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A Chill Wind from China's Coronavirus

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Key takeaways

» *We believe uncertainties about the potential spread and human toll of the coronavirus are being exaggerated by the vulnerability of the Chinese economy, and the potential spillover to the global economy.*

» *Here at home, as long as new cases of the virus don't affect a wide swath of the U.S., wage growth should remain stable, consumption solid, and confidence at elevated levels.*

» *The latest jolt to the global economy has added to the probability of steady-to-lower U.S. interest rates this year amid a more sanguine outlook for inflation and for monetary policy.*

What it may mean for investors

» *We favor making no portfolio changes at this time. We expect slightly lower U.S. interest rates, and additional upside but more volatility in U.S. equity markets over the balance of the year.*

Uncertainties are rising with the spread of the coronavirus disease. Adding to market jitters is the ever-present threat of a pandemic fostered by globalization (e.g., the large increase in air travel in the past 20 years), a more susceptible, aging population, previously unknown pathogens, and resistance to antibiotics.

The timing also is negative, as the outbreak comes at the beginning of China's Lunar New Year celebration, China's biggest season of the year for travel and consumer spending. Beijing's decision to extend the Lunar New Year holiday from January 30 to February 2, to help contain the disease, probably adds to the negative impact. Overseas, markets are reacting to the more rapid spread of the disease and to the added potential for economic disruption with a more noticeable sell-off of stocks and other risk assets on January 27, a departure from surprisingly muted declines much of last week.

Concern about the spread of the virus may not have peaked. So far, the disease has spread to various countries, including five cases in the United States, as of this writing. The Centers for Disease Control (CDC) latest news release (January 24, 2020) indicated that the CDC believes "the immediate risk of this new virus to the American public is believed to be low at this time."[1] Chinese officials are recognizing that the spread of the virus is accelerating faster than most had originally thought. [2] Beijing has locked down cities where 56 million people live, but this decision may not have come fast enough to prevent the spread of the virus in China. People carrying the disease but not yet showing symptoms may still infect others, making the disease difficult to control. Thus, as the disease spreads, financial markets may show more volatility.

Yet, there are some positive signs as well. Some evidence suggests that the virus may be less potent than the related Severe Acute Respiratory Syndrome (SARS) infection in 2003. So far, the fatality rate has been only 3% of cases (versus final statistics of 14%-15% for SARS).[3] The early signs also point to potentially a faster medical response. Research into SARS-type viruses has been ongoing since 2003, and the accumulated body of research has allowed U.S. and Chinese scientists to discover early on that the new virus uses the same pathway to enter human cells as the SARS virus. Researchers do not yet have a vaccine, but may develop one this time faster than the 20 months needed in 2003.[4] Put another way, globalization in travel may aid in the spread of the virus, but globalization in research also helps the counterattack against it.

Coronavirus could be another short-lived economic and market shock

As long as the new cases are limited and less fatal than SARS in the U.S., wage growth should remain stable, consumption solid, and confidence at elevated levels. The latest economic jolt should be more serious for China, particularly as it comes at a time when the more resilient, but consumer-exposed non-manufacturing sector has been losing momentum, and weak-sister manufacturing has been stabilizing. S&P Global Ratings estimates a loss of as much as 1.2 percentage points of Chinese economic growth this year—similar to the SARS impact—from a rate originally expected to be just shy of 6%, according to Wells Fargo Securities' economics team.

If past is prologue, however, fallout from the latest strain of the coronavirus will be short-lived and largely reversible, leaving more of a tactical than strategic challenge for investors. During the SARS outbreak, the greatest decline in Chinese economic growth came between the first and second calendar quarters of that year. However, the Chinese economy recovered half of that loss by the third quarter, as tourism recovered to pre-SARS levels. Also, the greater the economic impact of the virus, the more likely Beijing is to inject new economic stimulus. Consequently, at this point, the balance of positive and negative factors suggests short-term market volatility, a transitory economic headwind that could be offset by additional government stimulus, and then economic recovery later in the year.

[1] *Centers for Disease Control and Prevention*, press release, January 24, 2020.
[2] *Wall Street Journal,* "China Urges Calm Over Virus During 'Critical Period,'" January 26, 2020.
[3] *Forbes*, "Everything You Need to Know About The Wuhan Coronavirus Outbreak," January 23, 2020 and *World Health Organization*, "Update 49 – SARS case fatality ratio, incubation period," May 7, 2003.
[4] *The Washington Post,* "Scientists are unraveling the Chinese coronavirus with unprecedented speed and openness," January 24, 2020.

Based on these expectations, we favor making no portfolio changes at this time. Our market expectations are still in line with our broad outlook, as recently updated:[5]

1. The currencies and equity markets of Hong Kong, China, Taiwan, and Singapore may struggle in the coming weeks, but could recover later in the year. Our outlook has called for some additional weakness in emerging market currencies this year.

2. More importantly, we have been favoring U.S. equity markets over international markets and maintain that stance.

3. Domestically, financial market volatility while the disease is still spreading could help keep domestic interest rates low, again in keeping with our outlook.

We maintain a neutral tactical stance between equities and fixed income. Along with slightly lower interest rates, we believe that U.S. equity markets have some additional upside, but with volatility occasioned by various factors, including the coronavirus and the U.S. election season.

[5] For more details, please see, "Adjusting U.S. Economic Growth and Equity Price Targets," January 23, 2020, available from our investment professionals.

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