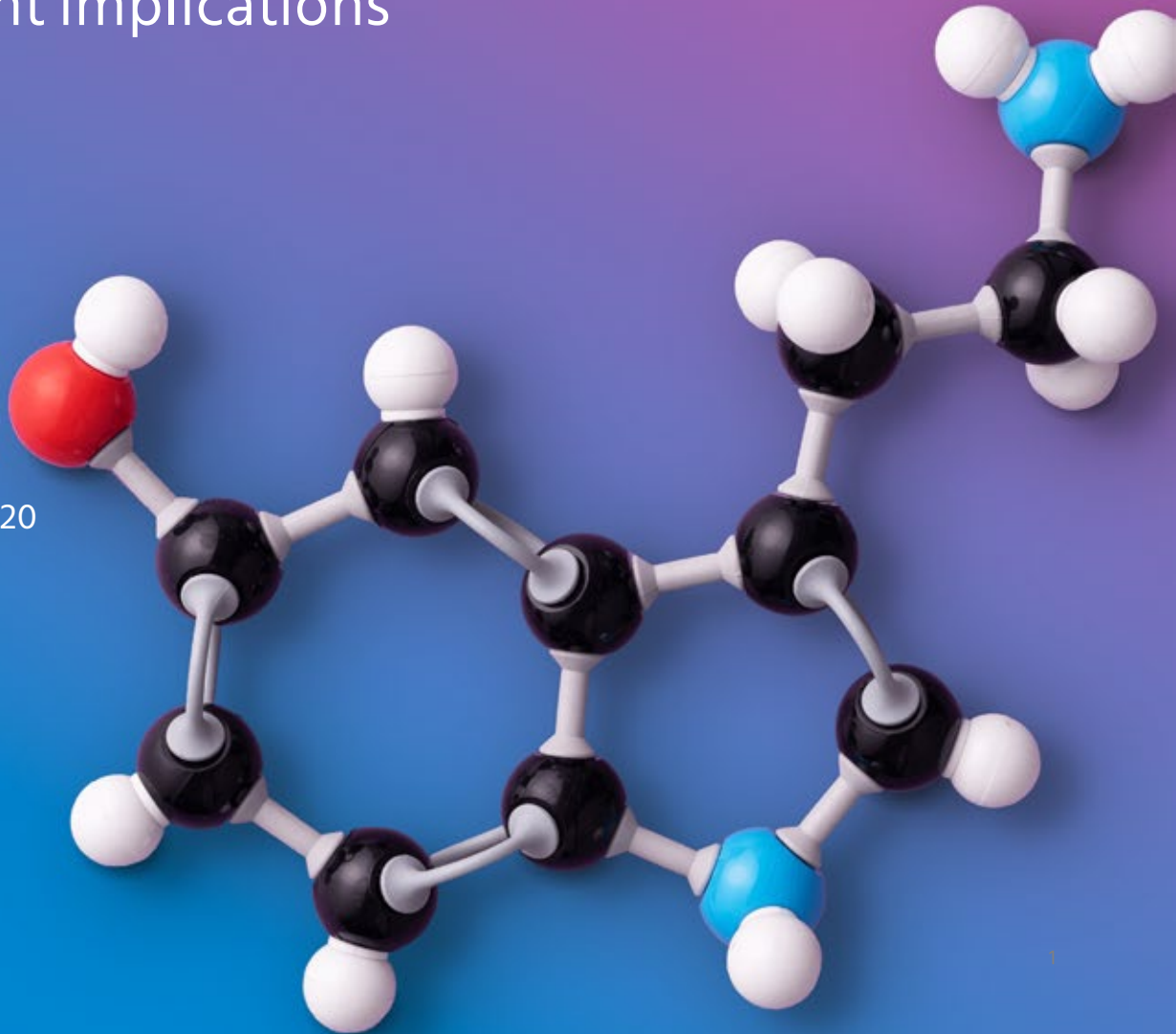


Coronavirus outbreak update

Investment implications

February 28th, 2020



Recent developments and market impact

Toward the end of February 2020, equities and other risk assets sold off, and safe-haven assets rallied amid increasing concerns about the novel coronavirus. The virus, now known as SARS-CoV-2, is expected to spread further than was initially anticipated. Over the three trading sessions from February 21 through February 25, global equity markets fell by around 6% while gold increased by over 2%.¹ The US 10-year Treasury yield edged closer to the 1.3% mark, the lowest level ever recorded.

