

INDEX House View

Since January this year, in the fifth month since the emergence of the Coronavirus in China, the country has begun slowly to return to a normal social and economic life. While Wuhan City is still locked down, the rest of the Hubei region and the country are gradually re-igniting business. Since trouble arrived in December, China seems to have effectively stopped the rise of infected cases by locking down the epicenter of the contagion. The economy has indeed suffered a -20% contraction in Q1, with more damage to come in Q2 quite probably. Assuming the official numbers and news are to be trusted, the Communist Party appears to have achieved control over the disease through a Big Brother grip on its population. But has it really?

Anthony Fauci, director of the National Institute of Allergy and Infectious Diseases in the US, and the poster face of the American fight against Coronavirus, tells us the mortality of this disease is about 1%, i.e. 10 times that of the seasonal flu we all get. If that is true - the source seems trustworthy - then 42,336 deaths globally mean the infected are over 4 million people, not 860,000. If we use this datapoint with the recent news that China forgot to stop 7 million people exiting the Hubei region before locking it down, and the further datapoint that many also left New York state before it was locked down, it then seems logic that either some country is not being forthcoming about the real situation - maliciously or innocently - or that the fight is rather far from over.

This is probably what President Trump has realized last night in his latest press conference. Somebody, probably Dr. Fauci, has managed to inculcate into the President's mind that this disease is (1) not another seasonal flu and (2) that more pain is to come. In such extreme situation, it is unfortunate that the Trump administration disbanded the team responsible for pandemic response on the National Security Council at the White House, cutting funding to the Federal Emergency Management Agency. The country is now paying the price of being unprepared to exactly this kind of emergency. Enough facts are today available to say that even though the state of New York will reach its peak in 2 or 3 weeks, the rest of the country is in for a longer challenge. These considerations make the choice of a date for re-opening the economy more political than realistic, as seen with the postponing of the deadline of Easter to April 20 and probably May.

What does all this mean for markets?

Markets are waiting for a date for the US economy to re-open, that's simple. Uncertainty over when exactly that will happen has already costed an average loss of 20% of US equity market value. This uncertainty might continue for a while, as the fight is now against uncontrolled contagion and a vaccine seems still months away. The higher the uncertainty, the higher the chance that the authorities' liquidity interventions will not hold well against the sudden drop of economic productivity. As fundamentals tank across the board, people will be laid off while Western companies try to repay a heavier debt load. The high yield sector of the fixed income world is already in a distressed state - zero investors' appetite there. The investment grade sector, the only one receiving government support, is enjoying better liquidity conditions but is also shrinking in number of companies - as they are being downgraded to high yield status. The government bailout of vulnerable and essential economic segments - i.e. airlines and banks - is welcome in the short-term, but it risks to become dangerously unsustainable if the entire country's economy ends up depending on it in the long term.

In light of these considerations, a further drop in equities is not so illogical to expect. Being prepared for one is also supported by past experience, where the S&P 500 lost between 40% to 60% even with heavy authority interventions.

In the present conditions of high volatility and uncertainty, valuing any business in the very short term is rather difficult, but also rather useless. Since we are long-term investors, we prefer to ask ourselves (1) whether the current valuations are low enough to start buying, (2) which part of the capital structure we want to buy, and (3) which companies we believe will maintain their competitive advantage in 5 years.

Our answer to (1) is that, while equities have indeed reached astronomical valuations 4 months ago, it is also true that they are now touching the fair price range. In our experience, excellent businesses very rarely reach dirt cheap valuations, unless of course a major economic crisis hits the markets. Regarding (2), equities currently present more upside than bonds for specific companies. This is because the fixed income market has reached yields that are pretty much contrary to the concept of capital growth, while exposing our money to more downside than upside. On (3), we already began accumulating a number of equities - not bonds - that we believe will do well with the present test and maintain their competitive advantage in the coming 5 years. These companies include luxury, consumer staples, agriculture, aviation equipment, automotive, pharma and very few tech. Each of these companies has an established product or service, is entrenched in its markets, enjoys high margins & returns and is in competition with very few incumbents.

Should market continue on their way down, we will continue accumulating selectively.

For further details, please contact:

INDEX & Cie Limited

Index Tower, 20th Floor, # 2001

Dubai International Financial Center

PO Box 507069, Dubai, UAE

www.indexcie.com

Tommaso Leodari

Chief Investment Officer

Email: tl@indexcie.com

Disclaimer

The information herein contained, including any opinions and any terms and conditions presented (the "Information") has been prepared and distributed by INDEX & Cie Ltd. (the "Asset Manager"), and is directed at, and related financial products or services are only available to wholesale clients (non-retail customers) who qualify as either Professional Clients (as defined in DFSA's Rulebook, Glossary Module ("GLO") or Market Counterparties (cf. GLO) under the Rules (cf. GLO) enacted by the Dubai Financial Services Authority ("DFSA"). This document is being furnished to the intended recipient solely for information purposes and no other Person (cf. GLO) shall act upon the Information. Any investment carries its own risks; the investor must be aware of the risks posed by an investment (cf. GLO) and is fully responsible for the risks incurred. The Information is not and cannot be understood as impartial investment research. The Asset Manager does not guarantee the accuracy or completeness of the information and the opinions expressed herein are the Asset Manager's opinions at the moment they are conveyed only and are subject to change without prior notice. The Asset Manager is not under any obligation to update or keep current the Information and the opinions expressed herein. Neither the Asset Manager nor any of its officers directly responsible for the Information (or a close relative - cf. GLO - of the latter) have a financial interest or material interest that relates to any on the investments herein recommended or suggested, nor the Asset Manager either, as far as the Asset Manager is aware of, any Asset Managers associate (cf. GLO) owns (unless stated otherwise elsewhere in this document) 1% or more of the total issued share capital of any of the Issuers (cf. GLO) mentioned herein. The Asset Manager does not act as a corporate broker to any of the Issuers (cf. GLO), although one of the Asset Manager's associates may act or have acted as such. The Asset Manager has not undertaken any corporate business with or for any of the Issuers over the past 12 months, nor has in the pipeline any future relevant corporate finance business initiative involving the latter, nor is a market maker (cf. GLO) in any of the investment recommended. None of the Issuers herein mentioned has a material shareholding in the Asset Manager. This document cannot be reproduced, in whole or in part, in any form or by any means, without the Asset Managers specific authorization and any distribution of the information on behalf of the Asset Manager is strictly prohibited. Neither this document nor any copy hereof may be sent or taken or transmitted into or distribute, directly or indirectly, in any jurisdiction other than the Dubai International Financial Center. Any failure to comply with this restriction may constitute a violation of the laws of the jurisdiction where the document is being redistributed. This document does not constitute or form part of, and should not be construed as any offer or sale or subscription of or solicitation of or invitation to make any offer to purchase or subscribe for any financial products or services and neither this document nor any part of it shall form the basis of or be relied on in connection with or act as an inducement to enter into any contract or commitment whatsoever. The Asset Manager does not accept any kind of liability for losses or damages which may arise from the use of this document or its contents, nor for the unlawful reproduction and/or redistribution of the same. The Asset Manager is duly licensed and Regulated by the DFSA.