ODDO BHF

CIO VIEW

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Coronavirus: markets are coughing

The deadly coronavirus, which was first reported on 31 December 2019 in Wuhan, China, and has since spread rapidly, appears to have inspired fear and anxiety worldwide. The bad news just keeps rolling in. The Chinese equity market (CSI 300 Index) dropped as much as 9.1% shortly after opening the 3 February 2020. Markets in Shanghai and Shenzhen had reopened after having remaining closed from 23 January to 3 February 2020, hence for two additional days after the Chinese New Year celebrations. The Chinese central bank announced that it is making more liquidity available, in order to stabilise the economy and the markets. On Friday, US president Trump had already announced travel restrictions from China into the US. Our clients are asking us what impact the new coronavirus will have on global financial markets. This article attempts to provide an initial assessment of the disease's possible economic repercussions, based on scientific sources and past experience with the SARS coronavirus in 2002 and 2003.

In its latest Situation Report (No. 13 of 2 February 2020), the World Health Organization (WHO) reported 14,557 infections worldwide from the new coronavirus (2019-nCoV). 99% of these infections have been reported in China, where 304 people have died of the virus. So far, just one death has been reported outside China. This puts the virus's mortality rate at 2.1% currently. Although we are focusing here on an initial assessment of the economic consequences of the coronavirus, we must not overlook the fact that the virus is causing tragic human suffering and the deaths of too many people.

Physicians Corman et al. (2019) point out that, so far, only six different types of coronavirus have been found that are transmissible to human, of which four emerge often on a global basis, but they usually cause only slight infections and respiratory illnesses. Two other types of coronavirus emerge less often but can lead to serious cases of pneumonia. These two coronaviruses, which are often fatal, are Severe Acute Respiratory Syndrome (SARS) and Middle East Respiratory Syndrome (MERS). SARS-CoV and MERS-CoV are so-called zoonotic coronaviruses. Zoonotic diseases are those that can be transmitted from vertebrate animals to humans.

SARS-CoV is thought to have been transmitted to humans from bats and Viverridae (civet cats) before leading to human-to-human transmission. In China, civet cats are also kept for human consumption. SARS, a serious respiratory disease, first broke out in November 2002 in the southern Chinese province of Guangdong, causing an outbreak of often fatal viral respiratory illnesses. According to WHO, the SARS epidemic ended in July 2003. Since 2004, no human cases of SARS-CoV had been reported, although it continued to circulate in animals. According to WHO, SARS-CoV led to 8096 infections and 774 deaths worldwide between 1 November 2002 and 31 July 2003, with a mortality rate of 9.6%.

Physicians Al-Osail and Al-Wazzah (2017) have researched the MERS coronavirus, which was first reported on 13 June 2012 in Jeddah, Saudi Arabia, and until now has circulated mainly on the Arabian peninsula. MERS-CoV can be transmitted from camels to humans and from humans to humans. It is transmitted through respiratory droplets or contact with secretions. The average incubation time of MERS-CoV is 5.2 to 12 days and can lead to respiratory illnesses, with fever, coughing, serious shortness of breath and organ failure. According to WHO, between September 2012 and November 2019 2494 infections of MERS-CoV with 858 deaths were confirmed in 27 countries, with a mortality rate of 34%.

No authorised vaccinations or specific therapies exist for either the SARS-CoV or the MERS-CoV virus, according to Corman et al. (2019) and WHO. Symptoms of coronaviruses include secretions from the respiratory tract, nose and throat. A prompt diagnosis, common-sense hygienic measures, travel restrictions and quarantines can help prevent coronavirus epidemics.

While not exactly fool-proof, the 2002-2003 SARS crisis can be used as a possible benchmark in assessing the economic repercussions of the new coronavirus, based on its medical similarity and its almost identical geographical footprint. According to WHO, SARS infections were concentrated in China, Hong Kong, Taiwan and Singapore, with more than 96% of reported cases. The new coronavirus will probably also be concentrated in its region of origin, thanks mainly to travel restrictions and quarantine measures. Similar to SARS, MERS and other viral illnesses, the number of infections will presumably peak in a few months before receding. SARS had an impact on the financial markets mainly between November 2002 and July 2003.

