Global Risk Trends & Analysis

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Chris founded Longview Economics in 2003 with a desire to produce research that was independent, courageous, and relevant to every type of investor.

Longview has built relationships across the globe and is constantly seeking to deliver cutting edge market analysis and trading ideas.

Coronavirus and global supply chains: What does it mean for equities?

From trade wars to fears of recession, the global economy has struggled to catch a break. Now, global economic growth is taking another hit as efforts to contain the novel coronavirus (Covid-19) are causing shutdowns in factories and offices and sharp declines in travel and tourism—an important segment of global spending. Unlike SARS in 2003, the number of Chinese tourists traveling outside China each year is now a key factor in global tourism.

*In 2018, the number of Chinese tourists traveling internationally surged to an estimated **149.7 million**—a year-over-year increase of **14.7%**. They spent an estimated **$257.7 billion** overseas—**nearly 20%** of total global tourism dollars.*[1]

As countries ban inbound travel from mainland China, businesses are losing significant income, especially when it comes to tourism. China is the number one source of tourists for most countries around the world.

That impact on local businesses is most obvious in places like Macau in Hong Kong, where gaming tables are empty causing individual share prices of those stocks to plummet between 2.5% to 11% since the start of 2020 (see **Figure 1** on next page).

The situation is similar for airlines, with many based in or near China temporarily shutting down many of their routes. As a result, like the gaming stocks, their share prices are also down sharply—China Eastern Airlines (-14% YTD), Cathay Pacific Airlines (-9% YTD), and China Southern Airlines (-12% YTD).

1. Source: chinadaily.com, 2/21/20.

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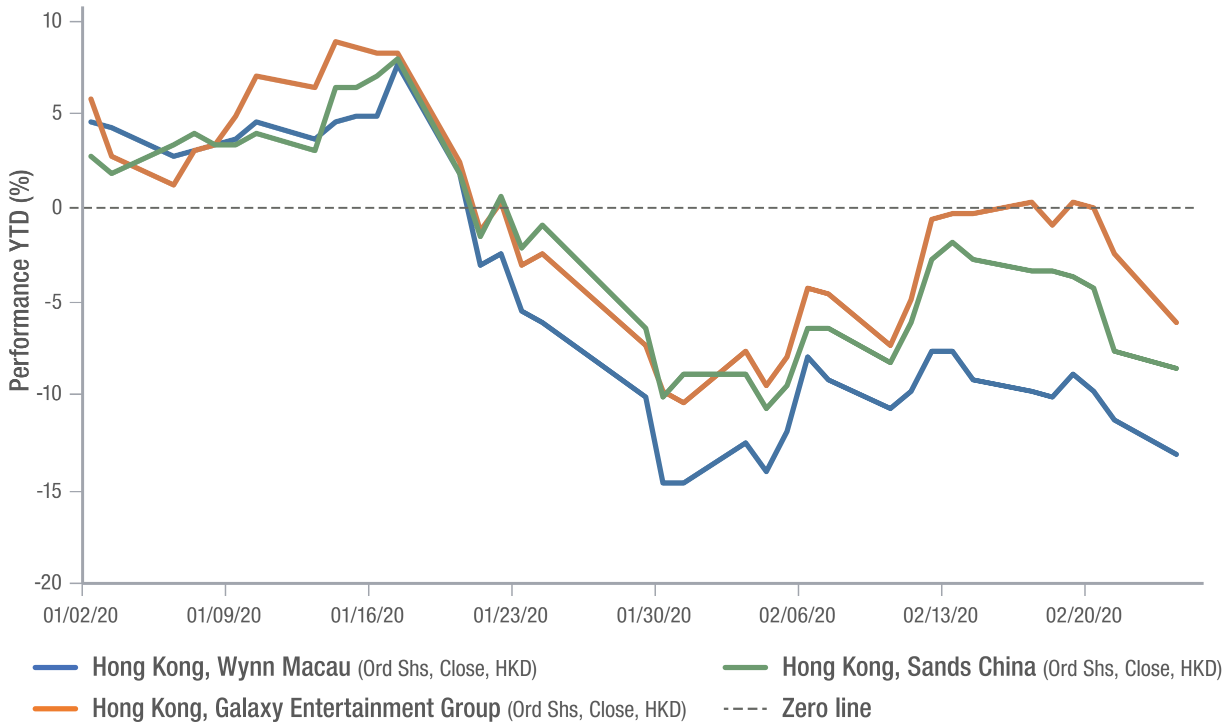
Figure 1: Macau Gaming Stock Share Prices Decline As Tourism Slows



Sources: Longview Economics, Macrobond, 2/24/20. Past performance is no guarantee of future results.

