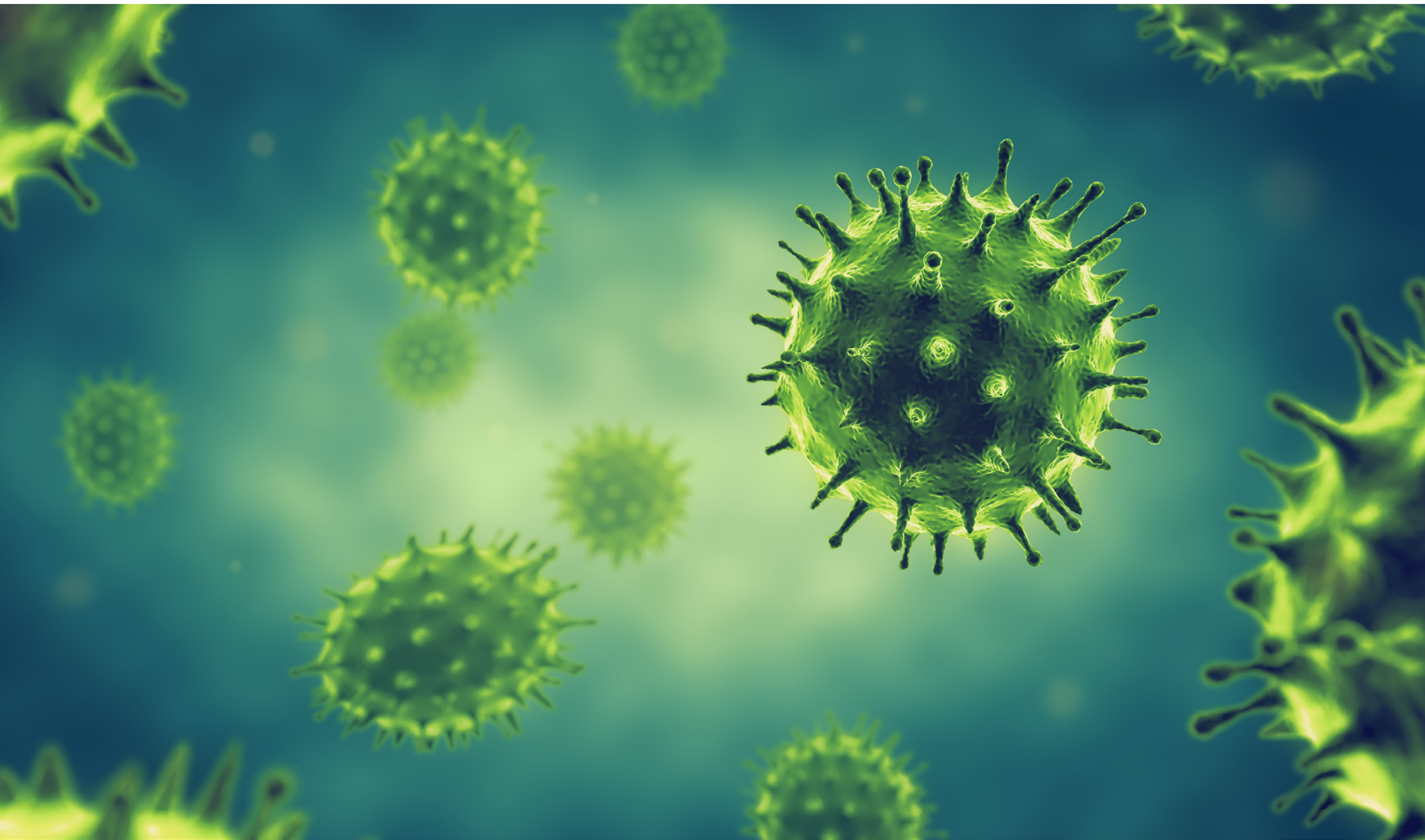
Omba Advisory & Investments Limited



COVID-19

An Update on the Impact on Markets and Economies

28 February 2020

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OMBA Advisory & Investments Ltd is an authorised financial services provider (FSP No. 49101) in South Africa
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Market Impact

		Original Currency			
	Currency	28 Feb 2020 11:37:48 GMT	Week-to-date 28 Feb 2020	Year-to-date 28 Feb 2020	52-wk peak to 28 Feb 2020
FTSE 100 - UK	GBP	-2.95%	-10.94%	-12.58%	-14.64%
TOPIX - Japan	JPY	-3.65%	-9.74%	-12.23%	-13.53%
DAX - Germany	EUR	-3.43%	-12.05%	-10.12%	-13.45%
JSE TOP 40 - South Africa	ZAR	-3.26%	-9.94%	-8.58%	-12.71%
STOXX 600 - Broad Europe	EUR	-2.66%	-11.47%	-8.87%	-12.63%
CAC40 - France	EUR	-2.68%	-11.31%	-10.54%	-12.48%
S&P 500 - US	USD		-10.76%	-7.80%	-12.22%
MSCI All Country World Index	USD		-8.86%	-7.67%	-10.17%
MSCI Emerging Markets	USD		-4.94%	-7.53%	-10.13%
CSI 300 - China	CNY	-3.55%	-5.05%	-3.82%	-6.71%