According to the World Bank, China's gross domestic product (GDP) rose, in current dollars, from USD 1.339 trillion in 2001 to USD 1.471 trillion in 2002, to USD 1.660 trillion in 2003 and to 13.608 trillion in 2018. GDP figures show that SARS had almost no impact on China's long-term economic development. China is now the world's second-largest economy, after the US. In 2019, it expanded by 6.1%. Just prior to the outbreak of the new coronavirus, the two winners of the Nobel Prize in Economics, Abhijit Banerjee and Esther Duflo (2020) reported that China's economy would expand by 5% over the long term and that its pro capita income could reach that of the US within 35 years. Like SARS in 2002 and 2003, the new coronavirus is likely to have only a marginal impact on this long-term development.

According to the US investment bank JP Morgan, China's GDP expanded in the four quarters up to the first quarter of 2003 – just before the outbreak of the SARS crisis – at an annualised and seasonally adjusted rate of 10.5%. As a result of the SARS crisis, annualised GDP growth dropped to 3.4% in the second quarter of 2003. In the second half of 2003, after the SARS crisis receded, GDP growth rebounded sharply at an annualised rate of 13.5%. While not at all certain, a similar trend could happen in 2020. China's economic growth is likely to fall sharply in the first quarters of this year, as consumers restrict social contact, stay home and consume less, in order to prevent infections, and companies scale back production, and investments are postponed amidst the prevailing uncertainty. Last Saturday, the iPhone maker Apple announced that it was temporarily closing all 42 of its facilities in China. The Financial Times reported that the US automaker Tesla would close its Shanghai facility on 1 February 2020 for a week and a half, in accordance with instructions from the Chinese government. Many other Chinese and international companies will be shortening hours and closing factories, workshops and offices in the regions hit by the new coronavirus. These measures will undermine companies' revenues and income and lead to a decline in GDP. Once the coronavirus recedes, Chinese growth is likely to catch up in the following quarters, with the reopening of businesses, pent-up demand from consumers, and a resumption of investments – similar to what happened during the SARS epidemic.

Goldman Sachs reported in a study dated 31 January 2020 that outbreaks of viruses typically produce a short-term economic shock lasting from one to three quarters, and that economies then make up lost ground in the three to four following quarters. As Mark Twain once said, history doesn't repeat itself, but it often rhymes. Based on the typical spread of viruses and human behaviour observed in the past, the economic repercussions are likely to be abrupt, followed by a steep macroeconomic recovery in the post-crisis quarters. The abrupt impact of the SARS epidemic can be seen in many other metrics apart from GDP. Siu and Wong (2004) cite the occupancy rate of hotels in Hong Kong, which was hit especially hard by the SARS epidemic. It fell from 80% in January 2003 to below 20% by May 2003, as guests stayed away. By August 2003, the occupancy rate was back over 80%. Based on various metrics, Siu and Wong (2004) demonstrated that economic shock of the SARS epidemic was brief and followed by a robust recovery. Goldman Sachs forecasts that Chinese growth will slump to 4% in the first quarter of 2020, thus lowering full-year GDP growth expectations from 5.9% to 5.5%.

However, how serious an impact the new coronavirus will have on Western industrial economies is quite uncertain. Economists look at the yield curve as a possible bellwether of future recessions. The yield curve is said to invert when 10-year government bond yields are lower than 3-month government bond yields. US recessions since the 1960s have been regularly preceded by an inversion of the yield curve. The spread between 10-year and 3-month US government bond yields has once again sunk into negative territory, due to coronavirus-related concerns, as had already occurred in 2019. In past months, central banks have shown a marked aversion to deflationary trends in the economy. We expect central banks to stick to their expansive monetary policies, in order to counter a potential downturn in economic activity. Based on our current assessment, monetary policy will remain expansive in 2020.

