GADD
WEALTH MANAGEMENT

Market Insight

WINTER 2020

At night, all swans are black

At this time last year, investors were struggling to contemplate good investment returns for the new year, stunned as they were by so much red in the stock market performances of the previous year. Red went green in 2019 for virtually all asset classes. But the mood of investors remains grim. And it is not the coronavirus that will make the situation better. We started the year on an optimistic macroeconomic note. The rather rich market valuations, however, warranted some caution. This is reinforced by the impact of the virus on global growth which is likely to be marked.

The big problem with financial markets swaying at the start of the year is that they tend to darken our expectations for the rest of year. This is the famous anchoring bias: when we try to estimate an unknown phenomenon, we rely on what is familiar to us. And the bad news of the week is spread to the rest of the year.

Investors are doing the same. We decipher the last vindictive Tweet of the American President on Chinese exports or his dismissal, we discover with fright that Apple's figures may be down if the blockade in China continues, and ... splash, our crystal balls are suddenly filled with black ink. When anchoring rhymes with inking ...

Black is also the color of the much feared swan. The one that symbolizes exogenous shocks which are as highly improbable as damaging ... like the coronavirus.

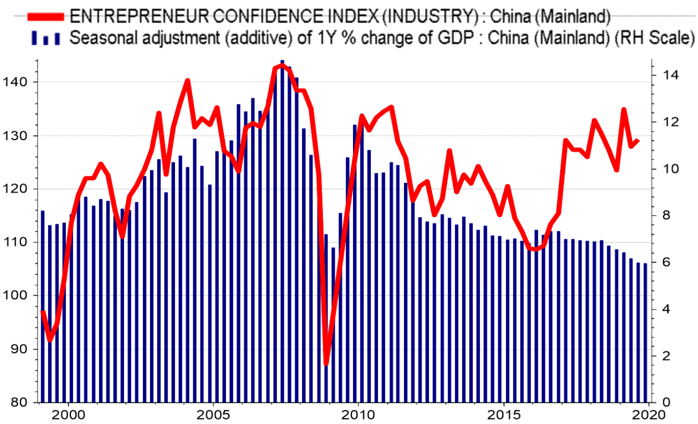
Coronavirus infects global growth

Estimating the impact of the virus on the global economy is a perilous exercise and ... that is the problem. It is no secret that financial markets hate navigating with uncertainty. In finance, everything comes down to discounting future cash flows - whether positive or negative - at a current value. But when the most complete uncertainty prevails over cash flows, the worst-case scenario dominates.

As a guide, comparison with the SARS virus (Severe Acute Respiratory Syndrome) is essential. Nearly 800 victims, or 10% of the 8,000 people infected and an impact on growth estimated at 40 billion dollars. The virus appeared in China at the end of 2002, and it took more than a year to be mastered. Contrary to what happen then, the current Chinese authorities are not seeking to minimize the dangers. As a result, China finds itself isolated from the world and ... the impact on Chinese and global growth will obviously depend on the duration of the blockade. What is certain is that China today weighs much more heavily in the world economy than in 2003. Its weight represents 17% of the world economy, which places the Middle Kingdom in 2nd place, behind the United States. In many areas, it is already a leader: it is the biggest market for new cars and semiconductors. It is also the country that spends the most on tourism abroad, and the one where practically all iPhones are manufactured.

Before the virus arrived, growth forecasts for the Chinese economy reflected already its worst score in the past 10 years, as shown in Chart 1.

1. Even before the appearance of the coronavirus, Chinese growth was the weakest in the last 10 years



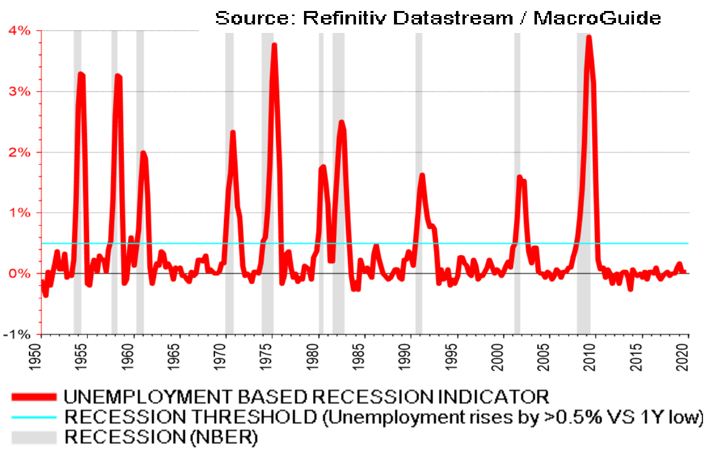
Source: Refinitiv Datastream / MacroGuide

The coronavirus came at the worst time, that of the Chinese New Year, which traditionally gives rise to a tremendous boom in consumption and domestic travel.

