BRIEF MARKET INSIGHTS

FEBRUARY 27, 2020

Putting the Current Volatility into Perspective:

Our Take on the Implications for Markets and Economy

The sell-off in the U.S. stock market has been driven primarily by uncertainty surrounding the coronavirus. Although Q1 eps estimates have contracted, in Q2-Q4 they are largely unchanged, (according to Bank of America Global Research). This leads us to the conclusion that the recent market sell-off was largely driven by a P/E multiple compression. Substantial cuts to GDP would need to occur resulting in lower earnings to account for the size of the sell-off from its peak. However, Q2-Q4 consensus estimates by analysts are largely unchanged to date.

While the speed and breadth of the coronavirus outbreak is being monitored/measured, the full magnitude remains unknown and therefore prevents us from drawing a hard set of conclusions at this time. But in studying past pandemics, we find that over the long-term stocks tend to out-perform bonds. Therefore, we recommend that diversified portfolios remain invested and avoid panic selling - even if it means further downside in the immediate weeks/months.

The potential for a global health emergency is of utmost importance to the International Monetary Fund. If the virus is contained quickly, we could expect a short-lived impact on world markets with a blunt but transitory drop in Q1 GDP in China. However, a long-term global scaled outbreak could impact supply chains and further assault investor confidence. This would have a longer-term impact on the global economy. From a portfolio strategy perspective, we have revised our expectation for Chinese growth for 2020 from 4.5% to 3.5%, which should reduce global GDP growth by about 0.4ppts from our pre-virus forecast of over 3.0% to 2.7%.

We Remain Vigilant, Not Fearful

We had always assumed that the virus would have wider global effects. And the rise in new cases outside of China points to the growing risk of a "global pandemic", which has already been partially reflected by markets raising the magnitude of the global economic impact. There are five issues to consider when assessing how the economic disruption might spread: The first is the direct impact on affected economies due to measures taken to contain the virus. The second is the knock-on effect on other economies due to trade and supply chain links. Third is how people react, and the extent to which they decide to avoid leisure activities such as travel or shopping. Fourth is the financial market impact. And fifth is the fiscal and monetary policy response.

We expect the coronavirus outbreak to be contained, as the previous three major viral outbreaks were. SARS (2003-04), MERS (2012), and EVD (2014-16) all were contained using traditional public health measures—e.g., testing, isolating patients, and screening people at airports and other public places. Eight months after SARS began circulating, for example, the virus died out. Our research uncovered that when SARS had reached 29 countries at its peak it suddenly disappeared. The seriousness with which governments and health organizations around the world are taking the coronavirus suggests its spread likewise will be minimized.

The bottom line is that we aren't too afraid of the virus right now. While we are not virologists, our take is that there are two sanguine outcomes: (1) the virus spreads to lots more people, but most cases are mild, and we learn to live with the threat; and (2) public health efforts and less close human contact during warmer months causes the virus to die out.

More fearsome than the virus itself is the global contagion of fear - this could feed on itself as governments continue to react with extreme measures and the media continues to hype the threat. Governments' responses have been drastic, as evidenced by China's quarantine of 60 million people in Hubei province, halting economic activity, and the U.S. travel warnings and ban on entry of any non-American who has been to China in the past 14 days. As noted above, just yesterday, the CDC warned Americans to prepare for a "severe disruption to everyday life" in the U.S. in the event of an outbreak here.

As a final note: we believe that investors will soon conclude that there is good reason to expect that this too shall pass, and that reallocating assets to long-term securities remains the prudent conclusion.

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