February 6, 2020

Novel coronavirus: A market view …

The global economy and financial markets are in quarantine

The coronavirus is not only having a serious human impact but is also affecting global consumer and financial market sentiment and comes at a time when the world economy can least afford it. While forecasts and calculations are difficult, we want to provide some thoughts about the potential economic and financial market impact.

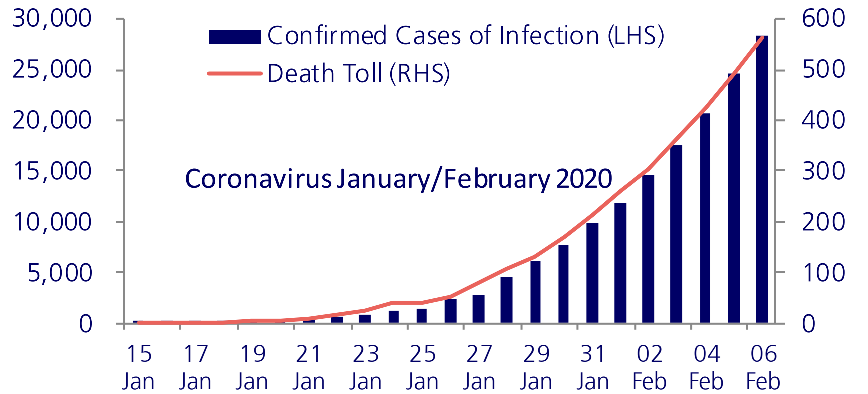
Source: iStock

"We are sure to be able to win in this battle to beat the epidemic through prevention and control."

Xi Jinping (China's President, quoted in NYT)

Even though the outbreak of 2019-nCoV, the novel coronavirus, first occurred in December last year in the city of Wuhan in China, it has only become headline grabbing over the last twenty days, when it was confirmed that the virus is spreading on a human-to-human basis. Since then public and social media reports about the virus and its implications have surged. Many reports have tried to find comparisons, with the outbreak of SARS, another coronavirus in China's Southern province of Guangdong back in 2002, being the prime example. We note that the confirmed number of people infected by the current coronavirus has already exceeded that of SARS and is accelerating faster, even though the fatality rate, currently below 3%, remains lower than the 10% reported during the SARS pandemic. Among the more than 28,000 confirmed cases, of which nearly 4,000 are critical, more than 200 have been reported outside of China. 565 fatalities have been reported so far in China, and one in the Philippines.

Coronavirus continues to spread



Source: National Health Commission of China, worldometers.info

Putting pandemics into perspective

Without being medical scientists, we note that there were more than 140,000 deadly cases of measles globally in 2018. The recent outbreak in Congo was reported at the same time as the Wuhan coronavirus and has been characterised as the worst measles pandemic ever. However, it has not been headline-grabbing. Malaria caused 405,000 fatalities in 2018, mostly in Africa, but also in Papua New Guinea, however, very few in developed countries have been affected. It is not widely known that in the same year there have been 1.5mn deadly cases of tuberculosis, nearly 100 times more than the current coronavirus has caused so far. Most fatalities occurred in the Southern hemisphere. In their report 'A World at Risk' the World Health Organisation (WHO) and the Word Bank criticise that there has not been enough focus on global preparedness for health emergencies and urge the world to be better prepared, as infectious disease outbreaks are increasing.

What makes the current coronavirus seemingly more dangerous than the other

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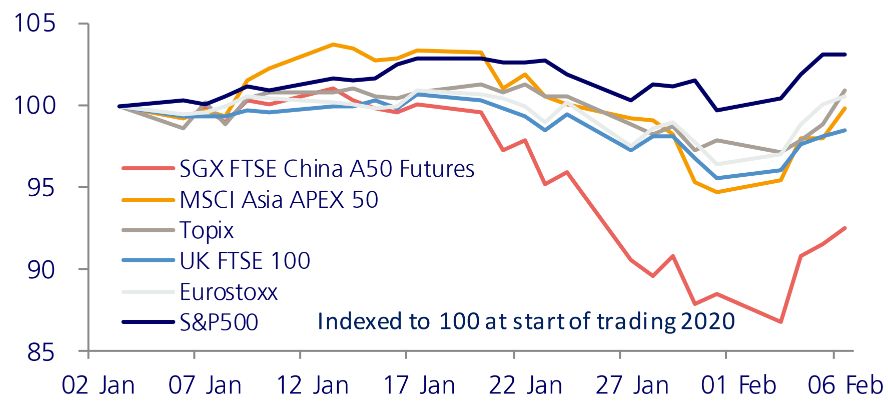
Shock and relief: Performance of equity market indices 2020