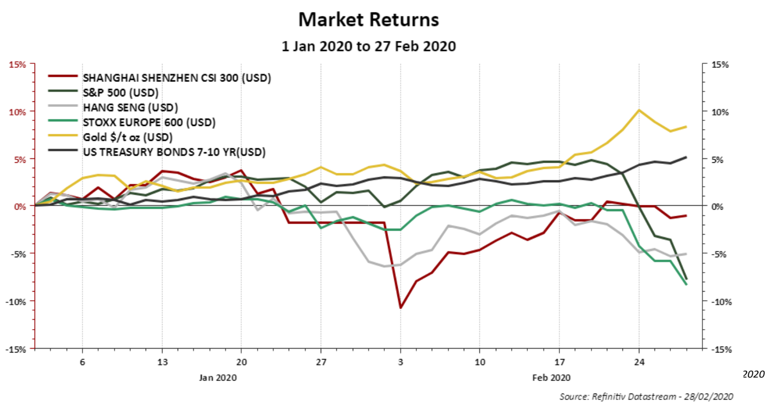
Last updated at 11:37 GMT on 28 Feb 2020. *Source: Refinitiv.*

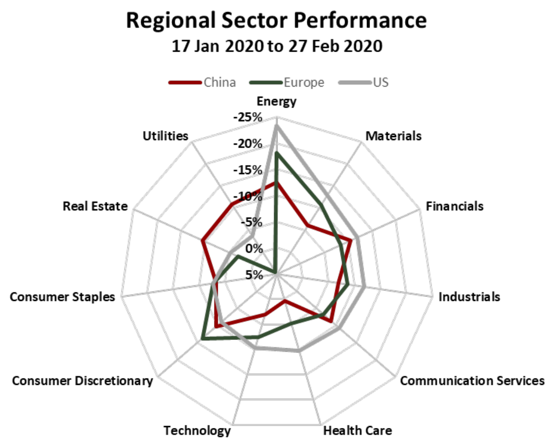
- Following an extremely volatile week equity markets have officially entered correction territory (dropping more than 10% since their recent high). On Thursday 27 February 2020, the S&P 500 dropped 4.4%, its worst 1-day drop since 2011. And its 10.76% drop is one of the fastest ever for the S&P 500 (taking just 6 days from market close on Friday 21 February 2020). The VIX, a measure of volatility, spiked to 39.31 – a level breached only twice since 2011. Safe-haven assets like gold and high-quality bonds have moved sharply higher. Bond yields on 10-year US Treasuries decreased 0.75% since the start of the year, with 10-year UK Gilts and 10-year German Bunds decreasing 0.41% and 0.43% respectively.
- Markets have largely been mispricing risks from the spread of the coronavirus. The virus that causes the coronavirus disease (the disease named COVID-19) is called severe acute respiratory syndrome coronavirus 2 (SARS-CoV-2)). Initial market expectations were for a V-shaped market impact (a sharp move down followed by a quick recovery) and for the impact to be largely isolated to South-East Asia. This view has evolved as the scale of economic disruption spreads globally with supply chain disruption far more extreme than the SARS outbreak of 2003. A U-shaped or L-shaped market impact is now seen as more probable outcomes, although we think a W-shaped recovery is more likely in time.
- Our base case remains for a recovery in the medium (12 to 24 months) to long term (>2 years). Downside risks have however increased as continued spread of the disease is resulting in economic disruption as many factory and office workers are encouraged to stay home and schools are being forced to close. Large multi-national corporates are also taking steps to restrict travel and large gatherings. Other events from China's two-week long annual parliamentary meeting due to start on 5 March to Ireland vs Italy's Six Nations clash on 7 March have been postponed.
- It remains important to distinguish between economic and social impacts and the reaction of asset prices. The disparity in timing and impact on different regions and sectors is a key consideration for investors as asset prices adjust to reflect market expectations and sentiment. Japan is already flirting with a technical recession (after a 1.6% GDP contraction in Q4 2019) and Eurozone growth in Q4 2019 a mere 0.10%. Weak Q1 data and weak earnings from companies, which is now inevitable could exacerbate the sell-off at the beginning of Q2.

