BREWIN DOLPHIN

Putting the coronavirus in perspective

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As the coronavirus continues to dominate the news, our Head of Research Guy Foster looks at what the outbreak could mean for the markets in the coming weeks and months.

Stock markets have been sent sharply lower by news that the coronavirus is continuing to spread outside mainland China, with clusters now in Italy and Spain in addition to an uptick in cases in Iran and South Korea.

More encouragingly, reports suggest that the number of cases is stabilising in the Chinese province of Hubei, where the virus was first discovered.

Even so, as the virus spreads to other parts of the world, risk assets are being sold off, and investors are heading into perceived safe havens such as gold and government bonds.

Why have markets taken so long to react?

There have in fact already been several sell-offs following the intensification of the virus in mid-January, but the market largely shrugged off any concerns – broadly due to the fact that events had been very well contained, with over 90% of cases restricted to China.

We believe that investors initially saw this outbreak as a temporary anomaly, with efforts to restrict its spread, such as factory closures and disruptions to supply chains, weighing on growth in the first half of 2020. But that deferred activity gave investors something to look forward to in the second half of the year, as economies were expected to rebound.

However, news that the virus has spread in a meaningful way outside of China to Italy and South Korea is forcing a reappraisal of that expectation. Now, the worry for investors is that tougher quarantine measures outside China to prevent or slow the spread of the virus make it increasingly difficult for companies to maintain normal production levels. This in turn will hit sales and profits.

We have already seen companies such as Apple warn that their next quarter's trading periods will be impacted because of broken supply chains and closed factories, and this will only get worse if the virus spreads further. Such disruption will have an effect across sectors, making its cumulative impact difficult to predict.

It seems clear that this outbreak has further to run and investors should therefore brace for more volatility in stock markets as investors react to more bad news.

This volatility is quite the opposite of the circumstances that have preceded previous downturns. These have tended to be driven by a slowdown in consumer demand. In this instance, however, companies are being restricted from selling their goods and services that consumers still want to buy. So, while growth is being "deferred" rather than destroyed, weakness in share markets will likely be a temporary phenomenon.

Where it becomes a bigger issue is if the economic pause lasts longer than expected, forcing companies to cut back on staff because then it creates classic recessionary conditions, where demand begins to shrink faster than supply.

That doesn't seem like a sensible practice unless the spread of the virus accelerates once more.

What should investors do?

Worrying as this outbreak is, we are urging clients not to allow fear to govern their decisions. We have been in similar territory before in terms of health scares, and there are lessons to be learned from previous outbreaks such as SARS, Ebola, MERS and Zika.

Given its Chinese origins, the SARS outbreak in 2003 is the best comparison, although circumstances are very different today. Back in 2003, China's share of global GDP was just 4%. Today it is almost 16%, so there is more at stake.

Share market valuations around the world are also higher, and we are at a later stage of a more mature economic cycle.

Nevertheless, history has shown it is better to ride out near-term volatility and wait for markets to recover in the medium term.

Without downplaying the human tragedy or the looming economic fallout, we suspect the current crisis will share some similarities with the SARS outbreak.

It is worth noting that Asia ex Japan equities bottomed out in 2003 shortly after the rate of change in total SARS cases definitively began to move lower.

In just the same way, earlier this month, we saw equity markets rally on the back of data showing that the rate of new coronavirus cases in China had slowed.

Equities remain in demand

However, equities were vulnerable to any new bad news, and that came with reports of the virus spreading into Europe. Ironically, that will mean the prospect of higher returns on cash or bonds becomes an even dimmer prospect – market interest rates now suggest that investors believe it is highly likely interest rates will be cut in the US and UK this year, meaning continued demand for equities, which offer the prospect for higher returns.

So, we are encouraging investors to focus on the medium term. It is important to remember that consumption has not disappeared – it has merely been postponed. And if the outbreak is contained relatively quickly, this delaying of economic activity can give markets a significant boost a little further down the line because it will lead to a surge in activity in forthcoming quarters, as economies recover.

Countries are taking extraordinary steps to contain the virus and pharmaceutical companies around the world are working towards a vaccine at a record pace, with reports that human testing could begin in April.

For equities to begin rallying anew, however, investors will need to see evidence that the rate of growth of new coronavirus cases outside of China is being quickly contained.

Guy Foster, Head of Research

Guy leads Brewin Dolphin's Research team, providing recommendations on tactical investment strategy to Brewin Dolphin's investment managers and strategic recommendations to the group's Asset Allocation Committee. He is a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. Guy frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of Brewin Dolphin.

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