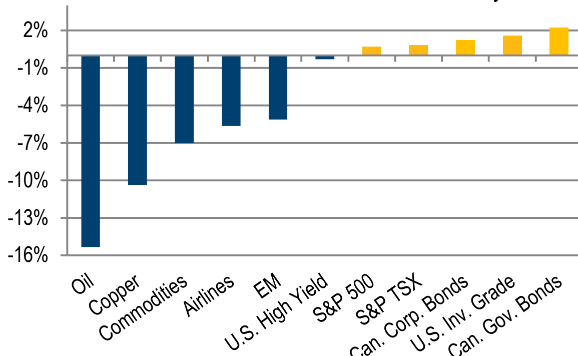
Laurentian Bank Securities
ECONOMIC RESEARCH
AND STRATEGY

Tactical Asset Allocation (Feb. Update): The Coronavirus Starts to Destabilize the Economy but not Equities

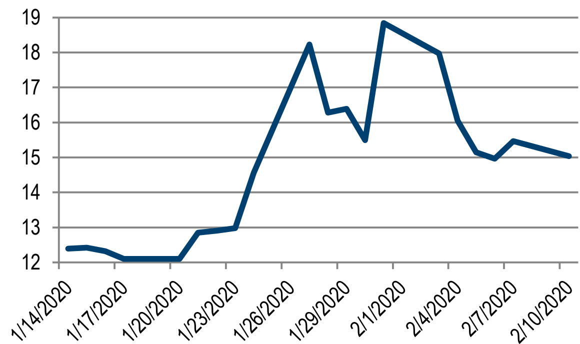
During the last couple of months, we have been recommending to slightly overweight stocks versus bonds. This somewhat riskier stance has boded well for our tactical asset allocation in December, but has rendered a slight underperformance in January. The coronavirus outbreak late in the month has triggered a risk-off reaction in markets and a rise in volatility (charts 1 & 2). For the month of January, government and corporate bonds registered gains of 2.9% and 2.6% respectively. Conversely, the MSCI World ex. U.S. declined 1.9%. The biggest loss came from the MSCI Emerging Market index, down by 4.7% during the month. The S&P 500 ended mostly flat for the month while the S&P TSX increased by 1.7%.

Chart 1: Assets Performances Since January 20



Note: Performance from January 20 to February 10.
Source: Bloomberg Finance L.P., LBS Econ. Research & Strategy.

Chart 2: Implied Volatility of the S&P500 Index (VIX)



Source: Bloomberg Finance L.P.

Starting the year 2020, some grey clouds have cleared off but have been replaced by others. The much awaited phase 1 trade deal has been signed on January 15, the USMCA agreement has been ratified by the U.S. and Mexico and the U.K. has finally left the EU. These events have briefly provided market participants greater confidence during the first half of January. Since then, the coronavirus has been at the forefront of financial news.

Many compared the potential effect of the coronavirus to the SARS outbreak of 2003, which only shed 0.1% of global GDP that year. More generally during past episodes of disease outbreaks, equities have quickly recovered within one month from the initial hit to economic activity. However, investors cannot jump to conclusions simply by looking at past pandemics because the economic context is very different this time. First, investors cannot take refuge in government bonds as easily because global risk-free interest rates are ultra-low today. Second, since China makes up around 16% of global GDP now compared to 4% in 2003, any Chinese economic slowdown now have greater global ramifications than in the past. Third, public and private debt in China has soared, making Chinese companies and state-owned businesses more vulnerable to a slowdown scenario. Fourth, the Chinese economy was already witnessing its softest pace of growth in three decades last year. Fifth, public health experts are still trying to assess the severity and duration of the coronavirus. Altogether, the economic pain related to the coronavirus could be easily greater than during other pandemics such as SARS. The Economist Intelligence Unit from the Economist magazine estimates that the virus outbreak could reduce Chinese real GDP growth in 2020 by 0.5 to 1.0 percentage points.

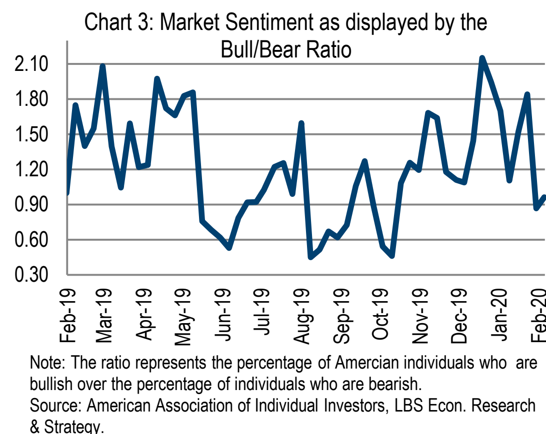
As of today, we know that measures aiming containing the global spread of the virus such as quarantines, travel bans, store closures and factory shutdowns unsettle part of the global supply chain and disrupt economic activity in the short-term. If the outbreak is contained soon, the dip in economic activity will be short-lived and restrained for the most part to China. Under a more severe scenario where the virus widely spreads to various parts of the world, it

would have larger systemic second-order effects in a broader number of sectors. Thus, the coronavirus gives rise to an asymmetric risk to our outlook: only downsides and no potential upsides. Accordingly, a prudence stance is warranted from a tactical asset allocation standpoint.

