Market Insights & Strategy

Global Markets

3rd February 2020

Simon Ballard
Executive Director & Chief Economist
Market Insights & Strategy

Please click ***here*** *to view our recent publications on MENA and Global Markets*

Macro Strategy View: Thoughts on Coronavirus – The beginning of the end, or the end of the beginning?

- **Coronavirus is impacting the 2020 macroeconomic outlook**
- **A comparison to SARS 2003 helps to put risks in context, but this time may be different**
- **The outlook for the disease is now binary; a near-term containment or a socioeconomic escalation well beyond that of SARS in 2003**

While global financial markets began 2020 with the optimism that the world economy should see a modest improvement in growth metrics this year, this sentiment is now being tested by event risk emerging from left field. Among other issues, we were braced for ongoing uncertainty surrounding global trade and in particular U.S./China trade negotiations. We were braced for volatility and uncharted territory on the Brexit journey. We were braced for further geopolitical buffeting and oil market gyrations around Middle Eastern news flow.

But at the beginning of this year, we would suggest that the one thing that global markets weren't braced for – or weren't even anticipating – was the re-emergence of a potential global pandemic that would disrupt the global macro outlook and certainly not one that could put the SARS epidemic of 2003 into the shade. The sudden rise of the novel coronavirus pathogen and the pace at which it has spread has only helped to exacerbate market reaction and fears of its eventual (economic) impact. Moreover, with health authorities still struggling to locate and isolate the source of this new virus there is no guarantee that coronavirus will be eradicated any time soon.

The longer the virus exists, the more damaging will tend to be its potential impacts (economic and social). If we look at the 2002/2003 SARS episode, that earlier disease lasted around 9 months from initial discovery to eventual eradication. And its economic consequences, while reasonably localised, were nonetheless not insignificant. As we have noted previously, we estimate that SARS shaved 1% off China GDP in 2003, and cut over 2% from Hong Kong's economic growth profile, in turn triggering a recession in the region.

So, with over 17,000 cases of infection of coronavirus in China as of February 2, and with 362 reported deaths from the disease, including one outside China in the Philippines, it remains to be seen how bad the current situation will get.

Current numbers suggest the latest strain is far more contagious than that of SARS 2003, but not yet as deadly. According to the World Health Organization there were 8,098 cases of SARS between November 2002 and July 2003, of which 774 died.

As such, given the pace at which the new virus has been spreading, the fatality rate of today's novel coronavirus seems set to chase that of 2003. We would therefore conjecture that investors are right to now be adopting a more cautious approach to risk and favouring safe haven trades.

As such, given the pace at which the new virus has been spreading, the fatality rate of today's novel coronavirus seems set to chase that of 2003. We would therefore conjecture that investors are right to now be adopting a more cautious approach to risk and favouring safe haven trades.

The economic impact of the latest strain of virus will also bring economic costs in China, regionally and further afield. Tourism to and from China will be constrained. News that some companies have put manufacturing operations on hold to avoid unnecessary spread of disease will not only dampen China's economic activity, but will surely also impact the global supply chain (think China-manufactured tech and mobile phones etc).

So how bad could it get?

The outlook as it stands today seems fairly binary. Either we can see a swift containment of the disease and a near-term eradication of infection; a SARS 2.0 would effectively be avoided. Or we could see a further deterioration in the situation, greater level of infection and a likely deeper, more protracted economic impact – something that we could label as SARS 2.0.