The number of cases across the globe has now increased to 80,239, as of February 25, according to the World Health Organization (WHO).² Meanwhile, WHO has also reported 2,700 deaths from COVID-19 (the disease associated with SARS-CoV-2). The vast majority of these cases remain within the Hubei province in China, which is the epicenter of the outbreak. Outside China, there have been 2,459 cases and 34 deaths reported in 33 countries. With sadness, we note that more people have now died from COVID-19 than died during the SARS outbreaks between 2002 and 2004.

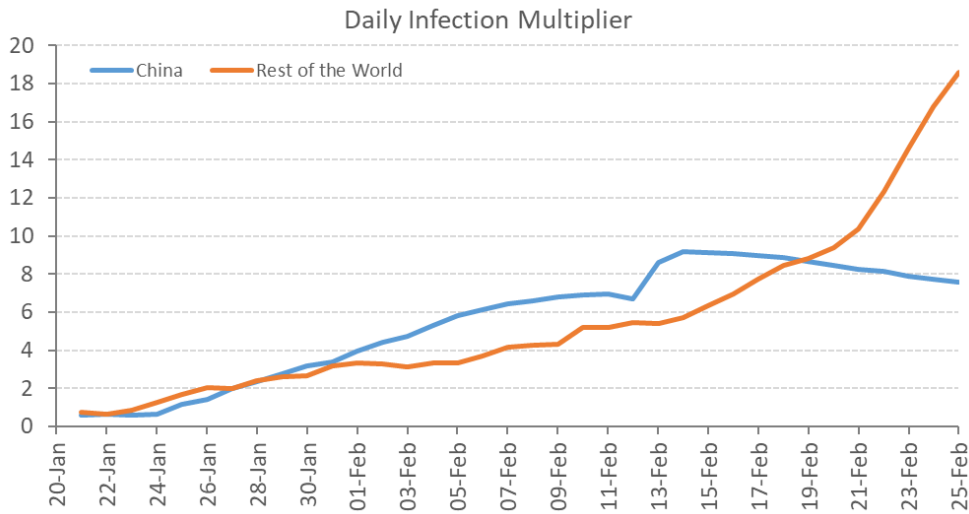
Outbreaks outside China

Although the number of cases outside China is low, there is concern about the rapid escalation in other countries. As the charts below show, the infection multiplier (a measure of the speed of the infection spread) and new cases outside China have increased significantly over the last week. Over the week up to February 25, the number of cases in Korea rose sharply from 30 to 977, while in Japan cases jumped from 59 to 157 (excluding the cruise ship Diamond Princess). In Italy, the number of cases rose from 3 to 229.³ In both Korea and Italy, where numbers have risen most dramatically, outbreaks were concentrated in specific areas.

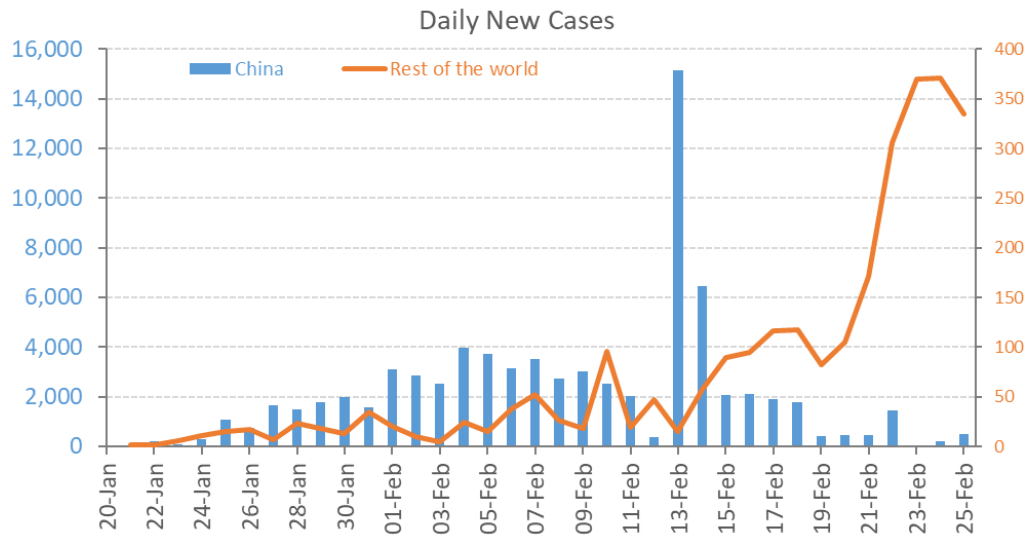
¹ For more information on gold, please refer to our latest paper “[Gold – You’re Indestructible](#),” available at <https://www.mercer.com/our-thinking/wealth/gold-you-are-indestructible.html>

