Confidence must be earned
Amundi
ASSET MANAGEMENT

29 January 2020

INVESTMENT TALKS

Focus on fundamentals: virus volatility provides entry points for EM equities

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- ***Overview:*** *The coronavirus has been the strongest driver behind the recent volatility in financial markets, providing the trigger for a break in the rally in risk assets, which had been running uninterrupted since October. We should be aware that the trough for markets could be well in advance of the peak of the epidemic, as markets tend to overreact at the beginning of a crisis and then stabilise and rebound, despite the continuation of the negative news flow.*
- ***Overall assessment:*** *Unless the "elevated uncertainty" is able to derail the global economy into a shock – which is not our scenario now – excessive downward setbacks in prices could provide entry points for asset classes with attractive valuations and good fundamentals. In particular, we see selective opportunities in EM equity given the reacceleration of earnings growth, attractive valuations and the prospect of a weaker USD. The short-term issue due to the Chinese situation is an opportunity to add to this asset class, barring any disruption to the global outlook.*
- ***Multi-asset view:*** *Against the current backdrop, we believe that a diversified risk allocation could help investors navigate this phase of uncertainty. We have a risk-on stance, favouring European equity and European credit, as we believe that the economic picture has not fundamentally changed, but we believe that investors should keep (or potentially increase in the most conservative allocation) hedges against tail risks or reduce their exposure to a single risk driver. "Growth" is the main driver for markets now. To contain the volatility in portfolios by playing a cyclical rebound, we have downgraded to neutral our view on EM FX, which is more vulnerable to short-term volatility. This is a tactical assessment: this year we believe that EM FX will provide opportunities to investors once the situation in China normalises.*
- ***Emerging markets view:*** *On the equity side, we have become more cautious on Chinese tourism-related sectors such as hospitality, aviation and consumer discretionary. However, we will continue to closely monitor quality consumer discretionary companies that could provide entry points should stock prices fall significantly. On the fixed income side, there will be some negative impact from weakening currencies, but this will be partly offset by the downward pressure on global yields. We think hard currency bonds are likely to be less impacted as the negative impact on spreads is likely to be largely offset by lower moves in core yields.*
- ***Global fixed income view:*** *As the fundamental picture has not changed, we believe investors should remain focused on hedging key risks rather than changing their allocations on the back of a volatile news flow. We favour US treasuries, which are proving a good hedge as safe haven assets and have performed well so far. Investors should also favour currencies such as GBP and EUR, which have proved to be relatively isolated from the outbreak.*

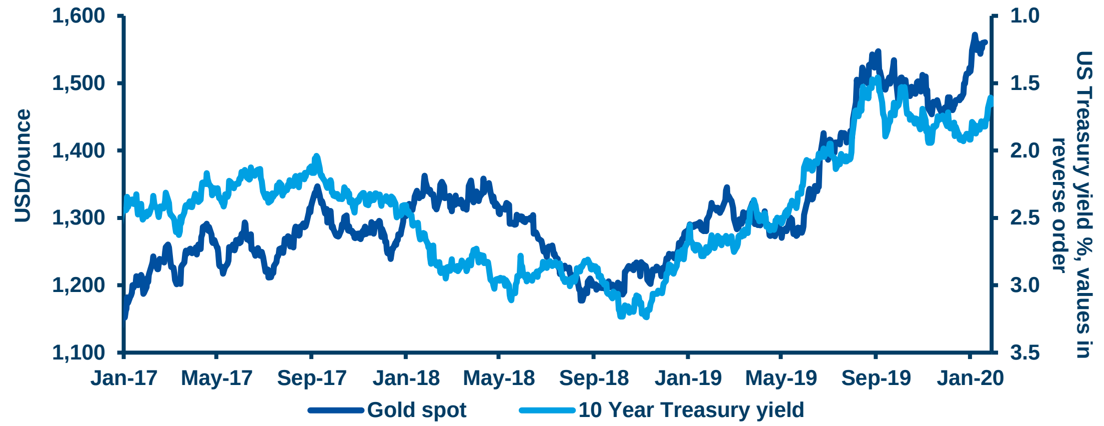
"Excessive downward setbacks in prices could provide entry points, unless a global shock occurs."