Perhaps more troubling is the concern about global supply chains. China now accounts for 13% of the world's exports and sits in the middle (or beginning) of many of those global supply chains. Already, U.S., European, and other companies acknowledge the challenge of sourcing certain components from China. Apple's comments were widely reported in the newspapers, and comments from other companies include the following:

"Car makers in Wuhan are in the dark about when they'll really be able to resume production, and can only wait for new guidance from the authorities. With the situation still critical in the city, it's hard to envision work commencing before March, at the earliest."

—A Renault factory manager, quoted in the Wall Street Journal, 2/13/20

"Samsung has begun flying electronic components for its latest Galaxy phones from China to its factories in Vietnam as it grapples with sweeping supply chain disruptions caused by coronavirus."

—Financial Times article, February 2020

Indeed, during the recent U.S. earnings season, Bloomberg calculated that more than 400 companies mentioned the virus either in their performance reports or during conference calls. Topping the list is Yum China with 46 mentions; next is Chinese ecommerce giant Alibaba with 44 mentions; Kering (a luxury goods company) had the third highest number of mentions with 40; manufacturer Schindler Group had 32; Sensata Tech, Lumentum, and Carlsberg Group had 30 each; and Las Vegas Sands had 28 mentions.

Mentions of Covid-19 in earnings reports and conference calls, by sector:

Industrials: 149

Technology: 146

Consumer Discretionary: 103

Healthcare: 86

Materials: 78

The list of mentions by sector highlights those areas of the global economy currently most affected by Covid-19. The main impacts are in the industrial and technology sectors, reflecting China's significant position in the global goods supply chain.

Elsewhere, commodity prices have been hit because China is the largest global consumer of most commodities, hence the high number of mentions from companies in the materials sector. The number of comments from the consumer discretionary sector is high because it includes the auto companies—many of which manufacture certain parts or entire cars in China.

In keeping with the magnitude of a global economic shock, the numbers being discussed are large. Therefore, perspective is needed. Wuhan, the city at the center of the outbreak, has a population of 11 million. It is part of the province of Hubei, which has a total population of 58 million (with approximately 90% of the population living in 16 cities). Hubei is the 8th largest regional economy in China (accounting for 4.2% of Chinese GDP and, therefore, approximately 0.7% of global GDP). It has the 9th largest regional population in China. Its main industries are all heavy industries and include: autos, iron & steel, petrochemicals, food processing, equipment manufacturing, and electronics. In autos, for example, Hubei produced approximately 2.3 million cars last year, which accounted for approximately 8% of the Chinese car market.

