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When Sickness Strikes

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Markets started the year with a lift from the phase one trade agreement between the U.S. and China and firming economic signals. However, the backdrop abruptly shifted as the outbreak of the coronavirus dashed hopes for a strong turnaround in global trade and industrial activity. While the long-term impact of the virus on human health and economic growth is unknown, global markets have already seen some of their worst trading days in months amidst the uncertainty.

Managing the risk within our portfolios

At the onset of the virus, we reduced equity across all income and balanced portfolios by 3-4%, primarily from international and emerging market equities. This includes our exposure to Chinese markets, which remains low. In our income mandates, we also added 30-year U.S. Treasuries and Japanese yen. Across all U.S. equity mandates, we reduced our U.S. dollar hedge, raising our U.S. dollar exposure. When Chinese markets reopened after the Lunar New Year on February 3, the market nosedived 9%, the biggest intraday drop in years. With quarantines, work stoppages and travel restrictions, we expect China's GDP growth to slow substantially. It's also important to consider how today's economic context is very different from the SARS outbreak in 2003. China now plays a much bigger role in the global economy and we believe the market may not be fully appreciating the steep deceleration in global GDP growth that is likely to occur. The economic fallout is reverberating around the globe, disrupting travel and manufacturing supply chains, and we are being proactive in our allocation and risk management strategies.

Global impact

In China, consumer spending and services will undoubtably be hit hard by the quarantine. The phase one trade deal with the U.S. included large increases in energy, manufacturing and agricultural imports by China. The targets seem even more unrealistic after the virus outbreak. This could cause a re-escalation of the trade war, especially after the U.S. elections. Japan and the rest of Asia are the most susceptible to disruptions in Chinese supply chains.

In Canada, the tourism and oil industries have been affected the most, and there has been a drop in the prices of many other commodities. China is the second-largest consumer of oil and the driver of global demand growth. An abrupt downturn would alter the supply/demand balance for oil. We could see a supply-side response from the Organization of Petroleum Exporting Countries (OPEC) to counter some of the decline in demand. The Canadian dollar has fallen (-2.4% year-to-date as at February 7) and Canadian fixed-income markets are fully pricing in one rate cut for 2020. In addition to the coronavirus, this could reflect other economic concerns and a general flight to safety.

What comes next

As the outbreak gets under control and the Chinese government implements an investment heavy stimulus response, markets may get some short-term relief; however, the full impact will take longer to assess. If more cases emerge outside of China, we expect the economic impact could be more severe. Scientists have vaccines in development, but it could be several months or even years before one is available to the public. In the meantime, we remain modestly overweight equity and will be monitoring the situation closely. Although we have reduced our exposure from the end of last year, we are maintaining modestly overweight equity positioning because we believe that valuations are fair, money supply will support prices and fixed income is comparatively expensive.

Source: Bloomberg Finance L.P. and CSI 300 Index

Combined top 15 equity holdings as of January 31, 2020 of the Evolution 40i60e Standard portfolio with Alpha-style exposure:

1. Microsoft Corp. 2. Enbridge Inc. 3. Canadian Natural Resources Ltd. 4. AltaGas Ltd. 5. iA Financial Corporation	6. Alphabet Inc. 7. Toronto-Dominion Bank 8. E-L Financial Corp. Ltd. 9. Royal Bank of Canada 10. Ashtead Group PLC	11. Apple Inc. 12. ATCO Ltd. 13. Fortis Inc. 14. Keyera Corp. 15. Bank of Nova Scotia