What Wuhan pneumonia means for investors

UBS House View - Weekly Global

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Key Messages

1. The impact of coronavirus on markets.

Chinese stocks fell 4.9% last week after the breakout of a virus which has already caused multiple casualties in the country. Health officials have enacted a travel ban on Wuhan, a city of 11m at the center of the scare, and neighboring cities. We expect the outbreak to pressure the airlines, consumer discretionary, and tourism industries. And if the severity of the outbreak increases, retail sales and tourism could be affected more significantly: the Chinese yuan would likely weaken due to the impact on growth, and the Japanese yen would benefit from safe-haven flows. But, based on initial reports on the virus, we think the economic fallout is likely to be less than during SARS in 2003. SARS lasted as a health risk for eight months, but led to a sharp fall in Chinese growth over only one quarter, followed by a swift recovery. Last week’s drop in MSCI Asia ex-Japan stocks has resulted in a greater valuation discount to global markets, and strong earnings prospects in both Axi (13.8%) and China (12%) mean we still see opportunity there. We also have to bear in mind that the recent selling pressure may in part reflect traders selling positions ahead of a lengthy market holiday.

Takeaway: We remain alert for an increase in the severity of the outbreak, although at this time do not believe it warrants portfolio action. We are inclined to view the drop in markets as an opportunity to add exposure to emerging market and Chinese stocks.

2. Positioning in emerging markets.

We reiterate our conviction in emerging markets. While markets took a hit last week after the virus outbreak in China, we think the fundamental picture for emerging markets looks solid. Sentiment in EMs has picked up overall since the US and China announced a Phase 1 trade deal, and we think the benefits of the deal should accrue more heavily to EMs as a whole than the US. We forecast that the growth differential between

Week Ahead

1. Can the US earnings season push stocks higher? 84 companies in the S&P 500 have reported their fourth quarter earnings so far, with two-thirds beating sales and EPS estimates. 145 companies will report this week, and we expect full-year earnings growth to come in at 6%. With the index now close to a record high, investors who are afraid to deploy capital into markets all at once could consider phase-in strategies, such as put-writing.

2. Is further monetary easing on the cards? The Bank of England and US Federal Reserve meet this week. The main focus will be on the BoE, where market pricing suggests a rate cut chance of 60% due to outgoing governor Mark Carney’s dovish comments earlier this month. Sterling has flirted with the 1.30 mark since then, though the currency remains undervalued in our view, particularly against the US dollar. No action is expected from the Fed, supporting our view that rates will stay accommodative, supporting borrowers.

3. Will the coronavirus continue to hit markets? With the Chinese market shut for the Lunar New Year holiday, investors will be on the lookout for a more marked fall in sentiment if the virus outbreak worsens. For those
emerging and developed economies will increase from its recent plateau of around 2.5ppt toward 3.5ppt this year. Earnings growth dynamics also look supportive; this year in EM we expect 13% vs. just 6% in the US and a 2% contraction in the Eurozone. We express our positive view on emerging markets through overweight positions in equities and currencies. That said, we now see less of an opportunity in US dollar-denominated EM sovereign bonds given recent spread compression, though they remain important on a strategic investment basis.

Takeaway: We expect EM stocks to outperform their Eurozone counterparts. While we close our overweight to US dollar-denominated EM sovereign bonds, we continue to like yield-enhancing strategies in a low-rate environment, adding a preference for the Brazilian real to our EM currency basket in our FX strategy.

3. The long path to sustainability.

Climate change was high on the agenda at last week’s World Economic Forum, whose theme was building a “cohesive and sustainable world.” Ahead of the event, UBS released a white paper on *Becoming climate aware*, and, separately, European Central Bank President Christine Lagarde said climate change “would be an important matter” to discuss for the strategic review of the central bank. We believe that policymakers, businesses, and consumers all making sustainability an increasing focus is creating a number of attractive investment opportunities. Investors can fund companies that are pioneering ways to reduce carbon emissions and pollution, such as in renewable energy and energy-efficiency technologies. They could also place funds with companies leading the way in addressing environmental, social, and governance (ESG) challenges in their industry – such firms could offer strong returns due to their ESG leadership. And, for the companies with room to improve in using ESG standards, investors can employ an engagement approach, which uses investor influence to promote best practices, having a positive impact on sustainability and potentially on the long-term prospects of the companies.