² [World Health Organization. *Coronavirus Disease 2019 \(COVID-19\) Situation Report – 36, 25 February 2020*, available at \[https://www.who.int/docs/default-source/coronaviruse/situation-reports/20200225-sitrep-36-covid-19.pdf?sfvrsn=2791b4e0_2\]\(https://www.who.int/docs/default-source/coronaviruse/situation-reports/20200225-sitrep-36-covid-19.pdf?sfvrsn=2791b4e0_2\).](https://www.who.int/docs/default-source/coronaviruse/situation-reports/20200225-sitrep-36-covid-19.pdf?sfvrsn=2791b4e0_2)

³ [World Health Organization. *Coronavirus Disease 2019 \(COVID-19\) Situation Report – 28, 17 February 2020*, available at \[https://www.who.int/docs/default-source/coronaviruse/situation-reports/20200217-sitrep-28-covid-19.pdf?sfvrsn=a19cf2ad_2\]\(https://www.who.int/docs/default-source/coronaviruse/situation-reports/20200217-sitrep-28-covid-19.pdf?sfvrsn=a19cf2ad_2\) \(using February 17 as base\).](https://www.who.int/docs/default-source/coronaviruse/situation-reports/20200217-sitrep-28-covid-19.pdf?sfvrsn=a19cf2ad_2)



Source: Kompa, Mercer. The daily infection multiplier is defined as the ratio of total cases to date compared with the number when the outbreak was first reported (January 20, 2020), adjusted for the number of days since the outbreak.



Source: Kompa, Mercer.

Quarantine measures have been taken in the two affected regions in Italy, similar to those taken in the Hubei province. The small towns that seemed to be the main sites of the Italian outbreaks have been locked down by the military. In Korea, the outbreak appears to have emerged from a mega-church and the affected city has put voluntary quarantine measures in place. Italy, Japan and Korea are all key manufacturing hubs and parts of the global supply chain, contributing 1.7%, 4.0% and 1.6%, respectively, to estimated global GDP, according to the International Monetary Fund.⁴ Our main concern is that the virus may spread rapidly and untraceably into other countries, disrupting economic activity in much the same way as it has in China, but on a global basis. In Italy, authorities have struggled to trace the origin of the outbreak, leading to the concern that a hyper-contagious individual (a so-called “super-spreader”) is still causing infections. Furthermore, the outbreaks in Italy and Korea have occurred in important manufacturing heartlands that are key drivers of economic growth for those countries.

There is also unease about the current outbreak in Iran, the scale of which has likely been hidden for weeks. The potential lack of cooperation and transparency from Iran increases the risk of the virus spreading across the Middle East, especially due to pilgrimage flows.

As a result, future disruptions to regions of similar economic importance are a plausible scenario, and there could well be random economic shocks to the global economy. In such cases, we expect heavy-handed measures such as lockdowns and travel restrictions, even if they come at a high economic cost; the political cost of inaction would be far too high for most governments to contemplate. Although good progress has been made on treatments, including a vaccination, large-scale manufacture and distribution are likely to take months.

Meanwhile in China, the number of reported new cases continues to trend downward, aside from a spike on February 13, due to a change in the classification method.⁵ Further quarantines, delays to resumption of economic activity and restrictions on people movements appear to have contributed to slowing the spread of the virus outside the Hubei province. Chinese authorities reported just nine new cases in other provinces on February 25.

Economic impact

Aside from the concern regarding the spread of SARS-CoV-2 beyond China, the extent to which economic activity is being disrupted within China appears to be greater than many economists and market participants had previously thought. This has prompted further downgrades in economic forecasts for the first quarter and calendar year 2020, both in China and across the globe.

