

March 5, 2020

MONTHLY



Global Investment Letter



Notable Inside This Issue:

- *Coronavirus Strategy - Take Refuge in US Treasuries*
- *Bearish on S&P and other Equity Markets*
- *Volatility Trade Closed at Large Profit*
- *Turned Bearish on Healthcare Trade*
- *Top Pick is US Treasury Bonds*
- *Expect Continued Strength By US Dollar*
- *Turned Negative on Gold*

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CORONAVIRUS/MARKETS AND SLINGSHOT MOVE?

This issue will be largely concerned with the Coronavirus both for its anticipated role as a catalyst for substantial market volatility and the lingering misperceptions about its nature. Our comments this month are by necessity more short-term in their orientation than is typical because of the emergence of the Coronavirus. Its effects will almost certainly be significant and will, in turn, influence the performance of capital markets once the pandemic passes. Investors' response to this threat will play a material role in determining their long-term investment results.

Examples abound as to the lack of understanding of the Coronavirus. It is commonly thought of as a type of influenza when it is not. As a result, it is presumed by many that the Coronavirus will fade as the weather gets warmer, like an influenza virus when there is no evidence that this will be the case. Also, the death rate is often referred to as being at 2% when, in fact, it is over 3% based on reported cases. Perhaps the 2% number is used because that was the lethality of the Spanish Flu of 1918-19 but the Coronavirus appears to be 50% more deadly.

The apparent ease of transmission and the long incubation period (up to 24 days) during which an infected person can spread the virus without demonstrating symptoms makes the probability of avoiding a major pandemic very low.

While the duration of the expected pandemic is unknown, its economic effects will surely be profound. Many conferences are already being cancelled, travel is being postponed, and the NBA is even contemplating playing games without an audience. Attendance at movie theatres, baseball games, etc., seem certain to be impacted. Sales at bricks and mortar retailers will likely also be affected. The negative potential of this virus will likely not be realized for several more weeks, by which time the number of cases in North America and Europe is expected to rise exponentially.

The markets in 2020 will be a battleground between the negative effects of the Coronavirus and the stimulus efforts of central banks and governments. We have already seen emergency 50-basis point interest rate cuts by the Fed and the Bank of Canada. We expect other central banks around the world to follow suit. As well, we anticipate that governments will institute fiscal programs to generate economic activity.

We believe that another 50-basis point rate cut will occur sooner rather than later and that U.S. rates may eventually move into negative territory if the recession caused by the Coronavirus is severe enough.

The effect of interest rate cuts and other measures may not be sufficient to avert a serious economic downturn as the effects of a serious Coronavirus outbreak will affect the levels of both supply and demand. The dampening effects on the economy of the virus will likely mitigate much of the significant stimulus that we expect will be applied to the economy.

The likelihood of further aggressive rate cuts by central banks makes US Treasury bonds the clear choice for investors. There are no compelling reasons to hold major positions in equities at this point given the clear economic risks and lack of clarity as to the duration and severity of the pandemic. In the presence of great uncertainty preservation of capital is paramount.

