Investors to look beyond short term weakness, and embrace opportunities

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FULLERTON FUND MANAGEMENT

Executive summary

- The economic impact of the COVID-19 virus could be more painful than the SARS period.
- China's policymakers are committed to keeping growth around 6% in 2020, and are likely to resort to stimulus to boost the recovery.
- Given sound fundamentals there will be buying opportunities, and investors will reach a point where they look beyond cyclical weakness.

Impact of COVID-19 outbreak could be more painful than SARS

With such unprecedented responses to the spread of the COVID-19 in China and across the world, the adverse impacts on growth are likely to last a bit longer, and be more painful, than the SARS-period of 2003. China is a key hub in manufacturing supply chains and is much more inter-connected domestically, and with the rest of the world, than it was 15 years ago.

Adverse impacts will firstly stem from less retail spending, transport, and tourism, as consumers stay indoors and avoid crowded places. Manufacturing output and export activities will also suffer as China has extended Chinese New Year (CNY) holidays for some of its industrial hubs.

Weaker manufacturing and less spending by households will spill over into second-round effects with less trade, investment and hiring by firms. Because the virus can spread before symptoms are evident, authorities in China, and the rest of the world, may tighten travel and activity restrictions further. As a result the economic cost from the COVID-19 outbreak can be acute and long-lasting even if confirmed cases are contained.

China's economy may recover in the second half of 2020

The drag on China's GDP growth in Q1 2020 could be as large as 1-2% and with recovery not until the second half of the year. The rest of Asia will also suffer from a weaker China. Firstly, cuts in tourist spending from China will have significant impact on Hong Kong, Thailand, Vietnam, and Singapore. Secondly, the longer that factories in China are closed, or operating below full-capacity, then the greater the adverse spill-overs to manufacturing across Taiwan, South Korea, and Japan, as they are forced to cut production because of a lack of supplies from China. The economic impact beyond Asia, into the US and Europe, is likely to be less significant because their domestic demand spending is still well supported.

Number of Chinese Tourists to Asia

Source: Haver Analytics, Barclays Research, 2018

Policymakers likely to use stimulus to boost recovery

China's policymakers are committed to keeping growth around 6% this year and they are likely to resort to significant stimulus to boost the recovery – with easier financial conditions, tax breaks and more infrastructure spending. So far, and in contrast to the normal practice of withdrawing liquidity after CNY, China's central bank (the People's Bank of China) has injected significant cash into the banking system and has instructed banks not to cut lending to sectors and regions stressed by the COVID-19 outbreak. If regional growth falls by too much then policymakers across Asia are also very well-positioned to respond.

Ultimately, the economic impact will be a function of how long it takes to bring the virus under control which is still difficult to gauge. There are typically three stages surrounding adverse economic shocks - an initial period of uncertainty (where we are right now), followed by a period of stabilisation and thereafter, a period of sharp market rebound.

Sound fundamentals will push investors to look beyond cyclical weakness

Risk assets that will suffer the most are those that have 'priced-in' most of the good news before the COVID-19 outbreak. But given sound fundamentals there will be buying opportunities: investors will reach a point where they look beyond cyclical weakness, and any policy stimulus will quickly boost sentiment.

Therefore, we remain positive on risk assets as liquidity support remains significant, and global policymakers will ease further if growth falls too much. Our longer-term optimism remains in play, and so we will look to take advantage of corrections to build positions, especially in structural-growth equities.

That said, it is prudent to minimise the downside risk to our portfolios by reducing some China exposure in our regional strategies, as well as trimming equity positions across sectors that are most dependent on consumer spending. Further downward pressure on bond yields can give some support to corporate credit performance although the higher yield sector may struggle with weaker demand conditions. As growth suffers, Asian currencies are also likely to weaken and coupled with some cyclical flight to safety, the USD may hold-up for longer than we expected.

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