Close Brothers Asset Management

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Investment Insight

What does Covid-19 mean for markets?

WHAT HAS HAPPENED?

The outbreak of Covid-19 that began in China's Hubei province in December has spread to other regions of the world. Given that Covid-19 is a new strain, we do not yet know how it may develop, which is obviously a concern for governments worldwide. Outside of China, the worst afflicted areas have been Iran, Italy, South Korea and Japan, with the spread of the virus to the Middle East and Europe likely to make containment much more difficult - particularly in regions with fewer resources and less developed contingency plans. While data indicates that new cases are slowing in China, there has been a sharp increase in reported cases in Italy and Iran especially. The understanding around how quickly and how far the virus will spread clearly remains the key risk.

WHAT DOES IT MEAN FOR ECONOMIC GROWTH?

The impact on growth will clearly depend on the scale and duration of the outbreak but history suggests that the disruption caused so far will weigh on growth. As a large share of the global economy, China matters for growth everywhere. Assessing the extent of the impact is difficult. Current estimates are still very broad, with Q1 Chinese GDP growth expected at c. 4% annualised compared to 6% in 2019, depending on how quickly economic activity is able to resume. While the Lunar New Year is seasonally a quiet time for industry, it is usually a busy time for services sectors, and the bulk of missed consumption activity is unlikely to be recovered. In contrast, delays to industrial activity are expected to result in a rebound once businesses return to work, which could cause growth to accelerate later in the year.

The overall global impact of weaker Chinese growth is also very difficult to quantify at this stage, but the cost is currently expected to be at least 0.2 percentage points of GDP growth in 2020. Economic activity outside of China may also suffer directly if outbreaks in other regions are sustained, especially within the services sectors. In Japan, where economic growth has been weak anyway, Covid-19 has forced officials to cancel a number of public events, and even threatens the Tokyo Olympics. In Italy, the part-cancellation of the Venice Carnival will exacerbate the impact on tourism revenue. Encouragingly, Covid-19 is not yet widespread in the US, the world's largest economy. If the US can avoid a severe outbreak, and economic growth continues to be robust, this would provide welcome support to the global economy.

We note that governments are already implementing policies designed to mitigate the negative economic impact of measures to contain Covid-19. In China, both tax relief and liquidity measures have been enacted; while in Italy measures include a boost to redundancy funding and the deferral of tax bills and mortgage payments. Germany is also preparing for accommodative fiscal measures.

WHAT DOES THIS MEAN FOR OUR INVESTMENT STRATEGY?

The initial market response to news of the Covid-19 outbreak was relatively sanguine, with emerging markets the only region where equities fell significantly at the end of January. Declines elsewhere were focussed on stocks with exposure to the Chinese consumer. However, following the news of outbreaks outside of the Asia Pacific region, we have also seen a more pronounced downward move across global equity markets. As one would expect, companies with a greater sensitivity to economic growth have suffered somewhat worse, though the sell-off has been broad-based as companies begin to estimate the likely impact on profitability. Global supply chains are also experiencing disruption, indirectly impacting many other companies in the near term.

Given the risk of the virus spreading further, we believe it is possible that markets have further to fall. However, we would also note that, once markets are able to fully price in the growth impact, shares may look attractive once more and present a buying opportunity. There is a balance to strike between immediate alarm (broadly seen in the market as we write) and sound longer-term judgment, based on fundamentals. With this in mind, we have trimmed exposure in areas of the market which we expect to be most vulnerable, partly with a view to being able to swiftly deploy cash once we believe the negative impact can be more accurately assessed.

As global, long-term investors, our portfolios continue to benefit from diversification. Indeed, it is precisely at times such as this that our allocations to fixed income and alternative assets are most important. We will remain vigilant to developments, enabling us to swiftly respond to further risks and anticipate emerging opportunities.

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