When China sneezes

"When Wall Street sneezes, the rest of the world catches a cold" goes the old saying. What happens when an outbreak of a novel coronavirus shuts down many of China's major cities is a new question. The particularly virulent nature of the virus, combined with the apparently long incubation period, where sufferers can show no symptoms, are posing challenges to those trying to contain the outbreak.

After initially trying to suppress the news, the Chinese authorities have imposed strict measures to try to curb the spread of the virus. These have included extending the Lunar New Year holiday and imposing "lockdown management" in many cities. Schools, universities, restaurants, shops and many factories have remained closed. Travel restrictions are in place across the country. Despite these measures, there are already more than 5 times the number of patients and more deaths in China than there were in the entirety of the SARS outbreak in 2003.

China represents a unique case in its ability to impose quarantine measures on its population. It is difficult to think of another country which would be able to clamp down on the movement of its citizens so easily and effectively. This represents a significant advantage in dealing with the outbreak but will inevitably have a negative impact on economic growth for as long as the restrictions are in effect.

The impact is already starting to be felt. Shipments of copper have been delayed or cancelled by Chinese importers and it has been reported that up to 70% of February's imports of seaborne natural gas could be cancelled. Companies including Apple, JCB and Hyundai have already acknowledged disruption to their supply chains, with differing abilities to mitigate the impact. Multinational luxury goods companies, including Burberry and Pernod Ricard, have warned about the impact on sales, whilst fast fashion houses' supply chains are also affected. Meanwhile in the tourism industry, flights, both in and out of China, have been cancelled. Macau has closed its casinos for 15 days. Disney has closed its Shanghai and Hong Kong theme parks, and the Chinese Grand Prix, amongst other events have been cancelled.

To help assess the economic impact of COVID-19, analysts initially considered the 2003 SARS outbreak. Back then, the first cases were reported in November 2002, with the numbers peaking in April 2003 and by July, the outbreak was considered to be under control. Despite dipping in the second quarter of the year, economic growth sharply rebounded in the third quarter. Overall growth for the year was minimally impacted and the spill-over globally was also muted.

However, we feel that the situation is somewhat different today as compared to the 2003 SARS outbreak. Firstly, China is a much more significant player in the world's economic growth engine this time around, with an economy around 10 times larger than in 2003. Globalisation has also resulted in manufacturing supply chains which are more complex and significantly more reliant on China. In addition, the scale of the quarantine measures in place, which will mostly determine the economic outcome, are unprecedented. All of this makes the impact on international businesses much more difficult to forecast. Add to this a much more rapidly spreading disease and the prospect of international outbreaks, forecasting is made almost impossible.

Moreover, the “risk-reward” seems worse today as compared to the start of 2003. Back then market sentiment was subdued after a 3-year bear market, with the S&P 500 approximately 40% off its 2000 high. In contrast, today, we are over a decade into one of the longest bull markets on record, with the same index now near all-time highs. This, we believe, means there is less scope for the market to shrug off any earnings disappointments over the coming months.

Ultimately, no one knows how long this outbreak is likely to last or what the total economic impact will be. We try to avoid positioning the portfolios in such a way that they are substantially affected by events outside of our expertise. As a result, we have taken action to adjust our exposure, where we felt the risk reward no longer stacked up. For example, we sold our position in Las Vegas Sands (LVS), having enjoyed good performance in the years since we originally bought the position. Over the past few months the share price has outperformed, buoyed by improved sentiment around the preliminary US-China trade deal. Going forward we felt that there was significant risk to tourism in Macau, both from government-imposed restrictions and a more cautious tourist base less willing to travel, as happened after the SARS outbreak. The casinos are already closed for a preliminary 15-day period with extensions possible. With the shares trading at the level they were, we did not feel the risk reward to be in our favour, so we sold the position.

One thing we can be sure of, is that uncertainty will lead to market volatility. Volatility inevitably creates opportunities and as events unfold, we remain poised to make the most of these as they come.

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