ClearBridge Investments

Coronavirus Business Impacts Likely Short-Lived

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Key Takeaways

- Efforts to contain the rapidly spreading virus have curbed industrial activity at the epicenter of the outbreak in China and caused most consumers to remain home, slowing retail and tourist activity.
- Companies followed by ClearBridge most affected by the national shutdown include semiconductor equipment makers, global retailers and online travel agencies. We believe, however, that such impacts will likely be temporary.
- Dynamic changes in the Chinese economy since its last major health scare in 2003 make comparing the impacts of each outbreak less relevant.

Technology, Retail Sectors See Initial Impacts of Chinese Efforts to Contain Outbreak

The outbreak and rapid spread of the coronavirus this month beyond its origin in central China has severely limited business activity across the country. As the world's second largest economy directs its efforts to containing the virus and treating the affected, reports suggest industrial production in the city of Wuhan and the Hubei province – ground zero for the virus – has been shut down. Air travel in and out of China has also been curtailed, with several global carriers suspending service into Shanghai and Beijing, where normally bustling streets are nearly deserted.

Streets in Central Beijing Deserted as Coronavirus Outbreak Spreads

The companies we follow at ClearBridge that conduct business in China or rely on Chinese demand are also beginning to quantify the estimated impacts of the virus outbreak on their operations. Here is a brief summary of what we are hearing and our projected impacts on specific companies and industries.

From an information technology standpoint, Wuhan is a technology manufacturing hub that houses several large Chinese semiconductor manufacturers including leading Chinese flash memory producer YMTC, which by our estimates accounted for about 8% of memory semiconductor equipment spending in the fourth quarter.

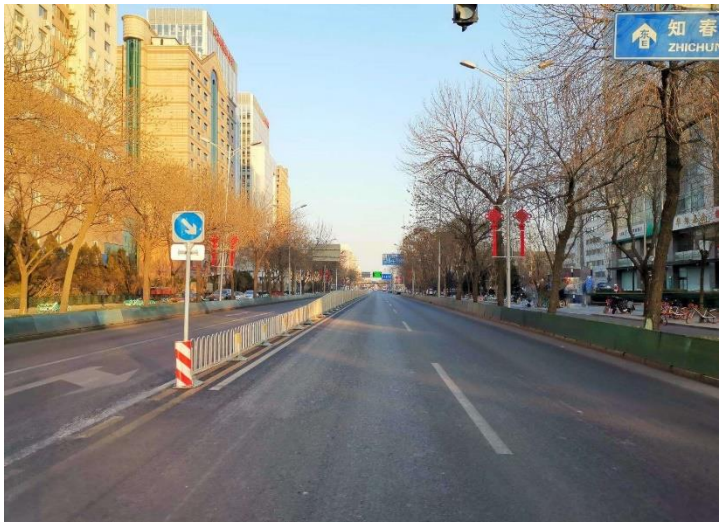
We expect suspension of manufacturing by YMTC would be an incremental negative for semiconductor capital equipment stocks including Applied Materials, Lam Research and ASML, electronic sensors maker TE Connectivity and display equipment providers and a slight positive for NAND manufacturers by removing incremental supply from the market.

Consumer demand in China has already been affected by precautionary store closures and lower foot traffic to retailers remaining open.

- Starbucks shared in its first-quarter earnings call that the coronavirus is taking its toll on the business, causing it to keep full-year guidance unchanged despite positive margin trends. More than half of the over 4,000 Starbucks locations are currently closed while open locations are seeing fewer visits. China is home to 13% of the company's locations and generates about 10% of overall revenue. Past health scares in China demonstrate how sales can be impacted. During the 2003 SARS outbreak, sales at Yum China (operator of KFC, Pizza Hut and Taco Bell franchises in China) fell between 20% and 30% in the quarter when the health scare peaked. KFC was negatively impacted by two separate food scares where sales declined by 25% in the first half of 2013 and 16% in the second half of 2014. Yum regained all of its lost 2003 sales the following year as brand strength was strong. Recovery was more difficult in 2013 and 2014 due to lingering brand issues and an economic slowdown. Starbucks believes strong brand strength on the mainland will enable sales to normalize once the virus threat fades.
- Internet and media stocks have less direct revenue exposure to China but could also be impacted in limited ways. Over the past week, Disney closed both its Shanghai and Hong Kong theme parks to reduce the spread of the virus. Closure of the parks for longer than a week will negatively impact current quarter earnings. Online travel agencies Expedia and Booking Holdings, meanwhile, could be hurt by reduced outbound travel by Chinese tourists. Over the weekend, the country banned group travel reservations out of the country. China is currently the largest single market for outbound international travel with about 160 million such trips taken by Chinese travelers in 2019.

Much of the impact on global cosmetics, luxury goods and spirits companies will depend on the duration of the crisis. Fourth quarter and full-year earnings for these companies are just beginning to come in and we have seen luxury names announce strong full-year numbers. Short-term negatives in these areas are generally absorbed through cost savings in marketing, rents and in other channels. The Chinese consumer will remain an important source of demand and we are confident that a permanent impairment is not in store.

Travel Within China Has Ground to a Halt



China Acting Aggressively to Control Outbreak

China has experienced similar health scares in the past, most notably the SARS outbreak in 2003, but a lot has changed since then, making comparisons less relevant. Over the last 17 years, China's GDP has grown from about 4% of global output to close to 16% and Chinese tourism has increased ten-fold. The creation of a massive, dense high-speed rail system, with Wuhan as a major hub, raises the risk of contamination compared to 2003 when such a system did not exist. The rapid rise of the Chinese economy means more is at stake, however, the government's more transparent approach and rapid mobilization in dealing with the outbreak could mitigate some of these risks.

In addition, the government's decision to delay the return to work for its population following the Chinese New Year as well as the power of social media in communicating to its population how to take precautions against the virus' spread have also helped.

The early stages of these types of events tend to add a great deal of uncertainty. Risk assets have begun to respond to this uncertainty, with stocks selling off, the CBOE Volatility Index rising nearly six points, and high yields spreads widening approximately 65 basis points. Over time, as the global health community gets a better handle on the disease (containing its spread, potentially developing a vaccine) uncertainty will ebb and risk assets should normalize. Typically both economies and financial markets have experienced relatively quick bounce-backs from these types of events. The expected short-term economic weakness caused by the outbreak will likely motivate China and other countries to add to existing fiscal and monetary stimulus measures. Chinese GDP will fall in the first quarter due to the shutdown, which will have an impact on global GDP. Preliminary estimates have wide ranges, but right now most economists do not believe this will lead to a recession either in China or globally.

U.S. equities are more exposed to China than U.S. GDP and the re-injection of economic risk in China has sparked a sell-off in cyclical stocks, especially commodity and energy shares. While the U.S. has a substantial trade gap with China, trade done by S&P 500 companies is much more balanced as many companies have Chinese operations that sell goods/products back into the mainland. These entirely Chinese transactions do not impact U.S. GDP, but do impact the company's financial well-being.

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