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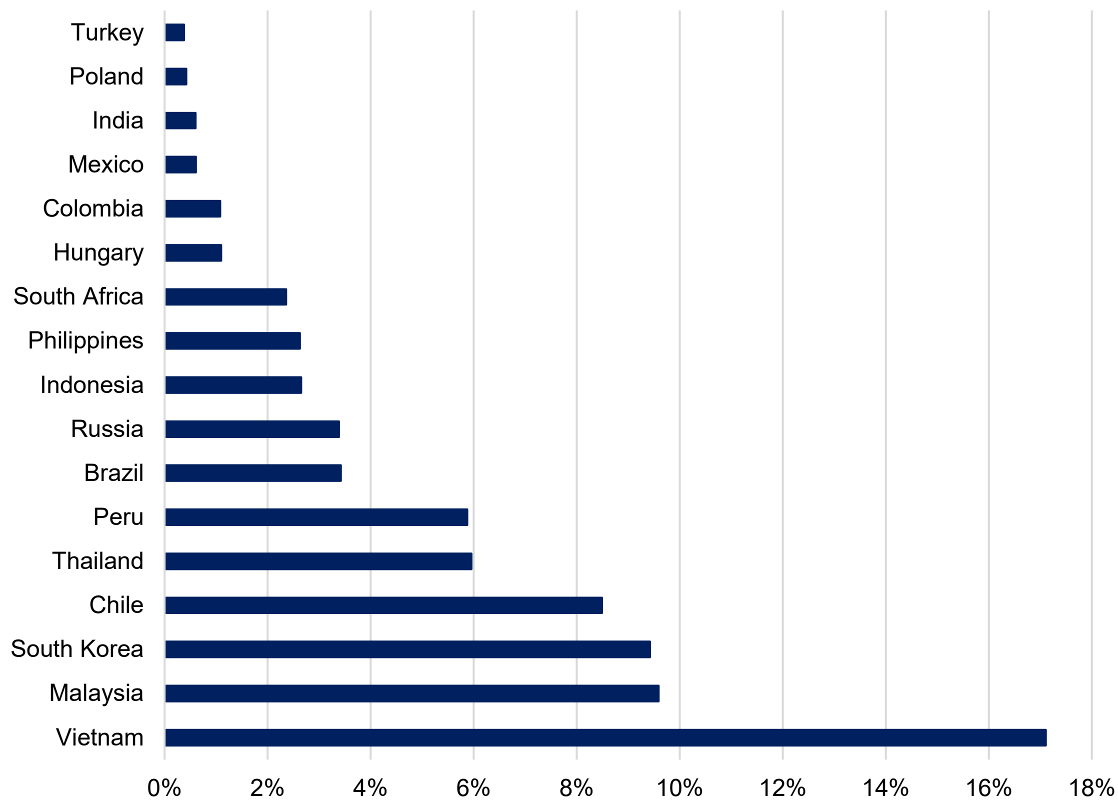
CORONAVIRUS AND THE OUTLOOK FOR EMERGING MARKETS

The impact of a coronavirus-based economic slowdown is a global GDP story, but over the last week, there was a particular emphasis on the expected impact for China and emerging markets. The MSCI EM Index pulled back 5.1% for the week ended January 31 (vs. 2.5% for the MSCI ACWI) on reduced appetite for risk, as the number of reported cases more than tripled. It now stands at more than 20,000, with the first death outside of China reported in the Philippines. The current coronavirus outbreak is more contagious but less deadly than SARS, and we are in the acceleration phase of infections, which is what has markets so spooked.

Relative to when SARS hit in 2003, China is a much larger portion of global GDP (16% now v. 4% then), its debt to GDP is twice as large, and its GDP growth is lower (6% now v. 10% then). Among emerging markets economies, exposure to China varies widely. Stock markets in Taiwan and South Korea, which are heavily reliant on China, were down 6% and 9%, respectively, from January 20 through January 31 (the S&P 500 is down 3% for the same period). The impact on Indonesia's GDP from the outbreak is expected to be much more limited than on Thailand's given less reliance on Chinese tourism. Approximately 4% of Indonesia's GDP came from tourism and China accounted for about 13% of all inbound tourist traffic versus Thailand's 11% tourism GDP share and 30% Chinese inbound traffic. The South-East Asian Nations Travel Association believes Thailand and Vietnam are the most at risk given their reliance on tourism.

Exhibit 1: Exports to China as a share of local GDP



Source: Columbia Threadneedle Investments. Data as of 12/31/2018

In the SARS outbreak, the annual impact on Chinese GDP is estimated to have been 1% for 2003. The composition of the Chinese economy is very different now, however, with consumer spending accounting for nearly 70% of GDP growth. As a result, the impact on the Chinese economy, and those reliant on Chinese consumers, may be longer-lasting. That said, the impact of the outbreak while a short-term negative, is not expected to derail the longer-term drivers of the asset class. We expect an economic impact, but a transitory one, with a quick rebound in growth once the virus is contained. Our expectation is that the market will look through any earning misses or reduced guidance once containment is in sight. Given the quarantine in Hubei province (the epicenter of the outbreak), we are watching the rate of new infections outside of Hubei. When this rate reverts to linear rather than exponential growth, we will be more comfortable calling a market bottom.

Weather and central banks both matter in the coming months. Like flu season, the SARS and MERS coronavirus infections ebbed as the weather warmed, and warming trends in March and early April may help limit the spread of the current virus. In the face of higher volatility and weaker global growth we expect to see central bankers in China and globally bring liquidity to the system, helping to buffer any market downturns. The central bank of China has already announced that it will inject 1.2 trillion yuan (US$173 billion) into markets and pledged its commitment to use monetary policy tools to ensure liquidity remains ample and supportive of firms affected by the virus.

While we expect volatility to continue, we remain constructive about the outlook for emerging markets and China. Having said that, we had been taking profits in China even before the outbreak, given the rapid rise in some portfolio holdings over the past couple months as the risk/reward profile became less attractive and valuations more full on a shorter term basis post the U.S.-China phase one trade agreement. Fundamentally, our emerging markets portfolios have minimal exposure to areas which suffered the most in previous outbreaks (e.g., tourism, catering services, transportation, and retail). In areas where there may be some exposure to the corona virus, we own the highest quality companies that have ways to mitigate the impact of the outbreak.

Going forward, given our adjustments over the last few months, we have ample dry powder to deploy should the sell-off become more pronounced, and we are actively looking for top-tier companies/franchises that we may be able to buy for a discount. E-commerce and online entertainment (game play and streaming) are obvious beneficiaries as much of the country is on lockdown. Once we see containment, we also expect to see a sharp acceleration in modern retail as the government cracks down on older, unhygienic wet markets where it is believed this (and other) viruses originated. Tutoring companies, which were starting to transition students from offline in-person tutoring to digitally-enabled online platforms should also see an acceleration of this transition in the current environment. A focus on quality of health care and the need for insurance (areas we focus on in our portfolio) will likely be reinforced by this outbreak.

Sources for this article include: MSCI; New York Times; Bloomberg; Trading Economics; CNBC; Wall Street Journal; Reuters; Standard and Poor's; and Columbia Threadneedle Investments

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