Coronavirus Update

January 2020

The World is in the midst of a rapidly unfolding situation relating to the emergence of a new coronavirus, similar to SARS (Severe Acute Respiratory Syndrome) and MERS (Middle East Respiratory Syndrome), whose epicenter has been identified as the city of Wuhan in the Hubei Province of China. The virus is believed to be zoonotic, meaning it was initially communicated from animals to humans and now appears to be spreading from human to human similar to the common cold and flu. In this brief update, we will share the basic background of the virus, highlight the steps that are being taken to mitigate its spread, consider the economic impacts and discuss the investment implications. Early indications suggest to us that like outbreaks in the past, this one will create anxiety and volatility in markets but we do not expect it to have a severe and lasting impact. Therefore, we suggest that investors maintain their normal equity risk exposures.

Background & Context

The current coronavirus is believed to have first infected humans starting in December 2019. At last count, the number of confirmed cases of the virus was 4,593, most of which have been identified inside China. There have been at least seventeen other countries with confirmed cases, but none with more than twenty instances. These figures will inevitably understate the true number of cases. Symptoms may include runny nose, headache, cough, sore throat, fever, and a general feeling of being unwell. More severe cases of this respiratory illness may lead to pneumonia or bronchitis. The global health community led by the World Health Organization (WHO) is actively coordinating the analysis and communication around this outbreak. Chinese President Xi Jinping, who also serves as general secretary of the CPC Central Committee, has been actively involved in directing actions of the National Health Commission and other government agencies to take actions to treat patients, analyze the risks, and prevent further spread of the virus.

Thus far, there have been 106 fatalities resulting from the illness—a roughly 2.5% mortality rate. It may be useful to put these figures into perspective using data from the SARS and MERS outbreaks of 2001 and 2012 respectively. SARS infected 8,273 (85% of which were in China/Hong Kong), with 775 related deaths or a 9.6% fatality rate. MERS was much smaller, with only 1227 cases of infection but much more deadly, with a fatality rate of 37% according to the WHO. Again, over 80% of the MERS infections took place in the country of origin, Saudi Arabia in this case. In comparison, the flu virus typically infects millions of people worldwide each year and may be responsible for more than 300,000 deaths on average.

It is still too early to make any assessment from the early statistics on the current coronavirus outbreak, as its evolution is impossible to predict. We are hopeful, however, that we have learned some lessons from prior outbreaks of similar viruses that may prove helpful in addressing the present situation.

Mitigation Efforts

Chinese officials have enacted a quarantine and travel ban for citizens of the city of Wuhan, and a restriction of large gatherings in other cities during this Chinese Lunar New Year celebration. There are health checkpoints at major travel arteries, where citizens are being evaluated for indications of fever or other symptoms. Amusement parks and schools in some parts of China have been closed to help limit the spread of germs. A broad effort to disinfect public transportation and major gathering spots is also underway. Many countries outside of China have instituted their own policies as it relates to travelers arriving by aircraft or boat. The U.S. has increased its screening of passengers arriving into five major international airports as a precautionary measure.

The various health agencies, like the WHO and Center for Disease Control (CDC) in the U.S, suggest basic precautions including avoiding all non-essential travel to China. If you must travel to China, they recommend avoiding contact with sick individuals, animals and animal markets, and wash your hands frequently. There is no known cure for the illness, only treatment for the symptoms.

Economic Impact

Thus far, most of the impact of the coronavirus has occurred inside China, but there is the possibility its impact could affect other countries as well. The most obvious impacts will be on transportation, lodging, entertainment, and retail. In the last couple of days, the most impacted equities were airlines, cruise ships, hotel groups including casinos (particularly those with exposure to Macau), and other consumer discretion-driven businesses (think Starbucks, McDonald's, and KFC for example). Natural resource-related equities in the energy space as well as industrial metals sold off, some speculate, in anticipation of a decline in demand from China. Many businesses and factories may already be closed this week due to the Chinese New Year and therefore may not actually be suffering lost productivity, at least until the holiday ends on February 8th.

Using history as a guide, we can see that there are some impacts that are permanent, but many that are temporary. The consumer-driven economic impact tends to be dictated by the heuristic or rules that individuals have established based on prior experience and their assessment of the current situation. This assessment, as we all know, is highly influenced by the media. While we cannot say how much more this virus will spread or how likely it is to be fatal to someone that contracts it, individuals will be constantly adjusting the probabilities in their minds and will adjust their lives accordingly. This will dictate how quickly life returns to normal.

Standard and Poor's provided the following assessment for some context around the potential impact on the Chinese economy. "To give a sense of how big the effects could be, consider that consumption contributed about 3.5 percentage points to China's overall real GDP growth rate of 6.1% in 2019. A back of the envelope calculation suggests that if spending on such services fell by 10%, overall GDP growth would fall by about 1.2 percentage points. This assumes that consumers allocate about 20% of their spending on discretionary transport and entertainment (based loosely on the household survey)."

Investment Implications

Market volatility spiked on Monday, as we experienced a meaningful sell-off in global equities and a commensurate flight to safety move that drove up prices on U.S. Treasuries, Gold, and the safe-haven of the Japanese Yen as examples. Across U.S. equity sectors, the biggest losers on Monday were Energy, Technology, and Materials, all dropping more than 2%. From a broader perspective, the worst losses were seen in the Emerging Markets, with a lot of the angst centering around China and its neighbors in Asia (based on U.S.-listed Exchange Traded Funds, since some markets are closed for the Chinese New Year). On the other side of the coin, there may be several industries that enjoy at least a brief boost to their businesses based on growing demand for disinfectants, masks, and protectant suits for medical workers.

History has shown that events similar to this one including SARS, MERS, Zika, Ebola, etc have come and gone with a pick-up in volatility early on, but no correlation between these health scares and equity market prices after twelve months. We anticipate that equity market volatility, both up and down, will continue in the near term as investors speculate on whether the situation is evolving into something worse or whether it is improving. Based on what we have seen so far in terms of efforts to mitigate its spread, the lower level of fatalities compared to SARS and MERS, the lack of mutation, and the global coordination of health resources, we are anticipating that investors' concerns and the commensurate volatility associated with the coronavirus will dissipate somewhat rapidly. Having said that, we will continue to monitor the situation and will consider whether a broader economic impact would suggest the need for any adjustment to portfolios.

What would change our stance and what would we suggest if we were concerned about this turning into a major pandemic? We will be monitoring the situation, particularly for changes to the level of contagion, mutations, the spread outside of China, and the likelihood of fatalities from this virus. We would be more concerned and more likely to take portfolio action should it appear that the effects might lead to a recession globally. Then, we would look to reduce portfolio risk (equity exposure) and increase safe-haven assets (Cash, Treasuries, etc). There is a very low probability of this occurring. More realistically, the economic impact is likely to be felt more in China than elsewhere and should be mostly transitory. Meaning that any dip in economic activity now would likely be made up by a boost from deferred spending later.

For the time being, we will be evaluating market movements to identify relative value opportunities created from the panic-driven behavior of some investors.

Disclosure