	Currency	28 Feb 2020 08:45:52 GMT	Last week 21 Feb 2020	Last year 31 Dec 2019
Gold price	USD	$ 1,631.93	$ 1,643.70	$ 1,517.40
US Treasury 10-year yield	USD	1.17%	1.47%	1.92%
UK Gilts 10-year yield	GBP	0.41%	0.57%	0.82%
German Bunds 10-year yield	EUR	-0.62 %	-0.43 %	-0.19 %

Last updated at 08:45 GMT on 28 Feb 2020. *Source: Refinitiv.*

- The disparity in how different equity sectors (in different regions) have been impacted is notable. Broadly, Chinese, European and US sectors follow a fairly similar pattern as measured from market close on Friday 17 January 2020 – the day just before markets started to react to the coronavirus outbreak in China. China Health Care and Technology has been a standout relative performer along with Utilities (in both the US and Europe,). The Energy sector has been hardest hit (-23.4%) as demand for energy has plummeted.





- Regionally, the focus is moving outside China as daily new case counts rise faster outside of China (although scepticism of numbers and definitions remains prevalent). With Chinese equities being such a strong relative performer in 2020 (down just 3.82% by 28 February 2020), further downside risk to Chinese equities cannot be ignored (foreigners have been net sellers of mainland companies through Northbound Stock Connect).

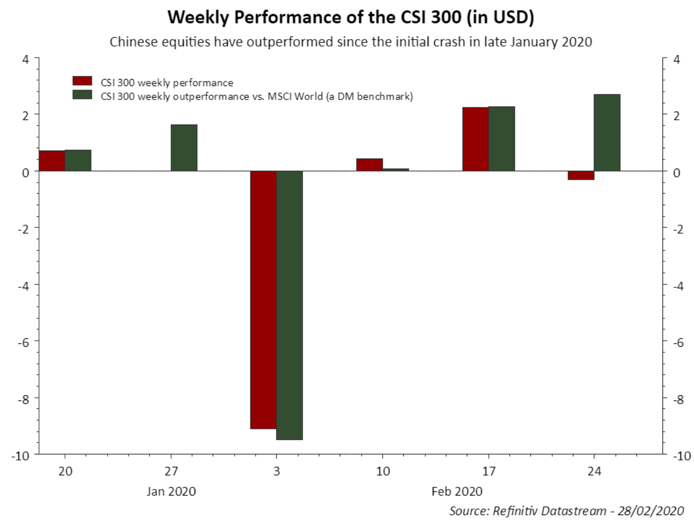
- With the prospect of a widely available vaccine being more than one year away, the use of quarantine is critical to controlling the outbreak. A relatively effective quarantine will slow the transmission of the virus but may also protract the negative economic impact and delay the resumption of growth. The obvious downside of quarantine has already been witnessed in China from a social and economic perspective. This is yet to be felt directly in Europe and the US.

- The attention of markets has also turned to fiscal and monetary stimulus as they increasingly rely on these measures to support slowing global growth. China has very clearly exhibited their willingness and ability to provide necessary stimulus. Expectations are now for three rate cuts, by the US Fed, by year end (up from less than 1 cut at the beginning of 2020). While equity prices may respond positively (at least initially) to monetary stimulus the biggest concern is the ineffectiveness of such measures to dealing with supply side shocks (a rate cut is more effective in stimulating demand as borrowing becomes cheaper).

Update on China and Broader Asia

China remains the worst affected nation with 78,630 of the 82,294 confirmed cases and 2,747 of the 2,804 deaths worldwide (as of 27 February 2020). South Korea is the second worst impacted, with 1,766 confirmed cases in 13 deaths. Italy is the third worst affected nation, while Japan is fourth. Due to the proximity to the Chinese epicentre, the spread of the virus has been most pronounced in Asian nations while closely-knit logistics and supply chains and a relatively large degree of integration between populations pose greater economic risks to the region (for now). As such, Asian asset prices bore the brunt of the initial sell-off in late-January 2020.

Interestingly, while many global equity indices trade at 2020 year-to-date lows, Chinese benchmarks such as the CSI 300 have proved to be more resilient in February 2020 due to (i) the Chinese government and People's Bank of China implementing a variety of supportive measures, (ii) decreasing rate of new infections from a peak on 5 February 2020, (iii) news suggesting that quarantine restrictions have been relaxed, and (iv) the fact that Chinese assets demonstrated an earlier and more severe sell-off than global counterparts.



The chart on the right shows the week-on-week performance of China's CSI 300 in US Dollars, both on an outright basis and compared to the MSCI World Index. For the week ending 21 February, the CSI 300 posted the best weekly gain since June 2019 thanks to the strong policy response which supported investor confidence. Despite this brief recovery, we do not believe the outlook for Chinese asset prices is outright positive and we continue to monitor domestic and international risks. Note that this strong performance followed a sharp correction the week prior. On 3 February 2020, the day investors returned from an extended Chinese New Year holiday, the CSI 300 fell 7.9% in local currency (or 9.1% in US Dollars) – the worst daily performance since 2015. We summarise some of the different measures used by the Chinese government and the People's Bank of China ("PBoC") to support domestic assets below.

