Assessing the market impact of the Wuhan coronavirus

Weekly Market Compass: How does today's situation compare to the 2003 SARS outbreak?

Jan 27, 2020 | Kristina Hooper, Chief Global Market Strategist

The outbreak of novel coronavirus in Wuhan, China, and in pockets around the world has garnered significant public concern, and the global financial market is on edge. We have received numerous questions about the potential impact to investors and how the economic effects of the coronavirus might compare to past outbreaks such as the spread of SARS (Severe Acute Respiratory Syndrome) in 2003. Below, we seek to answer those questions, given the best information that we have at this time.

What has happened?

Ten Chinese cities with around 30 million people have been placed in lockdown in an effort to contain the coronavirus.[1] The speed that the disease spreads is alarming and reminiscent of the spread of SARS back in 2003. As of last week, five weeks after the first reported case, the coronavirus had infected over 2,600 people globally with 56 deaths,[2] and the number has continued to grow since then. Cases have been reported in the United States, France, Australia, Japan, Malaysia, Nepal, Vietnam, Singapore, South Korea, as well as China itself

How have markets reacted?

The global financial market has been concerned by the growing number of coronavirus cases and fatalities. Last week's confirmation by Chinese authorities that the coronavirus had indeed spread from human to human pared 2.8% from the Hang Seng Index (HSI) on Jan. 21.[3]

With hundreds of millions of Chinese people traveling during the Lunar New Year, there are understandable concerns that the outbreak could potentially spiral into a pandemic in the coming weeks. One positive factor is that the Chinese government has tried to mitigate these circumstances by prohibiting travel and cancelling many of the official festivities scheduled to celebrate the Lunar New Year. But given that traveling activities are still likely to remain at a relatively high level until a week after the official holiday ends, and that the incubation period of the new virus appears to be around 10 days or more, there is a possibility that new cases could continue to be reported at least until mid-February. In our view, this suggests that financial markets may be affected by first-quarter growth concerns in China, Asia as a whole, and perhaps even globally.

What are the investment implications?

Historically, major episodes of contagion have impacted economies and markets. For example, the SARS outbreak in 2003 had a material but relatively short-term economic and market impact.

The SARS epidemic, which originated in China's southern Guangdong province from animal sources, lasted approximately six months before containment. It infected 8,096 people across 29 countries, causing 774 deaths.[4] SARS had a significantly negative impact on the Asian economy, especially in the tourism, food and beverage, retail, airlines, casinos, and property sectors. For 2003, GDP growth fell about 1% for China and slightly more than 2.5% for Hong Kong.[5]

We would note that an outbreak's effect on market confidence can far exceed its actual impact; the annual US and global influenza death toll is thought to average about 56,000 and 646,000 respectively, yet hasn't impacted market confidence in the same way that SARS did.[6]

What is our outlook on the situation?

Although there are similarities between the two outbreaks, especially in the transmission patterns, there is currently no evidence that points to the coronavirus being more contagious or more deadly than SARS.

On the negative side, the Wuhan coronavirus does appear to have a significantly longer transmission period. While the incubation period for SARS was 2-7 days, the incubation period for the Wuhan coronavirus has been reported to be approximately 10-14 days. In addition, Chinese health authorities have indicated that the coronavirus can be spread by people who do not yet exhibit symptoms, which could complicate tracking, quarantine, and ultimately containment.

On the positive side, the Chinese government's response to this crisis has been much better, in our view. For example, during SARS, Beijing tried to block an investigation by the World Health Organization (WHO) and stifled all media reporting of the mystery illness for months. This time around, government officials have acted more transparently and aggressively. Authorities have already published the genome of the coronavirus, and the Chinese Communist Party declared that any official trying to cover up infections would be marked a "sinner of millennia" to the Chinese people and party.

