Newsletter

April 2020

# 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