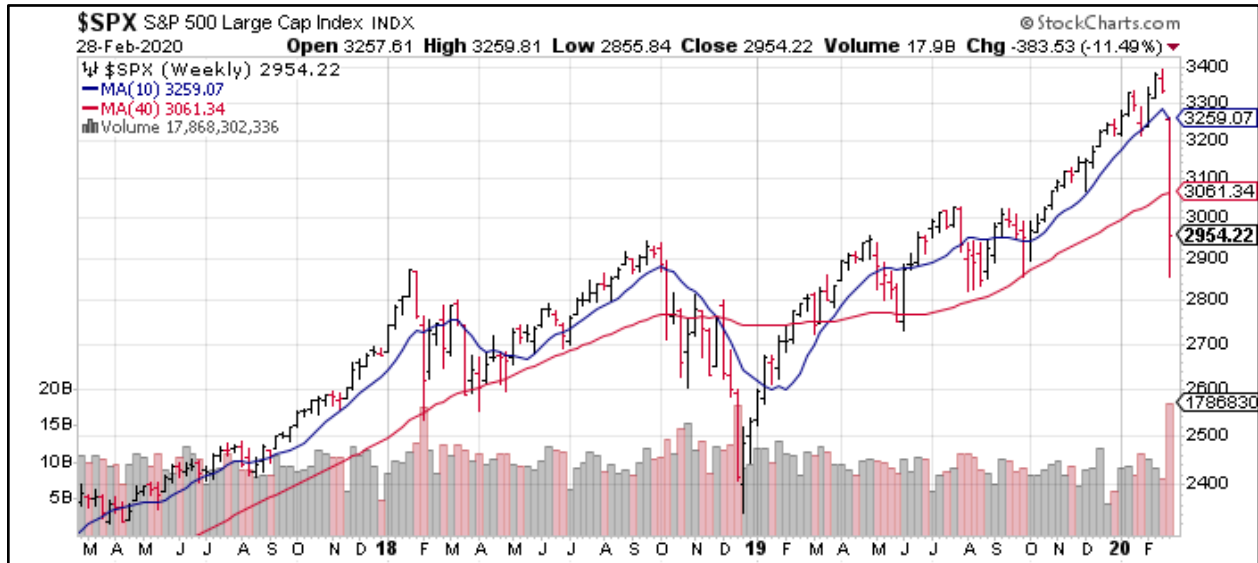
Ironically, the Coronavirus may ultimately present a great buying opportunity for equity investors in the form of what we call a “slingshot” rally. When the Coronavirus eventually subsides, the pent-up demand produced by the economic downturn combined with the stimulus efforts should produce a very sharp economic rebound. The strength of the rally will be amplified by the depressed levels of stocks most impacted by the Coronavirus. But that may not be for some time yet...

The behaviour of capital markets in 2020 will be highly dependent on the duration and severity of the Coronavirus pandemic. We are erring on the side of caution and presuming that the outbreak will have serious economic consequences. Our view is not currently shared by equity markets....or they would be significantly lower.

We may be proven to be over-estimating the effect of the virus on North America and Europe, but we think it wise to take cover in US Treasuries for the next 3-4 weeks until more clarity is available on the nature of the pandemic.

EQUITIES COMMENT

S&P 500 (WEEKLY)



The S&P 500's late February collapse inflicted considerable technical damage on this index. The decline negated the gains produced by the rally that began last fall. The failed breakout and close below the long-term 40-week moving average are both very bearish from a technical standpoint.

From a fundamental viewpoint, the Coronavirus is certain to negatively impact earnings for at least two quarters, and likely longer. The severity of the economic effects remains uncertain, but the example of China suggests it will be significant.

On a positive note, the S&P 500 did manage to finish the month well off the lows, which could furnish a measure of support. A pause in the decline can be expected as the effects of the Fed rate cut and short-covering are felt.

However, no clear market bottom has had time to emerge, and we think the potential for a V recovery at this point is low given our views on the serious nature of the Coronavirus. It is not only the economic but the psychological aspects of the pandemic that markets must contend with.

At this juncture, we are inclined to limit exposure to equities and seek refuge in US Treasury bonds.

While we see the potential for an unusually attractive buying opportunity in equities when this outbreak passes, we do not know at this time when that opportunity will be presented. In the interim, we see more downside risk than upside potential in common stocks.

VOLATILITY TRADE

S&P 500 VOLATILITY INDEX (VIX) (DAILY)



We noted the contraction of the S&P 500 Volatility Index (VIX) to to the circa 12 level late last year. Low levels of implied volatility reflect investor complacency. Complacency often precedes significant market declines. The mean-reverting nature of volatility suggests that muted volatility will be followed by a compensating period of above-average market turbulence which is typically associated with market declines.

The circa 12 level also appeared to represent major support for the VIX, producing an attractive risk/reward trade.

The VIX soared on the market weakness in late February and we sold our position in the circa 45 area. The VIX position was closed then because the price was nearing the high of the previous sharp market downturn in late 2018. The level at which to close the trade is subjective, our experience suggested that as a reasonable price target.

