MAERKI BAUMANN & CO. AG

PRIVATBANK

Virus volatility

Market Comment, February 2020

The spread of the coronavirus that originated in China is dominating the headlines. Although equity markets have improved, its impact should not be underestimated. While China's economy and stock market have bounced back from reverses in 2003, a comparison with SARS 17 years ago is hardly valid, as China is now around four times as important to the global economy as it was back then. Furthermore, the measures taken by China will have greater repercussions this time for the global and above all the Chinese economy. And finally, China's share of the business done by numerous major Western companies is also incomparably greater than it was 17 years ago.

The rapid spread of coronavirus is causing a frenzy in the media, and represents a clear growth risk to both the economy and corporate earnings over the next few weeks – and possibly months. Its effects on profitability and economic development ultimately depend on China's success in containing the outbreak. The financial markets may have already reacted much in the same way as they did to the SARS virus, but that is not to say the economic impact will be the same. Just as at the end of 2002, the current virus – which belongs to the same family as the SARS virus – originated in China, hence a comparison with the outbreak and repercussions of 2003 appears a logical place to start.

During the spread of SARS, Chinese economic growth declined from around +10% year-on-year at the start of 2003 to just 6.6% at the peak of the crisis. Over the same period, travel activity slumped by more than 40%, while freight volumes fell by around 15%. The retail trade was particularly hard-hit. Following some 8,000 virus cases over a period of around six months, SARS was finally contained and the economy recovered. However, any comparison between 2003 and 2020 is difficult, and likely to underestimate the repercussions this time round for a number of reasons. For a start, the current outbreak is on a greater scale: The 8,000-case mark was exceeded after just a few weeks, and the speed at which the latest virus is spreading is greater. The drastic containment measures taken by the Chinese government affect well over 50% of the Chinese economy, which is far more than in 2003. Moreover, the proportion of the Chinese economy accounted for by consumer spending and services is much greater nowadays than in 2003 – and these sectors have been particularly hard-hit this time.

But most crucial of all, China is now four times as important to the global economy as it was 17 years ago. Whereas it contributed around 4% to global economic output back in 2003, the equivalent figure today is around 17%. The city of Wuhan, which lies at the heart of the virus outbreak, is home to 11 million people. It is also an enormously important transport hub in China, heavily involved in automotive production, and a major centre for a variety of technology products. The key question now is for how long – and to what extent – Chinese production, consumer spending and exports will suffer disruption. At the time of writing, the answer to this question is wholly unclear, but the impact will surely be substantial.

> "In turbulent market phases, quality and lower volatility are important for both equities and bonds."
>
> Gérard Piasko, Chief Investment Officer

How is the coronavirus crisis likely to spread in an economic sense? As the Chinese government has slammed the brakes on human mobility, production, and transportation, there are first of all the direct repercussions to consider. As so often, however, the indirect repercussions, such as a slump in consumer sentiment and business confidence – which is in turn likely to manifest itself in lower investment, lower consumer spending and lower production – are likely to prove even greater. As China has become so vital to global (and particularly Asian) trade nowadays, other countries will likewise suffer the economic knock-on effects, particularly Taiwan, Singapore and South Korea. In Japan too, where the Chinese account for more than 30% of all tourists, economic growth will suffer, just as it will in many other countries – and not just in Asia. What matters for equity markets is the extent to which business with China

contributes to earnings of companies, taking into account the corresponding margins. Among global companies this percentage differs widely, but it may generally be said that the more cyclical the industry or the more export-oriented the country, the greater the share of business accounted for by China. For that reason, the US stock market, in which we have long held an overweight position, is probably less vulnerable than many emerging markets, not least because the market consensus was to overweight the latter at the start of the year. Nota bene: When Hong Kong and Taiwan are included, China's share of the MSCI Emerging Markets Index is around 50%.

What's more, the coronavirus crisis shows us that globalization perhaps does need some rethinking given China's huge importance. The Middle Kingdom's share of global trade has become so great that dependency on China should probably be classified as a serious risk in itself. This is true of supply chains, the impact on climate change, political risks and a number of other factors. What has been the response to the economic risk posed by coronavirus? The bond markets have started to anticipate interest rate cuts not just in China but also elsewhere. The repercussions may be limited, depending on how vigorously China unleashes monetary and fiscal stimuli to counter global economic slowdown. At the time of writing, China appears likely to suffer a decline in annualized gross domestic product of -0.5% to -1.5%. When the Chinese government's stimuli measures are factored in, this could mean a global GDP decline of between -0.25% and -0.50%. However, the spread of the virus makes quantification very difficult.

For that reason, portfolio diversification appears absolutely essential to us right now. High-quality bonds (government and corporate investment grade) and gold have historically proved useful instruments for diversifying away from equities. Quality stocks with a defensive growth orientation and lower market sensitivity than the MSCI World Index, i.e. lower volatility, represent a source of stability and will offer some protection against bouts of panic selling, particularly in turbulent times such as these.

Gérard Piasko

Gérard Piasko is CIO and head of the investment committee of private bank Maerki Baumann & Co. AG. Before he was for many years CIO of Julius Baer, Sal. Oppenheim and Deutsche Bank.

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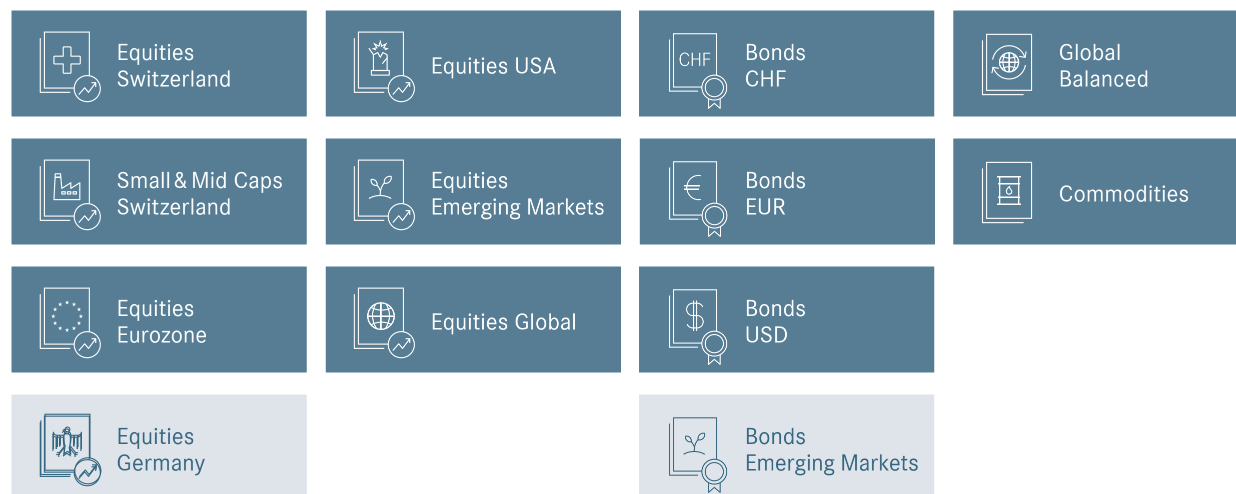

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Editorial deadline: 7 February 2020

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