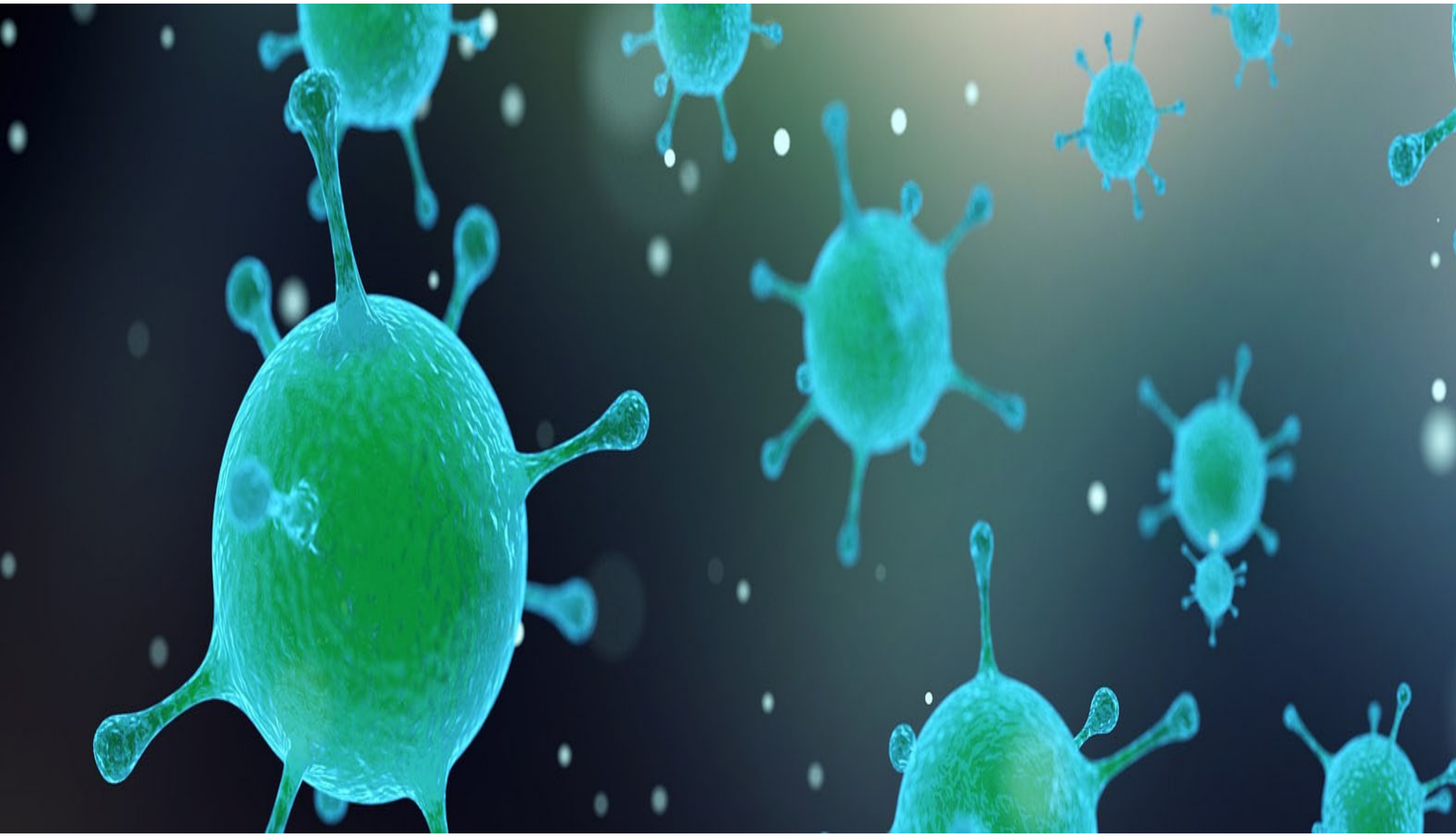
NOVEL CORONAVIRUS OUTBREAK

INVESTMENT IMPLICATIONS

FEBRUARY 2020



BACKGROUND

Market sentiment has deteriorated materially in recent days, as investors assess the potential impacts of the Novel coronavirus (2019-nCoV) outbreak. The virus has spread rapidly throughout China, and cases have been reported as far away as the UK, Europe and North America. The MSCI Emerging Markets Index has fallen by 7.4% in USD terms between its recent peak on January 17 and January 31 2020, while the S&P 500 and MSCI World ex USA indices have fallen by around 3.0% each over the same period with fears of the situation escalating further. The gold price has increased by around 1.3% over that period, as we would expect during unforeseen events like this one[1]. On February 3, both the Shanghai Composite and the Shenzhen Composite fell by around 8% after opening for the first time since the extended Lunar New Year break, the sharpest decline since August 2015.

Little is known about the virus, though it is known to have emerged in early December 2019 in Wuhan, the largest city of central China's Hubei province. Investor concern initially grew with reports of the first human-to-human transmission on January 20. Since then, the number of confirmed cases has increased considerably, even if the mortality rate has remained stable at 2%-3%, significantly lower than for SARS and MERS[2]. Whilst easily transmittable between humans, its transmission rate is much lower than for measles but higher than for seasonal flu[3]. The virus is estimated to have an incubation period as long as 14 days. Many people do not show symptoms during this period, which implies that it may have spread much more widely than we currently are aware, particularly before restrictions on people movements and forced quarantines, were put in place. The World Health Organization, which has designated the virus a global health emergency, reported that as of February 3, 17,391 cases have been detected and 362 deaths[4] have occurred as a result of viral pneumonia that can be caused by the virus in severe cases. The epidemic has mainly been concentrated in the Hubei province, which has confirmed 11,177 cases and the vast majority of fatalities. Outside of China, 153 cases and two deaths[5] have been confirmed.

To prevent the virus spreading throughout China, Chinese authorities implemented travel restrictions in and out of Wuhan and other cities in Hubei province in the week commencing January 20. Since then, a