Elsewhere in China, solid growth is likely to be undermined

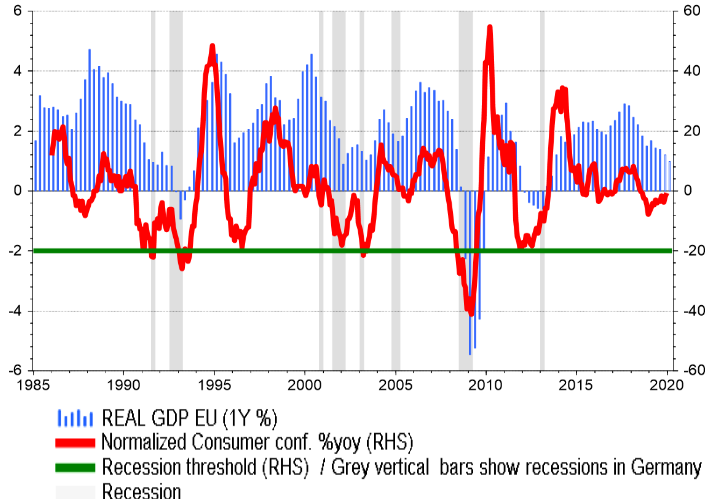
Before the virus appeared, the growth prospects in developed countries were rather encouraging. The United States remains buoyed by consumers and their confidence is largely based on the solidity of the job market. Witness this second graph which shows a new indicator that we took from the St-Louis Fed to quantify the danger of recession: it is based on the difference between the average of the last 3 unemployment rates and the lowest recorded on the past 12 months. Since 1950, each time this gap has exceeded 0.5%, the US economy has experienced a recession. We are far from it today. And it is not the return to an inverted yield curve in the United States that will change our mind. We have already pointed out here several times that the indicator is biased by the impact of the unconventional monetary policies implemented by the Federal Reserve over the past 10 years.

2. Strong job market performance in the United States testifies



The specter of an extended trade war had made us fear the imminence of a recession in Europe after the summer, in particular in countries like Germany where the weight of the manufacturing industry is important. As in the United States, one indicator that works well for predicting the European business cycle is that of consumer confidence. When it is down more than 20%, the recession is not far off, as shown in Chart 3.

3. Improving consumer confidence in Europe removes the specter of recession



When a slowdown rhymes with a recession

Americans are used to defining a recession by two consecutive declines in gross domestic product. The practice was established by Professor Wesley Mitchell on behalf of the National Bureau of Economic Research (NBER), a New York research institute founded a century ago on January 23, 1920.

This rule has the merit of existing and complementing qualitative assessments, such as that given by the Federal Reserve in the United States: "The recession marks the significant decline in economic activity in a country, lasting more than a few months, visible in employment figures, industrial production, retail sales and, of course, gross domestic product. " When the recession is severe, we speak of depression: we were not very far in 2008 and certain countries like Greece experienced in 2011 a drop in activity comparable to that experienced by the United States during the Great Depression of the 1930s. The recession and, even more, the border with depression are difficult to define and any statistical measure that can help us are welcome, if we are not to define them as Harry Truman, former President of the United States, did: "*There is a recession when your neighbor loses his job, depression when you lose yours.*"