The almost 300% increase in the VIX left room for satisfactory returns for a variety of sale price points.

We will revisit the volatility trade when another opportunity is presented. That will most likely be a return to very low levels in the VIX. Less likely, will be an extremely high level in the VIX that would warrant selling volatility. At this point, we are neutral on the VIX.

iPath S&P 500 VIX ETF (DAILY)

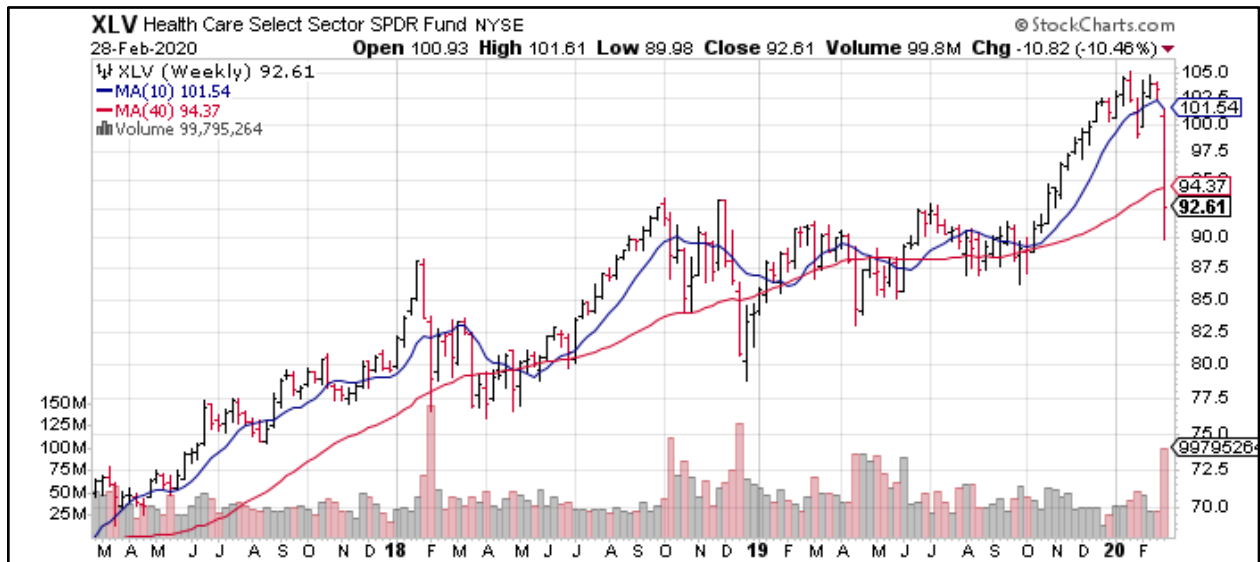


We use an ETF to serve as a proxy to illustrate a trading idea, in this case, we use the iPath VIX ETF. The sale of the ETF that corresponded to the 45 level of the VIX was circa \$24. That represents about a 100% return on the price when the trade was first discussed.

There are, of course, alternatives to using ETFs to implement trading ideas. In the case of the VIX, the derivatives markets would have yielded a return more closely matching the increase of the VIX than the iPath ETF. However, not everyone is comfortable trading derivatives and a 100% return in an ETF is certainly acceptable.

HEALTHCARE TRADE

HEALTH CARE SPDR ETF (XLV) (WEEKLY)



That even the healthcare sector participated in the sharp decline is a reflection of the comprehensive response by the market to the Coronavirus.

Healthcare was one of the most bullishly positioned sectors heading into February, having staged an impressive breakout in November. As well, the fundamental picture was positive, with the sector's valuation metrics being below long-term averages.

The failure of its recent breakout compels us to change our formerly bullish view as further price weakness, as with the general market, would not be surprising.

The fading chances of Bernie Sanders becoming the next President, or even the Democratic candidate, reduces the likelihood of major changes to the U.S. healthcare system. While the Coronavirus may also financially benefit some aspects of the healthcare industry, the effect is expected to be transitory and will be mitigated by the more general economic influence of the Coronavirus.