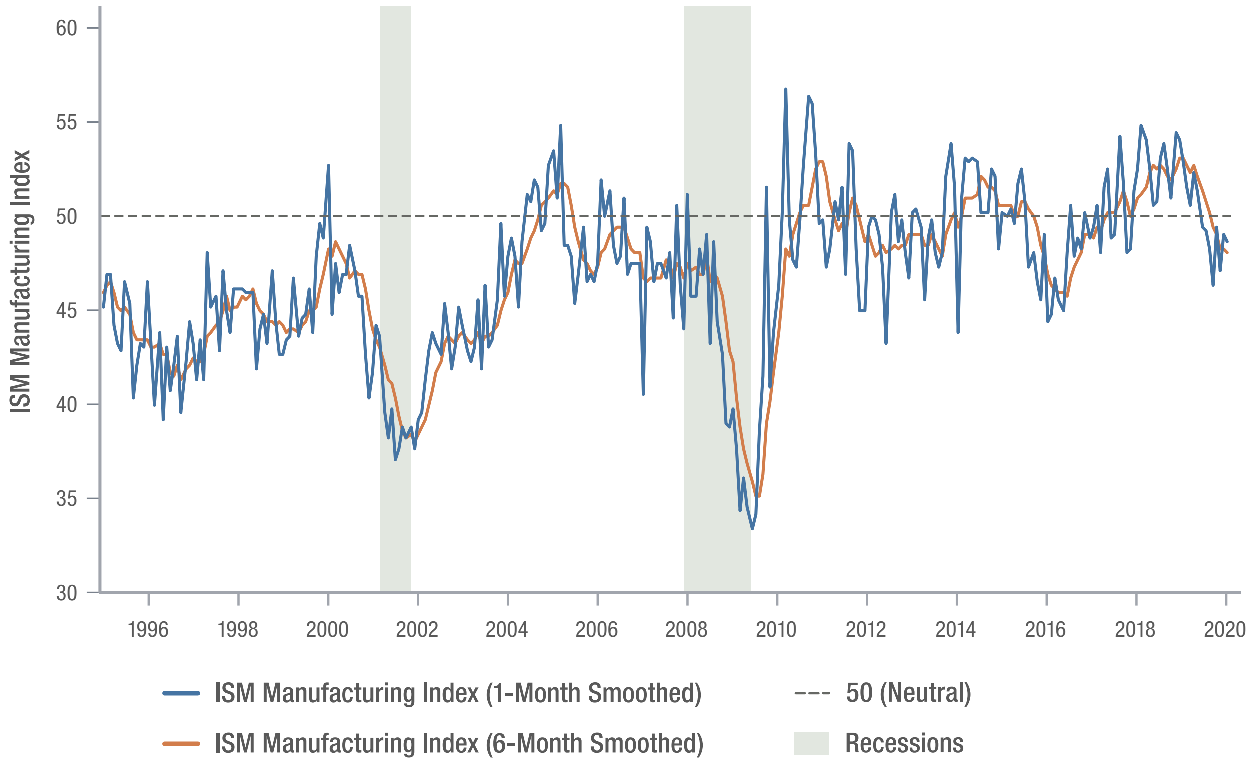
While Hubei, Wuhan, and more widely, China, are heavily involved in global supply chains, the recent U.S./China trade war, as well as the GM strike in America, have spurred companies to seek alternative sources for parts. Equally, there are also winners from China's short-term disruptions. Those alternative sources of production, often from China's neighbors (e.g. Vietnam), are in many instances operating at, or even beyond, full capacity.

Markets, though, are both reactive and forward looking. With the recent spread of the virus in South Korea, Italy, and Iran, we began to see a degree of market panic begin. The virus, as well as impacting economic growth, has also prompted a significant degree of fiscal and monetary stimulus across the globe—with more expected over the coming weeks.

If the global health authorities remain on top of the outbreak, then the markets should continue to enjoy the benefit of all this offsetting stimulus. Equally, once Wuhan, and China in general, start to open up for business as usual, a period of global restocking is likely. That point was illustrated by recent national ISM survey readings, which show a low level of inventories (see **Figure 2** on next page).

Figure 2: ISM Survey Shows Low Inventory Levels, Potentially Leading to a Global Restocking Scenario

US ISM Manufacturing Inventory Index (1 & 6 Month Smoothed)



Sources: Longview Economics, Macrobond, 2/24/20. The ISM Manufacturing Index is a widely-watched indicator of recent U.S. economic activity. Past performance is not indicative of future results. An investment cannot be made directly into an index.

More Upside to Come in the Equity Market

Getting China back to work and ensuring that the authorities remain on top of the outbreak are critical components for helping the global economy get back on track. If the number of new cases re-accelerates and widens more broadly across China and the rest of the world, companies in those industries highlighted above are likely to start to struggle to source various components. For now, the signs are good. Chinese authorities have lowered the virus threat level in six provinces, while the number of new cases in China continues to trend lower. Added to that, the effects of stimulus on the market should over time largely outweigh the effects of the production shutdowns.

However, the number of new cases remains the key metric to watch—along with the speed with which the newly designed vaccine is taken through testing to production, and the willingness of the global fiscal and monetary authorities to provide new stimulus measures. For now, we think that U.S. and Western equity markets should trend higher and perform well in this U.S. presidential election year. Current bouts of volatility should, therefore, be viewed as an opportunity for longer term investors.

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