Coronavirus Emerging Markets Impact

by Rich Thies

As headlines about the coronavirus (COVID-19) roil global markets, we wanted to share our thoughts on how the virus is impacting emerging markets (EM) currently and how it may leave its mark going forward. We are not epidemiologists and won't pontificate about the specifics of the disease or its spread, simply how we see the impacts to EM equity markets.

Economic Impacts

To state the obvious, uncertainty about the global economic outlook has risen considerably which is in itself a material negative. While we are not epidemiologists, we do think we've seen enough to say that the only way to cure the economy from this virus is to turn the global economy off for a period of time. There's not much of an analogue of that to analyze and we think many areas of the demand shock will just be delayed consumption while others will be more or less permanent. There have been some episodes of major shocks (the 2011 Japanese earthquake and tsunami being the most obvious) but nothing as globally pervasive as this could be. On the supply side, we see very different risks to different industries, with the supply-chain shortfalls most obvious in the pharmaceutical space and less meaningful in areas like auto parts, consumer goods, etc. given we can anticipate slower demand growth. We think it's important to highlight that the timing of this outbreak is bad given quite low inventory levels across industries in Asia, though that does mean when this does eventually pass, the recovery will likely be strong. Given there are already whispers about fiscal stimulus in response from countries like Germany, we'd say the potential for a V-shaped recovery once this passes is high. In the short-term, there should be a noticeable uptick in inflation, which is ignored both by the Fed and the market, as the pricing of the rates market itself indicates.

The outbreak in China came at a time when signs of an upswing in activity had already begun and many sectors, specifically tech hardware, were seeing a faster than expected recovery on 5G buildout and a better-than-expected handset cycle. Further, the end of the deleveraging campaign combined with some more targeted infrastructure stimulus and the tepid end to the trade war were unlocking a recovery in data. We are seeing somewhat divergent trends within China relative to the rest of the world assuming data are accurate. Tuesday (2/26) showed only 406 new cases and almost all of them in Hubei, compared to over 2000 a day rate a little over a week ago. Workers are very slowly returning to work, and migrant workers from higher-risk areas are not, which is creating a labor shortage in some cities like Guangdong. While the initial response had issues, it seems many of the measures the government has taken have started to slow the spread of the virus. Chinese economic activity will be deeply depressed in the first half of 2020, at minimum. We do not anticipate a big-bang stimulus response to this, which the government has shown very limited desire to do, but likely it will front-load spending on strategic initiatives like 5G and improvements in healthcare infrastructure.

Interestingly, trends outside of China are now going another direction and containing the virus' spread will certainly be more difficult. We are anticipating the biggest issue now to be the size of the demand shock, rather than a large-scale human cost. COVID-19 has shown, so far at least, fairly low mortality rates in places where people have good access to healthcare. Outside of Hubei province itself, which was poorly equipped to handle this, the mortality rate has been very low. While this should provide some comfort on the ultimate impact in many places, it gives us serious concern should the virus find itself in countries like India which would likely struggle to contain its spread and its human cost.

Currency

As our long-time clients are aware, we think the US dollar is one of the key drivers of EM asset returns. Typically, a collapse in US real rates like we've been witnessing is a positive for EM FX. That has not happened this time for a few reasons. First and foremost, EM FX almost always struggles in weak or decelerating global growth environments. Second, in the initial phases this seemed like a China specific problem, then a China and Japan issue, then a European issue as well with the outbreak in Italy. While there's no evidence today of a material outbreak in the US, the market likely rightly assumes it will now happen eventually. This removes the idea that the US is relatively unaffected and should limit some of the USD upside that would have been present otherwise. We are not saying that the USD will stop being a safe-haven entirely, but that there are finally some countervailing forces. While we do not think this is a problem that will be remotely solved by monetary policy, we've seen enough from the Fed that they will respond with easing anyway. As of this writing, the market is pricing two cuts in the next year which if delivered, alongside a continued fiscal blowout in the US, would someday weigh on the dollar. If the current trend could be extrapolated (China's outbreak improving while the rest of the world deteriorates), you'd have a recipe for dollar weakness, but it's too soon to forecast that.

EM Equity investment implications

While we wouldn't go so far as to call these silver-linings, one of the interesting things about following the virus' impact on EM equities (since December in China) has been the differential impact on different business models. Speaking very broadly, trends that have been in place for many years have been sent into overdrive by the outbreak and fortunately, our EM strategies have been invested in many companies that will benefit from the virus. For years and years consumers across EM have been spending more and more time online every day. Younger cohorts have been playing video games a lot more every day and have been doing basically every other activity (socializing, drinking, smoking, etc) less and less. Similarly, Chinese consumers have been far ahead of the global curve in areas like fresh food delivery, micro-mobility, gaming, and more recently, telemedicine adoption. This virus and the quarantine has just accelerated adoption rates of all those trends. While undoubtedly a large negative event from a macro level, there are relative beneficiaries at the company level.

Other implications

There are of course a myriad of implications that are beyond the scope of this update, but we do think a few of the ones on our minds are worth highlighting. Assuming the virus does indeed spread more globally, we see this further benefiting the increasingly isolationist political impulses around the world. While you could argue this will highlight the need for improved healthcare, we'd guess the isolationist impulse will be stronger. We believe this would be most acute in the European Union where the sudden ability to not control borders is going to feel a lot more contentious than it even was during Brexit, especially if a country (like Italy) is seen to be bungling the response. In short, we see the potential that this virus achieves more for de-globalization than all the politicians and tariffs in the world could have hoped.