Date	Various PBoC and Chinese government policy measures
01-Feb-20	The PBoC and domestic financial regulators issue more than 30 different policy measures to support the economy. They included providing banks CNY 300 bn for relending purposes, a lowering of lending rates and fees to some of the worst impacted companies, and allowing insurers to raise equities investments from existing limits.
03-Feb-20	The PBoC injects a net CNY 150 bn worth of liquidity into money markets, the largest ever single-day addition since 2004 data.
03-Feb-20	The PBoC cuts 7-day and 14-day reverse repurchase agreement rates by 10bps each.
04-Feb-20	The PBoC injects a net CNY 400 bn into the banking system (as opposed to money markets), the largest single-day addition since January 2019.
11-Feb-20	The Chinese government relaxes limits on local government debt issuances, allowing for the sale of a further CNY 848 bn worth of bonds.
14-Feb-20	Amid rising defaults, China's banking regulators offer a grace period whereby Covid-19 related defaults do not need to be considered in non-performing loans.
16-Feb-20	The Chinese government says it will implement measures to reduce corporate taxes and cut government expenses.
17-Feb-20	PBoC offers CNY 200 bn worth of 1-year loans to commercial lenders and cuts the respective interest rate by 10bps, the lowest since 2017.
18-Feb-20	Expectations of further policy response pushes China's yield curve to the steepest since 2015 as its equity markets recover US$ 1 tn worth of value (relative to the earlier lows).
20-Feb-20	The benchmark borrowing costs for new corporates and household loans are lowered. The 1-year loan prime rate was trimmed by 10bps while that of the 5-year tenor was trimmed by 5bps.
21-Feb-20	Chinese policy makers pledge to be "more flexibility" in monetary policy and to be more "proactive" in fiscal policy.
25-Feb-20	China offers CNY 500 bn worth of relending and rediscounting funding to commercial banks at a 25bps discount in a bid to increase lending to small firms and the agricultural sector.
25-Feb-20	The government waives VAT for small Hubei firms between Mar-May 2020 and lowers the tax rate to 1% (from 3%) for small firms in the rest of the country.

Economic activity in China and Asia

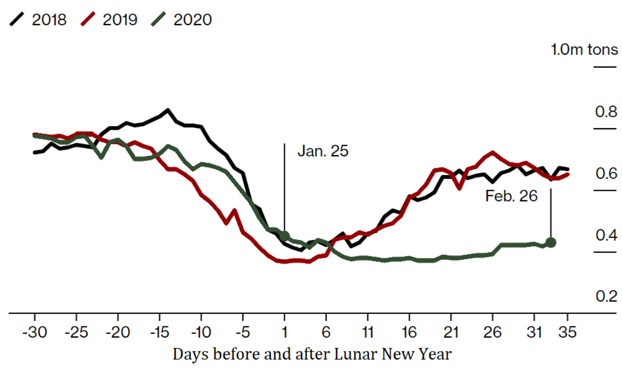
Below we provide some interesting snippets of data coming out of Asia to help better form a view on the gravity of the situation.

Wuhan, as well as other parts of Hubei province, are currently in "lockdown" as schools and all companies deemed "non-essential" have been ordered to remain closed. As recently as 20 February, the government issued an extension of the lockdown which is now set to span until 10 March 2020 – more than a month after the Chinese New Year was supposed to end. The prolonged shutdown increases risks of supply chain bottle necks for other regions in China, many of which reopened on 10 February 2020. The Hubei province is not only a manufacturing hub for steel, semiconductors, and automobiles, but is an important logistics hub. The city of Wuhan is even known as the "Nine Provinces' Thoroughfare" due to its key role in domestic transportation. The effects of transport restrictions (which impact logistics networks) and a quarantined workforce have the greatest direct impact on economic productivity. The spillover into global supply chains is also meaningful but difficult to quantify.

