40%	-7.78%
DAX	12,018.51 DL	+1.07%	-7.87%	-7.49%	-7.37%
CAC 40	5,390.03 DL	+1.50%	-7.04%	-7.27%	-6.96%
IBEX	8,723.20 ED	-	-8.02%	-6.88%	-4.73%
DB Italy 40 Index	21,770.00 RT	-3.50%	-6.67%	-5.94%	-4.41%
AEX	549.82 DL	+1.94%	-7.33%	-6.73%	-6.35%
OMX Stockholm 30	1,695.910 DL	+1.62%	-5.72%	-4.93%	-0.68%
Athex Composite	720.35 ED	-	-11.98%	-20.92%	-19.33%
SMI	10,083.3300 DL	+2.56%	-5.98%	-5.23%	-2.67%
RTX RUB	5,205.39 DL	+2.57%	-8.39%	-8.28%	-5.45%
Nikkei 225	21,344.08 ED	+0.95%	-8.73%	-8.02%	-9.29%
Hang Seng	26,291.68 DL	+0.62%	-1.97%	-0.08%	-0.58%
KOSPI Composite I...	2,002.51 RT	+0.78%	-3.68%	-5.50%	-4.27%
Nifty 50	11,360.45 DL	+1.41%	-4.01%	-5.07%	-5.75%
S&P/ASX	6,441.20 ED	-3.25%	-7.70%	-8.21%	-6.14%
Shanghai Stock Exchange Com	2,970.93 DL	+3.15%	-1.99%	-0.19%	+3.31%

Source: www.teletrader.com

We note the relative outperformance of Shanghai (-0.19% 1mth, +3.31%) and the Hang Seng (-1.97% 1mnth, -0.58% 3 mnth) in the context of Februarys' global sell off that saw the Dow decline 10.07% and Nikkei drop 8.02%. There appears to be significant disconnect between the response of Chinese / international asset markets.

Standard Deviation/ Volatility is at extreme levels for February 2020

Using the US S&P 500 as a reference, we note the standard deviation (the measure of index dispersion around the average) has increased over February 2020 to -1.14% (52 week average -0.64%) with 1 year annualized volatility at -10.22%.

The increase in volatility is significant and to be expected during a stressed month i.e. substantially above normal levels.

Date	Open			Close	(% daily change)	1 YR ST DEV	1 MTH ST DEV	1 MTH VOL	ANNUALISED VOL
Feb 28, 2020	2,916.90	2,959.72	2,855.84	2,954.22	1.26%	-0.644%	-1.144%	-5.24%	-10.22%
Feb 27, 2020	3,062.54	3,097.07	2,977.39	2,978.76	-2.81%				
Feb 26, 2020	3,139.90	3,182.51	3,108.99	3,116.39	-0.75%				
Feb 25, 2020	3,238.94	3,246.99	3,118.77	3,128.21	-3.54%				
Feb 24, 2020	3,257.61	3,259.81	3,214.65	3,225.89	-0.98%				
Feb 21, 2020	3,360.50	3,360.76	3,328.45	3,337.75	-0.68%				
Feb 20, 2020	3,380.45	3,389.15	3,341.02	3,373.23	-0.21%				
Feb 19, 2020	3,380.39	3,393.52	3,378.83	3,386.15	0.17%				
Feb 18, 2020	3,369.04	3,375.01	3,355.61	3,370.29	0.04%				
Feb 14, 2020	3,378.08	3,380.69	3,366.15	3,380.16	0.06%				
Feb 13, 2020	3,365.90	3,385.09	3,360.52	3,373.94	0.24%				
Feb 12, 2020	3,370.50	3,381.47	3,369.72	3,379.45	0.26%				
Feb 11, 2020	3,365.87	3,375.63	3,352.72	3,357.75	-0.24%				
Feb 10, 2020	3,318.28	3,352.26	3,317.77	3,352.09	1.01%				
Feb 07, 2020	3,335.54	3,341.42	3,322.12	3,327.71	-0.24%				
Feb 06, 2020	3,344.92	3,347.96	3,334.39	3,345.78	0.03%				
Feb 05, 2020	3,324.91	3,337.58	3,313.75	3,334.69	0.29%				
Feb 04, 2020	3,280.61	3,306.92	3,280.61	3,297.59	0.51%				
Feb 03, 2020	3,235.66	3,268.44	3,235.66	3,248.92	0.41%				
Jan 31, 2020	3,282.33	3,282.33	3,214.68	3,225.52	-1.76%				

Source: CSS Investments Ltd

Likewise the jump in the VIX Index (Chicago Board of Exchange) the well-known “fear gauge” (+22.1 points in the week to 28th February 2020) is the *second biggest rise on record*, the largest being the week ended 10th October 2008. However the VIX gains exceeded the 2010 “flash crash” gains (May 7th 2010) of 15.1 points.

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The VIX price is at 5 year high suggests i) US investors are fearful ii) “safe assets” are attracting premiums iii) US investors are viewing the Covid-19 event on a similar scale to other major crises, including October 2008. This appears an exaggerated response to the issue.

Conclusion

I want to avoid flippant answers to simple questions, but I am struggling to see the global declines as warranted by the Covid-19 virus. The fact is markets are treating this as a crisis, but my rational finding is the decline is possibly due to reasons in addition to Covid-19. Lower corporate profitability for example.

Assuming other factors are contributing to the sell-off then logically when Covid-19 abates it might be a bit of a non-event in market terms. Obviously if Covid-19 becomes a pandemic and expands its grip globally (a big assumption) then indices will be kept under pressure.

My sense is in UK terms that the 1,000 point sell-off to 6,600 (already seen) would price in the expected global GDP slowdown. What is possibly being overlooked are short term stimulus measures that could be employed. I note the innovative move by the Hong Kong government to deposit HK$10,000 in every adult’s bank account and the Bank of Japan’s promise to inject further liquidity. We expect a big cut in OPEC supplies, a giveaway UK budget and a possible US rate cut over March 2020. These are the positive short term catalysts that could provide emergency stimulus.

My view is the 1,000 point drop (UK 100 6,600) is sufficient and the UK market has limited further downside.

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