Source: Bloomberg

diseases mentioned is the fact that there is no vaccination available. While Chinese sources imply that an immunisation may be available within three months, Western physicians believe it will take more than a year. Another risk factor is the fact that the incubation period lasts up to two weeks, which increases the multiplier effect, as it was reported that about five million Wuhan residents left the city to travel during Lunar New Year holidays before a curfew was ordered.

China's global role has expanded significantly

In the eighteen years since SARS, China's economy has developed and opened up significantly, with the number of overseas Chinese tourists soaring amid higher disposable income and the range of destinations broadening significantly, which has increased the risk of infections. This is the main reason why the WHO has declared the coronavirus outbreak as a global threat. While the WHO believes that China's policies to curb infections are stringent, it warns of the virus spreading to populous nations with a less developed health system and political structures that may be less determined to impose tough measures to avoid infections.

How the international integration has advanced is exemplified by the case of a German company, where ten confirmed infections have been reported as one of the first person-to-person transmissions outside of China. The German automotive supplier, which runs 11 production facilities in China including Wuhan, had invited a Chinese employee from Shanghai, whose infection was only confirmed upon returning to China. A far more integrated global economy naturally goes hand-in-hand with higher infection risks.

Fears of another 'Spanish Flu' seem overdone

Fears that the novel coronavirus could end up being another 'Spanish Flu' of 1918-20, which infected 500 million people, about a third of the world's population, and killed an estimated 50-100 million, or 3-5% of the global population at the time, seem overdone.

We note that China's authorities have taken drastic measures to contain infection, including construction and operation of a 1000-bed hospital within only ten days. Other countries with confirmed or likely cases of infections have also applied a strict policy of quarantine. Globally, medical treatment and proper hygiene etiquette offer the potential for containment.

Investor fears appear to have spread quicker than the virus

We recognise that not only is the virus spreading, but that fear is spreading even faster, mainly through social media, impacting consumer and business sentiment. This makes it important to think about scenarios on how economies will be impacted.

Our core scenario assumes that the pandemic will peak relatively soon, as many other global and regional pandemics have done before. There have also been cases of a second, less intense wave. The question of the peak level of infections and the breadth of the bell-curve are needed to make somewhat reliable forecasts, however difficult this is.

China's retail, accommodation and entertainment sectors will suffer most

The prime impact will of course be seen in China. We assume that consumption will take the biggest hit. Not only have about 50mn people in the province of Hubei been confined, but many other spots have been closed to the public, with the Forbidden City in Beijing just one example. Public events have been cancelled, and travel agencies have had to cancel group tours. Popular public places are now deserted, while working from home is promoted. It is unavoidable that service sector activity will take a severe hit at least in Q1, with the retail sector, travel, catering and entertainment being most affected. Manufacturing should take less of a hit, but supply chain issues and workers not being able to travel back to their factories from their New Year holidays will make it difficult to run production as usual.

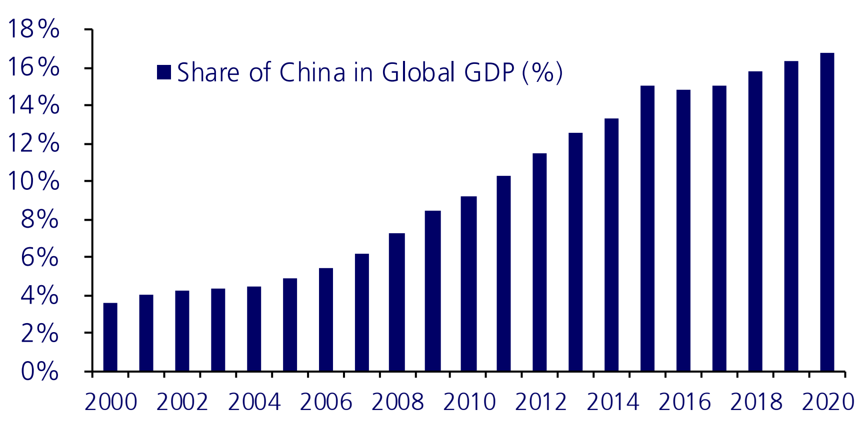
Despite encouraging economic indicators for December and early January, before the impact of the coronavirus escalated, GDP growth in Q1 will come under severe pressure and will be much weaker than previously expected. The big unknown is what happens in Q2, which depends on whether infections peak earlier or later. In the former case, a recovery should already be underway in Q2, accompanied by strong public support measures both on the monetary and fiscal front. However, if the pandemic continues to expand into Q2 before peaking, the recovery will set in later than in our base case.

Ambitious growth targets remain intact

2020 is an important year for China as it is the last year of the ten-year plan to double real GDP and income. Due to statistical revisions, GDP growth has been revised up by 0.1 percentage points in each year between 2014 and 2017, which enables China to achieve its minimum goal of 5.6% GDP growth in 2020. We believe the government will do its utmost to guarantee its growth target for 2020 that was decided at the Economic Work Conference last year but will only be officially announced at the National People's Congress in March. We believe a target of 'around 6%' is likely.

Due to the dramatic, unexpected consequences of the coronavirus, China's government will focus on re-establishing public confidence and will not let itself be restricted by self-imposed deleveraging policies. However, we believe these will be adhered to in the following years. Financial

China's economy has a much bigger impact now



Source: IMF

Mainland Chinese tourists are playing a major role in Asia

Source: WTTC, HSBC (AU=Australia, HK=Hong Kong, ID=Indonesia, JP=Japan, KR=South Korea, MA=Malaysia, PH=Philippines, SI=Singapore, TA=Taiwan, TH=Thailand, VN=Vietnam)

regulators clarified they had full confidence that they would be able to maintain stable economic conditions in the long term. Banks have been urged to increase lending to the companies most affected in the Hubei province and to lower borrowing costs. On Monday, net reverse repo liquidity was injected, while borrowing rates have been cut. Firms are also allowed to delay reporting results for 2019. We believe that private SMEs will again be at the centre of stimulus measures.

Asia will suffer from its high dependency on China

Next to China we need to look at the impact on other Asian countries, whose exports to China will be affected by slower domestic demand in China and production disruptions. In terms of the impact on each country's GDP, Taiwan would be most affected by far, followed by Vietnam, Hong Kong, Malaysia and South Korea. Even though China is Japan's biggest export market, its impact on Japan's GDP is limited, as domestic demand is the major driver for growth.

From the opposite perspective, Asian countries may also be impacted by disruptions to imports from China. This issue is less critical for imported consumption goods, but more dire for critical components to the production process for re-exports. Vietnam stands out, as value added imports from China made up more than 16% of its GDP over the last three years, followed by Malaysia, Thailand and Hong Kong. These countries would quickly need to find alternative sources in order to maintain their production and export levels.

Chinese tourists will be missed

Over the last ten years, Chinese tourism has expanded significantly both at home and abroad. In the third week of January, China's domestic travel agencies were ordered by the authorities to cancel all group tours, while various international airlines have stopped flights to and from China. In terms of the impact of Chinese tourist spending on domestic GDP, Hong Kong, Thailand and the Philippines are most affected, followed by Vietnam, Japan and Singapore. Japan's inbound tourism has already suffered by a drop of two thirds in terms of tourist arrivals from South Korea due to the bilateral conflict. However, Chinese tourists spend much more per capita than South Korean visitors, which would be a blow to Japan's tourism revenues.