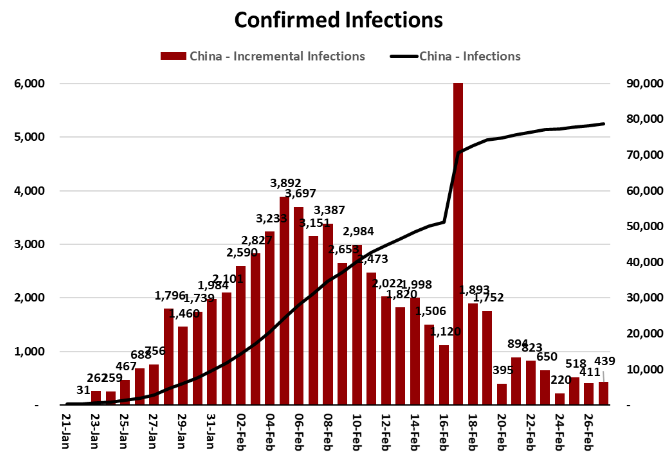
Despite the extension of the regional lockdown, some quarantine measures have been relaxed and some manufacturing gauges are showing signs of a recovery. Chinese officials estimate that 200 million migrant workers will have returned to work in China by the end of February 2020, and a further 100 million will have returned by end of March 2020. While a Bloomberg report[1] estimated that China's economy operated at 50%-60% capacity last week (ending 21 February), this measure could increase as the people return to work after the end of a two-week quarantine for those who travelled over the Chinese New Year period. One measure of economic capacity utilisation is trends in energy consumption, especially given China's large electricity intensive manufacturing sector. The chart on the right shows daily coal consumption for six major coastal power groups has been rising but remains well below the seasonal norm. Quarantine measures have largely been effective as can be seen below from the slower rate of confirmed infections.

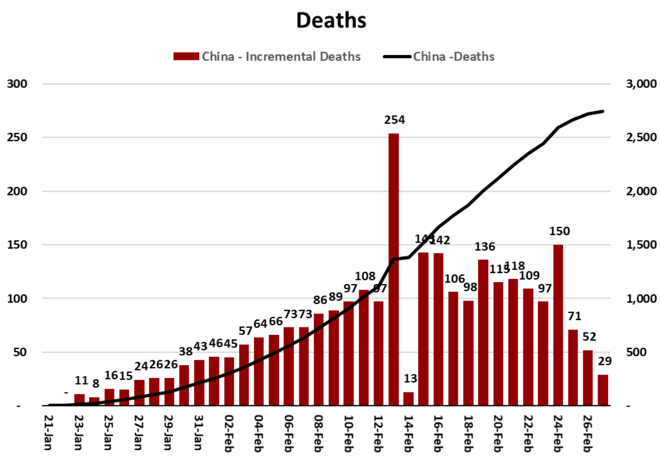
Demand Still Low

Use of coal at power plants rebounded slightly but is still lower than normal



Source: Bloomberg, China Coal Transporation & Distribution Association



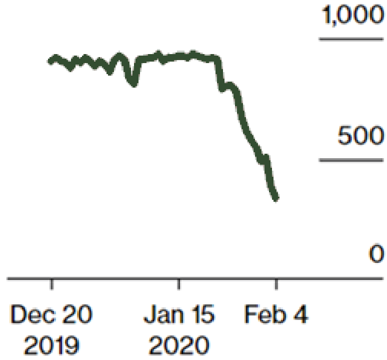


China

- One positive signal is that companies are starting to resume operations across the country, but many are not yet working at full capacity. Toyota Motor Corp, for example, has now (by 25 February 2020) restarted production across all its factories in China although they will only operate on single shifts. Mazda, Honda, and Nissan had all reportedly restarted some operations as early as 17 February.

- Reportedly, year-on-year car sales plummeted 92% during the first two weeks of February. Our view is that durable goods purchases will rebound quickly as people will still want to buy their new car, refrigerator or microwave etc.
- Some measures suggest that the majority of industrial firms have resumed work in parts of China. One survey of 109 American manufacturers based around Shanghai showed that almost 70% were operating in the week ending 14 February, a number which was expected to rise to 90% shortly thereafter (although current data is unknown).
- Unsurprisingly, many measures of personal travel have fallen given the widespread travel restrictions. United Airlines, based in the US, announced it saw an "approximately 100%" fall in near-term flight demand to China as US authorities recommend the avoidance of all nonessential travel to China. United Airlines also withdrew all full-year guidance for 2020 "due to the heightened uncertainty surrounding this outbreak."[2] The airline said it has also seen a 75% drop in the rest of its trans-Pacific flights. A sharp drop in air traffic can be seen in the chart on the right, which counts the number of flight departures from Beijing airport. Qantas said it has suspended all direct flights to Beijing and Shanghai until 29 March and British Airways has suspended flights to China until after Easter amongst many other airlines globally.

Beijing Departures



Source: Bloomberg, Flightradar24

- Shipping activity, as measured by the number of active vessels on the Yangtze River and around Shanghai (as of 20 calendar days after the Lunar New Year in 2020), was measured as being 40% lower than the same point in 2019.
- Looking closer to the ground, road traffic (which provides key insights into logistics activity) has demonstrated a sharp weekly uptick. For the 7-days prior to 27 February 2020, week-on-week highway traffic jumped 96% for passenger vehicles and 136% for trucks.
- Low electricity demand in China has reduced carbon emissions by 100 million metric tonnes (close to what Chile emits in a year).

