First State Investments

EMERGING MARKETS AND ASIAN FIXED INCOME PORTFOLIO POSITIONING UPDATES WITH REGARDS TO NOVEL CORONAVIRUS (COVID-19) SITUATION COMMENTS

Asian Fixed Income
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In January, our Asian Fixed Income team provided ***an outlook for the asset class (please click here for the full article)*** *in 2020. Since then, developments associated with coronavirus have dominated attention and affected sentiment towards financial markets worldwide. In this update, Jamie Grant, Head of Emerging Markets and Asian Fixed Income, explains why the disease has attracted so much attention and outlines some of the changes that have been made to First State Investments' Asian Fixed Income portfolios as a result.*

In recent days the pace of new coronavirus infections have shown signs of slowing in China, but we have seen an increase in outbreaks as far away as Korea, Japan and Italy. The effectiveness of government-imposed shutdowns in various regions in China has received global attention and, from some, criticism. Yet if the pace of new infections continues to decline, it is reasonable to suggest that measures taken have helped achieve a slowdown in the spread of the disease.

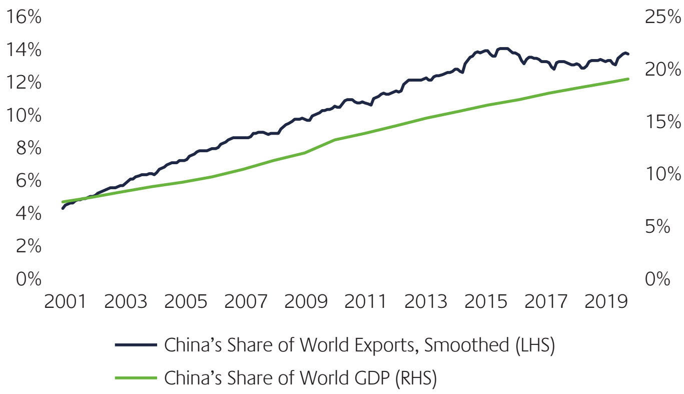
Some manufacturing activity in China has come back on line over the past few days, with most regions encouraging workers to return to work in a flexible manner. This process is a slow one, however, and is likely to remain so for some time given travel restrictions that remain in place across the country, school closures and a general unwillingness to leave home.

The impact of the shutdowns on general activity levels has been immense, both in China and elsewhere. For example, Hong Kong has partially closed its border to China, impacting a significant amount of children that go to school each day in Hong Kong. In turn, this is affecting parents' ability to work, directly impacting productivity in Hong Kong. At the same time, Hong Kong government offices closed or restricted working hours, whilst various industries enacted disaster recovery procedures. This has seriously impacted services sectors – ultimately, significantly lower numbers of employees at work means less customers. In China, ships were blocked from entering and leaving certain ports, disrupting trade flows.

Elsewhere, Vietnam has restricted entry and exit in certain areas, again affecting trade. Cruise ships in Hong Kong and Japan have been quarantined following outbreaks resulting in further disruption, logistical issues and cost overruns for operators. Major airlines cancelled up to 40% of flights across the Asia Pacific region and various banking, business, government and sporting events have been cancelled or postponed until later in the year. Lastly Italy has placed several towns in Lombardy and Veneto on lockdown and cancelled sporting events. These examples are just a small snapshot of what has occurred and how activity levels in Asia and elsewhere have been impacted.

Understanding the likely economic impacts for China and surrounding countries is challenging, as there are no direct precedents. Using the SARS period in 2002/03 as a comparison has limitations and is not necessarily informative; most factories and offices in China remained open at this time, with the exception of Guangdong, where SARS was relatively contained. Accordingly the impact on Chinese industrial production and exports was limited. More importantly, China's share of manufacturing, global exports and worldwide GDP was much less significant then as it is now.

Figure 1: China – growing in relevance



Source: IMF, Bloomberg, First State Investments HK Ltd, as of 26th February 2020.

Fast forward nearly two decades and significant structural changes have occurred. The emergence of global and regional supply chains has changed the structure and complexity of trading relationships. As shown in Figure 1, China now accounts for around 14% of global exports (as opposed to around 5% during the SARS outbreak) and the country accounts for nearly 19% of global GDP today.

Further, a growing percentage of exports to China are intermediate products (unfinished goods), which are assembled before being consumed in China or exported elsewhere. Equally there are goods exported from China being finished in other countries before being consumed there or exported elsewhere. Severing these supply chains for over a month (at least) will have knock-on effects throughout the Asia Pacific region (and the world).

In fact, the effectiveness of these supply chains creates further unintended consequences. Industries such as autos, electronics and machinery typically manage inventories on a 'just-in-time' basis. What this means is that firms carry limited additional inventories to cushion them in the event of long delays in receiving supplied parts or components. Globally we have seen factory closures and warnings that production halts are increasingly likely. All of this comes at a time when suppliers were already reviewing their exposure to Chinese trade links given the trade tensions between the US and China. It appears increasingly likely that these disruptions will have a meaningful impact on GDP in the first quarter of 2020 at least, both in the Asia Pacific region and globally. How markets react from here will depend on the extent and length of the slowdown.

Monetary and fiscal policy adjustments have begun to soften the blow. The Chinese central bank has already made use of some of the multiple monetary policy tools available. Further, Chinese President Xi stressed that the government would maintain prudent monetary policy settings and roll out new policy steps as required as the situation evolves. We anticipate new measures (or further monetary policy adjustments) to occur in a timely and sensible manner as the likely impact on the economy becomes clearer. That said, some questions remain as to the effectiveness of monetary stimulus to what is essentially a 'supply-side' shock. We may get an early snapshot in this respect as the latest Chinese economic data are released. Consensus expectations point to a marked decline in manufacturing activity in February, for example, and we see downside risk to these already subdued forecasts.

Initially we watched with interest in the early stages as this situation evolved. We were surprised that equity and credit markets appeared not to be giving the outbreak the attention we believed it merited. Given our understanding of the connectivity of supply chains and the potential for disruption to multiple economies, we were always more concerned about the potential impacts of coronavirus. We recognise that the Chinese government and central bank have sufficient tools available and will use them as required, but we have nonetheless taken the opportunity to de-risk portfolios for now until more clarity emerges.

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