Bringing it all together to the global level

What will be the impact on global growth? In a preliminary estimate of the direct and indirect impact of the coronavirus outbreak Goldman Sachs assumes a hit of only 0.1-0.2 percentage points if infections peak in Q1. Should this peak be delayed into Q2, the hit to the global economy is estimated at 0.3 ppts, leaving the annual growth rate unchanged from last year. Our own global growth outlook is less optimistic, as we assume a mild US recession will occur later this year due to capacity constraints and a downturn in the job market. The outbreak of the coronavirus will add to our somewhat gloomier global scenario and highlights that the global economy has little capacity to absorb shocks.

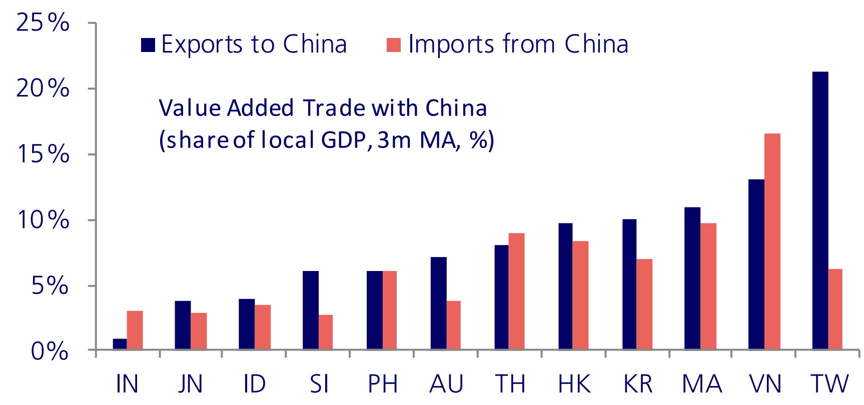
Risk assets: Another 'V'-shaped recovery

What about the impact on financial markets? In line with our introductory remarks, the novel coronavirus attracted global attention only starting from mid-January onwards. Until Monday this week, the Singapore A50 FTSE China futures have tumbled 15%, with both domestic 'A'-shares and Hong Kong listed 'H'-shares down a bit less. The MSCI Asia APEX 50 index, a liquid proxy to the MSCI Asia ex Japan index, fell about 10%. Other major equity markets reacted later and less, with the US S&P 500 index, UK's FTSE 100 index, the Eurostoxx 50 and Japan's Topix down in the 4-5% range. Before the virus had caught attention, the favourable global liquidity environment and some positive earnings reports had dominated investor attention. Meanwhile, the government bond market has reacted more swiftly, with the core government bond yields slumping last week, as the 10yr Treasury yield fell to 1.5%, just a touch above last year's low, and with the 10yr Bund yield at -0.44%, down 28bps from its recent high. Bond markets, as well as some commodity markets, have obviously been pricing in a more fragile global economy even before the outbreak of the coronavirus, matching our own more cautious assessment, before bouncing.

Pent-up demand should help to lead to a 'V'-shaped recovery of consumption, and production moving back to normal at the first signs that virus infections are starting to peak, and the disease is being contained. This pattern would be in line with previous instances of global pandemics, including SARS. We believe that investors will react even quicker, moving back into risk assets earlier, probably when the *momentum* of new infections (the first derivative) slows. This is the market reaction we have experienced over the last three trading days this week, when equity markets rallied, with the S&P500 futures even reaching a record high. We believe it is too early for a market turnaround of such a scale and at such an early stage.

At some point, hopes for further liquidity injections and company buybacks may add to a potential risk-on mood once coronavirus fears subside. However, this latest exogenous shock shows how vulnerable equity markets can be, particularly given stretched valuations.

Asian countries depend on trade with China: some more, some less



Source: OECD, CEIC, HSBC (AU=Australia, HK=Hong Kong, ID=Indonesia, IN=India, JP=Japan, KR=South Korea, MA=Malaysia, PH=Philippines, SI=Singapore, TA=Taiwan, TH=Thailand, VN=Vietnam)

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