South Korea

- Being the second worst hit nation after China, Korean President Moon Jae-in has raised the infectious disease alert to its highest level. This is the first time the alert has been raised to the maximum level since 2009 (during the H1N1 virus outbreak) as both MERS and Ebola were deemed to pose a lower risk. The domestic number of cases has skyrocketed from several dozen two weeks ago to 1,766 as of 20 February 2020.
- The Korean Consumer Sentiment Index fell by the most in 5-years. The reading sits at the lowest since August 2019, with the measure remaining below 2018 levels over the past 12 months. This was the largest fall since June 2015, when MERS hit (another type of coronavirus).
- A recent epidemiological model built my JPMorgan Chase & Co's insurance team suggests the number of confirmed cases could be as many as 10,000 next month before falling thereafter.
- South Korea's central bank surprised markets by not cutting rates at a recent meeting on 27 February 2020. Bank of Korea Governor Lee Ju-yeol suggested that the central bank would be better providing targeted support to companies worst affected rather than a broader rate reduction. The central bank also downgraded growth forecasts and acknowledged risks that the South Korean economy could be pushed into negative growth this quarter due to the disease spread.
- Joint military exercises between South Korea and the US have been postponed amid the virus outbreak.

Japan

- Officials say that the Tokyo 2020 Olympics is more likely to be cancelled than postponed. The future remains uncertain for the upcoming summer games.
- Japanese PM Shinzo Abe called for all schools within the country to close from Monday 2 March until the end of their spring holidays in an unprecedented move which affects 13 million students.
- The preliminary Jinbun Bank Manufacturing PMI for February 2020, a survey measuring Japanese industrial activity, fell to 47.6 from 48.8 a month before hurting an already fragile manufacturing sector. A reading below 50.0 indicates a contraction in manufacturing.

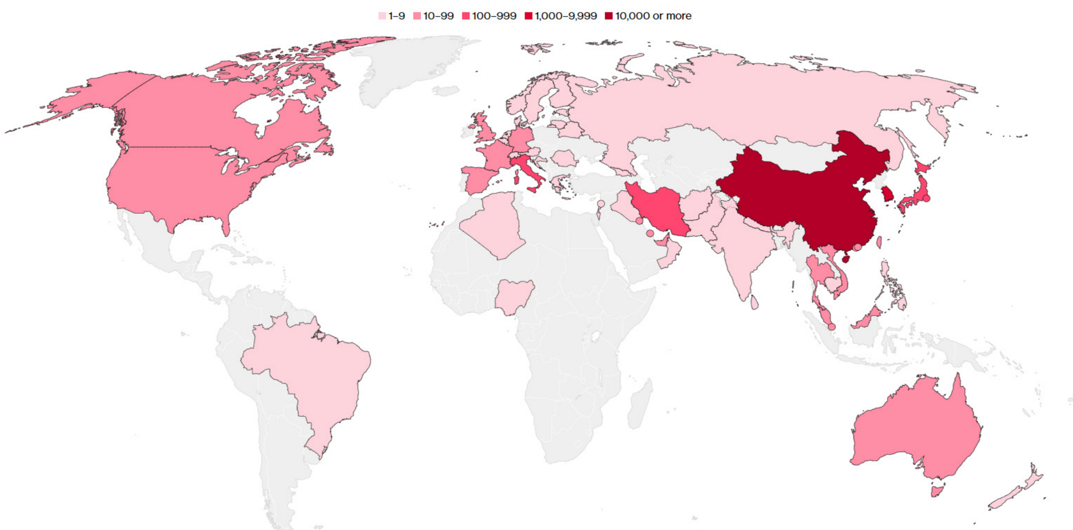
Hong Kong

- In a bid to stimulate the local economy in the face of a coronavirus-led slowdown, the Hong Kongese financial secretary has announced a HKD 10,000 cash handout for all permanent residents over the age of 18 amid a raft of other fiscal stimuli. The finance minister has forecast a deficit of USD 139.1 bn over 2020-2021, or 4.8% of GDP – the largest recorded deficit.
- More than 25,000 of the 33,000 staff employed by Hong Kong's Cathay Pacific Airways have opted to take unpaid leave on coronavirus fears. The airline requested all of its employees to take leave between 1 March 2020 and 30 June 2020. Airlines across Asia may lose USD 27.8 bn of revenue this year on reduced activity (with almost half this reduction coming from Chinese companies), the International Air Transport Association estimates[3].
- The Hong Kong Civil Assembly Team, a pro-democracy behind over 10 rallies since the pro-democracy demonstrations started in June 2019, is set to hold an "online rally" as disease fears forces residents to stay at home. The online rally will mark the 6-month anniversary of the riot police storming a subway station on 31 August 2019.