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[1] For more details on gold, please refer to our latest paper 'Gold – you're indestructible'.

[2] Severe Acute Respiratory Syndrome (SARS) and Middle Eastern Acute Respiratory Syndromes (MERS) are diseases caused by different coronavirus strains. SARS evolved into a similar epidemic in 2003 while MERS remained more confined to single cases across the Middle East over the last five years.

[3] Early estimates suggest the so-called basic reproduction number (R_0) is somewhere between 1.5 and 6 implying that each unchecked infected person can transmit the virus to between 1.5 and 6 people. For more details, refer to : https://www.theatlantic.com/science/archive/2020/01/how-fast-and-far-will-new-coronavirus-spread/605632/

[4] https://www.who.int/docs/default-source/coronaviruse/situation-reports/20200203-sitrep-14-ncov.pdf?sfvrsn=f7347413_2

[5] This includes a death reported from Hong Kong on February 4 which is not included in the WHO situations report as at February 3.

number of provinces have extended Lunar New Year holidays, and many companies have either remained closed, or have encouraged workers to work remotely. Meanwhile, major airlines have cut flights to China, and a number of other countries have closed land borders and implemented restrictions on arrivals from China.

ECONOMIC IMPLICATIONS

Our central view for global growth remains for a gradual pick up to trend over 2020 but the impact of the virus is certainly going to detract from growth in the first half of the year at least. Under this scenario, some of the lost growth in the first half of the year is likely to be recovered in the second half. China's economy amounts to over 15% of global GDP, up from 4%[6] during the SARS epidemic back in 2002/03. Early estimates suggest the detraction in Chinese growth for the first quarter of 2020 will range from 1.0-2.0% which implies around 0.2% -0.4% negative drag off global GDP growth (year on year). Growth across China's major trading partners is likely to come under more threat, given their interdependence with the Chinese economy, especially in the service sector. As an example, for tourism, China's estimated contribution to aggregate GDP of Australia, New Zealand, Japan, Thailand, Korea, Singapore and Malaysia ranges between 3% to 10%. Chinese inbound visits as a proportion of total visits range between an estimated 15% and 35% for these countries[7]. Direct first order effects will likely be material and second order effects are also likely.