While the risk/reward for allocating capital to equities is currently less than attractive, the healthcare sector may well be a leader of an eventual market rebound. The factors that produced the sector's recent strength may again propel healthcare stocks higher in a new market rally.

FTSE 100 (DAILY)



The chart of the London FTSE chart above needs little elaboration. As with other markets, the FTSE was affected by the recognition of the threat posed by the Coronavirus. As well, the ongoing lack of progress in reaching a Brexit separation agreement with the European Union, combined with a growing awareness that a sweetheart trade deal with the United States is increasingly unlikely, has diminished expectations for UK equities.

Our long-term bearish view of the FTSE remains. In our opinion, broad exposure to the FTSE should continue to be avoided.

DAX INDEX (WEEKLY)



We have on numerous occasions commented on the unattractive risk/reward potential of markets approaching major resistance points. The rationale behind our caution was aptly demonstrated by the actions of the DAX in February.

We maintain our bearish view of the DAX. The effects of the Coronavirus are a factor, but we remain more generally worried about the health of the European economy. Also, Germany is particularly vulnerable to an escalation of American protectionist trade policies directed at the European Union, which we expect in 2020, due to its dependence on exports.

CAC 40 (WEEKLY)



The Paris CAC 40 Index, which was one of our favourite equity bourses, suffered the same sharp reversal as other major markets in February. A good deal of technical damage has been done to this market with the failure of its recent breakout.

We must, therefore, change our bullish view in response to changing facts. We will remain alert for a new buying opportunity as we believe the CAC may well be the leading European equity market in the event of a new market rally given its previous strength and France's lesser vulnerability to protectionist trade policies than other European nations.

NIKKEI INDEX (WEEKLY)



As with the DAX, the Nikkei had been approaching major resistance at the circa 24000 level, and like the DAX, it was followed by a sharp price reversal.

The lack of a clear trend for the Nikkei has caused us to avoid commitment to this market. We continue to await a resolution to its narrow trading range over the past two years.

SHANGHAI COMPOSITE (WEEKLY)



The Shanghai index has performed surprisingly well given that China is the epicentre of the Coronavirus outbreak.

The index did experience a sharp decline, but then recouped a good portion of its losses. Of note is the bullish reversal bar posted in February.

It is still too early to reach any definitive conclusions about the Shanghai Composite, but its behaviour may offer important clues as to how other markets will respond to the pandemic. As China was the first economy affected by the Coronavirus it may be the first to recover.

We continue to treat the Shanghai market with caution, given the unpredictability of the virus outbreak, but would be inclined to a more favourable view on a move to the circa 3100 level.

SENSEX (WEEKLY)

