17 February 2020, 1:32PM UTC
Chief Investment Office GWM
Investment Research

Can the coronavirus be contained?

UBS House View - Weekly Global

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Key Messages

Jump in coronavirus infections conceals positive signals

Equity markets wavered late last week after the number of new confirmed cases in Hubei province, China, spiked to 14,840, compared with a prior daily rate of increase of fewer than 3,000. But the large increase in confirmed cases was largely the result of a change in measurement methodology, rather than acceleration of infection rates, as the province began using new testing methods which can yield results in just minutes, rather than the days needed to process results previously. We view the new approach as a positive sign of increased transparency, which should help China to combat the infection. The additional resources being dedicated to Hubei, including new and temporary hospitals and thousands more doctors, are also now operational. Our base case remains that the virus can be largely controlled by the end of March, and that the negative impact on the Chinese economy will be mostly confined to the first quarter, with a pent-up demand-driven rebound in 2Q onwards.

Takeaway: We remain overweight emerging market equities, and we also see long-term opportunity in Asia.Short term, we recommend that investors avoid vulnerable stocks that are likely to be most affected by the outbreak, including transportation, tourism, and entertainment, in favor of e-commerce, technology, and healthcare.

Europeans should rethink USD risk, switch to EUR credit.

The euro last week fell to its lowest level against the US dollar since 2017, and is now down 3% since the start of 2020. The move reflects concerns about a slowdown in Eurozone growth, as data showed German industrial production contracted at the fastest rate since the financial crisis. Low Eurozone interest rates and persistent currency weakness have led many euro-based investors to seek higher returns in US dollar bonds in recent years. But we believe this trade has become increasingly risky for both euro and Swiss franc investors: we expect the US currency to fall by around

Week Ahead

Will the coronavirus outbreak worsen? Updates on the infection and fatality rate from the outbreak will continue to gain as much attention as, or even more than, economic data.

Is the outbreak harming sentiment? A related question is the extent of the damage caused by the outbreak on business activity and sentiment. This week we get purchasing managers' survey data from the US and UK for January, and Germany's ZEW economic sentiment survey.

Will earnings season end on a strong note? Around 400 of the 500 constituents of the S&P 500 companies have already reported, with 74% beating expectations on earnings for the fourth quarter. Investors will be hoping for a strong finish, especially with US stocks hitting record highs.

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9% against the euro and 6% against the Swiss franc by the end of the year, significantly exceeding the less than 2% yield advantage offered by USD bonds. While the US has recently been the most resilient major economy, we expect its growth advantage to narrow in 2020. We expect the Eurozone economy to re-accelerate thanks to robust domestic demand, a pick-up in global trade following the Phase 1 US-China trade deal, and as Eurozone companies replenish inventories. We also expect the Swiss franc to strengthen, as the Swiss National Bank scales back efforts to restrain currency strength following objections from the US government.

Takeaway: We believe unhedged exposure to USD bonds by euro and Swiss franc investors is now a crowded trade. Given our currency forecasts and the narrowed yield gap, we think European and Swiss investors holding unhedged USD bonds should carefully consider currency risks. We recommend that CHF investors switch from USD into EUR credit. EUR investors also should reconsider their USD bond exposure.

Drive to lower emissions points to opportunity for investors.

Two more corporate giants added last week to a flurry of green initiatives. Airbus revealed a new airplane model it claims could reduce fuel consumption by as much as 20%, compared to current generation mid-sized planes, while BP revealed plans to cut its carbon emissions to net zero by 2050 for all operations and in-house oil production. The focus also underscores the broader shift by listed companies to address sustainability concerns. We believe this creates opportunities for investors, as companies with higher emissions face mounting pressure from stricter government regulations and shifting consumer preferences. These trends also look likely to favor disruptive companies with the potential to reduce global emissions including in areas such as smart mobility, renewable energy, and energy efficiency.

Takeaway: We believe investors can benefit from a shift to sustainable investing, especially by investing in companies with a focus on clean air, energy efficiency, and lowering greenhouse gas emissions. Investors can tailor their portfolios to focus on these themes. For more detail on sustainable investing, click here.

Deeper Dive

Can the coronavirus be contained?

by Global Chief Investment Officer Mark Haefele

There was a step change higher in the number of new coronavirus cases in China last week, but equity markets retreated only briefly, and finished the week higher. China's CSI index gained 2.2% on the week and is only 5% off its January peak, while the S&P 500 gained 1.6% and finished at a record high. Are investors being too complacent?

We continue to monitor the spread of the virus, and it will be especially important to watch for any signs of large outbreaks in new places. But based on current information we think the lack of negative market reaction last week makes economic sense:

- On 13 February the number of new confirmed cases in Hubei province spiked to 14,840 compared with a daily rate of fewer than 3,000 since the start of the outbreak. But the large increase was due to the introduction of computerized tomography scans to confirm suspected infections within just minutes, rather than the days needed to process the results from typical test kits. The new methodology should correct under-reporting in the data, and we believe the increased transparency should help the authorities control the virus.
- Up until 12 February, growth in the number of new confirmed cases had declined. On 29 January the rate of change of new cases was 32% in Hubei province and 34% for China ex-Hubei, but by 12 February this had slowed to 5% and 3% respectively.
- On Friday, Hubei province reported 4,823 new cases, of which 3,095 were diagnosed using the new method of diagnosis. On a like-for-like basis, this means the levelling off in the number of new cases remains intact. By Monday 17 February the daily rate of change in new cases in Hubei was down to 3%.
- Additional resources to combat the virus in Hubei are becoming operational, including new and temporary hospitals and thousands of additional doctors.
- The global spread has so far been kept under control, with China accounting for 99% of all confirmed cases so far.
- Public concern about the outbreak also already appears to be receding. Internet searches for the term "coronavirus" peaked at the end of January and have been declining since, according to Google data.

Our base case is that the virus can be largely controlled by the end of March, and that the negative economic impact is mostly confined to 1Q. We are continuing to monitor the impact of the virus on global supply chains. We expect a sequential rebound in Chinese growth in 2Q to 4Q driven by pent-up demand, and by monetary and fiscal policy support. China has cut interest rates and Reserve Ratio Requirements (RRR) and added liquidity. We expect an additional 100-300 basis points (bps) in RRR cuts and 10-20bps in medium-

term lending facility rate cuts. Overall, we expect 1Q GDP growth to fall by 100–200bps from 6% in 4Q19. Yet, the full-year growth impact could be limited, down to 5.6% from 6.1% last year.

We also expect the drag on corporate earnings to be relatively modest. We expect 10% earnings growth in China in USD terms this year, about 200-300bps less than would otherwise have been the case. Our base case remains for double-digit earnings growth for Asia ex-Japan and emerging markets (EM) as a whole, far outpacing developed markets.

Against this backdrop, we remain overweight EM equities and also see long-term opportunity in Asia. From an EM sector perspective, we recommend that investors avoid vulnerable stocks that are likely to be most affected by the outbreak, including transportation, tourism, and entertainment; instead, we prefer e-commerce, technology, and healthcare, which are more likely to benefit.

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

Appendix

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