Implications on markets and overall assessment

The spreading of the coronavirus has added some uncertainty into an economic environment that was becoming more constructive for equity markets amid the improving economic momentum and lower geopolitical risk after the US-China phase one deal. Volatility has risen across the board, with the VIX Index rising from 12 to 18 and the Move Index from 50 to 66.
Global stock markets, overbought after the year-end rally, have re-priced on the back of the virus fears, most significantly in Asia. The tourism and retail sectors look to be the most affected. Conversely, fixed income markets, especially core government bonds, have rallied. On the currency side, the US dollar has appreciated against a basket of developed markets currencies – the "safe haven" status coming play – while currencies linked to the growth of

China have fallen (e.g., the AUD). It is important to continuously monitor the evolution of the virus outbreak, however, **it is not yet time for excessive alarmism.**

US 10Y treasury yield and gold price: search for safe havens



Source: Bloomberg, Amundi. Data as at 28 January 2020.

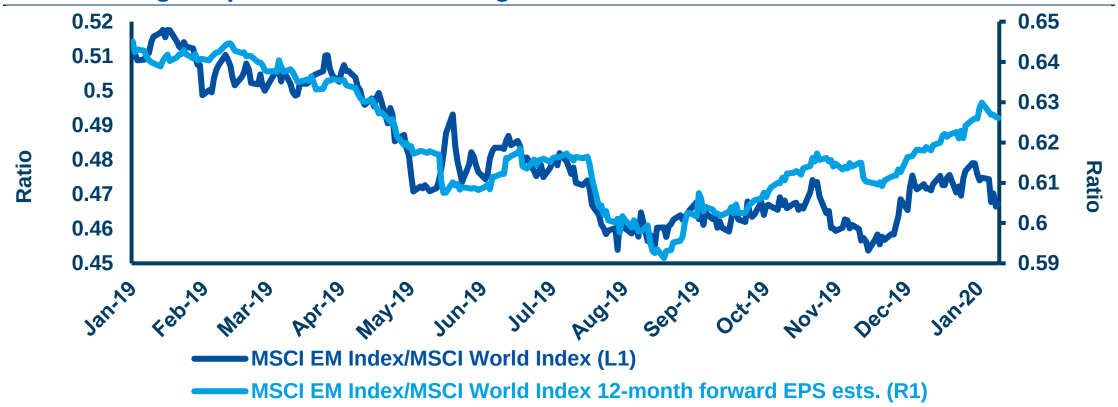
Unless the "elevated uncertainty" is able to derail the global economy into a shock – which is not our assumption – **excessive downward setbacks in prices could provide entry points for asset classes that retain good valuations and fundamentals**. The path towards stabilisation and a reacceleration of global growth in Q1 has not changed, as we believe that fiscal and monetary intervention should stabilise the outlook without major disruption for global growth, but with some "localised" damage. We are closely monitoring the evolution of PMIs (Purchasing Managers' Indices) as these are key thermometers of the impact of the crisis on the economy.

EM equities could be one of the main beneficiaries of this path

"Fundamentals are broadly unchanged: there are opportunities to play the extension of the cycle in EM equities in a selective way."

Last year, the stars aligned in January for EM bonds due to the change in central banks' policies. This year, we believe that EM equities should be in favour, thanks to a reacceleration of earnings growth, their attractive valuations vs. DM equities and the prospect of a slightly weaker USD. The short-term issue due to the Chinese situation may provide an opportunity to add to this asset class to play the extension of the cycle in uncrowded areas of the market, barring any disruption to the global outlook. Selection will remain crucial, because some sectors/stocks may be more vulnerable in the short term to the news flow on coronavirus. We focus on domestic stories, which are relatively insulated from the virus and which can benefit from strong domestic demand or the continuing shift in the value chain. For example, we expect strong growth to remain in Vietnam, activity to slightly rebound in Indonesia and, the Singapore economy to benefit from stabilisation and the eventual pick-up of industrial production and global trade.

