Keppel Capital

ResearchCOMMENTARY

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Novel Coronavirus (2019-nCoV): Likely Short-term Demand Blip

- Temporary disruption to growth, economic recovery likely by 2H2020
- Transport, retail, travel and hospitality sectors the worst-hit
- Few lasting effects on real estate, but more investment opportunities possible

Putting outbreak in perspective

In this commentary, we explore the potential impact of the ongoing novel coronavirus (2019-nCoV) outbreak that originated from Wuhan, Hubei in China. While the situation remains fluid, general expectations are for the outbreak to be contained and subside towards the summer months, with the global economy returning to gradual growth in 2H2020. If this outbreak turns out to be like similar ones in recent history, it will likely cause a temporary blip in economic growth in China and the rest of the world.

When China sneezes…

The first cases of a mystery pneumonia in Wuhan surfaced in December 2019. The virus was identified as 2019-nCoV by 9 January 2020, and by 20 January, human-to-human transmission was confirmed. The outbreak has since spread beyond Wuhan to the rest of China and at least 24 other countries, but community transmission outside of China remains limited for now. On 30 January, the World Health Organisation (WHO) declared the 2019-nCoV outbreak as a "Global Public Health Emergency". As of the date of writing, there are over 40,000 confirmed cases globally, with less than 1.0% outside China. The overall case fatality rate stands at around 2.2%, with only 2 deaths outside mainland China.

Transport and travel-related industries hit

The outbreak of 2019-nCoV came at a time when China was celebrating its Spring Festival or Lunar New Year, when hundreds of millions of mainland Chinese travel back to their hometowns to celebrate with their families. Roughly 400 million of such trips are made by rail. It was therefore imperative to contain the spread of 2019-nCoV. The city of Wuhan and 15 other neighbouring cities in the province of Hubei have been placed under lockdown since 23 January, affecting over 50 million people. Travel restrictions have been implemented in these cities, including all urban transport networks and outgoing flights. Some Chinese cities outside Hubei, such as Wenzhou, Hangzhou and Ningbo, are also under near-lockdown conditions to contain the spread. Subsequently, several countries including Singapore and the US have placed temporary travel restrictions on incoming visitors from mainland China, in some cases including any foreigner with a recent travel history to mainland China.

Due to its geographical location in central China, Wuhan is a major transportation and logistics hub. Such stringent quarantine measures in China directly impact its domestic transportation sector, including public transport and non-essential goods delivery. Domestic travel will be sharply reduced, impacting the travel and hospitality sectors. Cinemas and many tourist attractions across China are now closed indefinitely, while many shopping malls are either closed or operating with shorter hours, impacting the offline retail and F&B trades in the foreseeable future. Extended factory closures until 9 February at the earliest (13 February for Hubei province) will also lead to sharp production losses in 1Q2020.

Comparison with SARS

Over the past two decades, there have been a handful of flu-like pandemics such as the Severe Acute Respiratory Syndrome (SARS) in 2003 and the H1N1 “Swine Flu” in 2009, which was first reported in California. The most widespread thus far was the H1N1 outbreak, which the WHO estimated had infected one in five people globally in its first year and resulted in around 200,000 deaths at a case fatality rate of under 0.02%.

Given that SARS was similarly emanated from and largely contained within China and the pathogen was also a coronavirus, experts are making references with the SARS experience in estimating the potential impact of the 2019-nCoV. The key differences are:

1) **Fatality rates –** Despite a much higher number of reported cases than SARS, 2019-nCoV currently has a case fatality rate of ~2.2%, while SARS had a case fatality rate of 9.6%;

2) **Location of epicentre –** The majority of 2019-nCoV cases are in Hubei (4.5% of China’s total GDP) whereas most of the SARS cases occurred in Guangdong and Beijing (combined 14.5% of China’s 2003 GDP);

3) **China’s internal connectivity** – China is now much more densely connected internally via a sophisticated network of high-speed rail, highways and manufacturing supply chains;

4) **China’s global connectivity** – China is now much more integrated with the rest of the world, contributing 16% to global GDP compared with 4% in 2003. Outbound mainland Chinese tourists also grew from 20 million in 2003 to almost 160 million in 2019; and

5) **Swiftness of response** – The Chinese authorities acted more swiftly and aggressively in locking down affected cities to contain the 2019-nCoV outbreak compared to initial response to SARS.

