



MINERVA

INVESTMENT
MANAGEMENT
SOCIETY

MARKET UPDATE: COVID-19 IMPACT

by Nunzio Quaranta

Equity Research Analyst, Minerva IMS
MSc in Finance Student, Bocconi

25/02/2020



COVID-19 OVERVIEW

Originated in the Chinese city of Wuhan at the turn of the year, SARS-CoV-2 belongs to the large family of Coronaviruses (CoV) that causes illness ranging from the common cold to more severe diseases such as Middle East Respiratory Syndrome (MERS-CoV) and Severe Acute Respiratory Syndrome (SARS-CoV). It is a new strain not previously identified in humans and has zoonotic origins, meaning that it is transmittable from animals to people. More than 80,000 people in 27 countries have been infected by the new strain of coronavirus and more than 2,600 people have died. As with many crises, the repercussion of the Covid-19 (Corona Virus Disease 2019) does not represent only a health emergency, but also threaten the global economy and the financial markets.

ANALOGIES WITH 2003 SARS EPIDEMIC

Several analysts have underlined how the impact of Covid-19 on the Chinese and global economy would show similarities with the effects driven by SARS outbreak in 2003.

To be noted that in 2002 when the SARS emerged in China the country's economy was principally based on the production of low-cost goods such as T-shirts and sneakers for customers worldwide. As of today, after seventeen years, China has evolved into one of the principal players of the global economy and international companies rely on Chinese factories for the majority of their production and depend on Chinese consumers for sales. As a result, its share of the MSCI Emerging Markets Index – it captures large and mid-cap representation across 26 Emerging Markets – rose from 5% in FY03 to 11% in FY18. In addition, China's share of the Global GDP amounts to about 16% in FY19 (vs 4% in FY03), whilst China's share of the Global Trade is around 11% in FY19 (vs 5% in FY03).

More in detail, SARS led down China's growth from 11.1% yoy in the 1Q03 to 9.1% in the following three months, according to data from the National Bureau of Statistics of China. In the ensuing quarters, Chinese economy rebounded to register an

annual growth rate of 10%, faster than the previous year's 9.1%, according to Refinitiv.

The main economic effects of SARS can be summarized as follows:

- **Fall in retail sales growth:** the growth rate in retail sales dropped from 9.0% in Nov-02 to 4.3% in May-03, encountering the slowest pace in the last 5 years, due to the governmental emergency actions which led to the lockdown of cities and to several travel restrictions within the country.

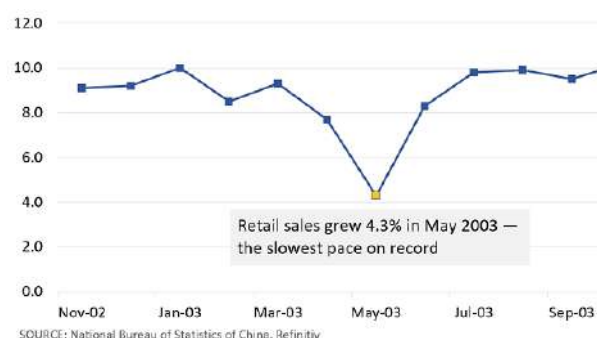


Figure 1 – Retail sales growth path during SARS outbreak

- **Drop in industrial output:** the industrial production registered a 13.7% growth rate in May-03, the slowest pace since Aug-02. Although economists from Société Générale claimed that the coronavirus could be mitigated in the later part of 2Q19, allowing the industrial firms to improve productions to meet orders, various economists underlined a more dramatic scenario in China, where the situation could not improve as fast as they expect.

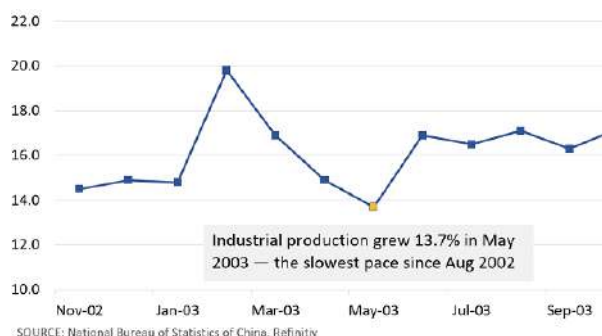


Figure 2 – Industrial production development during SARS outbreak

- **Changes in trade volume:** following the SARS outbreak, the expansion in exports was steady throughout 2003, driven by the increasing demand at YE02 which supported the Chinese economy to rapidly recover from the epidemic, according to Macquarie. On the contrary, the effect of Covid-19 could be different according to economists from S&P Global Ratings since imports and exports would be hit because of “supply outages and disruptions to the logistics networks”.