EPS earnings expectations bottoming out with China-US trade deal



Source: Bloomberg, Amundi. Data as at 28 January 2020.

On China equities is still too early to assess the potential impact of coronavirus, as much will depend on whether the virus is short-lived or not. If the outbreak of the new coronavirus continues to spread or looks like it cannot be contained, market sentiment will be severely impacted. As the situation is still unclear and stock markets have corrected, we have become more cautious on the most vulnerable sectors in China, such as hospitality, aviation and consumer discretionary, which will arguably suffer some price pressure in the near term. We have also become more defensive on tourism-related companies that benefit from Chinese tourists, for example, those listed in countries such as Thailand, Korea, and the Philippines.

The impact on consumer spending is hard to assess at this stage, however **we continue to closely monitor quality consumer discretionary companies that could represent a good buying opportunity should stock prices fall significantly**.

What we have learned from past virus spreads is that the impact on the market can be quite significant over a horizon of a few months, but also that once the virus tapers out, the market recovers very quickly.

Impact on Chinese economy

"We have not changed our GDP forecast for China in 2020 (5.8%): the upside scenario, based on the trade deal and the bottoming out of the manufacturing sector, has been neutralised by the impact of the coronavirus."

The latest available economic figures for China showed a broad-based rebound in economic activity, consistent with our outlook of just a moderate slowdown in 2020 GDP growth vs. 2019 (5.8% YoY vs. 6.2% YoY, respectively). The recent green shoots, together with the phase one deal signing, had tilted the balance of risks around our growth expectation to the upside. However, since last week the spreading of coronavirus has led us to question the sustainability of this upside scenario. The negative news flow has accumulated in recent days: death toll above 100; five million people leaving Wuhan before the travel ban; the discovery that the virus appears to be contagious during the incubation period (one/two weeks). The market's reaction has been coherent with the news and the comparison with what happened back in 2003 with the SARS epidemic is understandable.

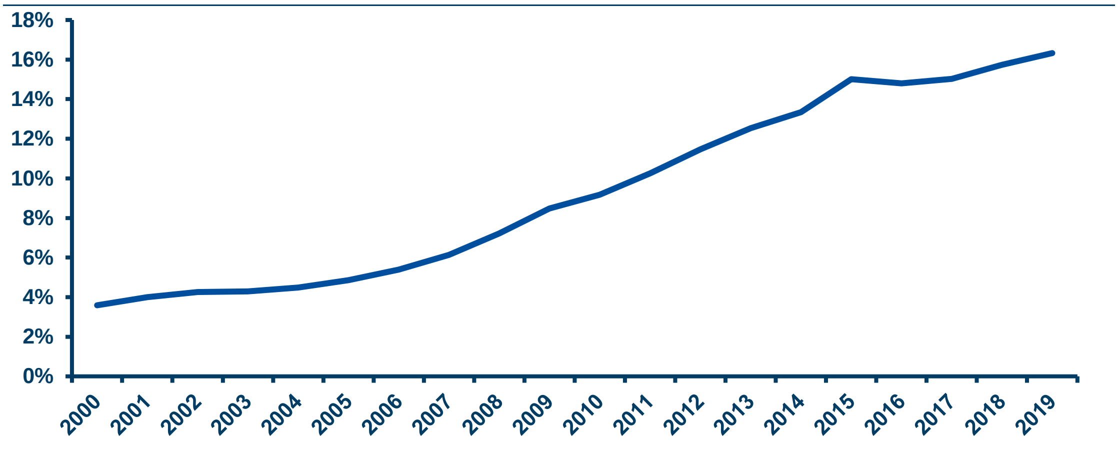
Notwithstanding that 2003 is a reasonable starting point, China and the world have evolved since then. China is much more integrated and interconnected to the rest of the world, while, at the same time, it looks better equipped (higher medical standards) to contain the virus.

