Amplia Monthly Investment Letter

Pandemia-fed panic

A month ago, the Coronavirus story was beginning to unfold, but at that time it was still a purely Chinese issue. We wrote back then that we would need to see an increased contagion and workplace shutdowns for it to have longer-lasting effects on economic growth.

A month later, these fears have come true. We know by now for certain that the virus has become pandemic and that it is wreaking havoc and causing misery across the globe. Investors have rightly reacted to the news and sold off various risk assets. Because the virus will dominate the markets in the coming months, we shall also focus on its implication in this letter.

From supply to demand shock?

In this first weeks of the virus outbreak, the main negative implications were disruptions in supply chains. China's decisive efforts to curb the spreading of the virus led the country and its neighbours (notably South Korea and Japan) to close schools, factories and offices. This has not gone unnoticed in the West where Apple warned investors already on 17th February that the supply outages would hurt its Q1 revenues. Subsequently, many prominent semiconductor manufacturers sounded alarm. Another sub-sector to start crumbling was European luxury. Overall, looking at total returns year-to-date (status 5th March 2020), S&P 500's Energy index has lost 25.3%, followed by Financials (-14.2%) and Materials (-10.4%). The only S&P 500 sectors to exhibit gains in 2020 are Utilities (+4.6%) and Real Estate (+1.2%).

Meanwhile, US Federal Reserve's emergency meeting earlier this week brought the markets' slide to a (temporary) halt. This is easy to understand, because the Fed stood for a great part of the market recovery in 2019 and has demonstrated its invincibility alongside the ECB on many occasions since the collapse of Lehman Brothers in September 2008.

Back to schoolbook economics. Policymaker response usually works well in (Keynesian) demand shocks, where the demand for goods produced in the economy falters, whatever the reason. This applies to both central banks (monetary policy) and governments (fiscal policy – assuming the governments are not overly indebted). When fighting a supply shock, however, expansive fiscal and monetary policies are to little avail, unfortunately. When the supply chains are at the limit, an extra boost to demand – be it via temporary tax reliefs or lower borrowing rates – only feeds the disparity and results in higher inflation. The oil crisis of 1973 serves as prime example of this.

Hence, to assess the situation as an investor, two questions arise: firstly, how the virus and its damage will evolve over the upcoming months and secondly, how effective the policy response will be.

The first question is something we as medical laymen cannot answer. Should the number of new cases decline by summer, the recovery would likely be U-shaped, meaning that the world economy would at least return to its previous growth trajectory in the second half of 2020, after posting declines in the first half. Should the virus however develop genetically or keep spreading expansionarily, the entire year could be lost and a global recession a fact already after Q2 2020.

The second question is slightly easier. If Southeast Asia and China can resume production soon, the strain on supply chains will ease, and policymakers can focus on supporting the aggregate demand. Should however the production outages last longer, the inflation and missed-out opportunities would weigh on growth significantly. Faltering demand in its turn can be fought easier. Tax reliefs, increased social benefits, public infrastructure projects, cheaper and more easily accessible capital (from quantitative easings, lower reference rates and bank reserve ratios) all belong to the everyday kit of the policymakers like a bento box to that of Japanese pupils.

The joker element here is the human psychology. If people were to stop going out and commuting, they would probably cut down on shopping as well. Such "animal spirits" behaviour is harder to combat, especially if the trust towards authorities dwindles. We are not yet there but on the other hand it is worrisome to see people hoarding groceries in developed countries such as Italy or Switzerland.

Our markets positioning

All the aforementioned uncertainty naturally decreases visibility. In this environment, we feel it would be foolhardy to be 100% invested in equities. Our quantitative model also signals a reduced risk due to deteriorated risk sentiment. Economic fundamentals are still positive, but this can also change quickly if earnings were to start declining on a broad basis. Thus, we cut down our equity exposure to half of the individual maximum.

Sector-wise, our preferences are on financials, industrials and healthcare. The former two are attractive especially from a valuation perspective whereas healthcare is soothingly anticyclical in this environment. Also, some individual European luxury-good manufacturers are starting to trade at reasonable prices, given their intact long-term growth story.

Gold has spiked upwards and we feel the time is ripe to reduce the overweight we have had on it. Whilst the lower interest rates and current market turmoil may keep it drifting higher, the high prices should activate more production and alternative demand, thereby balancing the price-setting in the medium-term.

Only parts of bond markets have emerged unscathed from the turmoil. Those investors who held good quality single bonds or US treasuries got rewarded royally this week, as the 10-year Treasury yield fell to 0.73 percent, its lowest standing on modern record. Meanwhile, our call for the intersection of USD-denominated high yield and investment grade with maturities over 5 years fared reasonably well, despite spiking credit spreads, due to the gains on the interest rate side.

A significant repercussion of the lower US interest rates is that the greenback has lost its interest rate carry superiority. This should result in further repatriation of money from the US and keep benefiting the EUR, JPY and GBP.

In Zurich on 6th March 2020

Yours sincerely,
Juho Kivioja