India

- Indian asset prices have been relatively insulated from the economic fallout of the coronavirus thus far. Analysis shows that India is less exposed to Chinese supply chains than other Asian countries, although many intermediate goods may be imported from China, Hong Kong and Taiwan.
- The Indian economy, by its very nature, is less exposed to the cyclicality of global trade than many of the "Asian Tigers" or China. The manufacturing sector accounts for less than 20% of India's real GDP growth. India's goods exports, as a contribution to GDP, is one of the lowest in Emerging Asia at just 12%. China also only buys c. 5% of Indian exported goods.

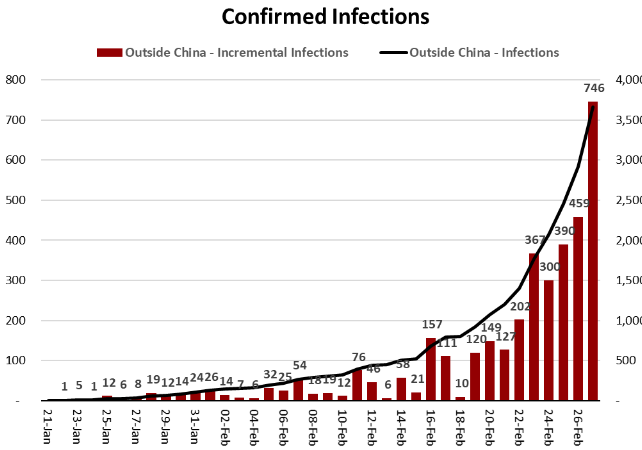
Map of coronavirus confirmed cases

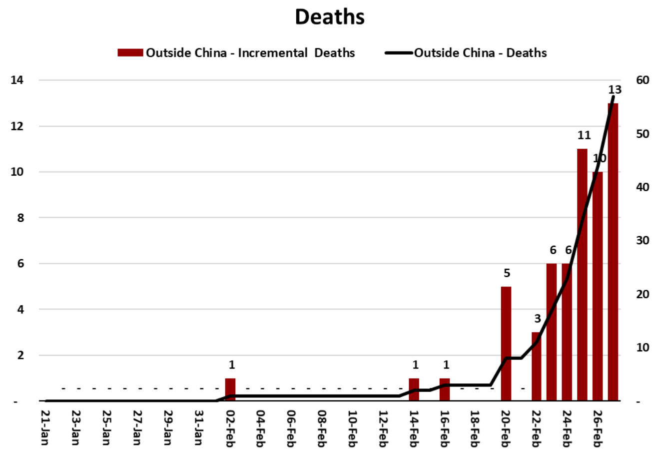


Source: Bloomberg

An Update on the Rest of the World

- Incremental daily infections outside China rose sharply to 746 on 27 February 2020. For the second day in a row this is higher than the number of new cases registered in China. A clear sign that the outbreak is spreading globally – and fast.





United States

- In a press conference on Tuesday 25 February the Centers for Disease Control and Prevention (CDC) in the US warned that it is a question of when and not if the US experiences community spread of the coronavirus. So far there are 59 confirmed cases (as of 27 February 2020) – which includes 42 cases of repatriated persons from the *Diamond Princess* Cruise Ship. On 26 February 2020, the CDC has reported the first "community spread" from a patient in California who did not have a relevant travel history or exposure to another known patients with COVID-19.
- The US has issued travel guidance (to varying alert levels) on travel to and from China, South Korea, Japan, Iran, Italy and Hong Kong in response to the outbreak.
- The US Fed is in the enviable position (by other central banks) in that it has the dry power to ease financial conditions (the current Fed Funds range is 1.5% to 1.75%). Following the 20% drop in the S&P 500 in Q4 2018, the Fed showed its willingness to act and quickly moved to stimulate the economy. The concern this time round is that markets are already pricing in three 25bps cuts by the Fed in 2020. This would not leave the Fed with much more dry power should more adverse financial conditions arise. Monetary policy (especially through the use of rate cuts) can also have a limited impact on financial conditions when the problem is less about a demand-shock and more about a supply-shock.
- Leading up to the November 2020 presidential election, President Trump, (who has already shown his willingness to stimulate the economy through tax cuts and large fiscal deficits), will likely do his utmost to keep the economy strong and the stock market at all-time highs – a personal bellwether for his own success.
- Goldman Sachs, Citi and JP Morgan have all downgraded expected earnings growth for US companies to zero for 2020[4].
- On 27 February 2020 the S&P 500 just breached it's 200day moving average (a popular technical indicator). The current Price-Earnings ratio of the S&P 500 has recently dropped from 23.9 in January to below 22 (with the NASDAQ 100 still above 27). But with an average PE ratio of just 18.7 (since 2000), current valuation levels still remain stretched.

Europe

- In comments made to the FT on Thursday 27 February[5], Christine Lagarde reiterated that the ECB's base case scenario is "containment in reasonably short order". Market expectations are currently for a 10bps cut by June 2020 (from no change expected at the beginning of 2020).

