

Supply chain disruptions, equity market falls, the COVID-19 survivors are rhodium, palladium and gold...

COVID-19...China and global supply chain disruptions.....China then US equity market falls.....welcome to 2020!

If you thought 2019 was volatile with the US-China trade war, 2020 is looking even worse. The US S&P 500 just dropped 10% so far this week, with the biggest one day points fall in history on Thursday.

Supply chain and metal markets disruptions stem from China

The coronavirus has massively disrupted much of China's industrial heartland in Hubei and nearby regions. The lock down and closing of factories caused a 92% fall in China auto sales in the first half of February. Naturally, all of this has had a significant impact on the metals markets as well as global supply chains.

Added to the car makers woes are manufactures of most types of goods, including consumer electronics. Apple has warned of global iPhone supply shortages, and analysts have estimated that the virus may slash demand for smartphones in China by half in Q1 2020.

Critical materials expert Jack Lifton commented to InvestorIntel:

"In China the main concern is the impact of the coronavirus on the Chinese government's control of the Chinese economy. In the USA the main concern is how the political parties can benefit most from hyping the coronavirus story. Politics is

trumping economics, health, and safety in both countries.”

Commodities are generally down with a few exceptions

Given the extreme February China slowdown and supply disruptions, most commodities have been sold off. The CRB Index is down 6.02% for the past month. The oil market has been particularly hard hit due to the Chinese lock down. Oil prices are down ~14.63% over the past month and iron ore is down 8.81%. Copper and nickel have so far been resilient, perhaps due to the fact they had already been beaten down from the trade war.

Of interest, the only commodities doing well the past month are rhodium (+29.69%), palladium (+23.07%), molybdenum (+6.61%), and gold (+3.36%). Rhodium and palladium are the key emissions metals whose demand has surged in 2020 due to tighter emissions standards in Europe and China, as we wrote about last year here.

A comparison of commodity returns over the past 1 month since the coronavirus worsened

	Crude Oil	Iron ore	Nickel	Copper	Cobalt	Gold	Molybdenum	Palladium	Rhodium
1 month return	-14.63%	-8.81%	-1.27%	-0.98%	1.52%	3.36%	6.61%	23.07%	29.69%

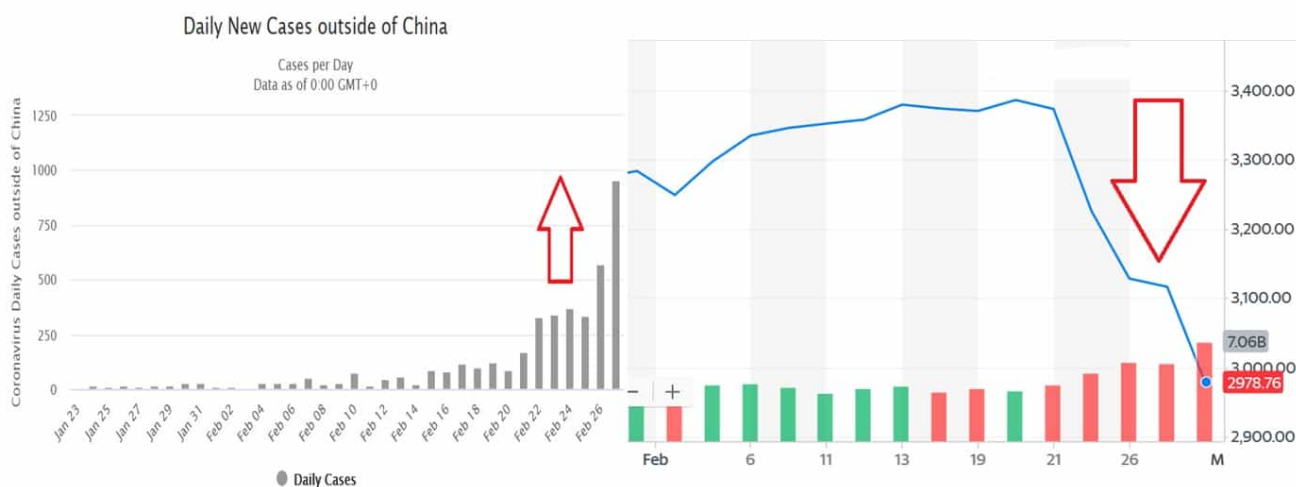
Source

Looking out to Q2, 2020 as Chinese factories are re-opening now and ramping back up, the demand for commodities is expected to resume. Of course, this will depend on the global coronavirus situation. If it worsens in the coming months and western markets also contract then we can expect H1 2020 to be a write off.

What To Watch Out For Next

The US equity market fall has been heavily correlated to the escalation of new coronavirus cases outside of China, as shown by the chart below.

As new cases outside China escalated from February 21, the US equity market started to fall heavily



Source: Worldometers.info/coronavirus

This means if the new coronavirus cases outside of China (especially in the USA) continue to escalate we can expect further downside (~10%) for US equity markets, depending also on the duration and extent of the disruption.

Gaining some equity market long term perspective

Whilst the past week's ~10% fall of US markets is concerning and indeed a sharp fall, investors can gain some long term perspective from the chart below of the S&P 500. Here are some thoughts to consider:

- US equity markets were about 20% overvalued before this week's 10% fall.
- Based on the long term trend line below, US equity markets could fall another 10% to reach approximate fair value. Current Price Earnings (PE) ratios would also support some further fall, even when taking into account low US interest rates.

Using the rule of 20 (which adjusts for interest rates) we could expect the US historical PE ratio to be at 18.25 (20 - 1.75). The current US historical PE is 20.9 as of February 26.

After yesterday's ~4% market fall the February 27 PE will update to ~20.1, and is therefore 10% above the 18.25 fair value figure.

The above valuation guidelines would suggest the US S&P 500 has a further 10% to fall to be back at fair value. Given it has already fallen 10% from its high an additional 10% would bring the total fall to 20%, should it occur, and we would officially be on the brink of a bear market.

Beyond that, it will depend on the severity of the coronavirus globally, and the economic disruption that may follow.

US S&P 500 1994 to Feb. 27 2020



Closing remarks

The massive China lock down in February has caused a huge disruption to global supply chains, especially given China remains the world's biggest factory. Effectively much of Chinese production of goods was lost in February, but looks to be heading back on track in March assuming the coronavirus does not worsen in China.

The oil market has taken a short term hit, while base metals have been resilient in February. Assuming we get a 'V' shaped economic recovery in China then March should see some signs of recovery in both the commodity and Chinese equity markets. Looking further out a full recovery will likely take several

more months, and will depend on how badly the coronavirus spreads globally.