STATE STREET GLOBAL ADVISORS

Multi-Asset

"My Corona!"

- Global markets in Q1 will be dominated by the coronavirus.
- Currently most impact has been confined to China but rest of the world is starting to see the effect.
- Estimates have Chinese growth for 2020 impacted by one to two percent.

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The outlook for 2020 which was for global economic resilience was challenged as we started the year. A related strain of the SARS virus, the coronavirus has now resulted in more deaths than seen by SARS in 2003. The drastic measures taken by Chinese authorities as well as internationally have thus far curtailed its spread internationally. The seriousness of the situation is evident in the global responses we have seen. Travel bans have been imposed with numerous airlines cancelling flights to affected regions. Travel has also been limited between the mainland and Hong Kong. While Chinese authorities also told companies to extend the Lunar New Year holidays until 10 February to contain the deadly virus from spreading further. All these measures have helped to some extent contain the virus.

However, markets are fully aware of the potential impacts and fears over the coronavirus which saw the Chinese market drop 9% at one point after reopening post the Lunar New Year holiday. Manufacturing, materials, and consumer goods companies were among the hardest hit, while healthcare shares soared. The People's Bank of China (PBOC) unexpectedly lowered short term interest rates as part of its attempts to relieve pressure on the economy from the rapidly spreading virus. It also implemented fiscal stimulus measures which may only be the start of their efforts to ensure there is enough liquidity in the banking system.

Recent events come against a very different backdrop. China saw economic growth of 6.1% in 2019 and the overall view was that economic growth was robust enough to see global growth maintain around long term averages. Partial trade deal eased tensions and concerns to help support this view. However, we now see estimates of the economic impact from the coronavirus range from one to two percent on Chinese growth. Most base cases expect a recovery to this later in the year but Q1 (QoQ%) GDP for china could come in flat.

While initially much of the impact is localised to China, the rest of the world has not been immune. And from a market perspective, China's crucial role in the global supply chain and world economy means there have been knock on effects in related sectors and markets.

Most noticeable has been the impact on oil prices. China is the world's largest oil importer but because of the virus, air travel, road transportation and manufacturing have all been impacted and has seen Chinese demand for oil fall 20 percent[1]. The price of West Texas intermediate crude fell below $50[2] having ended 2019 close to $87.

If production in China can resume quickly 1Q20 global growth impact may be more muted than estimates suggest. The speed and effectiveness of the Chinese authorities to contain the virus and stimulate the economy will determine how extended the impact is. Policy support is unlikely to be withdrawn quickly with manufacturing ramped up as soon as possible. We could also see further policy action to cushion the growth impact. That could see a recovery in global growth through 2Q20. However, the situation is fluid and constantly changing. There are still uncertainties as to how quickly the coronavirus situation will be brought under control or when production and travel (including goods transportation services) will return to normal levels.

As we continue through Q1, coronavirus will continue to dominate markets. President Trump has managed to avoid impeachment but there are still US elections later in the year to contend with. At the start of the year we highlighted two themes we thought would come about this year. Firstly, our expectations for growth to remain robust and secondly, earnings to come through to support the valuation expansion that drove returns in 2019. Our view around growth was based on an idea of resilience in divergence, not only service sector resilience in the face of a manufacturing recession but also consumer spending resilience in the face of weak business investment. We also cautioned that the lateness of the market cycle was going to mean more frequent periods of volatility. In the face of that, our systematic approach and focus on diversification and managing portfolio risk will continue to guide our portfolio allocations and help us navigate these market conditions.

Portfolio positioning and performance[3]

With events like these, often termed black swans, they are often unknown, appear from nowhere and can have significant impact on markets and portfolios. However, through the end of 2019 and going into 2020, our view was that markets were beginning to get complacent and we were seeing extremely low levels of volatility across markets. These kind of environments, although still favorable for growth assets, can often see outsized reactions to any change in sentiment.

Although not forecasting the eventual news of the Coronavirus outbreak, the portfolio was positioned slightly more defensively, while maintaining a healthy exposure to growth assets through January. We began to see increases in market volatility across equity markets and risky debt spreads though the last week of January and further moderated our exposure to growth assets. Over a couple of weeks we removed over 10% of the growth asset exposure to end the month with 62% in growth assets.

During the month, global equity markets were largely negative with Europe (MSCI Europe Net total return local index) down -1.6%, Japan (MSCI Japan Net total return local index) down -1.6% whilst the US (MSCI US Net total return local index) was marginally positive, up +0.2%. Emerging markets (MSCI EM Index Net total return local index) had a negative month returning -3.3% suffering from China's direct exposure to coronavirus. Australia was an outlier for the month however as local equity markets (S&P/ASX 200 Net total return index) benefited from a weak Australian dollar and recent underperformance relative to global equities and posted very strong returns up 5.0% and are up 24.7% for the last 12 months. Local based fixed income returns saw positive monthly returns in January with Australian corporate bonds up for the month after yields moved lower over the month. Our investments in Emerging markets bonds was also positive for the month benefiting from a weaker Australian dollar. We did however see negative returns from our exposure to Commodities with Oil posting very large losses

[1] https://www.bloomberg.com/news/articles/2020-02-02/china-oil-demand-is-said-to-have-plunged-20-on-virus-lockdown
[2] WTI Crude close at $49.45 on the 4th Feb 2020 – Source: Bloomberg Finance L.P.
[3] Bloomberg Finance, L.P. SSGA as at 31 January 2020. Past performance is not a reliable indicator of future performance. This information should not be considered a recommendation to buy or sell any security or sector shown. It is not known whether the securities or sectors shown will be profitable in the future. Characteristics are as of the date indicated, subject to change, and should not be relied upon as current thereafter. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income.

over the month on the back of coronavirus concerns. Our exposure preferences in January was an overweight in global equities relative to fixed income. With the brunt of the market impact concentrated to China, EM and Asia Pacific, the global exposure was able to weather some of the impact. Through the month as we repositioned the portfolio, we favored increasing the fixed income exposure. Performance wise, our diversified exposures across equities, fixed income and alternatives saw the fund deliver a positive return in January in a very challenging environment.

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