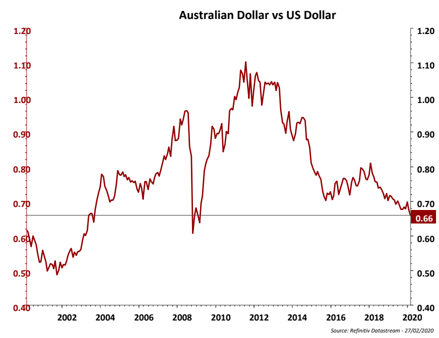
- Italy has the third highest number of confirmed cases (12 deaths and 400 cases as of 27 February 2020, up from 11 deaths and 322 cases a day earlier), after China and South Korea. Italy has looked for leniency from Brussels on budget rules as it seeks to contain the outbreak in the industrial north of the country (where approximately 50,000 people have been quarantined).
- Germany (with 21 cases and 0 deaths as of 27 February 2020), through their Economic Affairs Minister, Peter Altmaier, said that the government was discussing additional steps should the virus spread more rapidly and cause significant economic damage[6]. This is a far cry from their previously resolute response not to implement fiscal stimulus to aid its wavering economy. Germany has also indicated that it cannot trace all paths of infection in Germany – meaning only worse to come? Germany's auto industry, which has already been under significant pressure, now has the added headache of supply chain disruption as China struggles to meet the industry's demand for components.
- The UK has reported 13 infections and 0 deaths as of 27 February 2020. Direct impact from the outbreak has been relatively limited however officials and multi-national corporates remain on high alert. The FTSE 100 benchmark's poor year-to-date performance has been partially driven by the poor performance of two of its largest counters – Royal Dutch Shell and BP, as the oil price continues to come under pressure. Boris Johnson's hard line on a Brexit deal is also putting further downward pressure on UK asset prices.

Middle East

- The Middle East has been particularly impacted by the sharp fall in oil prices as demand fell off a cliff. From a high of $71.75/ barrel on 8 January 2020, Brent Crude has lost almost 30%, to trade at about $51 / barrel on 27 February 2020.
- Iran, still reeling from its fallout with the US, has been hardest hit in the Middle East. With 141 infections and 22 deaths (as of 27 February 2020, up 95 infections and 15 deaths from a day earlier) concern is high. Iran's deputy health minister tested positive for infection and social media accounts are accusing officials of not being transparent about the seriousness of infections in Iran. The United Arab Emirates has also banned all flights with Iran over the outbreak.

Australia

- While Australia has only 23 reported infections (as of 27 February 2020), it felt the brunt of the US China trade conflict and softening commodity prices. The Australian Dollar is at the lowest levels against the US Dollar since 2008/2009.



Latin America

- With Brazil reporting it's first case on Wednesday 26 February 2020, the coronavirus has officially spread to all continents except Antarctica.

Africa

- The number of reported cases is just three – in Egypt, Algeria (as of 27 February 2020) and Nigeria (reported on 28 February 2020). We question the accuracy of this as many African countries lack the diagnostic capabilities to identify the coronavirus timeously.
- From an humanitarian perspective there is a high level of concern as many countries in Africa may lack the necessary resources to quickly and effectively manage the spread of the virus and their healthcare systems may not have the excess capacity to deal with a large outbreak of serious infections. Economically, while the impact has the potential to be extremely harmful on a local level, the knock-on impact on the global economy is likely to be far more limited due to Africa's global GDP contribution when compared to China or Europe.

Disclaimer

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[1] Bloomberg Economics, https://www.bloomberg.com/news/terminal/Q61O5DT0G1L3?sref=tty3CqEI
[2] CNBC, United Airlines withdraws 2020 forecast on coronavirus uncertainty, 24/2/2020, https://www.cnbc.com/2020/02/24/reuters-america-united-airlines-withdraws-2020-forecast-on-coronavirus-uncertainty.html
[3] IATA, Covid-19 cuts demand and revenues, https://www.iata.org/en/pressroom/pr/2020-02-20-01/
[4] CNBC, Goldman sees zero earnings growth for US companies this year because of coronavirus, 27/2/2020, https://www.cnbc.com/2020/02/27/goldman-sees-zero-earnings-growth-for-us-companies-this-year-because-of-coronavirus.html
[5] FT.com, Christine Lagarde says coronavirus yet to cause 'long-lasting shock', Martin Arnold and Guy Chazan, 27/2/2020, https://www.ft.com/content/9228eefa-5975-11ea-a528-dd0f971febbc
[6] Reuters, Germany eyes tax breaks to counter coronavirus impact, 27/2/2020, https://www.reuters.com/article/us-china-health-germany-stimulus/germany-eyes-fiscal-plan-to-counter-coronavirus-impact-handelsblatt-idUSKCN20L24T