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Coronavirus spread forces investors to think again

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Summary

As the humanitarian costs of the coronavirus continue to rise, outbreaks beyond China are challenging the previous consensus view that the impact on markets could be relatively contained. Global stock markets are down, and negative sentiment may become a self-fulfilling prophecy, adding to the need for caution and an active approach.

Key takeaways

- China has acted to bring the coronavirus under control, but global outbreaks will prolong uncertainty and stock markets across the world have been impacted
- While the outbreak is impacting demand – both in China and globally – there will also be global supply implications, particularly for the automotive and technology sectors
- We expect the dominant trend to be a "flight to safety" into the US dollar and US assets
- This crisis underscores the vulnerable outlook for global risk assets following a strong end to 2019, but long-term investors will want to sit tight and monitor how events play out

With official statistics suggesting that the coronavirus outbreak in China was coming under control, many investors concluded that the disease would have only a short-term impact on the global economy. But a marked uptick in cases outside of China – with significant incidences in South Korea, Italy, Iran and elsewhere – suggests the initial response to the virus may not have been rigorous enough and is challenging investor complacency. Concerns about the possible implications of a global outbreak are fuelling uncertainty, as the outbreak turns into a "black swan" event with far-reaching and as yet unpredictable implications. While the long-term impact may still turn out to be limited, investor sentiment is a key factor and the response of global markets has been broadly negative – European markets fell for a fourth consecutive day and the S&P500 has lost 7.9% in the past week. As some investors shift into perceived safe-haven assets, including gold and US Treasuries, this negative sentiment may become a self-fulfilling prophecy.

Global growth is facing demand and supply shocks

In China, the virus containment efforts will have a significant impact on the economy, with a sharp fall expected in first-quarter economic growth – potentially down to zero. With more than 10% of the country's population effectively in lockdown, consumer demand is depressed across multiple sectors. Luxury goods, travel, aviation, hotels and related sectors are potentially most vulnerable. Over the course of two weeks in January, as the outbreak first took hold, hotel occupancy across China fell from 70% to just 14%. Flights and travel have also been reduced or cut altogether, while retailers, cinemas, restaurants and casinos have been closed in major centres.

A fall in tourism will have an impact beyond China, particularly in surrounding Asian economies. Tourism is an important growth driver for the Philippines, Thailand and Hong Kong, which depend on revenue from tourists arriving from mainland China.

Overall, consumer demand has experienced a notable slowdown in China and elsewhere in Asia, and this subdued sentiment is spreading to Europe. Global growth could suffer a demand shock in the first half of 2020. In some sectors, such as automotives, this demand may be deferred; in other sectors, where spend is more discretionary, it will be lost for good.

Global GDP will likely take a hit

The size of the Chinese economy – and the extent to which it is integrated globally – leave the world economy highly vulnerable to any prolonged disruptions. Our estimates indicate that the global value chain can withstand up to a month of Chinese production outages, given current inventory buffers. If Chinese factories remain closed beyond February, the impact could cause production shutdowns and product shortages in other countries. The most vulnerable sectors include automotives and technology, and retailers could experience product shortages. In the US, estimates are for a GDP hit of 0.25% per month starting in March and growing thereafter. European companies with production facilities in China have begun to report that they are ramping up production, which could help provide some respite for global supply chains.

Central banks may need to act further

China and its financial system will likely need to support a serious cash crunch due to decreased economic activity – with reduced employment, production and taxation. Rising financing pressures could lead to credit withdrawals and resulting bankruptcies. Smaller enterprises are particularly vulnerable as companies face reduced demand, supply bottlenecks, labour shortages and wage pressures. Those with weak balance sheets or low capital reserves could struggle to survive and consolidation will be a key theme, with industry leaders likely to gain market share.

The People's Bank of China (PBoC) will continue to do all it can to ensure that smaller enterprises and related sectors do not collapse, having already cut interest rates – a move mirrored by the central banks of Sri Lanka, Malaysia, Mexico, the Philippines and Thailand. Whether central bank liquidity can boost economies and markets more generally is moot since the underlying economic fundamentals are seizing up quickly, and this additional stimulus may not be a panacea.

The longer the uncertainty continues, the greater the pull of safe havens is likely to be for investors. A strengthening US dollar could drain confidence from many Asian and emerging markets, especially against the worrisome backdrop of Argentina's debt restructuring. We expect the dominant trend to be a "flight to safety" into the US dollar and US assets.

Take an active approach amid continued volatility

Following a rally in the last quarter of 2019 on expectations of a recovering global economy, risk assets are looking stretched and vulnerable – particularly in growth and cyclical areas, which have seen over-positioning. The prevailing concern for investors is that the immediate outlook is clouded by the coronavirus – and the shape of any bounce-back is unclear.

With interest rates low – and expected to remain so – we continue to recommend that clients take some risk as there are still some good investment opportunities in markets. Long-duration assets – especially US treasuries – will continue to offer a hedge for many long equity positions, although these positions need to be tested for rising recession risks. Other global bond markets like Australia and New Zealand offer the same attraction and could be paired with the high USD yields in India and Indonesia to support a "hunt for income". In addition, given that large parts of the European market did not fully participate in the earlier rally, European equities may fare comparatively better in a market under pressure as the "height of fall" is lower than in other markets.

With governments and central bankers concerned that the coronavirus outbreak represents a serious "black swan" event, we think there could be more interest rate reductions and expansions of existing quantitative easing policies, which will support gold and related commodities.

With volatility rising, the case for being active is clear. Those looking to be contrarian, given the recent concentration into mega-cap US technology stocks, should consider revisiting unfashionable areas like UK equities, which were thwarted by Brexit. China A-shares, where the recovery within China will be felt first and sharpest, could be another opportunity. Investors with long-term horizons may choose to see how the crisis plays out before making any major moves.

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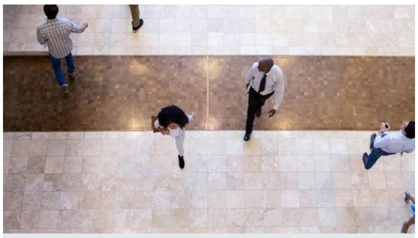

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10/03/2020

Summary

As covid-19 spreads, fear of uncertainty has gripped the financial markets. Equity and oil markets have fallen, and investors have flocked to investments perceived as safer, including government bonds (particularly US Treasuries), cash (particularly the US dollar) and gold. Is this the right move? We believe caution is warranted, but we also think investors should pause before reflexively hitting the panic button.

Key takeaways

- The global economy was already late in the cycle, with growth expected to slow in 2020, and the combination of covid-19 fears and oil-price shocks could now trigger a recession
- More emergency measures from central banks are likely: they see a high risk of financial contagion and are ready to supply limitless credit to their markets and economies
- As the price of oil falls, energy stocks and high-yield issuers could suffer, but we expect the strongest to survive and eventually prosper from this reset
- This risk-off environment could continue for some time; if so, look for quality companies with low leverage, stable cash flows and good dividend yields as the more vulnerable parts of the markets sell off

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