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CIO Viewpoint

The coronavirus and portfolio implications

Investment Solutions

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Photos of the Chinese city of Wuhan, home to 11 million people, show deserted streets. Since 23 January, Wuhan, followed by much of the surrounding Hubei Province, was quarantined in an effort to contain the spread of a new coronavirus, a respiratory illness. In the first quarter of 2020, the impact on China's economy will certainly be damaging.

The quarantine measures in Hubei Province have affected as many as 59 million people, making the lock-down a public health experiment on a never-before attempted scale. Only food and medical supplies can move into or out of around a dozen of the province's cities. As we go to print, the situation is still evolving rapidly and the human cost is rising. China's authorities have reported more than 17,000 confirmed infections and 361 deaths. That suggests a virus that is already more contagious, but less deadly, than the 2003 SARS outbreak, which infected around 8,000 people and killed almost 800.

The shutdown has also spread internationally along with reports of cases outside China. The World Health Organisation last week declared the virus a global health emergency and many governments have imposed bans on Chinese citizens entering their country, including the US, Australia and New Zealand. Others, including the Swiss, French and British, advise against non-essential travel to mainland China. Airlines including Swiss Airlines, Air France, Lufthansa and British Airways suspended all flights to and from China while companies including carmakers Renault and Toyota, and food chains such as Starbucks and McDonald's, paused production or shut branches, keeping employees away from factories and public transport as they return from the break.

Short-term damage

So far, the virus' international contagion is limited. This remains our working assumption. That said, we remain alert to negative risks.

China is now integral to the global economy. For example, it accounts for 17% of global GDP, compared with just 4% in 2003, and 13% of global trade, against 5%. It contributes nearly 70% of global demand for metals, almost three times higher than 2003, as well as 20% of aggregate global tourism spending, against 3% 17 years ago. The immediate impact will be impact on travel, which will hurt economies such as Hong Kong, Thailand and Vietnam, which rely on Chinese tourists.

Key takeaways

- The coronavirus' short-term impact on the Chinese economy in Q1 will be severe
- Comparisons with SARS in 2003 are of limited use; China's share of the world economy has multiplied since and the economy is at a different phase of the cycle
- As markets re-opened, China announced a series of measures to counter the economic impact
- We expect Chinese manufacturing activity to recover, perhaps as early as Q2
- A balanced portfolio, with hedges in gold and US Treasuries, will help navigate volatility.

From a short-term macro point of view, we believe that the economic impact of the virus on China will be severe. China will report its forecast for growth in gross domestic product for the first quarter in mid-April, with fourth-quarter 2019 GDP posted at 6.0%. SARS shaved 2 percentage points from the yearly growth rate in the quarter it struck, and the coronavirus will almost certainly undermine growth. The services sector now accounts for 53% of the Chinse economy, compared with 42% in 2003. However, online retail sales make up a large share of total sales, which should provide some offset.

Reaction within China since the start of the outbreak has been muted as many exchanges and businesses closed over the Lunar New Year holidays. When the Chinese equity markets re-opened on 3 February, the Shanghai composite fell 8.7% and the Shenzen composite index dropped more than 9%.

Chinese government stimulus

As markets re-opened, the country's authorities announced a series of measures to contain the negative economic impact. These include measures to ensure banking sector liquidity, interest rate subsidies to affected firms and incentives to boost bank lending to the economy. While these measures can help confidence, they are unlikely to prevent a slowdown in the first three months of the year. If needed, the authorities could signal more proactive fiscal spending when the National People's Congress meets in March.

We expect Chinese manufacturing activity to recover as production returns to normal, which may start as early as the second quarter of the year. However, consumption patterns may take longer to mend from what should have been a high-spending holiday period. With adequate stimulus, China will likely continue on its path for its domestic economy from manufacturing-led to consumption and services-driven growth.

Asset class implications

The economic and market impact of SARS was short-lived and localised. This historical comparison may be misleading as the business cycle was then at an early stage and, consequently, valuations much less expensive. Global equities continued to recover in early 2003, while Asian equities underperformed until the number of cases peaked, before strongly recovering once the spread was contained. Similarly, growth-sensitive Asian currencies underperformed, but high carry, emerging market currencies held up well.

Despite a strong start to the year, major equity markets are now negative year-to-date. US equities have been more resilient, with emerging and Chinese equity markets down almost 10% since the beginning of the year.

The price of US Treasuries and German Bunds rose in response to the evolving spread of the coronavirus, with ten-year yields declining around 30 basis points and 20 bps respectively since 23 January and gold appreciated USD 25 per ounce. Both offer safeguards in a multi-asset portfolio.

We are also watching closely the dollar/Chinese yuan rate, which is trading around the psychologically important threshold of 7.00 yuan per US dollar supported by the recent US/China 'phase 1' trade truce. We believe lower liquidity over the holiday period exaggerated the recent move higher in dollar/yuan. The stronger yuan fixing as markets re-opened shows that the Chinese authorities want to anchor the currency. The dollar/yuan looks too high, compared with our expectations for a weaker dollar this year.

Managing portfolio volatility

From an asset allocation perspective, we believe that our current balanced positioning, which is slightly underweight equities and overweight carry strategies with hedges in gold and US Treasuries, will help navigate the current volatility.

Equity markets have seen some profit taking since the start of the year and valuations still look relatively high. We remain neutral on our exposure to emerging equities, as we believe that the effect of the virus will prove short-lived and we expect stimulus from the Chinese central bank.

There is also support for equities in this environment in the form of the fourth quarter earnings. In the US, nearly 40% of companies have already reported, compared with 16% in Europe and 21% in Japan. Initial results show positive surprises in both the US and Europe with strong technology sector results.

For now, we are watching coronavirus developments closely, in particular for signs that infection rates have peaked. We are prepared to adapt portfolio exposures, and waiting to confirm that the coronavirus is behaving as a seasonal flu that dies out as transmission rates fall and immunity grows, in line with the WHO's expectations.

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