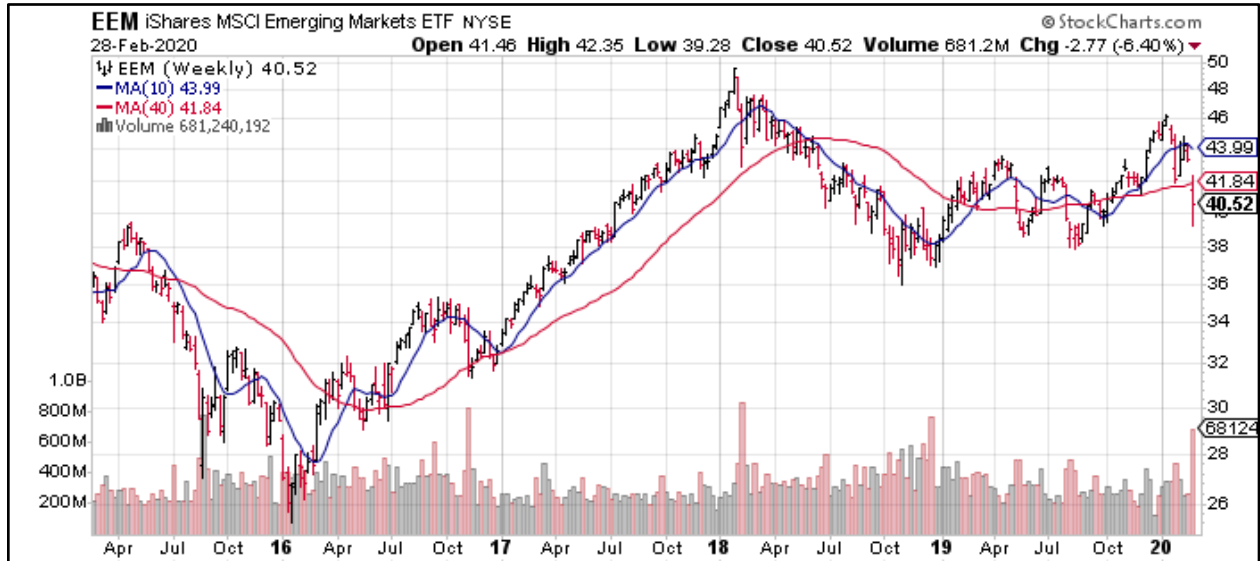


The drop in the SENSEX has produced a failed breakout, which negates our previous bullish view. We had alerted our readers to this possibility in previous issues.

An emerging market such as India will be particularly vulnerable to a Coronavirus pandemic. The dense population will accelerate the transmission of the virus while its medical infrastructure is less equipped to cope with a pandemic than those found in developed markets.

India remains our favoured emerging market for the long-term, but significant downside risk exists for this market at present. We are bearish on Indian equities until more clarity is available on the ultimate course of the Coronavirus or until a clear buying opportunity presents itself.

EMERGING MARKETS ETF (EEM) (WEEKLY)



As with the preceding comment on the Sensex, we believe emerging markets will prove more vulnerable to a pandemic than developed markets, creating the potential for even more downside risk.

Our proxy for emerging markets, the EEM ETF, is already trading in a bearish mode. A move below the circa 38 level suggests a worst-case scenario of a decline to the 2016 low of circa 26.

As such, the risk/reward for the EEM is decidedly bearish and thus we see no reason to change our bearish view initiated in the February issue of this letter

FIXED INCOME COMMENT

10-YEAR US TREASURY NOTE (WEEKLY)



Our bullish view of US Treasuries continues to be well rewarded. The anticipated temporary stalling at the circa 132 level was effectively eliminated by the emergence of the Coronavirus.

The 10-year Treasuries have now broken out to new highs, which suggests much higher prices ahead. The aggressive 50-basis point rate cut by the Fed on March 3 in response to the anticipated negative economic effects of the Coronavirus will likely not be the last rate cut we see this year. As well, we expect Treasuries to benefit from capital inflows from the equity markets as well as continued capital flows from foreign investors seeking a haven.

We remain very bullish on US Treasuries.

CURRENCY COMMENT

US DOLLAR INDEX (DXY)(WEEKLY)



The US Dollar Index (DXY) weakened in the last week of February, coincident with the decline in stock markets. The DXY was also put under pressure by assumptions that the Fed will resume its interest rate cuts, narrowing the interest rate differential enjoyed by the dollar versus other major currencies.

We remain bullish on the dollar and favour it over all other currencies. We do expect the Fed to cut rates this year but we also expect other central banks to behave in a similar fashion such that the interest rate differential will not narrow materially. As well, we anticipate that the dollar will continue to benefit from positive capital flows from the European Union and from Japan, where interest rates are negative. Lastly, the dollar remains the world’s reserve currency, which assures it will continue to be the recipient of capital flows seeking shelter from economic and geopolitical risk.

For these reasons and the lack of a compelling alternative, we remain bullish of the US dollar.

CAD/USD (WEEKLY)



We have long maintained a bearish view of the Canadian dollar versus its American counterpart. The sharp decline in the price of oil has been a major factor in the Canadian dollar’s decline. The high correlation between the Canadian currency and oil should not be ignored in forecasting its price.