More importantly, Chinese health care service providers have learned and improved notably over the past 17 years and are much more sophisticated in their ability to handle the viral outbreak. With more transparent communication, better public preparedness, and upgraded health care services, there is a strong case to be made that the current outbreak could be more quickly contained than the six months it took for SARS.

In addition, China is reportedly restricting foreign travel, which could help contain or at least reduce the geographic spread of the virus and limit its transition from epidemic to pandemic. From an economic perspective, the draconian measure of quarantining cities and restricting travel may have an immediate drag on services activity and regional consumer confidence – but limiting the spread of the disease would promote the eventual normalization of economic activity.

The economic impact of the virus is very hard to quantify as it depends on various factors including scale and geography of the contagion as well as effectiveness of the containment policy of the Chinese and other authorities. However, we believe the Chinese economy is likely to be more greatly impacted by this new virus, all else being equal, given that the economy is more dependent on consumer spending now than it was in 2003 at the time of the SARS outbreak.

There are signs that aviation and tourism industries in China have been negatively affected – the spread of the virus is occurring at the advent of the Lunar New Year, which makes it even more impactful – and it is clear this could worsen as it spreads. This is what happened when SARS hit Singapore in March 2003. Singaporeans panicked – people stopped going out to shopping centers to avoid a crowd and watched TV all the time to understand the latest updates on SARS. While they curtailed spending on almost everything else, they ramped up spending on food and other necessities for fear that the supply would be disrupted due to a spread of the disease. People wanted to avoid riding on trains and buses, which created a long waiting line to ride a taxi. Fortunately, the panic ended after several weeks, and people's lives returned to normal.

How is today's economy different than in 2003?

The experience of SARS suggests that this new coronavirus could cause a substantial decline in consumption activities (except buying necessities) and a sizeable drop in business activities, as well as a decidedly risk-off sentiment in the market. In gauging the macroeconomic and market responses, it would be useful to factor in differences in the structure of the Chinese and global economies today versus 2003.

- Today, China's outbound tourism is a far larger factor than in 2003 for both Asia and the world as a whole. Indeed, China has rebalanced significantly from manufacturing and net trade to consumption and services as a source of economic activity.
- Back in 2003, China was explicitly pegged to the dollar and much of Emerging Asia was engaged in considerably more exchange rate management; today exchange rates are generally closer to free floats in much of Asia, and China formally manages against a near trade-weighted currency basket – all of which suggests that exchange rates may weaken as part of the adjustment.
- Finally, the global economy in 2003 was in a much earlier phase of the business cycle in most major developed and emerging economies, and global integration in trade and investment was accelerating rather than in danger of partial fragmentation – which would arguably have been considerably more supportive. Indeed, the manufacturing and consumption cycles would probably have been more supportive, whereas at present, an acceleration of this epidemic could put additional pressure on global growth via consumption and services on the heels of the recent deceleration in manufacturing, investment, and trade in goods.
- The monetary policy position was also quite different: major central banks have turned accommodative, whereas policy easing had already run its course by 2003 and would begin to gradually normalize by 2004, once the growth recovery was fully underway; now however, with rates at, near, or even below zero, monetary policy space is widely seen to be limited.
- In addition, many asset valuations are now richer, especially in the US, and had been performing strongly with the pivot by the Federal Reserve and other major central banks toward easing and improvement in US-China relations leading up to the Phase I trade deal.

What do we expect from markets?

We expect stock prices to continue to fall in China and other Asian markets and, to a lesser extent, globally. We also expect lower oil prices, higher gold prices, and a likely appreciation of Japanese yen against the US dollar.

The market reaction may deepen further if the virus spreads further. The most recent revelation of new infections in China and elsewhere suggests that the market will be faced with further downside risks. But when the coronavirus is successfully contained, we believe the situation should normalize and financial markets are likely to stabilize.

