January 30, 2020

RBC WEALTH MANAGEMENT

Global Insight Weekly

Will the coronavirus infect markets and the economy?

Kelly Bogdanova – San Francisco & Joseph Wu, CFA – Toronto

A spasm of volatility has shot through markets in the wake of the outbreak. We look at the knock-on effects of the pandemic for the world economy, and what sort of market impact investors should brace for.

As Wuhan Coronavirus (2019-nCoV) spreads, capturing more public attention about the many uncertainties and risks associated with the virus, financial markets have reacted. The increases in infections and deaths have pressured equity markets worldwide and boosted safe-haven sovereign bond prices. The flight to safety, for example, briefly pushed the 10-year Treasury yield down to 1.53 percent, a six-month low.

The economic and market impacts stemming from the outbreak could be material, especially for China and global industries that are most affected, such as travel and segments of transportation. But ultimately the impact should be transitory, in our assessment.

Compared to the 2003 SARS outbreak, Chinese authorities and other countries appear better prepared to deal with public health crises, underscored by improved transparency, pre-emptive measures to restrict travel, and a worldwide push by scientists to develop treatments and vaccines.

At this stage, we don't think the outbreak warrants making major changes to investment portfolios for long-term investors. But we would refrain from putting new money to work in equities, particularly in emerging markets, until at least the number of new cases and fears surrounding the spread of the virus have peaked.

Where things stand

Thus far, the newly identified pathogen is largely concentrated in mainland China, but has reached other parts of the Asia-Pacific region, Europe, North America, and the Middle East.

Compared to SARS in 2003, this coronavirus seems to be more contagious, though less fatal, in these early days.

Fortunately, the convergence of DNA sequencing, machine learning, and gene editing may make these pathogens easier to identify, and possibly, to control. Unlike in 2002–03 when China suppressed information about SARS for three to four months, Chinese researchers sequenced 2019-nCoV within days of the outbreak, yielding key insights into the transmission and prevention of the disease. The Chinese government quickly provided the full genome of the pathogen to other governments, and to global health databases and organizations.

RBC Global Asset Management Inc. Chief Economist Eric Lascelles points out, "Most countries have better protocols in place today to screen, treat and limit the spread of serious outbreaks. Many of these protocols were inspired by the mishandling of SARS."

As of this writing, 2019-nCoV has killed 171 people (all in mainland China), or roughly two percent of the 8,236 cases identified, according to Johns Hopkins University, which is tracking the spread of the virus within its Center for Systems Science and Engineering (CSSE). This compares to the nine percent to 10 percent fatality rate in the roughly 8,000 SARS

Market pulse

Click here for authors' contact information. Priced (in USD) as of 1/30/20 market close, ET (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see page 6**
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cases identified in 2003. Regularly updated Johns Hopkins CSSE data can be accessed here.

However, the bulk of people who have been diagnosed with 2019-nCoV have yet to be officially categorized as having recovered, and scientists indicate the virus has a longer incubation period than SARS.

Economic diagnosis

The economic impact of SARS was largely concentrated in China, both on the mainland and in Hong Kong. China's GDP growth slowed by two percentage points on an annual basis during that time, according to Lascelles. Canada's economy briefly shrank during the SARS episode, as infection rates were higher than in many other developed countries, and because the U.S. was not firing on all cylinders at the time. These economies quickly rebounded soon after the worst of the epidemic passed.

"This episode will likely follow a similar trajectory—there will likely be a palpable hit to China's economy but this should prove short-lived, in part because China will likely deliver more economic stimulus, in part because conditions should almost immediately normalize as soon as the disease abates," Lascelles wrote. He added, "For the moment, we have not adjusted our global growth outlook. In fairness, whereas we had contemplated a growth upgrade for China, that may now be sidelined."

What's "different" this time is that China contributes a much greater share of global economic activity today than it did compared to 2003, as the charts show. So any temporary economic pain in China could be a greater headwind for global growth, in our view.

Tom Porcelli, RBC Capital Markets, LLC's chief U.S. economist, does not believe the SARS period is a useful analogue for the effects of the coronavirus on the U.S. economy. There were other issues holding back the U.S. in 2003, such as overall weakness stemming from the aftermath of the 2001 recession, and the temporary disruption caused by the U.S. and allied invasion of Iraq, both of which overlapped the SARS epidemic. He points out that this go-around, U.S. economic fundamentals are much sturdier.

