February 10, 2020

Portfolio implications of coronavirus outbreak

After a volatile period beginning in late 2018 and continuing for most of 2019 when trade tensions between the United States and China rattled financial markets, 2020 started on a more upbeat note with the ratification of the Phase One Trade Deal and the IMF expecting an acceleration of global economic growth from 2.9% in 2019 to 3.3% in 2020. Combined with highly accommodative monetary and fiscal policies around the world, the stage was set for a very promising year for equity portfolios.

However, this favorable backdrop has been interrupted over the past three weeks by the emergence of the coronavirus outbreak in China. Fear and uncertainty over the human and economic impacts of the outbreak are currently weighing on equities, particularly the energy, mining and travel industries, as investors have again shifted their asset allocation away from stocks towards bonds, as well as towards equities benefiting from low interest rates. As a result, stocks markets hesitated in January but have been recovering in early February.

The situation is evolving rapidly, and it remains impossible to predict how the coronavirus will evolve. Although the seasonal flu claims up to 650,000 lives each year and the Center for Disease Control estimates that in the 2017-2018 season, between 50,000 to 90,000 died in the U.S. alone, coronaviruses deserve the special attention they are getting. Because these viruses are not normally present in humans but rather jump from animals, humans have not developed the same immune resistance to them. This is reflected in the mortality rates observed for recent outbreaks: MERS 35%, SARS 10%, current coronavirus 2%. This compares to 0.05% for the common flu. One of the significant differences with the current coronavirus outbreak seems to be that it can transmit from human to human before symptoms are evident, which leads to a higher transmission rate and hinders its containment. However, this non-symptomatic transmission is now being questioned.

Current estimates are that it takes between 2 to 14 days for symptoms to appear and possibly another 14 days for the illness to run its course. The classic response in severe outbreaks is to implement “social distancing”. Drug treatments are being tested.

As part of its efforts to contain the virus, China locked down non-essential businesses in its most affected provinces on January 23rd, the day before the start of the Lunar New Year holiday which would have normally run from the 24th to the 30th of January. The lockdown was extended to at least February 10th, adding an extra 11 days to business closures. A little more than 80% of China’s GDP comes from provinces where the lockdown is in effect. The disruptions are in consumption, production, labour and transport. If the lockdown is not prolonged, the number of economic days lost will be small and could be recouped during the rest of the year. The effect on sales and payments will have an impact on financial commitments that the government banking system will have to mitigate. Using very rough numbers, if the lockdown lasts an extra 30 days and 20% of the economic activity in the affected provinces is suppressed, the effect on China’s GDP would be 1.3% for the year, bringing real growth for 2020 to around 4.5%. The 30-day estimate may be low but the 20% of activity may be high. Although the worst and best cases are still highly speculative, it is important to remember that the event is transitory.

China is the world’s second largest economy and the effect on global growth will be noticed. The industries initially most affected have been travel, transportation and oil demand (previously estimated to grow by +1.3

million barrels per day in 2020, now cut to +0.8 million barrels per day for the full year). Given cuts to industrial production and inventory destocking, most other commodities have declined. Major consumer ticket purchases such as housing and car sales will likely also be down. Supply chains may be disrupted if the dislocation lasts long enough.

The ultimate effect of all of this can be counter intuitive. Air Canada for example has 5% of its revenues linked to China, a negative, but the decline in oil prices, a positive, more than offsets this. Each company must be examined individually.

Irrespective of the current coronavirus outbreak, we remain concerned about the frothiness we see in certain asset classes such as long bonds (trading at 56x P/E with no growth in the E!), technology, real estate and infrastructure. Although some investors may find comfort in hiding in these assets during turbulent times, we worry about the risks of facing permanent losses of capital when conditions in financial markets normalize.

The historical comparison of SARS and MERS (both variants of coronavirus) is imperfect, but the important takeaway is that there was no lasting impact of these events on stock market performance. In both episodes, the immediate impact on markets was negative and material, but at the 3-, 6- and 12-month intervals (since initial outbreak) the performance of equities was broadly positive. Neither of these episodes were able to derail economic growth or stock market performance over the medium-long term. However, this outbreak may be different, and we are reviewing each of our holdings with multiple scenarios in mind.

We are concerned with these developments, but we believe the best strategy is to stay invested in equities. Your equity portfolio is very well supported by earnings (11-12x P/E), cash flows (5-6x) and dividends (3.5-4.0% yield). Valuation multiples are at the low end of their historical ranges and a 30-40% discount to the market index. We expect the current turbulence created by the coronavirus outbreak to dissipate over the next several months, followed by a complete recovery in equity markets. We are monitoring the situation closely and will make every effort to safeguard your capital. Your portfolio is well positioned to benefit from sustained global economic growth and should deliver satisfactory returns over the long term.

This document has been prepared by Letko, Brosseau & Associates Inc. for informational purposes only and is not intended to provide, and should not be relied upon for, accounting, legal or tax advice or investment recommendations.

Where the information contained in this document has been obtained or derived from third-party sources, the information is from sources believed to be reliable, but the firm has not independently verified such information. No representation or warranty is provided in relation to the accuracy, correctness, completeness or reliability of such information. Any opinions or estimates contained herein constitute our judgment as of this date and are subject to change without notice. Past performance is not a guarantee of future returns.

This document may contain certain forward-looking statements which reflect our current expectations or forecasts of future events concerning the economy, market changes and trends. Forward-looking statements are inherently subject to, among other things, risks, uncertainties and assumptions regarding currencies, economic growth, current and expected conditions, and other factors that are believed to be appropriate in the circumstances which could cause actual events, results, performance or prospects to differ materially from those expressed in, or implied by, these forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements.