

Focal Point

The Corona virus: What to expect?

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GIAM Macro & Market Research

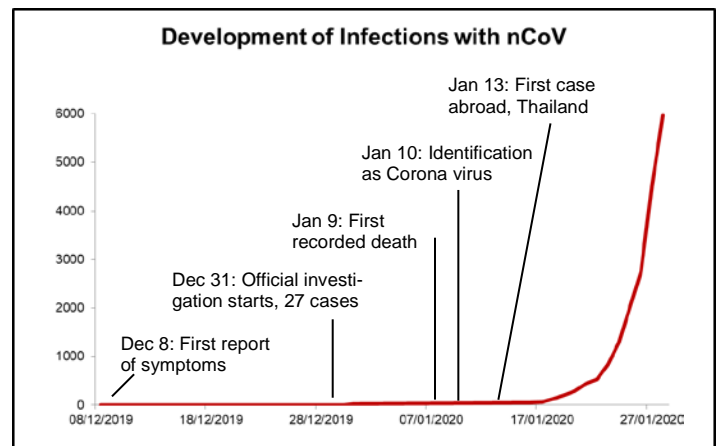
- The fast spreading of the Corona virus is rattling financial markets in reminiscence of the deadly 2002/03 SARS epidemic.
- Indeed, Corona is spreading even faster than SARS as it is deemed infectious during incubation. Also, given China's heavier weight in the world economy (19% today vs. 9% in 2003) the potential damage to global growth is even stronger.
- That said, there are important mitigating factors. The mortality rate among infected people is lower (2-3% vs. 10% for SARS), and the reaction by Chinese authorities has been much swifter and stronger this time. Medical advances will likely facilitate a much quicker development of vaccine, too.
- Markets tend to overshoot as the number of cases rises exponentially. Past evidence shows a V-shape recovery once the number of new cases per day starts to slow. Investors know this, and some will try to front run the turn in sentiment.
- The near-term outlook is shaky (and more so as the first US primaries are around the corner) but unless the drastic measures to contain the spreading fail, we expect this to be a buying opportunity.

The outbreak of the Corona virus (2019-nCoV) is spreading fears around the globe and rattling financial markets. Since it likely sprang over to humans in the city of Wuhan in central China in early December 2019, new infections have grown exponentially. By the time of writing, China reports 7,711 people infected and a death toll of 170.

China's response to the outbreak

As there is no immediate therapy available, China tried to limit transmission by minimizing human contact. The outbreak hits China at a critical time as millions of people are on travel to visit their families during the Chinese New Year. However, authorities cut off outgoing travel from the 11m city of Wuhan on Jan. 23. The measures were extended to other major cities in the province of Hubei. Beijing also extended the week-long Lunar New Year holidays by three days to February 2 and called off major celebrations. Other places of "mass" attendance remain closed at least in the most affected areas. In some regions factories will shut down even longer.

In contrast to the 2002/03 SARS epidemic, China's authorities have collaborated rather openly with international health organizations and other countries. The WHO has stopped short so far of calling the outbreak a global health emergency. Outside China, the virus was detected in limited cases in a number of Asian countries, the US and Canada as well as in France and Germany. As the incubation is estimated by the WHO to last up to 14 days, the effects of the Chinese measures will not be properly assessed before early February (two weeks after Wuhan was put into quarantine). Until then, the number of infected people and the death toll will likely continue to accelerate.



The current outbreak in comparison to SARS

The SARS epidemic lasted for nine months, from November 2002 to July 2003. It peaked in March. In economic terms, SARS like the current outbreak greatly reduced social activity and thus mainly weighs on consumption related items. In terms of sectors, transport, the "leisure" industries, accommodation and catering are most affected.

During SARS, the financial market impact was predominantly felt on stock markets. HK's stock market dropped by as much as 13%. However, globally the upcoming Iraq war proved much more important for the international arena.

The impact of SARS on government bond markets was less clear-cut. While there was a noticeable downward move in yields, the epidemic coincided with increasing geopolitical concerns (US invasion of Iraq). Hence, it is difficult to attribute the decrease to SARS. Similarly, the US

and European credit markets have been mostly unaffected by the SARS, although some volatility emerged around February/March when the pandemic reached its climax.