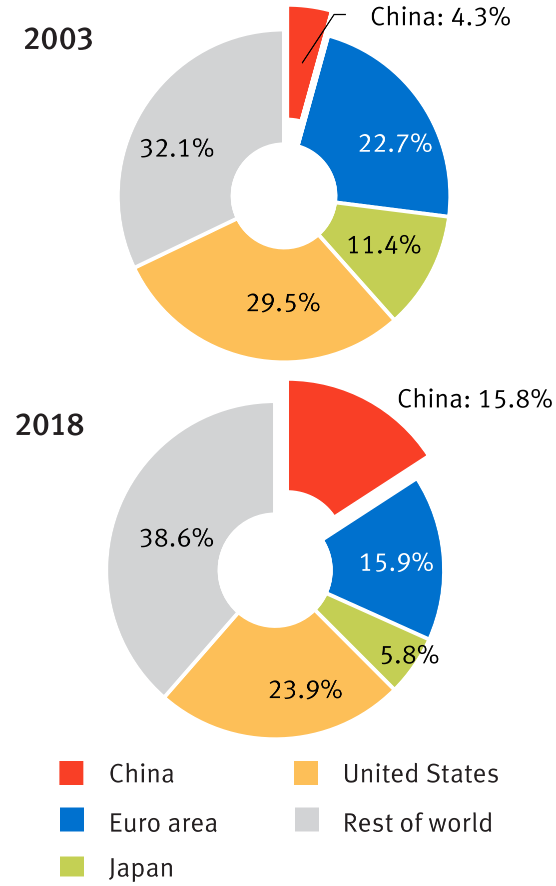
How exposed are markets?

Whether coronavirus will continue to pressure equity markets will depend on the pace at which the virus spreads and the associated death rates. Similar to the economic risks, we would expect that the markets in countries most impacted would continue to experience the greatest pullbacks.

Lascelles wrote, "To the extent the incubation period really is two weeks long and transmission truly is possible asymptomatically, we flag the risk that the outbreak proves worse than currently imagined. But no less relevant is the

China's economic influence has increased considerably

Percentage of global gross domestic product (in U.S. dollars)



Source - RBC Wealth Management, World Bank

observation that in every prior episode, those lows have ultimately represented buying opportunities."

Regarding the U.S. equity market specifically, RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina said, "We think coronavirus fears could contribute further to U.S. equity market volatility in the short term if they continue to build, since this poses a risk to the modest improvement in corporate optimism that has resulted from the completion of the Phase 1 trade deal with China. The bigger issue here is that investors could at least temporarily start to doubt the 'hope trade' that has propelled U.S. equities higher since last fall. That market move was driven by the anticipation of a positive inflection in global economic conditions."

Let volatility run its course

While the prevailing period of heightened anxiety and risk aversion will eventually fade, if the number of new cases remains on the uptrend, we would expect to see further volatility and downside in equities in the near term, more concentrated in those markets and industries most affected by the disease. During past viral outbreaks, the inflection point for market sentiment typically arrives when the number of new cases has peaked.