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In terms of domestic impacts in China, the service sector may be hard hit in the short term but there are some mitigating factors such as the digitization of the economy; while people are seeking shelter, consumption for goods/food deliveries/ groceries have remained stable. China's central government have mandated against price increases across core products. While price controls tend to exacerbate rather than alleviate shortages in goods, this might help to reduce panic and disruption if this remains a temporary situation. The exact impact will ultimately depend on the extent of the protections and duration.

Industrial activity is likely to be disrupted, with factories delaying their restart following the Lunar New Year holidays. Aside from direct impacts on Chinese activity, this may also disrupt supply chains across Asia, weighing on other economies with close links to China, such as South Korea and Japan. If the situation persists, we could see disruptions on a global level, reminiscent of the ash cloud of 2010. A number of technology companies have already warned of the potential negative impact on their businesses.

In terms of the policy response, a combination of both monetary and fiscal stimulus is likely to be implemented in the foreseeable future.

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[6] https://www.theglobaleconomy.com/China/gdp_share/

[7] Source: National Statistics Agencies, Bloomberg, Mercer analysis

From the monetary perspective, the People's Bank of China (PBOC) already responded by providing short-term liquidity across interbank markets and by cutting interest rates by 10bp to 2.4%[8]. Further reductions in the Reserve Requirement Ratio (RRR) may also be implemented in coming months to ease financial conditions. Fiscal policy is likely to be relaxed further and we expect to see the government shift its fiscal deficit targets to allow more room for action. These targets may come before or during the National People's Congress. Chinese economic dataflow for the first quarter of 2020 will be especially poor given the seasonal effects of the Lunar New Year Holidays and also the impact of the virus. Our expectation is that real demand generally bounces back post containment, with a "V-shaped" recovery likely. However, some economic output will be irretrievably lost, as certain festive activities related to New Year celebrations will obviously not be deferred to summer. At the same time, entry bans on travelers from China, might not be lifted for a while, which might also delay the rebound. Should the virus start to have impacts on activity outside of China, central banks outside China may also respond with monetary accommodation.

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FINANCIAL MARKET IMPLICATIONS

We believe that volatility is likely to remain elevated in equity markets and the Chinese Yuan over the coming weeks as more news on the virus emerges. The impact has been felt across both domestic and international markets and to a large degree reflects the temporary reduction in global growth. Across emerging markets, China accounts for roughly 35% of the MSCI Emerging Markets Index, and Asian equities constitute the vast majority of this index[9]. Therefore, we expect emerging markets will be most directly impacted by any perceived deterioration in the situation. Provided the virus does not spread too far beyond China, and disruptions to economic activity are only temporary, markets should begin to look past the short term impacts.

DAA VIEW

[8] https://www.bloomberg.com/news/articles/2020-02-03/china-adds-cash-to-ensure-liquidity-as-financial-markets-sink

[9] https://www.msci.com/documents/10199/c0db0a48-01f2-4ba9-ad01-226fd5678111

In our most recent Global Dynamic Asset Allocation report, we became more optimistic on the outlook for emerging market equities, in light of our expectations that global growth should return to trend levels in 2020 from below trend levels in 2019, as well as in light of reduced trade tensions between the United States and China. Although the virus may lead to short-term and potentially even medium-term disruptions, we retain our view that global growth should return to trend levels over the course of the year, especially on more supportive central bank policies. Emerging markets also remain attractively valued compared to developed market equities. With emerging market equities falling considerably in the past two weeks, we believe this may provide an attractive opportunity to increase exposure to the asset class, especially for investors with a medium- to longer-time horizon and thus take advantage of the current dislocation caused by excessive investor anxiety. Nevertheless, we would caution that our overall stance on equities remains neutral, so consideration should be given to offsetting higher emerging market equity allocations with lower allocations to developed market equities.

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