Also, the turnaround in market sentiment related to the coronavirus is observable in several metrics. For instance, the Bull/Bear ratio dropped to its lowest level since the U.S. and China negotiated a trade deal last October (chart 3). Similarly, the Fear & Greed index, which determines what emotion is currently driving the market, stands at a neutral level now versus extreme greed a month ago. In addition, the gold-to-copper ratio, a good indicator of risk tolerance, hit its highest level since September 2016 (chart 4). Finally, the S&P500 P/E 12m forward-to-VIX ratio has edged down closer to its historical average. At the same time, those indicators have not deteriorated yet to a point where the market could be deemed oversold, sending a buy signal for equities.

All in all, we decided to decrease our equity allocation from overweight to neutral compared to the benchmark. We have also added, for the first time, a cash allocation at the expense of equities, which would hedge the portfolio against major losses tied to a viral coronavirus outbreak with long-lasting negative economic effects.

If we see clear signs that containment measures are effective, the cash allocation would allow a rapid deployment of capital towards emerging market equities, IT and airlines stocks and copper futures. For the moment, we are not recommending to underweight equities. The last time we did so, with a 45/55 stocks-bonds allocation, we were at the peak of the U.S.-China trade war at the end of summer 2019. According to the Bank of Canada, that episode slashed around 1% of global GDP in 2019.



Note: The ratio represents the percentage of Amercian individuals who are bullish over the percentage of individuals who are bearish.
Source: American Association of Individual Investors, LBS Econ. Research & Strategy.

Source: Bloomberg Finance L.P., LBS Econ. Research & Strategy.

U.S. equities still in favor despite coronavirus

Mainly due to coronavirus worries, as of February 7th, analysts lowered earnings estimates for the S&P 500 for 2020Q1 by 2% based on Factset EPS estimates. The biggest downward revisions came from the materials and industrials sectors. As the number of infected persons increased, we notice further declines in 2020Q1 earnings estimates for companies highly dependent on China for both manufacturing and sales. For example, consumer discretionary companies relatively more dependent on Chinese consumption are expecting a short-term slump in revenues. The auto industry is also vulnerable due to a shortage of Chinese parts used in the manufacturing process. The same applies to electronics manufacturers. As a result, we underweight the following U.S. sectors: materials, industrials, consumer discretionary and technology. We also underweight the energy sector as a prolonged period of low crude oil prices will erode the ability of U.S. shale producers with weaker balance sheets to face their financial obligations.

Although the coronavirus exposes financial markets to a new risk, let us not forget that most factors still support the U.S. equity market. The phase one trade deal has alleviated some of the geopolitical uncertainty and contributed to

improve manufacturing activity lately. For instance, the January 2020 Manufacturing ISM returned in expansion territory for the first time since July 2019. The new orders component also reached its highest level since June 2019. Furthermore, China has started to satisfy parts of the trade deal by halving tariffs on US$75B of imports from the U.S, effective February 14th.

As mentioned in previous months, the U.S. consumer is supported by a sturdy labor market displaying a stronger positive trend in job creation lately (chart 5). Also, some of our short-term indicators further reiterate our positive views towards U.S. equities relative to other developed markets. These include a tightening in lending standards in the Euro area versus the U.S., a larger spread between U.S. and Germany unemployment rates, cheaper crude oil prices and lower copper prices. For the above reasons, we maintain our overweight position in U.S. equities despite the coronavirus. We specifically overweight utilities, financial, health care, telecom and consumer staples that rely on domestic revenues.

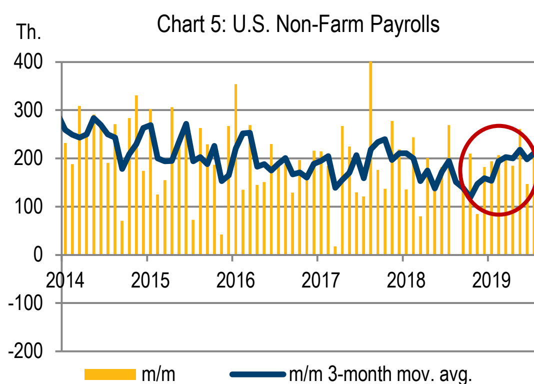


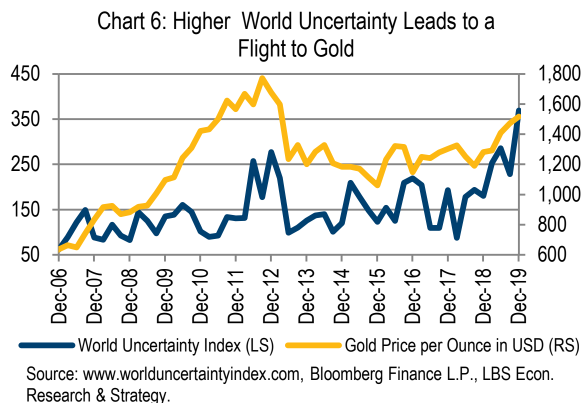
Chart 5: U.S. Non-Farm Payrolls

Source: BLS/Datastream, LBS Econ. Res. and Strategy.