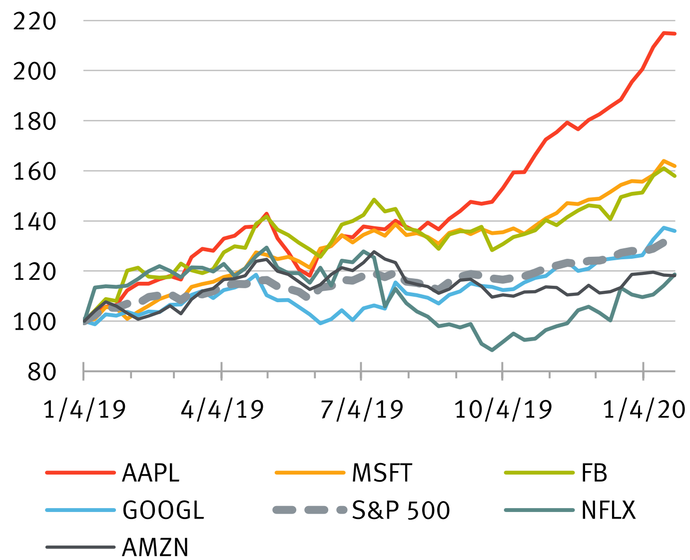
United States

Alan Robinson – Seattle

- **December-quarter earnings season kicked into high gear during the week, with tech bellwethers leading the charge**. Apple grew its quarterly revenues by 9% and EPS by 19% as iPhone sales continued to impress. Microsoft revenues and EPS were up 14% y/y and 40% y/y, respectively, thanks to strength in commercial sales. Facebook reported strong revenue growth of 25% y/y, but EPS was up only 8% y/y due to higher quarterly costs. In contrast to its hardware and product-focused peers, Facebook's stock fell as guidance implied an advertising revenue slowdown, impacted in part by new privacy regulations.
- With the FAANGM group of Facebook, Amazon, Apple, Netflix, Google, and Microsoft trading at a median P/E ratio near 29x consensus 2020 EPS estimates, we believe a lot of good news may be already priced into these stocks.
- **The U.S. economy grew at a respectable 2.1% clip in Q4 2019 and 2.3% for the full year**, despite trade disruptions over both periods. Although business investment edged lower for a third straight quarter, **consumer spending and residential investment continued to drive the economy**. January data from The Conference Board showed **consumer confidence in the U.S. remained solid**, with its index rising to 131.6 in January from 126.5 in December, as low interest rates and plentiful jobs supported consumer spending.
- **The Federal Reserve decided to keep interest rates steady** after its January 29 meeting, as expected. While there was little indication of a change in outlook in the Fed's press release, Chairman Jerome Powell addressed stock market valuations in passing. He sees "...asset valuations as being somewhat elevated" but suggested they are "...not at extremes" given the low level of underlying interest rates.
- **The U.S.-Mexico-Canada Agreement (USMCA) was signed** during the week, marking a further easing in global trade tensions. The agreement **adds climate change and labor safeguards** NAFTA lacked. New requirements for goods to qualify as North American will likely crimp the supply chains of multinational firms, including European auto manufacturers that build automobiles in North America.

Leaders emerging from the tech pack

Relative performance of select tech stocks (Jan. 2019 = 100)



Source - RBC Wealth Management, Thomson Reuters; weekly data through 1/24/20

Canada

Arete Zafiriou & Richard Tan, CFA – Toronto

- **The S&P/TSX Composite is off to a strong start in 2020** with the index reaching a series of all-time highs throughout January. The Information Technology sector is the best year-to-date performer, up over 10%, while Energy and Materials remain in the red, driven by falling commodity prices. With respect to the latter, we believe the recent **coronavirus outbreak has re-introduced a degree of fear into the market and caused a slight pullback** as talks of further economic deceleration in China has re-entered the conversation. China is a significant growth driver for future oil and copper demand; thus, concerns of a potential slowdown resulted in a **retracement in the commodity price environment**. We maintain our Market Weight stance on Canadian equities, but believe the 2020 setup is likely going to be challenging for the resources sectors and the Canadian Financials given our belief that we are in the late stages of the economic cycle. Upgrading the portfolio along the quality curve and tilting the portfolio towards companies with more stable cash flows continues to be the right call from our perspective.
- Following three years of slowdown in the Canadian housing and mortgage market, RBC Capital Markets believes the market is set for improvement this year. **Existing-home sales are on an upward trend**, increasing 11% y/y in Q3 2019 and 15% y/y in Q4 2019. On a national basis, **home prices have been steadily rising**. Toronto and Montreal are seeing price appreciation in both detached home and condo markets, while Vancouver prices are down year over year with signs of stabilizing. Fixed mortgage rates are around 5 basis points higher than they were five years ago, but have decreased close to 60 basis points in the past year.

The economic backdrop remains constructive. **Employment growth accelerated in 2019**, 2.1% y/y on average vs. 1.3% y/y on average in 2018. Although RBC Capital Markets is calling for gradual improvements in 2020, it notes that poor housing affordability in key markets and ongoing elevated household debt levels will likely keep the housing and mortgage market from growing at rates seen before the slowdown.

Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **Both UK and European equities followed the general risk-off trend**, retreating during the week. The UK's relative large exposure to the Energy sector dragged the FTSE All-Share Index lower as oil prices retreated to a three-month low. **In Europe, the luxury goods sector, which is heavily exposed to the Chinese consumer, retreated** as the number of coronavirus infections climbed.
- Moreover, **a number of high-profile, large-cap companies in the UK and Europe released lackluster earnings reports that spurred investors to cut positions**. BT Group announced earnings came in slightly below consensus expectations; Diageo cut its organic sales outlook for 2020 to the lower end of its 4% to 6% range; Royal Dutch Shell reported that net income undershot the consensus estimate and announced a slower pace for share buybacks; meanwhile, Unilever posted its lowest quarterly organic sales growth in over a decade.
- **The Monetary Policy Committee met for the final time of outgoing Bank of England (BoE) Governor Mark Carney's tenure**. **Rates were maintained at 0.75%**, as economic data released after the Conservative electoral victory showed enough signs of some improvement, though it remains very much mixed. The 10-year Gilt yield perked up on the news, but at 0.55%, it has fallen substantially from the post-election highs. We continue to expect that **the BoE could become more hawkish later this year should the economy recover, underpinned by a large dose of fiscal stimulus**.

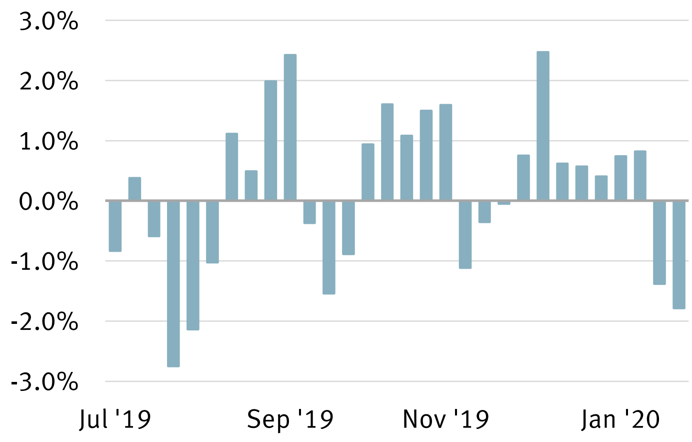
Asia Pacific

Jasmine Duan – Hong Kong & Nicholas Gwee, CFA – Singapore

- Asian equity markets traded lower this week, with the **MSCI Asia Pacific Index on track to post its biggest weekly decline in over five months**. The drop is led by Hong Kong and Japan, while China's markets remain closed for the extended Chinese New Year holiday.

Worst weekly return for Asian equities since August

MSCI Asia Pacific Index, weekly returns



Source - RBC Wealth Management, Bloomberg; data from the week of 7/5/19 through 1/29/20

- **Investors' risk appetite has been dampened by the outbreak of the coronavirus in Wuhan, China**. As of this writing, there are 8,236 confirmed cases worldwide, with 171 fatalities (only in China). The report of **38 new deaths marked the biggest single-day jump since the outbreak began,** and comes amid a massive quarantine that has effectively locked down more than 50 million people in and around Wuhan. The number of confirmed cases has also surpassed the 2003 SARS outbreak in mainland China (5,327). While some experts believe the new strain is less deadly than SARS, alarm has grown over its rapid spread and many unknown attributes, such as how lethal it is. Like other respiratory infections, the coronavirus jumps from person to person on the droplets from coughs and sneezes. Scientists indicate it has an incubation time between one and 14 days, and there are signs that it may spread before symptoms appear.
- **Global airlines are suspending or scaling back direct flights to China's major cities** amid an increase in travel warnings and a decline in passenger demand caused by the coronavirus scare. **Other multinational corporations have announced store/factory closures** in and around the affected areas.
- **We expect the outbreak to hurt China GDP growth in the near term**, with the services-related sectors hit the hardest. Extended factory shutdowns could also weigh on industrial output and trade. That said, we believe the drag on growth can be offset by stronger government policy support. With the number of new infections rising rapidly, **we maintain our view that we may not have seen the worst of the equity market pullback in Asia**.