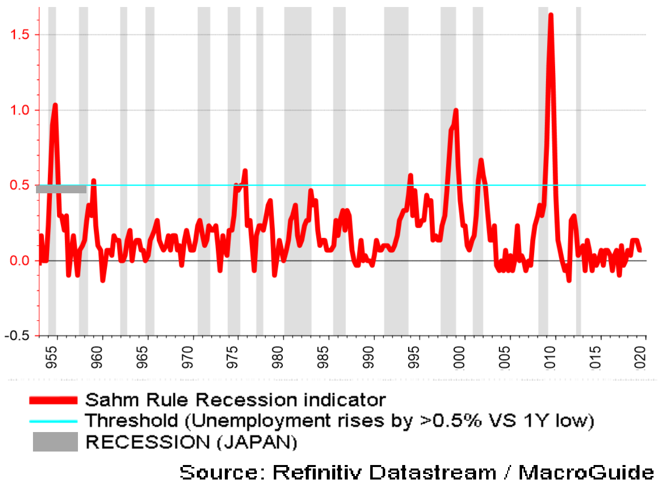
The rule of 2 consecutive declines in gross domestic product can, however, prove to be misleading. It should be noted that the NBER and, more generally, the United States, measure the variations in economic variables from a given period to the one preceding it. And therein lies the rub: with this method, you can be led to see a recession where it is only a simple slowdown.

Outside the United States, growth is measured from one quarter to the ... corresponding quarter, i.e. the 1st quarter of 2019 to the 1st quarter of 2018 and so on. Comparing a quarter to the same quarter of the previous year has at least 3 advantages compared to the American method: first, it corrects for seasonal effects. Example: if Christmas sales are particularly good, growth in the next quarter measured in American terms is likely to be weak. You no longer have this problem if you compare the last - or the first - quarter of GDP to the same quarter of a year before. The second advantage of comparing to the corresponding quarter rather than the previous one is that the figures are less volatile with the first of these two methods. The third advantage of the "non-American" method is that by taking the average of the 4 quarterly figures from Q1 to Q4, you get the growth figure on an annual basis, which is not the case if you use the American method.

We have had several recent examples of "recessions" which were in fact mere slowdowns in growth. In Germany, but also in Italy and, more recently, in Switzerland. Japan is actually a regular subscriber to these false recessions. This can be seen in Chart 4, where the vertical bars indicating recessions do not go hand in hand with other indicators such as the one based on the unemployment rate as shown in chart 2.

Rather than adopting the rule of 2 consecutive quarters of decreases on the basis of a quarter to the preceding one, we prefer that of the comparison of a quarter with that of a year before. And in this case, you don't need 2 consecutive drops to wave the red flag of the recession: one drop is enough. On this basis, no country in the world is in immediate danger of recession. Obviously, this statement would need to be adjusted according to the development of the coronavirus.

4. Too often, recession is decreed in Japan, when it is only a simple slowdown

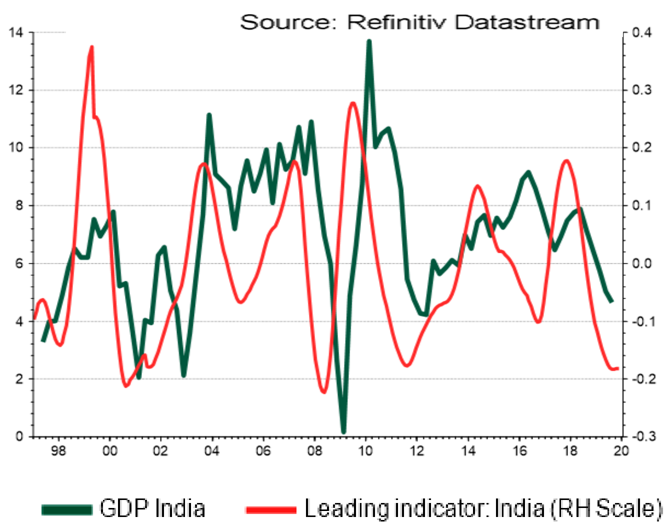


India, weak link in global growth

In most emerging countries, growth prospects improved at the end of last year. One exception: India. Linked to a large public deficit and a delay in structural reforms which is just as important, the growth failure worries the International Monetary Fund, to the point of making it the main reason for the downward revision of 3.4% to 3.3% of world economic growth.

Traditionally in the champions of global growth, India is going through a difficult period today. The lull on the trade war front bodes well for exports, but consumption and investment are lagging behind. While the country was able to benefit from budgetary policy support in 2018-19, the room for maneuver seems much more limited today, given that the public deficit will largely exceed 3% of GDP. The leading economic indicator visible in Chart 5 is not pointing in the right direction, and it is to be expected that India will experience sluggish growth in 2020.

5. Growth in India will remain sluggish in 2020



A word on financial markets to conclude. Before the virus appeared, we understood that the rather positive macro scenario for 2020 was already well reflected in stock market valuations. This is evidenced by the marked outperformance vis-à-vis bonds, as well as earnings multiples well above their average. The appearance of the coronavirus and the uncertainties it poses to the growth of the world economy reinforces our feeling of caution.

Michel Girardin, *Senior Economic Advisor*

Money-market and fixed-income

The global economy has stabilized at a low level. The US economy continues to be driven by consumption and employment, while in Europe the manufacturing slowdown appears to be approaching an end. In China, stimulus measures had begun to pay off, but their effects have now been masked by the impact of the coronavirus, which has shut down some of the country's economic activity. All in all, global growth slowed to 3% in 2019, including 1.7% in developed economies and 3.8% in developing economies. Inflation is low worldwide, allowing the main central banks to stick to their accommodative monetary policies. The easing in trade tensions, combined with upgraded macro forecasts cleared the way for a slight upturn in government bond yields in recent months, but this is now being undermined by prospects of a slowdown in Asia. The 10-year US yield has been locked since October 2019 into a 1.50-1.90% trading range, and the 10-year German yield has been stuck in negative territory between -0.60% and -0.20%. In addition to still-attractive spreads in high yield and emerging debt, the portfolio was driven by some yield niches in peripheral European debt, hybrid corporate bonds and short-term bonds in Chinese yuan and Mexican pesos. Bonds account for 32% of the balanced portfolio, including 8% in cash and short-term products, 8% in government bonds, 6% in corporates, 5% in high yield, 3% in emerging debt, and 1% in convertibles. We are sticking to our short duration of about three years on the portfolio.

Equities

Prospects for a stabilization in the macroeconomic situation, flexible monetary policies, and a reduction in trade tensions are promoting risk appetite. Despite almost-zero corporate earnings growth in 2019, the markets roared ahead. Valuations have now become stretched, with the S&P 500's price/earning ratio now at an 8% premium to its long-term average. We have kept the portfolio's allocation stable in recent months, while overweighting it slightly in Europe and Japan and underweighting it in the USA. We have nonetheless raised our equity weighting from 45% to 50%, in order to reflect its neutral strategic repositioning. Equities account for 49% of the balanced portfolio, including 16% in the US, 18% in Europe, and 4% in Japan. Asia-Pacific ex-Japan and other emerging markets make up 8% of the allocation, mostly China, India, Brazil, Australia and Korea. By sector, investments focused mainly on techs, healthcare, financial services, consumer cyclicals and manufacturing. We raised our tactical hedges, which lowered our net equity exposure to 41%.

Currencies

Despite US deficits, the US dollar still offers attractive yields and has retained its role as a trade and international reserve currency. The balanced portfolio's tactical allocation is 13% exposed to the US dollar, 3% to the yuan, 2% to the yen, 1% to the Mexican peso, and 4% to gold.

Alternative

Alternative investments account for 14% of the balanced portfolio. In recent months, Event-Driven and Cat Bond strategies have made a positive contribution to performance; our main strategies, Equity Long Short Market Neutral and Macro have levelled out; and Multi-Strategy has given up ground. In 2019, losses from the Equity Market Neutral strategy, which accounts for 41% of the allocation, were not offset by relative gains from other strategies, despite low overall volatility.

Outlook

The IMF forecasts 3.3% global growth in 2020, hence a "sluggish recovery" compared to 2019. Meanwhile, US corporate earnings are expected to increase by 8% this year, which, assuming unchanged bond yields, would produce a target for the S&P 500 at 3200 points. So, the markets seem to be fairly priced but could react to any shift in these parameters. Although central banks will stick to their dovish stance for as long as the economy has not taken off and for as long as inflation remains under control, other risks, mainly the coronavirus, but also the trade war, geopolitical crises, a hard Brexit and others, could cast doubt on this reasonably optimistic scenario. Inflows of liquidity continue to support the markets. We continue to underweight equities slightly and are tactically flexible in order to exploit any spikes in volatility. We are also managing our bond allocation very actively.

Armand du Pontavice, *CIO*

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