28 January 2020

MARKET UPDATE

Coronavirus Fears Hit Markets

WHAT HAS HAPPENED?

The coronavirus outbreak that started in Wuhan, Hubei province in China, has swept across the world. Of more than 4,600 confirmed cases as of January 28, 2020, at least 4,500 were in China, with others in Hong Kong, Macau, Taiwan, Thailand, Singapore, and more recently in North America, Europe and Australia. The death toll reached 106 as of January 28, with all fatalities recorded in mainland China, so far.

The current known fatality rate of 2.3%, appears lower than the 9.6% rate experienced during the Severe Acute Respiratory Syndrome (SARS) epidemic in 2003. While the coronavirus appears less harmful than SARS, it still has the potential to mutate and become more virulent.

Containing the virus has been very difficult, especially because the outbreak coincided with the Chinese Lunar New Year, which typically results in mass migrations of travelers back to their hometowns. The Washington Post cites a 'scientific study' that projects, with an optimistic 90% quarantine success rate, 59,000 infections and 1,500 deaths—twice that of the SARS epidemic.

THE GLOBAL GOVERNMENT RESPONSE

China has quarantined Hubei province and has shut down all modes of travel to over 10 cities, affecting over 50 million people. However, the Mayor of Wuhan has said that 5 million people have already left the city for other locations in China and overseas.

In an effort to contain the virus, China has extended the Lunar Holiday through the end of the week to allow symptoms to manifest in people who may have caught the virus. Schools in affected areas are closed for up to 2 weeks.

Many countries have begun restricting flights from locations in China and are conducting extensive health screenings of passengers. More travel restrictions may be put in place.

IMPACT ON GLOBAL ECONOMY AND MARKETS

Given proactive government efforts around the world, the drastic measures could have a short-term impact on global growth, particularly in China and more generally in Asia.

Capital markets, particularly equity and other risk markets, had been buoyed in recent months by expectations of improving global economic data and confidence after a phase-one US-China Trade Pact.

Deterioration in the macroeconomic data, even if only temporary, is likely to weigh on near term earnings growth and investor confidence. In the past two days, global equity markets have retreated over 2% and the 10-year US Treasury yield has fallen 20 basis points to 1.6%.

In China, infection-control practices are likely to hurt consumption and retail sales. In a recent report, our China economist wrote that this kind of collateral damage could translate into real economic cost. During the 2003 SARS epidemic, China's GDP growth fell two percentage points between first-quarter growth at 11.1% and second-quarter growth at 9.2%.

This history can be used as a rough guide, considering that the Wuhan coronavirus is less severe than SARS, and China's economy is larger today than it was in 2003. We therefore estimate that the current outbreak's likely impact will range from a 0.8% cut to China's real GDP if the epidemic is controlled within three months, to a 1.9% cost to GDP if it lasts nine months.

CURRENT AB BASE CASE EXPECTATIONS

If the Wuhan coronavirus has a similar trajectory to SARS, how should we expect equity markets to react? During the SARS crisis in 1Q 2003, global equity markets declined steeply by over 10%. However, at the time, equity markets had only recently begun to recover from the deep and prolonged bear market following the collapse of the dotcom bubble in early 2000, and sentiment was also affected by the imminent start of the Second Gulf War. Stocks bounced back by June 2003 to ending with high single-digit gains for the first half of 2003.

While we expect short term volatility, we don't expect significant long-term consequences for investors willing to take a longer-term view. As a result, we would advise against knee-jerk selling of risk assets given past experiences with health epidemics.

AB's portfolio managers are closely monitoring the unfolding situation. Our actively managed portfolios across asset classes are based on bottom-up security selection. Portfolio managers are considering the potential impact of coronavirus-related events on markets, sectors and securities.

A WORD ABOUT RISK

Market Risk: The market values of the portfolio's holdings rise and fall from day to day, so investments may lose value. **Interest-Rate Risk:** As interest rates rise, bond prices fall and vice versa—long-term securities tend to rise and fall more than short-term securities. The values of mortgage-related and asset-backed securities are particularly sensitive to changes in interest rates due to prepayment risk. **Credit Risk:** A bond's credit rating reflects the issuer's ability to make timely payments of interest or principal—the lower the rating, the higher the risk of default. If the issuer's financial strength deteriorates, the issuer's rating may be lowered and the bond's value may decline. **Allocation Risk:** Allocating to different types of assets may have a large impact on returns if one of these asset classes significantly underperforms the others. **Foreign (Non-US) Risk:** Non-US securities may be more volatile because of political, regulatory, market and economic uncertainties associated with such securities. Fluctuations in currency exchange rates may negatively affect the value of the investment or reduce returns. These risks are magnified in emerging or developing markets. **Derivatives Risk:** Investments in derivative instruments such as options, futures, forwards or swaps can be riskier than traditional investments, and may be more volatile, especially in a down market. **Leverage Risk:** Trying to enhance investment returns by borrowing money or using other leverage tools may magnify both gains and losses, resulting in greater volatility. **Below-Investment-Grade Securities Risk:** Investments in fixed-income securities with lower ratings (commonly known as "junk bonds") tend to have a higher probability that an issuer will default or fail to meet its payment obligations.