The Nobel Prize winner Robert Engle has shown in several studies that volatility is not stable over time and often spikes during crisis periods. The term economists use is "volatility clustering", when bad news piles up and volatility remains high over long periods of time. This matters to investors, as higher volatility means that they could suffer unusually heavy losses in a short amount of time. In past months, volatility has been historically low, amidst an almost constant rise in the equity markets. Volatility and, hence, financial market risk, is likely to rise sharply in reaction to a flow of bad news relating to the new coronavirus.

Wen et al. (2004) showed in a study that the Chinese tourism sector was hit hard by the SARS crisis, estimating its losses at USD 16.8 billion in 2003. The impact of the new coronavirus on the tourism sector is already clear. Hotel bookings have been rescinded, airlines are cancelling flights, and people are staying home. In addition to the US, Australian has also restricted access from foreigners who have travelled to China. Other countries will take similar measures, in order to hinder the spread of the epidemic. American Airlines, United Airlines and Delta Airlines and others have already announced cancellations of flights to China. Shares of China Southern Airlines and China Eastern Airlines and BTG Hotels Group have already dropped in reaction to the new coronavirus.

Similar to the SARS epidemic, the outbreak of the new coronavirus will hit shares not just of airlines and hotels, but also banks, insurance companies and sectors closely linked to China. Globalisation has brought the global supply chain closer together, particularly between the US and China in the making of electronic goods. In recent years, China has evolved from a mere manufacturer of goods to an important consumer market.

Even before the new coronavirus broke out, the Chinese auto market was in a slump. The China Passenger Car Association (PCA) reported in December 2019 in Beijing the 17th decline in car demand in China in 18 months. In November 2019 1.97 cars were sold in China. German automakers are already struggling with the diesel scandal and the transition to electric vehicles. For the German auto industry, the fallout from the presumably sharp drop in Chinese auto sales will probably spill over into the next two quarters.

About one third of the world's luxury goods are sold in China, driven by its sharply rising incomes and greater wealth. Because of China's increasing importance in the luxury sector, shares of companies such as LVMH, Kering, Hermes, Burberry and Richemont have already slumped since the new coronavirus broke out. Even oil prices dropped in January, as investors priced in a weaker economy and less demand for oil, particularly from airlines. Brent futures fell from USD 66/bbl. on 31 December 2019 to USD 56.40 on 3 February 2020 (as of 08:40 CET), a 14.5% drop.

Generally speaking, we at ODDO BHF Trust advocate an anti-cyclical investment strategy, keeping in mind Warren Buffett's motto: "Be fearful when others are greedy and greedy when others are fearful." Forecasting investor fears is not an exact science, but more negative announcements can be expected in the next few weeks on the coronavirus front, triggering fear-induced selling. A wise course of action would be to wait longer before making large share purchases, until the number of coronavirus cases begins to recede or, at least, levels off.

Economists often speak of "flight to quality". They mean that risk-averse investors tend to oversell especially risky asset classes during crisis times. Typically, this produces sharp drops in emerging market shares in particular – which are often considered high-risk. Presumably safer assets, such as US government bonds and gold, are typically overbought in crisis times and, hence, rise in value. Currencies such as the Swiss franc and US dollar are considered safer during crises, while oil, copper and other cyclical assets fall sharply when investors are seeking protection from losses in the perceived safety of government bonds.

Diversifying over several different individual securities and asset classes is far better than trying to time the market. Experience has shown that diversifying over several countries, sectors and asset classes can help distribute risk more efficiently. We reiterate the view we have often expressed – most recently early this year during the Iran-US conflict – that a 5-10% diversification in gold can contribute to better diversification for a broad-based portfolio and, hence, can offer protection from geopolitical risks. A portfolio's exact allocation, of course, depends mostly on an individual investor's risk appetite.

Based on empirical evidence, this article has argued that viral epidemics can have abrupt impacts on the economy, but that the economy typically recovers sharply within a few quarters. We also pointed out that an anti-cyclical investment strategy and diversification into various asset classes has often proven to be the wise course of action. Although these assumptions have proven correct thus far, the new coronavirus could, of course, take an entirely different path than comparable epidemics in the past. The title of this article should be taken at its word – this is only an initial assessment. The famed economist John Maynard Keynes once said: "When the facts change, I change my mind. What do you do, sir?". This also applies to this assessment.

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