Our bearish view continues, in keeping with our ongoing concerns about the price of oil. The rate cut of 50 basis points by the Bank of Canada, to match the Fed, in early March will put additional pressure on the Canadian currency. The next level of support is at the .73 level. If that is breached, a decline to the circa .69 level is a high probability.

EUR/USD (WEEKLY)



The euro rallied against the US dollar in late February but is still trading bearishly below its long-term 40-week moving average.

As discussed in the US dollar comment, we believe a good part of the strength on the part of other currencies versus the dollar over the past month rests with assumptions about aggressive Fed rate cuts slashing the positive interest rate differential enjoyed by the dollar. Presumably, the thinking in Europe is that with interest rates already in negative territory, The European Central Bank (ECB) has little room to manipulate rates. I think this notion is naïve given the brave new economic world we've inhabited since the 2008 Crisis. I believe the ECB will be willing to make interest rates even more negative in a bid to force cash balances into other asset classes. Under this scenario, the interest rate differential will likely remain significant, which will continue to favour the US dollar.

We remain bearish on the euro based on the interest rate differential as well as our trade and geopolitical concerns discussed in previous issues.

POUND/USD (WEEKLY)



The pound weakened against the US dollar in February and finished the month just above its long-term 40-week moving average.

It is worth noting that the pound has fallen steadily since the probability of Brexit rose to essentially 100%. We did get the expected short-term sentiment-driven move on a definitive decision on Brexit, but the move was not large enough to generate a sufficiently positive risk/reward trade opportunity to present to subscribers.

We remain bearish on the pound. The UK economy is sluggish, negotiations with the EU on an exit agreement remains problematic, and the relationship between Boris Johnson and Donald Trump has soured over Huawei. Britain cannot expect a sweetheart trade deal with the United States.

The next year is likely to be difficult for both the British economy and the pound.

YEN/USD (WEEKLY)



The yen strengthened against the dollar in late February, which likely had more to do with temporary dollar weakness than the merits of the yen.

The yen has traded without a clear direction for quite some time. We continue to think it best to avoid the yen until a definite trend is established.

YUAN/USD (DAILY)



The yuan continues to trade around the psychologically important 7 area following the signing of “Phase One” of a trade agreement with the United States.

The Chinese economy is certainly the most affected by the Coronavirus thus far, which may ultimately be reflected in the value of the yuan. The Chinese must weigh the economic benefits of a yuan devaluation against the potential political ramifications with the United States.

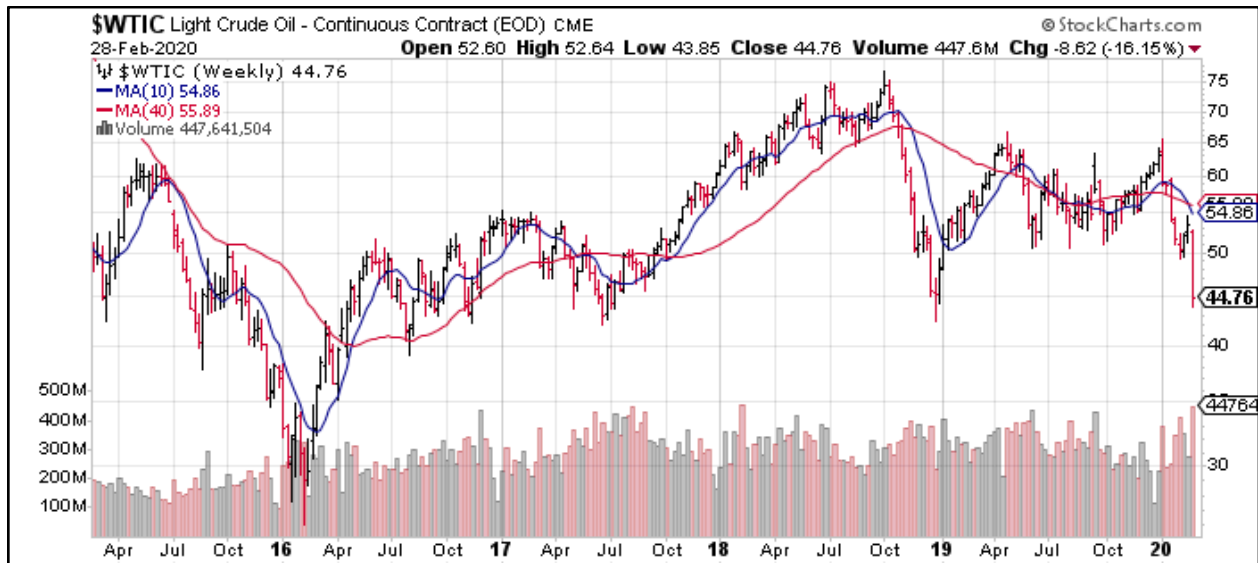
The opinion of the United States may carry less weight than previously, in light of the Huawei controversy and a host of other issues that have ratcheted up the adversarial stance of the two nations.