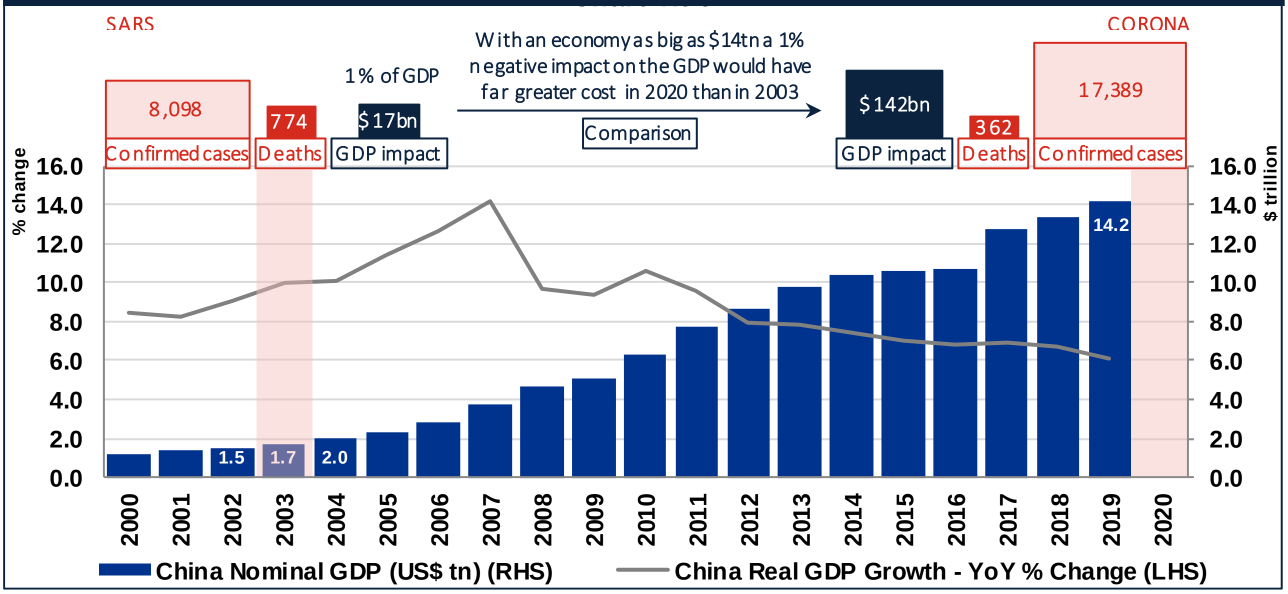
Early cure: In case of the former we would expect risk aversion to recede and risk premiums to fade. In this context, current low yields and wider spread levels would generally be seen as a buying opportunity. The recent rally in rates would provide possible hedging opportunities for floating rate liabilities, given the market's initial expectation of steadily improving economic growth metrics over the coming quarters.

SARS 2.0: If we assume a similar economic impact from the novel coronavirus to that of 2003, with China GDP losing 1%, then we believe that much of the downside risk may already be priced in. That said, even with the U.S. 10y yield having rallied almost 20% since the beginning of the year to now sit sub-1.60%, we are cognisant that the China macro position is far more fragile today than it was 17 years ago. A sudden leap into more negative pricing moves would surely trigger a further flight to quality bias and elevated levels of risk aversion.

Impact on China

In 2002/2003 the Chinese economy expanded from around 9% to 10%, net of the SARS impact. Today, with China GDP already flirting with sub-6% territory having been in steady decline from 12% in 2010, the prospect of reducing growth by a further 100bps has more severe psychological as well as absolute consequences. From a nominal perspective, the global economy has far more to lose today than it did back in 2003. World Bank data indicates the size of the Chinese economy was worth $1.66 trillion in 2003. As of end 2019 it is estimated to have been worth $14.2 trillion. Clearly a straight 1% of these two figures highlights the far greater cost of a hit to China GDP today than in 2003 as illustrated by the chart below. Furthermore, it is important to bear in mind that the true impact would likely be far wider than just the Chinese economy.

China macro position already fragile



Source: Bloomberg/FAB

Base case expectations

Given the rapidity and extent to which the Chinese authorities have responded to the emergence of this novel coronavirus, we are hopeful that it will soon be contained. We are encouraged by the news that as of Sunday 2 February, a total of 475 patients previously infected with the novel coronavirus have now been discharged from hospital in China after recovering, according to Chinese health authorities. As such, we hope SARS 2.0 will be avoided and the overall economic impact will be modest.

Travel bans, immediate infrastructure investment to provide new, extensive medical facilities are all very encouraging moves. But the fact that the medical profession still don't seem to have a handle on where the virus really comes from and how exactly it is spreading remain of great concern. Until these questions are answered the situation will remain fraught with uncertainty. Investors are best advised to retain a cautious bias for now, keeping rates anchored and risk assets under pressure.

Simon Ballard
Executive Director & Chief Economist
Market Insight & Strategy
FAB Global Markets
Tel: +971-2-6110012
Mobile: +971-50-9332806
Email: Simon.Ballard@bankfab.com

Please click here to view our recent publications on MENA and Global Markets