Weekly Digest

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A Virus With Chinese Characteristics

A presentation that I give to aspiring investment managers and newly graduated arrivals called An Introduction to Investment Strategy, has a slide listing all the "-ologies" in which I feel I have to display some level of knowledge or competence. One of them is Virology, which is a bit of a challenge given my lack of medical training! Nonetheless, it's time to don my surgical mask and, if not save the world from the new coronavirus (henceforth Cv, for short), at least assess its potential impact on economies and markets.

The first thing to say is that, despite the apocalyptic nature of some of the news headlines, this is "business as usual" in the world of viruses. I discovered recently that there are two hundred and sixty viruses known to affect humans, but an astounding 1.6 million viruses harboured by other mammals, reptiles and fowl.

Every now and then one of them makes the leap from an animal to a human host. Known or suspected vectors of viruses such as Severe Acute Respiratory Syndrome (SARS), Chinese Flu, Middle East Respiratory Syndrome (MERS) and Ebola include bats, camels, chickens and civet cats. Bats and snakes are the prime suspects in the Cv outbreak, which makes one wonder just what delicacies were on offer at the Wuhan Seafood Market!

Early attempts to gauge the effect of Cv make comparisons with the SARS outbreak of 2003. The starting location is similar, as are the means of transmission (droplet infection) and symptoms (flu-like tending to pneumonia). However, it's impossible to know just yet how analogous they will end up being. On the positive side, the fatality rate of Cv is initially running at about 3% versus 10% for SARS; on the negative side it looks as though the incubation period of up to eleven days is much longer and that carriers are contagious during this period, threatening a world full of asymptomatic human timebombs.

What other major differences are there between now and 2003? Starting with the negatives again, China is a much larger element of the global economy, meaning that any domestic effects will have a greater influence worldwide.

China now also sends many more business travellers and tourists out into the world (some 130 million per annum), with a far greater number of direct flights to major cities. And to make matters worse, the escalation of the virus has coincided with Chinese New Year, an event that is described as the by far the largest annual human migration (these anthropologists have obviously never experienced the wholesale decamping of Essex to Shoreditch on a Friday night!).

In a more positive light, the Chinese authorities have been quicker to own up to the current outbreak, although there is lingering suspicion that they still sat on the truth for too long. Modern science allows the DNA of the virus to be decoded much more quickly, meaning that tests can be developed faster and also that, hopefully, a vaccine can be created soon. Social media plays both ways. On the one hand it has immediately raised awareness of the Cv, encouraging the public to take evasive action; on the other it can also create alarm with endlessly circulating images of people wearing facemasks or hazmat suits. It's also fair to say that messages from people claiming to be "trapped" by travel restrictions help to amplify the image of China as an evil totalitarian state.

If we take SARS as the best available comparator for Cv, the economic effect will be noticeable, with the main impact in China and the ripples spreading across the world. Tourism and travel will be hit hardest, closely followed by resources and exports of luxury goods to the region. Shares of related companies have already taken a hit. SARS is calculated to have knocked around 2% off China's Gross Domestic Product in 2003, but that was from a much higher double-digit base of growth. Remember that China has just reported its lowest annual growth rate (6.1%) for three decades. S&P Global, the ratings agency, was first out of the blocks with a calculation of the current impact, suggesting a 1.2% shortfall, which would mean the GDP number starting with a four. Can you imagine the howls of anguish (accompanied by schadenfreude from many in the West) that might elicit? It's harder to estimate the effect on the rest of the world. It will be lower the further away one gets, certainly – unless, of course, the virus turns out to be much more potent and uncontainable than currently thought. But in 2003 the West was still suffering the effects of the Tech Bust and the aftermath of 9/11 as well as anticipating the start of the second Iraq War. Therefore, beware big numbers bandied around with extreme confidence.

From the investment perspective, my first observation is that the current situation implies great uncertainty, and, as we often repeat, markets hate uncertainty. Unlike "risk" it cannot be accurately measured or priced, and thus tends to lead to greater volatility and demand a higher risk premium. In simple terms, this means that the valuation and price of riskier assets will fall while safe haven assets such as government bonds, gold and currencies including the Japanese yen and Swiss franc, rise. Much of this will happen with minimal intervention by human traders, as computer-driven algorithms based on historical market data lead the charge.

Are we, as mere humans, able to make better judgements? This situation was discussed in some depth at our monthly Asset Allocation Committee meeting on Friday, and we concluded that it was not practical to finesse an exit and re-entry with great confidence, especially taking into account the frictional costs of trading. We have reasonable belief that this will be a contained event with a finite lifespan – no cases of SARS have been reported since 2004 - but also acknowledge that we have not yet reached "peak panic". More positively, it could provide a "pause that refreshes" for equity markets that have been very buoyant of late, as well as encourage policymakers to stick with, or even increase, stimulus, both fiscal and monetary. Threats of war, terrorism and virus have all provided buying opportunities during this cycle, and this could well provide another - so hold back any new cash for potential bargains.

Last week's Economic Highlights

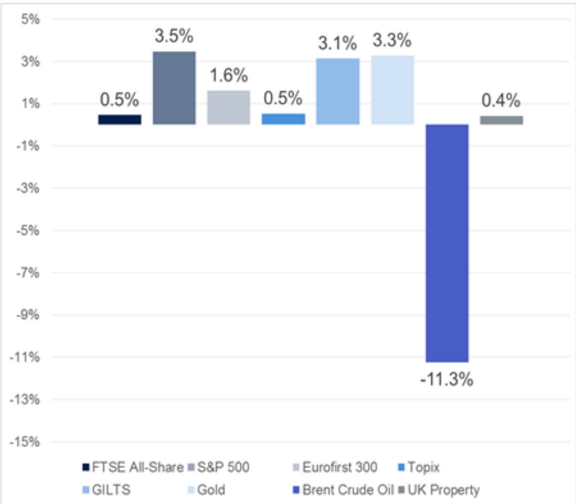
FTSE 100 Weekly Winners

Berkeley Group	7.0%
Persimmon	5.5%
Taylor Wimpey	5.0%
Sage Group	4.3%
Legal & General	4.2%
Melrose Industries	4.1%
London Stock Exchange	4.1%

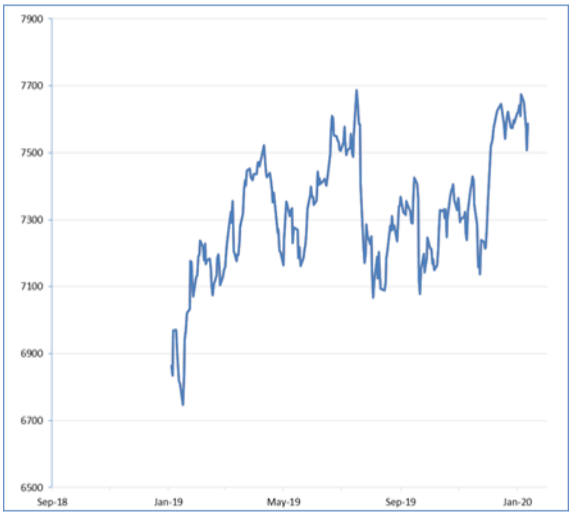
FTSE 100 Weekly Losers

NMC Health	-13%
Antofagasta	-11%
Burberry Group	-9.9%
Evraz	-9.5%
Carnival	-7.6%
IAG	-7.5%
BT Group	-7.1%

Year to Date Market Performance



FTSE 100 Index, Past 12 Months



Source:FactSet

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