RBC Global Asset Management

Update on the Wuhan Coronavirus (COVID-19) and investment implications

The RBC Emerging Markets Equity team

The new Wuhan coronavirus (COVID-19) has again put fear into the heart of financial markets as the focus shifts from what appear to be diminishing risks within China to rapidly rising risks outside of the country. Emerging markets (EM) equities have lost 5% to-date in 2020 and 9% from their high in mid-January (as of time of writing), on concerns about the spread of COVID-19 and its impact on economic activity.[1] Ironically, the Chinese equity market has been one of the best performing equity markets globally this year, recovering 14% from its recent low reached on February 3, and outperforming both the MSCI Emerging Markets and Developed Markets Indices by over 400 and 250 basis points respectively.[2]

It is possible that the market recovery was due to investors believing that the disease has been contained in mainland China and is therefore under control. In China (see Exhibit 1), the daily growth rate of COVID-19 cases has shrunk to just 520 on February 24, almost six times less than the peak on February 5. The daily growth rate in percentage terms has declined to just 0.7%, the lowest yet recorded (the peak was 85% in late January). In fact, on a net basis, there are now more people reported to have recovered from the disease in China versus those who are acquiring it. Twenty-four Chinese provinces – including Beijing and Shanghai – reported no new cases in the latest data.[3] President Xi has now called for a resumption of economic activity, with Wuhan now back to aproximately 70% of its normal run rate.[4]

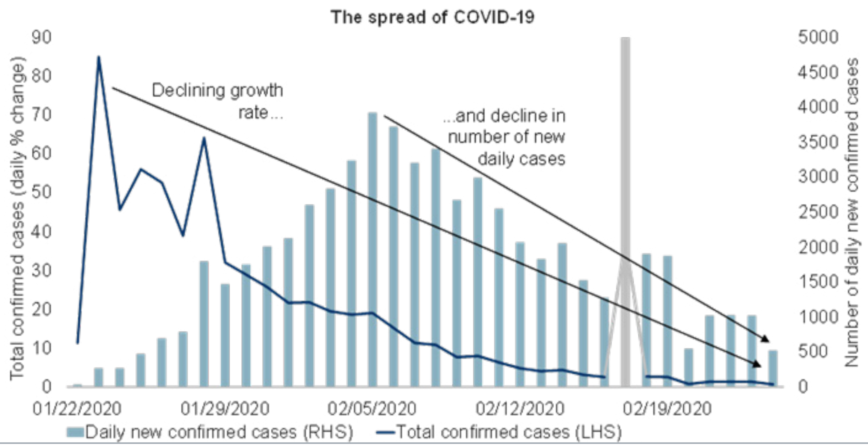
IIn contrast, the risk of the new coronavirus spreading in countries outside of China has actually increased as confirmed by recent developments in South Korea and Italy. There is a growing realisation that the COVID-19, which appears to be an extreme form of the viral flu, has not been successfully contained outside of China and this has begun to negatively affect financial markets. The number of new cases in the rest of the world has set a new record each day, with 2,069 new cases reported on February 24 alone (see Exhibit 2). While the percentage growth rate has declined from its initial highs, it seems to have stayed stuck at around +15%/day.

Two issues immediately present themselves as the rest of the world now grapples with COVID-19. First, while rich countries may generally enjoy a healthcare advantage over China (mortality rate from the virus runs at approximately 1.5%, half that of China), they may lack the ability to mobilize (or in this case, immobilize) their population to the extent that China did.[5] Second, the world's poorest countries would appear to be very vulnerable on both fronts, to the extent they lack quality healthcare and also that they do not possess the tools necessary to quarantine entire populations of people.

Outside of China, several countries are capturing particular attention:

- South Korea has suddenly exploded to 763 cases, with seven fatalities. The bulk of the cases have now been acquired domestically, rather than via direct travel to China. The country now has 7,000 troops in quarantine after a handful tested positive for the disease.
- Until recently, Japan had the highest number of cases outside of China, though much of this was from a quarantined foreign

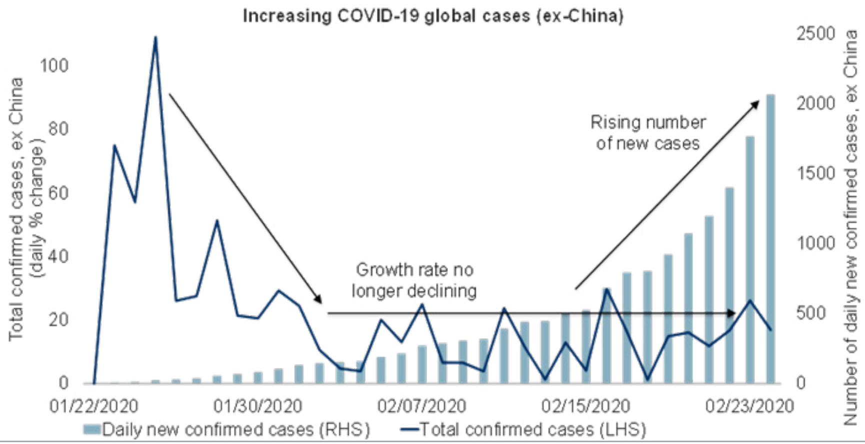
Exhibit 1: Confirmed cases of COVID-19 in China



Source: World Health Organization. Note: As of 02/24/2020. Spike on 02/17/2020 (grey colour) due to change in reporting methodology.

[1] Bloomberg. Data as at February 28, 2020.
[2] Bloomberg. Data as at February 28, 2020.
[3] RBC Global Asset Management. World Health Organisation. Data as at February 24, 2020.
[4] NDRC, J.P. Morgan. Data as at February 28, 2020.
[5] Jefferies, World Health Organisation. Data as at February 26, 2020.

Exhibit 2: Confirmed cases of COVID-19 outside of China



Source: World Health Organization. Note: As of 02/24/2020.

cruise ship (695 cases). Nevertheless, it still has 144 cases outside of that group and appears especially vulnerable due to its large elderly population (the disease disproportionately targets the elderly and vulnerable).

- Iran has been a source of concern since late last week when a Canadian was reported to have contracted the disease in Iran rather than China, and the country has since admitted to 43 cases. Iran is now reported to have closed its schools.
- Lastly, and further hinting at the highly contagious nature of the disease and its ability to seemingly pop up nearly anywhere, Italy has suddenly leaped from three cases on February 21 to 124 cases on February 24, with five deaths now reported. These are clustered within a region of ten towns not far from Milan. Italy is attempting to impose a strict quarantine.

There are clearly many uncertainties about how the virus will progress from here and how global it will become. It is our hope, and indeed still our base case, that COVID-19 will behave in a similar way to the SARS virus and recede when the weather improves (most viruses prefer cold and dry weather conditions, though it is yet to be seen whether this also applies to COVID-19). While there will be an impact on economic growth, we expect this impact to be a one-off event and we expect central banks and governments to continue to act in a synchronized manner in order to dampen the impact on economic activity and markets.

In terms of our positioning, we remain relatively fully invested in our favourite franchises. As highlighted in our initial update on the coronavirus, it is at times like these that we feel it is particularly important to remind ourselves that the intrinsic value of a company is derived from all cash flows expected over the next 50-plus years, and that the cash flows over the next 12 months represent less than 3% of the average company's total value. Markets tend to overreact to short-term news flow.

While heavy EM equity downside seems unlikely with global interest rates at, or potentially below, current levels, we would assess any further significant weakness in markets on a stock-by-stock basis, and we will look to take advantage of such weakness by adding to or buying into high quality franchises at historically attractive valuations.

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