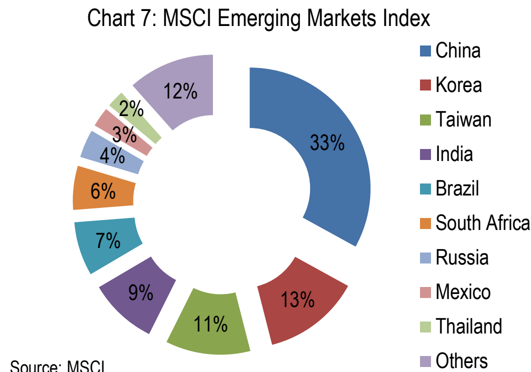
Underweight Canada, emerging markets and other developed countries equities

Compared to last month, we decreased our allocation to Canada and became underweight relative to the benchmark. So far, the coronavirus outbreak has mostly impacted oil prices and other commodities. China notably imports 20% of crude oil globally and represents 14% of global consumption. It is also the second biggest user of jet fuel after the United States. This news does not bode well for the Canadian energy sector, which constitutes approximately 16% of the TSX Index. From a shorter term perspective, a lower price momentum for emerging markets versus developed ones usually leads to Canadian equities underperformance; a factor supporting our underweight allocation to Canada.

From a sectoral perspective in Canada, in line with our reasoning for U.S. sectors, we overweight the TSX sectors with revenues generated mostly from domestic activity. Furthermore, a lower U.S.10 year government bond yield and a still overvalued S&P500 as per our fair value model are short-term indicators favouring TSX defensive sectors. As a result, we overweight the financials, telecom, utilities and consumer staples. Also, the utilities sector displays a strong price momentum and the consumer staples and financial sectors display a strong earnings momentum. We exclude the materials sector, which generates approximately 35% of its revenues from Asia. However, we recommend a stronger allocation to gold, as it can prove beneficial in times of elevated uncertainty (chart 6).



Source: www.worlduncertaintyindex.com, Bloomberg Finance L.P., LBS Econ. Research & Strategy.



Source: MSCI.

In the emerging markets space, we have the lowest allocation versus our benchmark since the peak of the trade war last September. China makes up one-third of the MSCI Emerging Markets Index. Asian countries along with India make up 69% (chart 7). The effect of the Chinese slowdown has begun to trickle down to neighboring economies such as South Korea. The latter is heavily dependent on Chinese tourism and Chinese automobile supply chains. Southeast Asia, especially countries like Thailand and Vietnam, is equally vulnerable as the area is a key destination for Chinese travel and is deeply linked to the Chinese economy. Those countries have also a lower level of healthcare capacity, potentially making the situation riskier for them. India also starts to feel the pain from a prolonged outbreak specifically through its tourism, aviation, electronics, automobile and entertainment industries.

Finally, we underweight other developed markets, which include Japan and the Euro Area. Japan, which has among the highest cases of coronavirus infections outside China, faces higher prospects of a worsening in consumption locally. In addition, spending from Chinese tourists represented 37% of all tourism spending in Japan in 2019. Furthermore, Nissan, the second largest automaker in Japan has stopped production due to the disrupted supply chain with China. On the European side, a potential halt in automobile manufacturing due to the lack of availability of needed components from China will negatively impact exports for countries like Germany, France and Italy. Also, several luxury retailers, mainly listed on European stock exchanges, already reported that they expect to witness a significant decline in their revenues at home and abroad due to weak consumer spending in China.

Taking a defensive stance within the bond allocation

We have decided this month to reduce credit exposure relative to our benchmark to a 75/25 government/corporate allocation, in line with our general defensive approach. A downward trend in the Citi earnings revisions index is not supportive of corporate profit margins. Also, a negative momentum in the U.S. consumer confidence index and a tighter spread are reliable metrics which suggest reducing our corporate bond exposure.

Recommended Portfolio as of February 2020				
Asset Classes & Regions	Recommended Weightings (%)	Benchmark Allocation (%)	Over/Underweights (%)	Recommendation
Bonds	46 (45)	50.0	-4.0	-
Government	34.5 (31)	34.4	0.1	+
Corporate	11.5 (14)	15.6	-4.1	-
Equities	50 (55)	50.0	0.0	=
Canada	18 (20)	20.0	-2.0	-
United States	20 (20)	16.0	4.0	+
Other Developed Markets	10.6 (11.6)	11.6	-1.0	-
Emerging Markets	1.4 (3.4)	2.4	-1.0	-
Cash	4 (0)	0.0	4.0	+

Note: Numbers in brackets represent previous month allocation.

Source: LBS Economic Research and Strategy.

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