MARKET SCORECARD

Data as of January 30, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,283.66	1.6%	1.6%	22.5%	16.3%
Dow Industrials (DJIA)	28,859.44	1.1%	1.1%	15.4%	10.7%
NASDAQ	9,298.93	3.6%	3.6%	29.5%	25.6%
Russell 2000	1,648.22	-1.2%	-1.2%	10.8%	4.1%
S&P/TSX Comp	17,490.56	2.5%	2.5%	13.0%	9.6%
FTSE All-Share	4,105.32	-2.2%	-2.2%	7.6%	-1.4%
STOXX Europe 600	415.16	-0.2%	-0.2%	15.8%	4.8%
EURO STOXX 50	3,690.78	-1.5%	-1.5%	16.7%	2.3%
Hang Seng	26,449.13	-6.2%	-6.2%	-4.3%	-18.9%
Shanghai Comp	2,976.53	-2.4%	-2.4%	15.6%	-14.7%
Nikkei 225	22,977.75	-2.9%	-2.9%	11.8%	-1.3%
India Sensex	40,913.82	-0.8%	-0.8%	15.0%	13.5%
Singapore Straits Times	3,170.68	-1.6%	-1.6%	-0.1%	-10.7%
Brazil Ibovespa	115,528.00	-0.1%	-0.1%	19.1%	36.7%
Mexican Bolsa IPC	44,862.76	3.0%	3.0%	2.8%	-11.0%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,573.58	3.7%	3.7%	19.2%	17.6%
Silver (spot $/oz)	17.83	-0.1%	-0.1%	11.0%	4.0%
Copper ($/metric ton)	5,612.75	-8.7%	-8.7%	-8.3%	-19.9%
Oil (WTI spot/bbl)	52.14	-14.6%	-14.6%	-3.9%	-19.2%
Oil (Brent spot/bbl)	59.21	-10.3%	-10.3%	-4.0%	-14.2%
Natural Gas ($/mmBtu)	1.83	-16.4%	-16.4%	-35.9%	-42.7%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	1.591%	-32.7	-32.7	-108.7	-112.9
Canada 10-Yr	1.333%	-36.9	-36.9	-58.1	-96.2
U.K. 10-Yr	0.542%	-28.0	-28.0	-71.3	-91.8
Germany 10-Yr	-0.406%	-22.1	-22.1	-59.4	-108.9
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	2.08%	1.7%	1.7%	10.5%	11.9%
U.S. Invest Grade Corp	2.62%	2.2%	2.2%	16.6%	15.4%
U.S. High Yield Corp	5.40%	0.2%	0.2%	11.2%	11.6%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	97.8570	1.5%	1.5%	2.6%	9.8%
CAD/USD	0.7578	-1.6%	-1.6%	-0.3%	-6.5%
USD/CAD	1.3196	1.6%	1.6%	0.4%	7.0%
EUR/USD	1.1032	-1.6%	-1.6%	-3.9%	-11.0%
GBP/USD	1.3093	-1.2%	-1.2%	-0.2%	-7.5%
AUD/USD	0.6723	-4.2%	-4.2%	-7.2%	-16.8%
USD/JPY	108.9900	0.3%	0.3%	0.0%	0.2%
EUR/JPY	120.2400	-1.3%	-1.3%	-3.9%	-10.9%
EUR/GBP	0.8426	-0.4%	-0.4%	-3.7%	-3.9%
EUR/CHF	1.0699	-1.4%	-1.4%	-6.3%	-7.7%
USD/SGD	1.3615	1.2%	1.2%	1.1%	3.8%
USD/CNY	6.9426	-0.3%	-0.3%	3.4%	9.8%
USD/MXN	18.7735	-0.8%	-0.8%	-1.9%	0.1%
USD/BRL	4.2472	5.4%	5.4%	15.4%	33.5%

Source - Bloomberg. Note: Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing. Data as of 9:35 pm GMT 1/30/20.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD -1.6% return means the Canadian dollar fell 1.6% vs. the U.S. dollar year to date. USD/JPY 108.99 means 1 U.S. dollar will buy 108.99 yen. USD/JPY 0.3% return means the U.S. dollar rose 0.3% vs. the yen year to date.

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Hold [Sector Perform]	625	42.46	127	20.32
Sell [Underperform]	82	5.57	5	6.10

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