Market	SARS: changes* vs. 16/11/2002				Coronavirus cng since 13/01/2020
	Mar 2003	Apr 2003	trough/peak date in 2003	max change till end of March, 2003**	
MSCI EMU	-16.6	-9.0	12-03	-24.7	-0.5
EU Growth	-11.7	-4.4	12-03	-17.0	0.4
EU Value	-10.8	-2.6	12-03	-17.9	-2.4
EU Cyclical	-13.2	-4.6	12-03	-20.2	-1.8
EU Defensives	-9.4	-2.5	12-03	-14.7	0.3
S&P 500	-8.4	-3.3	11-03	-12.0	-0.4
MSCI China	-3.9	-4.9	10-03	-6.9	-6.6
Shanghai Comp.	0.2	9.7	03-01	-9.8	-4.5
MSCI Hong Kong	-9.4	-14.4	31-03	-12.7	-5.7
Oil	38.6	14.3	12-03	48.2	-8.2
Treasury yield	-33	-9	10-03	-46.6	-25
Bunds yield	-43	-31	10-03	-65.6	-18
Euro HY	-133	-266	14-01	-217	23
Euro IG Corp.	-14	-28	26-03	-22	-1
EUR/USD	6.4	8.0	10-03	9.4	-1.1
YEN/USD	-1.8	-0.8	10-03	-3.0	-0.9

Caveat: the market performance during the period was heavily affected by the Iraq war.

*Changes for FI instruments are in bps, percentage changes are taken for the rest.

** at trough/peak date

The SARS epidemic

According to WHO data, the number of confirmed SARS cases was 5,328 and the death toll 349. China's GDP growth was most affected in Q2 2003. It dropped from 11.1% yoy to 9.1% yoy. However, growth recovered to 10% in Q3 and Q4 2003. On an annual basis, growth in 2003 advanced to 10%, after 9.1% in 2002. However, it must be taken into account, that the international backdrop was rather favourable. Different papers see GDP by 1 pp resp 1-2 pp lower than it would have been if the SARS outbreak had not occurred.¹

There is also a GDP split-up into major service sector categories available. According to these data, transport suffered the most. Its growth rate declined from 10.6% yoy in Q4 2002 to 2.1% yoy in Q2 2003, but recovered to about 6% thereafter. Hotel and catering growth dropped 4 pp in the same period.

The SARS epidemic resulted in more supportive policies. The PBoC delayed a tightening of the RRR to September 2003. Fiscal policy set up a RMB 2 bn SARS related fund and exceeded the budget by 0.7 pp of GDP.

While the SARS epidemic is an important reference, there are relevant differences. The following aspects aggravate the situation:

- People may infect others without having yet developed symptoms themselves. This would accelerate the spreading of the virus.
- China is now much more integrated into the world economy (GDP weight of 19% today vs. 9% in 2003) and accordingly travel has strongly increased. Thus, the virus is more easily spread around the globe.
- Private consumption in China has grown much more important since 2003, thus the impact on GDP tends to be larger.

¹ Knobler, S., Mahmoud, A., Lemon S. et al. ed. Learning from SARS, Preparing for the Next Disease Outbreak, Workshop Summary, Washington DC, 2004

Wen Hai, Zhong Zhao, Jian Wang and Zhen-Gang Hou, The Short-Term Impact of SARS on the Chinese Economy, Asian Economic Papers 3(1), Jan 2004.

- Back in 2002/2003, growth was much higher. In 2019 China's growth decelerated and the crisis hit the first green shoots in China and around the globe.

But there are also more reassuring aspects:

- The fatality rate is currently seen lower as compared to SARS at about 2-3% instead of 6.6% in China (world average close to 10%).
- China took drastic measures to isolate the region most affected.
- China reported at an early stage about the virus, facilitating precautionary measures by other countries.
- Substantial medical progress has been made compared to SARS which could result in a vaccine.

If China's measures prove successful

Looking ahead, a key signpost will be the development of fresh infections numbers. Currently, they are still rising exponentially. If China succeeds in limiting the spread effectively to the province of Hubei by its quarantine measures, then the acceleration speed could start mitigating and eventually flatten out. In such a scenario, China's GDP will likely only be limitedly affected. Back in 2003, the SARS epidemic mostly affected the regions Beijing and Guangdong which accounted for about 15% of GDP. Hubei accounts only for 4% of GDP. Assuming a proportional response, China's GDP could be negatively affected by about 0.5 pp of GDP short term. Given some rebound, the negative impact could mitigate to about 0.25 pp over the longer term. Another, more drastic approach, draws on the fact that private consumption contributed 3.6 pp to the 2019 growth rate of 6.1%. Thus a drop in private consumption by 10 pp would result in a loss of GDP growth by 1.2 pp. In such a case, we would expect monetary and fiscal policy to step up its support, beyond the expansionary measures we currently have in our forecast (RRR cut by 75 bps, 30 bps cut in Loan Prime Rate, FP to compensate for losses).