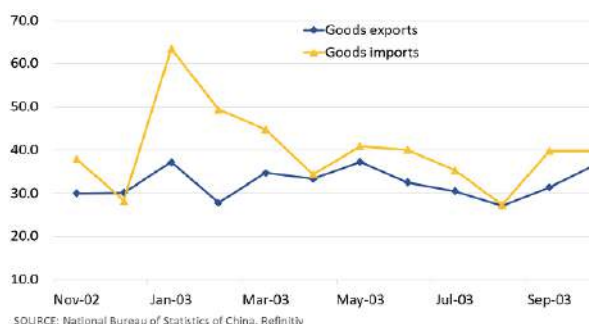


Figure 3 – Trade balance development during SARS outbreak

IMPLICATIONS FOR GLOBAL MARKETS

The impact of Covid-19 on global GDP growth for 2020 has been forecasted by S&P Global Ratings in the range of -0.3% in mid-February (-0.7% for China). However, according to Oxford Economics, the recent spread of the virus to regions outside Asia, Italy primarily, could knock 1.3% off global growth this year, the equivalent of \$1.1tn in lost income. Such implications for global growth will really depend on the effectiveness of containment policies adopted by political authorities.

According to MSCI latest analysis, the industries mostly affected by the spread of Covid-19 in APAC region will be:

▪ Airline sector

The International Air Transport Association (IATA), the most imminent trade body for the global airline industry, warned that the drop of passenger demand would cost more than \$23.9bn in lost annual revenues, with global air travel expected to fall for the first time in more than a decade. The most negatively impacted will be airlines operating in

APAC region, where revenues are expected to decrease by \$27.8bn. More in detail, IATA estimated that the loss for Chinese players could amount to \$12.8bn and drew the scenario in which the Covid-19 downturn would have a similar V-shaped impact on demand as was experienced during SARS, characterized by a six-month period with a large decline counterbalanced by an equally quick recovery.

To be noted that the negative effect of the drop of passenger traffic in APAC region could be mitigated by the decline in oil price. China consumes ca. 14m barrels of oil per day and, under a 10% demand decline, there would be 1.4 mmbbl (abbreviation standing for “one million barrels”) per day of lost demand, pressuring prices and worsening the oil companies’ metrics. Such hypothetical result would be confirmed by crude price benchmarks falling steeply since YE19.

In particular, WTI and Brent respectively fell from \$61.06 on 31-Dec-19 to \$51.56 on 31-Jan-20 and from \$66.00 to \$56.62, whilst NYMEX Crude Oil and ICE Brent Crude plummeted to \$53.46 and \$56.77 on 20-Feb-20.

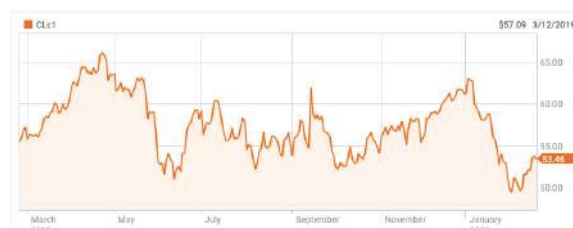


Figure 4 – NYMEX Crude Oil development for the last year (Thomson Reuters)

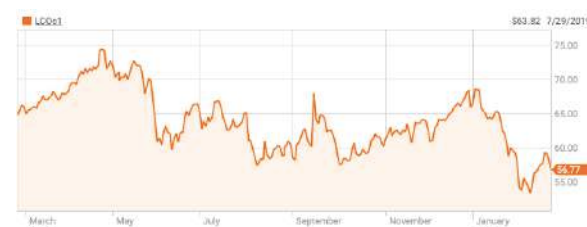


Figure 5 – ICE Brent Crude development for the last year (Thomson Reuters)

▪ Luxury retailers and tourism

Another sector at risk is represented by luxury retailers which are directly exposed to Chinese consumption and tourism. As a matter of fact,

Chinese shoppers account for 35% of the personal luxury goods markets, compared to Americans (22%), Europeans (17%), other Asians (11%), Japanese (10%) and RoW (5%), according to top-line origination of the main global luxury groups.