It is important to stress that the Wuhan coronavirus is unlikely to change economic fundamentals. However, it is worth noting that a recent research report from Societe Generale estimates that if the spread of the coronavirus "fails to stabilize" by March, first-quarter GDP growth for China could fall below 6% (annualized).[7] However, we would not be overly concerned if that scenario were to come to fruition given that, once the situation does stabilize, we are likely to see a significant improvement in GDP growth given that the signing of the US-China Phase 1 trade deal should spur an improvement in consumer and business confidence – and spending. It would just be delayed by the spread of the new coronavirus, but we could envision a coiled spring in terms of spending triggered once the new virus stabilized.

What is our resulting investment strategy?

Investors who have concerns about the market impact of the coronavirus should consult their financial advisor for advice specific to their risk tolerance and financial objectives. But in general, we believe that investors with longer time horizons may want to stay the course and maintain their current allocations, as history has shown that health scares and their impact on markets are very short-lived.

Those with a short time horizon may want to talk to their advisor about supplementing their portfolio with "safe haven" asset classes such as gold, US Treasuries and low volatility equity factor strategies.

What are the risks to our view?

It is important to look to history to understand the likely impact of a contagious outbreak on markets. Our observations, based on analyses of previous epidemics/pandemics, are:

1. It usually starts with a bit of concern but relative complacency during the initial outbreak. Markets have tended to fall modestly.
2. Once the outbreak spreads internationally, threatening a pandemic, a form of panic ensues. This is typically what happens when cases arrive in the US and Europe. Markets take it more seriously, and significant corrections have occurred. In particular, any stocks linked to travel and leisure have tended to suffer: airlines, shipping, travel companies, and oil have typically fallen. Safe havens such as gold and US Treasuries have tended to perform well, as concern spreads about the economic impact.
3. Economic activity normalizes and markets recover as the authorities contain the spread of the disease.

It seems as though we are reaching the end of Phase 1 and are on the cusp of Phase 2 (assuming the news worsens).

This comes at a time when equity markets have had a very strong rally — and this could be the catalyst that causes a correction. In a worst-case scenario, global equities could fall by as much as 10% to 20% before recovering. We will be following the trajectory of this contagion very closely for signs of stabilization. The longer the coronavirus spreads without government authorities being able to slow its spread and stabilize the contagion, the more impactful it will be to economies and markets. However, we would expect a fairly swift rebound as the contagion improves, particularly given the accommodative central bank environment supporting risk assets.

Source

[1]Source: Associated Press, "China expands lockdown against virus, fast-tracks hospital," Jan. 24, 2020

[2]Source: Associated Press, "China expands lockdown against virus, fast-tracks hospital," Jan. 24, 2020

[3]Source: South China Morning Post, "Hong Kong and China markets rebound as investors make most of Wuhan coronavirus-led declines to increase positions," Jan. 22, 2020

[4]Source: Centers for Disease Control and Prevention, "SARS (10 Years After)"

[5]Source: National Center for Biotechnology Information

[6]Sources: Centers for Disease Control and Prevention, MedicineNet.com

[7]Source: The Wall Street Journal, "Deadly Infection Keeps Chinese Consumers From Spending," Jan. 26, 2020

Important information

All investing involves risk, including the risk of loss.

Fluctuations in the price of gold and precious metals may affect the profitability of companies in the gold and precious metals sector. Changes in the political or economic conditions of countries where companies in the gold and precious metals sector are located may have a direct effect on the price of gold and precious metals.

Treasury securities are backed by the full faith and credit of the US government as to the timely payment of principal and interest.

There is no guarantee that low-volatility stocks will provide low volatility.

Safe havens are investments that are expected to hold or increase their value in volatile markets.

A free float is a system in which the exchange rate for a country's currency is determined by the supply and demand, rather than government intervention or other forces.

A trade-weighted currency basket is a collection of currencies whose combined value is weighted to reflect the importance of a country's trade relationship with each of the countries issuing the currencies.

The Hang Seng Index is an unmanaged index considered representative of the Hong Kong stock market and includes the largest companies traded on the Hong Kong Exchange.

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