This too shall (likely) pass

It is impossible to determine the economic impact and duration of the 2019-nCoV outbreak at this juncture with high confidence. Current estimates point to a base-case drag of between 0.2 and 0.6 ppt on China’s 2020 full-year GDP growth rate, taking it under 6%. Most economists, drawing references from SARS, expect the growth shock to be limited to 1H2020, before rebounding and normalising in 2H2020 as the outbreak subsides, supported by pent-up demand and stimulus measures.

The impact on other Asian countries will be mostly through the tourism and trade sectors. Most Asian countries, in particular Japan, Singapore, Thailand and South Korea, will be hit by the reduction of inbound mainland Chinese tourists, while supply chain disruptions will impact Taiwanese and South Korean exports. Travel bans by increasing number of Asian countries on mainland Chinese tourists may be necessary in controlling the contagion but will also impact the destination’s tourism and hospitality sectors. However, these economies still maintain some fiscal and monetary policy headroom to cushion the economic shock, which is expected to be limited to 1H2020. Early estimates suggest that major Asian economies may suffer losses of between 0.2 to 1.0 ppt to their respective 2020 GDP growth rates, but the impact on Hong Kong’s growth rate could be nearly 2.0 ppts due to its close economic ties with the mainland.

In the near term, the retail and hospitality sectors in China and other more affected countries are most vulnerable to the 2019-nCoV outbreak. Besides shorter operating hours and mall closures, some landlords in China like Longfor have offered their tenants rent-free periods (of up to 2 months) to tide over this difficult period.

Parts of central China’s industrial and logistics sectors will also be affected as the outbreak causes disruptions to supply chains. In some Chinese cities, the additional quarantine measures require white-collar employees to work from home. This is not expected to impact the office markets, except perhaps for co-working spaces as office workers avoid communities. Nonetheless, office leasing activity will decelerate as the outbreak approaches its peak, before gradually recovering as business operations return to normal thereafter.

Assuming that current estimates for the outbreak to subside towards the summer months are accurate, most of the affected real estate sectors will recover by 2H2020. Central China's industrial and logistics sectors are expected to experience a rebound from pent-up demand as inventories are restocked and retail malls return to normal operations. Leisure and business travel will gradually recover and the retail and hospitality sectors in China and other affected countries such as Singapore will resume normalcy.

Investment Strategies

Assuming the base-case that economic disruptions due to the 2019-nCoV are confined to 1H2020, there is unlikely to be any lasting effects on the real estate sectors in China and affected Asian nations. We continue to adopt the following strategies:

1) Focus on the macro trends. Based on past outbreaks, the economic impact of pandemics tend to be short-lived. We still believe in focusing on the gateway cities in Asia that benefit from the macro trends of urbanisation, growing middle-class and growing inter-connectivity. These secular trends will transcend the temporary disruptions caused by viral outbreaks and also underpin the resiliency and growth of alternative asset classes such as infrastructure (urbanisation), education (growing middle-class) and data centres (connectivity).

2) Stay vigilant for opportunistic deals. Real estate transactions in affected cities are expected to slow while the outbreak continues. The temporary market dislocations could present investment opportunities, as we found was the case after past crises, such as in 2009 following the Global Financial Crisis, with some of these opportunities eventually outperforming. Even though a prolonged outbreak is not the current base-case scenario, the longer the quarantines and travel restrictions drag on, the more likely it is for some asset owners in China to experience cash flow problems. Highly-geared asset owners could then be more willing to listen to offers although we do not envisage distressed pricings for high-quality assets.

Conclusion

The ongoing 2019-nCoV outbreak will cause an economic slowdown in China and many parts of Asia with strong tourism and industrial links with the former. If this outbreak follows a similar pattern to SARS in 2003, the economic shock is likely to be sharp but short-lived, with a recovery expected by 2H2020 as the outbreak subsides. The swift and aggressive measures undertaken locally and globally should help contain the outbreak and supportive stimulus measures will help the economies cushion the business disruptions and drop in demand.

As long as the outbreak does not become prolonged, lasting impact on the real estate sectors within China and the affected Asian countries is unlikely. We continue to invest along the positive macro trends in Asia and will be opportunistic should the temporary disruptions present investment opportunities.

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