Takeaway: We believe focus on sustainability will continue to increase, and investors who get ahead of the movement stand to benefit. Read more about going sustainable [here](#).
Deeper Dive

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by Global Chief Investment Officer Mark Haefele

Asian equity markets (MSCI Asia ex-Japan) gained more than 10% between early December and mid-January as uncertainty over the US-China trade dispute subsided. But the rally came to a halt last week over mounting investor fears that the pneumonia outbreak in Wuhan, China, might turn into a larger epidemic and negatively impact consumption, travel and tourism-related sectors.

Last week the MSCI AxJ index declined by 2.8% and China’s CSI 300 fell by 3.6% prior to closing for the New Year holiday. We believe the selling pressure in part reflects uncertainty ahead of a lengthy market holiday, with much still unclear over the severity of the virus and how fast it is spreading. But we think past experience in the region offers some guidance as to the potential economic and market impact in China and Asia:

• **Macroeconomic impact likely to be limited.**

Given initial reports on the virus, we anticipate the economic fallout will be smaller than during the SARS epidemic in 2003. SARS lasted eight months as a health risk, but led to a sharp fall in China economic growth over just one quarter, followed by a swift recovery. MERS in South Korea in 2015 followed a similar pattern.

We had expected 1Q 2020 to mark the turnaround point for GDP and corporate earnings growth in Asia. If the situation deteriorates, the turnaround time might be delayed by a quarter, based on our view that any potential outbreak takes time to contain. That said, one of the most positive legacies of SARS and other outbreaks is that governments and the public are more vigilant. The initial response by the Chinese authorities to this outbreak has been relatively swift, with Wuhan and neighbouring cities subject to a travel ban by 23 January in an attempt to contain the spread of the virus.

• **Market impact likely to be short-lived.**

**Equities:** The correction in the MSCI AxJ index has so far only pushed price-to-book valuations down closer towards their 10-year mean, but on a relative basis the index is now trading at an attractive discount to global markets. We expect Asia’s corporate earnings to grow by 13.8% in USD terms in 2020, which is significantly faster than expected developed market profit growth. We also remain positive on Chinese equities, with a forecast for 12% earnings growth (USD), and have preferences for a number of sectors, including tech hardware and ecommerce.

**Bonds and currencies:** Assuming the virus can be contained within a few months, any negative impact on APAC currencies should be short-lived. Based in part on the SARS experienced in 2003, we believe currencies sensitive to external demand (such as KRW,TWD, THB, SGD, MYR) would be relatively vulnerable, while domestic-demand-oriented currencies (IDR,
INR, PHP) should be more resilient. In our FX strategy, our long exposure to the IDR and the INR, combined with our short exposure to the TWD in our high-yielding EM currency basket should benefit in this scenario. For bonds, a worsening scenario could lead to a marginal widening of yield spreads. We recently closed our overweight to EM USD-denominated sovereign bonds, but we still recommend a strategic allocation to the asset class despite this tail risk.

So while we remain alert for an increase in the severity of the outbreak, we expect the impact on the region’s economy and risk assets to be short-lived. Since the timing around the extent of the outbreak is difficult to predict, we do not recommend investors take directional positions or withdraw from financial markets based on news about the virus – instead we would be inclined to view the drop in markets as an opportunity to add exposure to emerging market and Chinese stocks. We remain overweight EM equities.

More broadly, disease outbreaks reinforce the importance of investing through a diversified portfolio to mitigate idiosyncratic risks. In the risk case of a more severe outbreak we would expect a drag on discretionary spending, with retail sales and visitor arrivals most affected, which would put pressure on related industries including airlines, consumer discretionary, and tourism. Past experience suggests trade growth would be relatively immune. Investors worried about deploying capital near record highs amid heightened uncertainty can, however, take advantage of relatively low volatility in the option market at present to make use of strategies that reduce portfolio volatility or add explicit protection.

Read more in our report, "Market implications of Wuhan pneumonia".

Read more about what's happening in your part of the world in our regional views.
Appendix

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