⁴ IMF October 2019 World Economic Outlook database

⁵ [World Health Organization. *Coronavirus Disease 2019 \(COVID-19\) Situation Report – 24*, 13 February 2020, available at \[https://www.who.int/docs/default-source/coronaviruse/situation-reports/20200213-sitrep-24-covid-19.pdf?sfvrsn=9a7406a4_4\]\(https://www.who.int/docs/default-source/coronaviruse/situation-reports/20200213-sitrep-24-covid-19.pdf?sfvrsn=9a7406a4_4\)](https://www.who.int/docs/default-source/coronaviruse/situation-reports/20200213-sitrep-24-covid-19.pdf?sfvrsn=9a7406a4_4)

For example, consensus forecasts for first-quarter Chinese GDP growth have gone from 6% to heavily negative. With China now representing almost 20% of the global economy, this will have a material impact on global growth for the quarter and will be made worse by the spillover impacts on other economies.

Equity markets have also revised their earnings expectations modestly downward, with the MSCI Emerging Markets Index implied earnings per share for the next year falling approximately 2% over the past month. Although this is only a slight fall, it does follow a contraction in earnings in 2019 on the back of trade tensions and slowing global growth.

So far, no major economic data highlighting the extent of disruptions have been released (the January quarantines and shutdowns coincided with the regular Chinese New Year holidays). The first February data to be released will be the Purchasing Manager Indices, expected between February 26 and March 2. According to Bloomberg, economists are currently forecasting the official and unofficial (Caixin) manufacturing PMIs for China to fall significantly. This is not surprising given that surveys point to only half of firms having resumed activity after the Chinese New Year, and those are operating at lower capacity due to restrictions on workers. A number of proxy indicators such as traffic congestion, coal consumption and subway rides all point to a very slow resumption in activity.

Beyond China, there is mounting evidence of COVID-19 causing a degree of economic disruption. Factories have been forced to reduce capacity and send workers on unpaid leave due to inputs from China not being delivered. Earlier in February, Apple indicated that it might not meet its quarterly target as a consequence of disrupted production and stores' closure in China. Countries reliant on spending from Chinese tourists, including the US, are also feeling the pinch. Conferences and events across the world have been canceled or postponed. If the virus spreads more widely, we expect these disruptions to become more systematic.

Outlook

The recent outbreaks of the virus will only add to the uncertainty and significantly widen the range of outcomes for global economic growth.

If the downward trend of new cases in China continues, Chinese authorities may loosen restrictions on business in those provinces deemed less at risk of spread of COVID-19, enabling economic activity to resume. Economic data is likely to be very soft in February, however it may stabilize in March before ultimately returning to normal in April. In such a scenario, we still expect a v-shaped recovery in activity, but the inflexion point may be later than we previously anticipated.

Manufacturing activity that did not take place in February or early March could be made up in subsequent periods. But some services activity are unlikely to be recovered, such as those related

to the cancelled Lunar New Year celebrations. As a result, full-year economic growth figures for China are likely to be lower than expected, weighing on corporate earnings.

As for the rest of the world, much depends on whether the recent outbreaks outside China will be contained, how long this will take, and whether we will see many more outbreaks causing further disruptions, which is now highly likely. Countries reliant on tourism could well see lower growth for the year: The high-profile case of the cruise ship forced to weigh anchor off the coast of Japan might put off travelers all over the world from planning vacations until the epidemic is completely over. However, in some countries, fiscal easing is likely to bring some spending forward and thus smooth the growth impact. Moreover, central banks could employ another round of monetary stimulus.

In summary, although our base scenario is slightly impaired, we expect positive global growth for 2020, with the second half of the year recovering a substantial amount of the growth lost in the first half. That said, we caution that there is material uncertainty around our base scenario, and the situation could take a dramatic turn for the worse, should this become a prolonged global pandemic with many lockdowns and quarantines emerging across the world.

Dynamic asset allocation (DAA) view

Overall, our base case remains intact – we still expect global economic growth to return to trend over 2020 and 2021, albeit with higher downside risks than previously anticipated.

From an asset allocation perspective, we continue to recommend a neutral allocation to listed equities. Equities could fall further if COVID-19 becomes a global pandemic and efforts to control the spread further disrupt economic activity. However, equity market investors should look beyond short-term economic disruptions, and the downside could be cushioned by any monetary policy response.

We maintain our slight preference for emerging markets over developed markets. Emerging markets continue to be attractively valued on balance and likely to benefit from loose financial conditions. For the time being, volatility is likely to persist.

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