If the impact of the Coronavirus is serious enough, the Chinese will devalue. A move through the 7.2 level will be significant.

In any event, we continue to believe the path of least resistance is a weaker yuan in the long term. As such, we do not advocate unhedged exposure to the yuan.

OIL COMMENT

CRUDE OIL (WTI) (WEEKLY)



Oil moved sharply lower in February as concerns regarding demand associated with the Coronavirus pummeled prices. Oil closed the month at a key support level. A break below the circa \$44.75 level would suggest a fairly swift move to \$40.

The undisputed damage that the Coronavirus has inflicted on the Chinese economy will certainly reduce the size of China’s typically huge requirement for imported oil. A more general reduction in global demand for oil can be expected as the Coronavirus spreads.

OPEC may attempt to support oil prices with further production cuts. However, OPEC members may lack the discipline to further reduce production levels. As well, Russia has indicated that it will not match further production cuts by OPEC. While the drop in prices may slow or reduce US shale oil production, the effect is not expected to be significant for oil prices.

We maintain our bearish view on oil, with the caveat that geopolitical events could produce a price spike at any time. As such, oil is not a market we would short.

DEFENCE SECTOR COMMENT

US AEROSPACE & DEFENCE ETF (ITA)(WEEKLY)



The defence sector, as represented by our proxy, the ITA ETF, declined very sharply in late February. The general weakness of the equity markets was certainly a factor. The ETF's large position in Boeing (20%) served to exaggerate its price decline. Boeing's existing issues with its troublesome 737 model were amplified by more general concerns about deliveries of commercial aircraft because of the Coronavirus.

The technical damage to ITA is considerable and further downside is likely. We are suspending our bullish view of the sector until an attractive re-entry price presents itself.

The defence sector remains a key theme for long-term investors who are indifferent to potentially significant price retracements over the shorter term.

GOLD COMMENTARY

GOLD (WEEKLY)



The price of gold posted a strong increase in February before reversing sharply late in the month. This “reversal bar” is typically very bearish.

Most bearish is the weakness of gold in an environment in which it presumable should be strong. A price decline during falling equity markets and the threat of the Coronavirus is surprising and, hence, very bearish indeed.

We will take our profits from our buy signal initiated at the circa 1360 level and move to the sidelines until a further buying opportunity emerges.

ABOUT THE EDITOR

The Editor and Publisher of the Global Investment Letter is Jonathan Baird CFA. Prior to founding the Global Investment Letter, Jonathan spent more than 25 years as an award winning money manager in Canada, most recently winning a Lipper Award in 2010 for managing the #1 Global Equity Fund in Canada. Jonathan managed several #1 ranked funds over the course of his career as a money manager, investing in all major industries, asset classes and markets. Along with his interest in the world of investment, Jonathan has been a lifelong student of history and uses the lessons of history to help interpret and provide context to current events. Jonathan no longer invests money for others, managing only his own account. The Global Investment Letter represents his personal thoughts and opinions.

Jonathan well understands the difficulty of the investment process, and the essential role that quality information and opinion play in successful investing. Each monthly issue will contain comments on major markets, economics, geopolitics as well as investment ideas. There may also be discussion of investment philosophy or practices and reviews of books deemed of potential interest to readers.

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