However, if China's measures prove ineffective, the likelihood of a global pandemic substantially increases. In such a case, the financial market impact would be much more severe and lasting.

Limited spillovers to the US and euro area

The speed of the spreading depends on variables like tourist flows, geographical distance to China, health expenditures and sanitary conditions, government response to the disease, climate conditions and population density. We think that taken all these criteria infections in Europe and the US are likely to remain contained with no major restrictions on the population and firms being imposed.

The dampening economic effects emanating from China on the US and the euro area will primarily be due to the fall of Chinese output and, as partially compensatory measure, the decline in global oil prices. In 2018, 6.7% of the extra-euro area goods exports went to China (incl. HK). Assuming the numbers of the SARS case (2 pp fall in Chinese output in the short-term), the IMF's global model as well as the ECB's global model predicts output losses of 0.08% for the euro area and 0.1% for the US relative to baseline in the first year after the shock. In case the GDP impact in China was even more limited, the loss would hardly be felt.

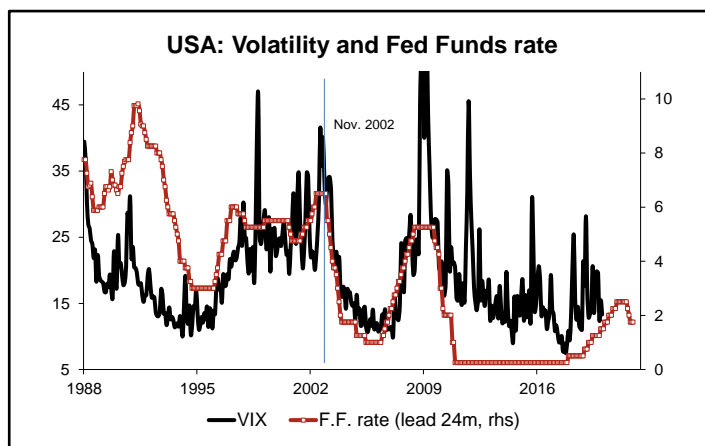
While these direct effects are expected to be small, some uncertainty arises from the effect on the recovery of the global manufacturing sector. Following a poor development in 2019, it has just started to recover, also helped by the recently struck US/China 'phase one' trade deal. Consumer confidence has been holding up well, but could be harmed by fears of wider spillovers so that purchases are cancelled.

Equities: high risk premia to help resilience

As the SARS epidemic started in November 2002, markets registered a loss of 10% over the next 4 months (MSCI World index) when SARS reached its contagion peak in March 2003. The euro area (EA) underperformed the S&P 500 (-16.6% vs -8.4%), whereas the MSCI China and the MSCI EM lost 4% and 7.5%, respectively. As to styles, Growth and Value were mostly aligned (with the latter being only slightly better also due to the oil sector which benefitted from an oil price increase of 39% from November till March) and Cyclical underperformed Defensives.

After having troughed in March 2003, markets recovered substantially and gained overall 7.6% in 9 months (since November 2002) or 13.6% in 12 months. It should be noted, though, that investors at that time were mostly influenced by the Iraq war more than the SARS.

Overall, our base case is not for an escalation of the pandemic. However, should it take place, we would recommend to go for defensive and growth indices/sectors, shorting the more cyclical and value ones.



That said, current market conditions for stock markets are different from those in 2002-2003. First, the risk premium is much higher and more attractive today. For example, in the EA, the dividend yield spread to BAA yield is currently nearly 2.5% vs -2.5% at that time. The spread between earnings yield and 10-year yield is slightly below 7% today while it was around 2% in November 2002. Second, the EA banking sector is currently 40% at a discount vs the MSCI EMU index in terms of P/E's while it was appreciably higher valued at that time (discount of 16%).

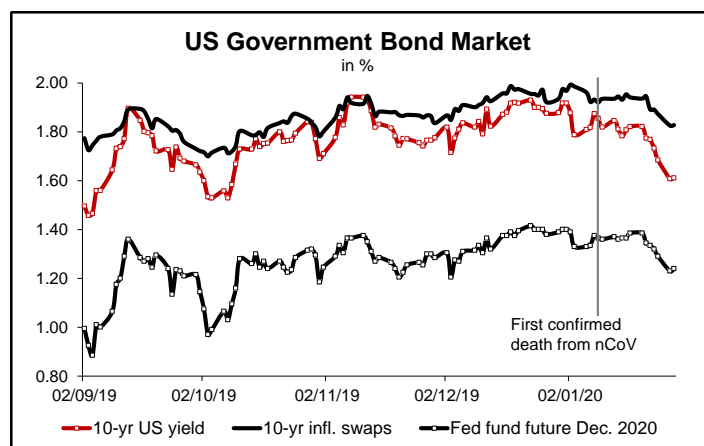
Furthermore, the trade-weighted euro was on its way up (around +10% yoy) which represented a headwind for earnings, while today it is around -4% yoy.