Having said that, we do see a negative impact in the short term coming from:

1. the lock-downs and the travel ban, impacting economic activity in the country, mostly the affected region;
2. the Chinese New Year (CNY) celebration, due to its huge migratory nature, likely amplifying that negative impact.

Even though it is rational to expect that the impact of the virus will fade away as we move out of the winter season, **the incremental lock-downs/travel bans and their durations will determine the deepness of the economic slowdown in Chinese growth** and, much more than in 2003, in global growth. China's share of global GDP has increased from 4.3% in 2003 to 16.3% in 2019.

China GDP as a % of world GDP



Source: Bloomberg, IMF. Data as at 28 January 2020.

"As the outlook has not materially changed, we keep a risk-on stance, selectively adding hedging on the most vulnerable assets in the short term."

On the policy mix side, we do expect more support to come and the People's Bank of China has already highlighted that it is ready to use its monetary policy tools to keep banking system liquidity at a reasonable level.

As usual, the impact on confidence measures will be the first thermometer to monitor. However, for a more reliable assessment of the country's economic conditions, we need to wait for January/February data, available by late February/early March, due to the periodical data distortion driven by the CNY days. In the meantime, the trade flows reported by other countries (although also sensitive to the Chinese seasonality) may offer some more clarity on economic developments.

Multi-asset views

Against the current backdrop, we believe multi-asset investors should keep a well-diversified and balanced risk exposure (US duration to balance the risk-on in EU equities and credit) and potentially increase hedges in their conservative allocation to protect their portfolios from elevated volatility. We **maintain a positive stance on risk assets**, despite the uncertainty of the coronavirus, due to the improvement in the economic and earnings outlook. However, to limit the volatility induced by the current market phase and the exposure to a single driver (cyclical re-acceleration of growth), we have moved to a neutral view on EM FX. These currencies are more vulnerable to the recent wave of volatility, though the mid-term view remains positive, based on fundamentals. We have not changed our positive view on EM debt in hard currency, which we see as a valuable source of income for the fixed income component. We will continue to look for entry points to add to EM equities once the situation in China stabilises.

"In EM fixed income, we expect the hard currency bonds to be less impacted than EM FX."

EM debt views

The situation is still highly fluid and the liquidity in some markets is affected by China being on holiday, which is distorting some market movements. In the near term, we expect concerns on the further spread of and deaths from coronavirus to continue to weigh on EM FX, especially on currencies which are more exposed to a further slowdown in Chinese growth and commodity exporting countries (such as the Thai baht and the Chilean peso). On the fixed income side, there will be some negative impact from weakening currencies, especially on countries with fiscal problems (such as South Africa), but this will be partly offset by the downward pressure on global yields. We think hard currency bonds will be less impacted as the negative impact on spreads is likely to be largely offset by lower moves in core yields (e.g., US treasuries).

"A global fixed income approach, favouring US duration, may mitigate short-term volatility and allow a reversal after the virus's containment".

Global fixed income views

At this stage, we believe it is premature to change portfolio set-ups significantly, but with volatility picking up it is more important than ever to manage risks carefully as new information comes to the market. Hedging key risks is vital to preserving assets. We favour US treasuries, which are proving a good hedge as safe haven assets and have delivered a strong performance so far. We are also constructive on currencies such as GBP and EUR, which have proved to be relatively isolated from the outbreak. In order to avoid incurring higher selling costs on news flow, investors should consider not making any significant portfolio changes until the situation is clarified.

We expect high quality bonds and safe haven currencies (such as USD and JPY) to continue to perform well in the short term, but we expect riskier assets to rebound strongly should the epidemic appear to be under control. **Based on previous outbreaks, after containment the reversal has been strong, with riskier assets seeing strong performance on relief.**

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AMUNDI INVESTMENT INSIGHTS UNIT

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Definitions

- **FX:** FX markets refer to the foreign exchange markets where participants are able to buy and sell currencies.
- **Volatility:** a statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

Important Information

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