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Global Emerging Market Equities: Coronavirus update

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As the virus outbreak spreads well beyond China, we remain constructive about the country and wider emerging markets, and are still actively looking for top-tier companies

Our view regarding the coronavirus has not changed materially over the course of the past few weeks – our primary focus has been to monitor the situation, concentrate on our process and bring decisions back to the stock level.

As the virus has spread well beyond China, it is hard to forecast the exact economic impact and as non-medical people it is not where our skillsets lie. Given the transmission rates it is hard to believe there will not be more significant cases; fortunately the death rate is much lower than the likes of SARS, and we are encouraged by the slowing pace of virus contagion within China.

What we can be certain of is the impact of the outbreak in the short term is certainly negative and creates volatility in the market. In the longer term we do not expect it to derail the key drivers of the asset class. We do expect an economic hit, but this is likely to be transitory with a rebound in growth once the virus is contained, with support of central bank liquidity and relief in transmission rates from the heat of summer.

Clearly, consumption and supply will be affected. While consumption will be hit hard in the short term and a significant portion of the drop lost forever, it will be temporary, and we will be back on trend before the end of the year. In terms of supply, there is evidence of critical component shortages and, like consumption, it will miss consumer demand and a portion will ultimately be lost. Furthermore, companies are likely to experience a period of negative earnings revisions, but if transitory the market will look through any earning misses or reduced guidance once containment is in sight. Weather and central banks both matter in the coming months. Like flu season, the SARS and MERS infections ebbed as the weather warmed, and warming trends in March/early April may help limit the spread of the current virus.

In the face of higher volatility and weaker global growth we expect to see central bankers in China and globally bring liquidity to the system. The central bank of China has already announced that it will inject 1.2 trillion yuan ($173 billion) into markets and pledged its commitment to the use of monetary policy tools to ensure liquidity remains ample and supportive of firms affected by the virus.

While we expect volatility to continue, we remain constructive about the outlook for emerging markets and China. Having said that, we had been taking profits in China even before the outbreak given the rapid rise in some portfolio holdings over the past couple of months as the risk/reward became less attractive and valuations increased. Fundamentally, our emerging markets portfolios have minimal exposure to areas that suffered the most in previous episodes (eg, tourism, catering services, transportation and retail). In areas where there may be some exposure, we have the highest quality companies that have ways to mitigate the impact of the outbreak.

Given our adjustments earlier in the year, we continue to have ample dry powder to deploy once we see fit, and we are actively looking for top-tier companies/franchises that we may be able to buy at a discount. Some examples of activity in the portfolio over the past week are: to increase our holding in Yandex, given the conviction in its ecosystem and reduced governance overhang; we started a position in Samsung SDI, given clarity on its electric vehicle business, market penetration and outlook on OLED TVs – the share price rallied significantly after we started our initial position and we used the recently volatility to add to this; further purchases including XP, Afya, MercadoLibre and Stone, all positions with Brazilian exposure where, given our process around price targets, we took advantage of price volatility, specifically upside potential, to build position sizes; and we sold KB Financial as our stop-loss rule was triggered and we had reduced conviction given NIM compression, loan growth outlook and the likely stress in asset quality.

In conclusion, while the events of the past few days have been concerning from the viewpoint of the virus spreading outside China, our short- and medium-term outlook hasn’t changed. We expect a transitory hit to growth over the short term given its impact on consumption and supply. We do not expect medium/long-term trends to change. As such we are taking advantage of this volatility and focusing on company fundamentals and valuations. Therefore, activity over the past week has focused on stock-specific stories where the volatility has presented an opportunity given favourable risk/reward profiles.