Lastly, current volatility (VIX, 16) is for structural reasons nearly half the one occurred by the end of 2002 (30), as the Fed Funds rates were much higher (at 6% vs 1.75 today) and global monetary support was much lower than nowadays. In sum, higher risk premia and lower volatility

should support markets better than 18 years ago. That is why in our base scenario (no pandemic escalation) market losses would represent an occasion to buy.

Impact on bond markets unlikely to last

Dampened global growth expectations amid the outbreak of the Coronavirus and worries about tighter financial conditions have triggered safe haven flows. 10-year US Treasury yields have fallen by 25 bps, with 13 bps of the move to be traced back to lower inflation expectations (see table on previous page). The sharp drop in yields likely triggered some convexity trading and exacerbated the move. 10-year Bund yields have decreased by 18 bps. Over the same period, financial markets have adjusted US key rate expectations, too. Until the end of the year, some additional 18 bps of rate cuts are priced.



Compared to the market development during the SARS epidemic, the current market move is already large. Still, given the high level of uncertainty in a more interconnected world economy, a further decrease in government yields cannot be excluded. This applies even more in case a global pandemic develops. If worse comes to worst yields will even come close to the troughs marked in late summer 2019.

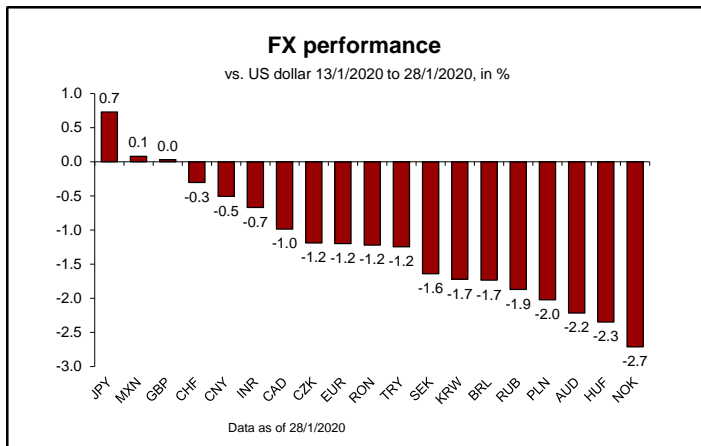
However, in the more likely case that the epidemic remains contained we see upside potential for government yields. Amid a recovering global economy yields are forecast to resume their moderate upward trend prevailing in Q4. Some of the safe haven rally is likely to be reversed with improving risk sentiment. Moreover, financial markets expect the Fed to cut at least once this year and do not expect any reversal in 2021. Meanwhile, we think government bond markets are running a bit ahead of themselves. In particular, euro area core yields have leeway to recover as the economy is already bottoming and inflation is seen to step up moderately.

On credit markets, IG has remained very resilient, likely supported by both the ECB and the flight to quality in core govies. On the opposite the HY market has seen a substantial spread widening versus Bund from 300bp to 335bp. If we indeed expected HY spreads to widen later on this year due to increased default rates, we think there is room for some tightening before a deteriorating default cycle starts to be priced in.

Corona virus benefits USD and JPY

The spreading of the Corona virus and associated concerns about its global economic impact are generally USD

positive. In case of a further spreading of the virus, the greenback would strengthen further against EM FX and commodity exporters in particular. By contrast, JPY would benefit even further as a safe haven from the uncertainties (despite Japan's regional proximity). EUR/USD would lose ground, but only moderately so given the euro's risen role as a global funding currency.



In the still more likely moderate scenario with a limited fall-out of the virus, we see the case for a higher EUR/USD medium term still intact. That said, given the increased risk to the nascent global green shoots, the upward path may prove more sluggish than our YE forecast of 1.17 is currently anticipating. Downside pressures on the CNY may persist for somewhat longer, even though we believe that the PBoC will aim to prevent a sharper depreciation to not infuriate the US Administration, just after the recently struck 'Phase One' trade agreement.

Imprint

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