Due to “particularly uncertain conditions”, Kering closed half of Chinese stores, started to reallocate inventory from China to other regions, reviewing product launches and weighting cost-cutting, while Hermès will provide an update to investors on 26-Feb-20.

Moreover, the tourism sector will be highly impacted by the reduction in mobility of Chinese citizens as Chinese customers accounted for around 20% of total global tourism spending in 2018, as calculated by United Nations World Tourism Organization.

▪ **Auto manufacturer producers**

China represents the world’s largest car market for traditional and electric vehicles, whose demand will be principally impacted by Covid-19 as most of sales of EVs are concentrated in the biggest cities, most inclined to be affected by the virus.

In addition, due to the plant-closing in the country’s main regions, auto manufactures will be affected by temporal production outages which is expected to reduce output by more than 1.7m cars. In detail, China accounts for 28% of light vehicle production, compared to United States (19%), Western Europe (18%), Japan (6%), Eastern Europe (5%), India (4%), Brazil/Argentina (3%), Canada (2%) and others (15%).

Tesla expects a potential 10-day delay in production at its new Shanghai plant after the shutdown required by government, whilst GM, Toyota and Volkswagen closed their plants, valuing a possible resume of operation at the beginning of Mar-20. According to JPMorgan Chase & Co. estimates, each month of lost production in China would erode operating profit by about 6.1% at Honda and 11% at Nissan. Jaguar Land Rover warned last week it could run out of car parts at its British factories by

next week and admitted it had been bringing in parts from China to the UK in suitcases.

To be considered is that industries such as textiles are able to relocate production quickly, but the car industry requires heavy equipment and could take two or three years to move a plant.

▪ **Health Care**

On other side, the health care sector would represent the biggest gainer from Covid-19, due to the increasing demand in medical equipment, larger spending in hospital care and the improvement in R&D investments driven by the mapping procedures for a Covid-19 vaccine. However, this is not the only possible outcome.

Drug-makers in India, producers of 20% of the world’s drugs supply by volume, are facing a potential disruption from the expansion of coronavirus due to the slump in raw material supply from China. According to the brokerage firm SBICAP Securities, almost 70% of the raw material used in India are imported from China and Hubei province is a major production hub. Companies producing anti-infective and hormones therapies, such as GSK India, Pfizer (PFE) and Cipla are most at risk from material shortages and, in order to be ready to successfully face the challenge, most of European and American players are watching for sourcing from countries other than China, worrying for the long-term consequences of the outbreak.

CONCLUSION

Our assessment of the Covid-19 impact highlights a situation in which the world is more connected compared to 2003 SARS outbreak since global companies’ revenues are more exposed to China. As a consequence, we believe that the market should examine revenue exposures and investors should diversify their portfolios across industries and asset classes, with the aim to reduce the weight of the negatively impacted sectors, particularly airlines, and increase their exposure to health care stocks.



In light of the above-mentioned dynamics, it is highly probable that there could be a flight-to-quality market reaction, from which securities such as U.S. Treasury and commodities such as precious metals would benefit, as confirmed by the upward momentum of gold. In addition, the Chinese yuan could depreciate vs dollar, and, as explained, crude oil could fall due to the dropping demand from airline companies and Chinese consumers.

DISCLAIMER

This is an academic paper related to an academic project that doesn't pretend to represent any investment recommendation nor offer any solicitation to buy or sell securities or to adopt an investment strategy. The opinions expressed are subject to change. References to specific securities, asset classes and financial markets are for illustrative purposes only and are not intended to be and should not be interpreted as recommendations. Reliance upon information in this material is at the sole risk and discretion of the reader. The material was prepared only in regard to the specific objectives of Minerva Investment Management Society virtual portfolios.