Financial markets are reeling as a result of the coronavirus outbreak. While the experience with Severe Acute Respiratory Syndrome (SARS) from some years back suggests calm would be restored soon, good sense and logic can remain in short supply in the meantime. Frances Donald and Sue Trinh from our macroeconomic strategy team take a closer look.

Coronavirus: what does it mean for investors?

As we head into February, we see three key macroeconomic themes that are likely to interrupt the global economic recovery narrative and the associated reflation trade: the coronavirus and its impact on economic growth, how global growth has yet to hit a trough which would then set the stage for a recovery, and finally, how markets might have underpriced the likelihood of further monetary easing from global central banks.

Coronavirus: an important economic shock, but not a permanent one

The outbreak of 2019-nCov, more widely known as the coronavirus, is first and foremost a human tragedy, but the market is left with the unenviable task of forecasting and pricing an event that is evolving by the hour.

From an economic perspective, we believe the coronavirus represents, at best, a one-to-two quarter data distortion and, at worst, a hit to the global services sector—the pillar of global growth. Either way, it's enough to convince investors to adopt a more defensive position. This isn't surprising, since it substantially reduces our visibility on the global macro landscape and, particularly, the magnitude and timing of China's much-hoped-for recovery.

While we view the coronavirus as an exogenous, sizable demand shock that also carries supply chain implications, the extent of the economic damage it can inflict will depend on the degree to which it alters consumer behavior and corporate response to the outbreak globally.

At this juncture, any claims to forecasting accuracy should be taken with a healthy pinch of salt. Past experiences (SARS in the fourth quarter of 2002[1], the avian flu in late 2003/early 2004, and the swine flu in the first half of 2009) could provide some insight.

Here's what we've seen so far[2]:

- **Currencies market:** Generally speaking, the "risk-off" moves we've seen (in terms of magnitude) have been limited so far—that is, market movements haven't been overly dramatic. That said, the *pace* of those moves has exceeded previous outbreaks (e.g., Japanese yen vs. the Australian dollar).

- **Commodities:** Market reactions in this space are outpacing previous outbreaks. We've seen a rush into gold, a traditional safe haven—gold prices have rallied by a wider quantum than in previous outbreaks. Conversely, industrials, typically viewed as a proxy for economic growth, experienced a steeper sell-off.

- **Rates:** Yields for 2- and 10-year US Treasuries and German bunds have flattened more than they did in previous outbreaks, as demand for these assets grew. Meanwhile, markets are beginning to price in the likelihood of more monetary easing from the US Federal Reserve (Fed) over time.

- **Global equity benchmarks:** The Euro Stoxx 50 Index experience the deepest sell-off during the

[1] SARS ended by July 2003: https://www.who.int/ith/diseases/sars/en/
[2] Bloomberg, Macrobond, as of 31 January 2020

SARS outbreak (-24% drawdown). As of this writing, both the Euro Stoxx 50 Index and the MSCI AC Asia-Pacific Index have come under a little more pressure relative to previous outbreaks. This isn't the case for the S&P 500 Index though—investors' response so far has been on par with earlier episodes.

- **Asian equities:** Regional stock indexes have experienced a steeper sell-off than in past outbreaks, as of this writing.

Comparisons with SARS may underestimate the potential impact of the current outbreak

Based on historical analysis on SARS, it's likely that Chinese GDP will slip below 6% in the first quarter and second quarter. The official response has been swift, and the measures introduced have been more aggressive, particularly with respect to travel bans. The implication here is that we're likely to see a quicker, deeper hit to economic growth and a delay in the consensus "China is stabilising" theme.

That said, it's possible that the various economic models that have been used to generate these estimates could have underestimated the potential impact of the current outbreak.

While economic growth, as well as the financial markets, rebounded quickly after the SARS outbreak 17 years ago, it's worth noting that China was in the early stages of a decade-long economic boom then following its ascension to the World Trade Organisation. The macroeconomic context today is very different.

Additionally, annual domestic travel in China has risen 4.5-fold since 2003, and international travel has become even more popular (up 7.6 times compared with 2003).[3] As such, the risk of virus transmission and the negative impact on international tourism is much higher today.

Let's also not forget that Wuhan plays a strategic role in the Chinese economy—it's a hub for transport, trade, and industry in Central China. The city's GDP growth in 2019 was 7.8% (on a year-on-year basis), outpacing the national rate of 6.0%. It's now forecast to grow just 6.0% this year.[2]

Meanwhile, the macroeconomic backdrop hasn't changed; China's ability to revive growth is much more constrained relative to 2003. All things considered, we believe investors can expect:

- An economic hit to the services sector (retail sales, hotels, entertainment), mirroring the SARS outbreak, particularly given how close the virus landed to the Chinese New Year
- Further weakness in the Chinese renminbi (RMB) on the back of both risk aversion and pressure from lower rates. We had previously expected the RMB to test the psychologically important "7 to the US dollar" level within the next three to six months. In light of these developments, it's likely that we could get there sooner.

Outside of China, we're also expecting developed markets to experience a more subdued, but no less relevant, confidence shock. As the virus spreads and the number of confirmed cases rises, the services sector could come under pressure. We're monitoring global housing and retail sales activity closely. These data points may be somewhat distorted in January/February but we don't expect this to be a game changer, yet.

A significant decline in Chinese tourists could also have important implications for the region's economies, particularly those that are more reliant on the Chinese tourist expenditure, such as Thailand, Cambodia, Hong Kong, and Vietnam.

Global growth hasn't bottomed yet; there's still scope for downside surprises

In our 2020 outlook, we posited that a mild global rebound will take place in the second half of the year. In our opinion, the recovery will be supported by low rates and cyclical sectors (housing), a bottoming in sentiment data, a stabilisation in China, and a gradual inventory restocking. Our view hasn't changed, although there's undoubtedly greater uncertainty in regard to the performance of China's economy.

[3] National Bureau of Statistics of China, Macrobond, Manulife Investment Management, as of 31 January 2020.

However, at present, the first quarter remains to be a “pain point” for US (and global) growth as the global manufacturing/trade recession and supply chain shocks work their way through the system. Taking a longer-term perspective, we believe this will ultimately represent a buying opportunity, but in the meantime, it’s likely to produce short-term macro-generated risk-off sentiment, amplified by the coronavirus outbreak.

More dovish central banks?

The risk for central banks is asymmetric: We believe there’s a lot more scope for interest-rate cuts to be priced into the market in the coming weeks, even if the trigger isn’t eventually pulled. Both the Bank of England and the Bank of Canada, both of which had until recently retained a hawkish view of monetary policy, made dovish noises in January—the development could well set the tone for what is to come. In truth, within the current environment, we believe the Fed will have no choice but to move even further into “dovish territory,” or risk tightening financial conditions further.

Market implications

Up until the emergence of the coronavirus outbreak, the first few weeks of 2020 have been relatively calm. Monetary policy remains easy, and the global economy has been displaying early signs of recovery, which we believe will take hold in the second half of the year. From a macroeconomic perspective, we don’t expect the coronavirus outbreak to materially alter that narrative. In terms of positioning, while it makes sense to adopt a relatively more defensive approach in the short term, we believe the current “interruption” could be seen as an opportunity from a more strategic perspective and we continue to expect equities to end the year higher.

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