Emergence of Two Black Swans

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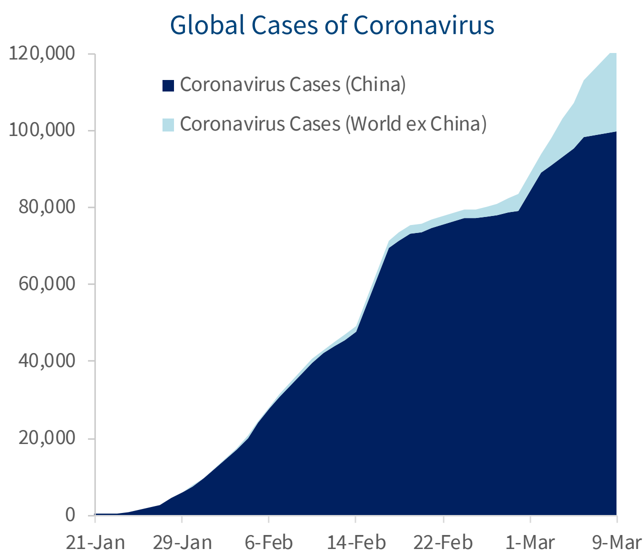
If the financial markets' hope for a quick "V" shaped recovery hadn't already fallen to the wayside, it vanished as the S&P 500 declined over 7% (more than 208.16 points) triggering circuit breakers which halted trading for 15 minutes shortly after the open this morning. The two 'Black Swans' that emerged over the last few weeks and over this weekend specifically were a continued global spread of the coronavirus evidenced by massive quarantines (e.g., Italy quarantined a quarter of its population until early April), and the Saudi-Russian oil price war. The CBOE Market Volatility Index is now at the highest level since 2011, and the second highest level since 2009. Until the magnitude and duration of both the virus and the price war can be determined, market volatility will persist.

1. Global Spread of the Coronavirus

   After ignoring the initial outbreak of the coronavirus in January, the markets are currently on edge, as there are now almost 120,000 reported cases and ~4,000 deaths, most of which are in China. While the lack of a peak in global cases continues to cause concern, varying reports regarding the mortality rate has further fueled the panic. What is for certain is that the mortality rate is heavily skewed toward the elderly, with 93% of reported deaths affecting people over 60 years old. In fact, the mortality rate for those 80 years of age and up is 10%+, while the rate for those under the age of 30 is a mere 0.2%. Individuals with pre-existing conditions, specifically respiratory issues, are at higher risk as well.



Impending Spread in the US

Chris Meekins, our Health Care Policy Analyst, believes we will see a notable widespread outbreak in the US, and as lab testing is soon to ramp up he thinks the number of diagnosed cases is about to skyrocket from the current ~500 cases. A widely acknowledged 'glitch' in the handling of the coronavirus within the US has been poor testing capabilities, but this should be improved this week as 137 state and local public health labs and two private companies prepare to ramp up testing capabilities to ~25,000 patients per day by the end of this week. So far, 6,000 tests have been conducted year-to-date. Enhanced testing is not only critical from a market volatility perspective, but also from a public health perspective, as the results will help determine the answers to two key outstanding questions: 1) How widespread will the coronavirus be in the US? and 2) How long will it take to reach a case number peak? In the meantime we will monitor events that would trigger strong market reactions (e.g., milestone case counts, community transmission in a major city, hospitals reaching capacity, school closing, telework for federal employees).

2. Oil Price War Compounds Uncertainty

   Today brought about the third largest daily oil price decline on record and the biggest drop for crude since the Gulf War in 1991, as WTI crude fell ~25% to ~$31/Bbl. While oil had already been in a bear market prior to the Saudi-Russian price war, current prices plummeted even further below breakeven levels. Prior to the developments this weekend, it was our expectation that the coronavirus could cause a 2 million barrel/day impact (~2% of global demand, estimated mostly in the Asia-Pacific region). Now, supply dynamics are compounding demand headwinds. The Saudis had been bearing the majority of the recent production cuts (~1 million barrels per day), especially compared to Russia (a few hundred thousand barrels per day), and their recent actions are being seen as a maximum pressure effort to bring Russia to the negotiating table. There are a few dynamics at play that should keep the current price war from escalating. Aramco is a public company this time around, and the Saudis need oil prices at ~$80/barrel in order to balance their budget. Ultimately, none of the major producers can survive at the current $30 price, and incentives should drive this price war to end sooner rather than later. Our forecast for oil prices has declined to $50/barrel for the first half of this year, with expectations for a rebound later on.

Concerns Not Confined To Coronavirus – Politics Turning Into An Equity Market Headwind

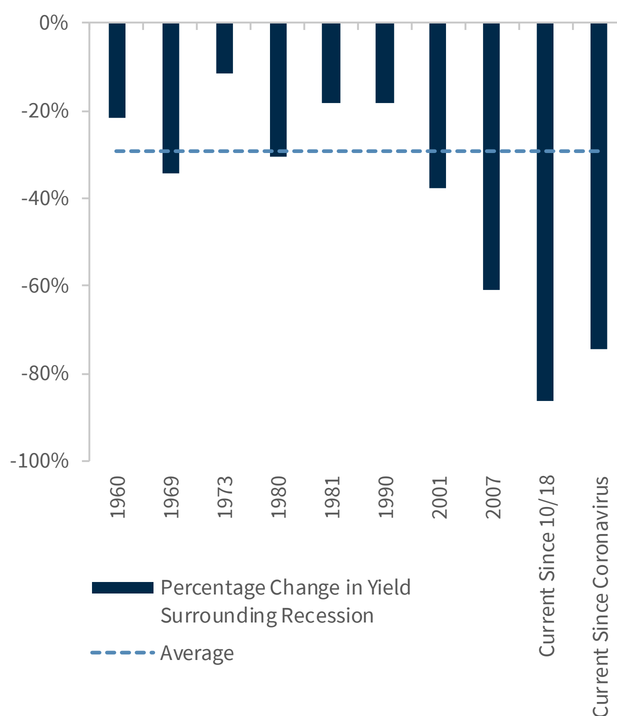
While the coronavirus outbreak and spread has garnered the majority of headlines and market reaction, the upcoming presidential election has also weighed on the financial markets. The probability of President Trump securing re-election peaked after the initial outbreak from the virus, but is now on the decline as the president's handling of the situation has been called into question. In fact, the percentage of those who somewhat disapprove and strongly disapprove of President Trump's reaction has doubled to 42% from 21% over the last several weeks. Meanwhile, moderate Joe Biden has emerged as the front runner to secure the Democratic nomination and the probability of a democratic sweep is on the rise. The realization that the Democratic Party could control both the Senate and the House of Representatives has started to weigh heavily on the markets, as the likelihood that the proposed roll back of corporate tax cuts rises.

Potential Impact to the US Economy

The US economy was resilient coming into the coronavirus concerns, and data as recent as last week continues to confirm such. A number of our real-time leading indicators remain positive with withholding taxes near record highs (~5% year-over-year), consumer spending still upbeat, jobless claims near 50-year lows, and the Bloomberg Consumer Comfort Index near cyclical highs. Readings on direct components to GDP show signs of strength too, the 3-month rolling average of job growth is at 243,000, the trade balance has much improved, both the ISM Manufacturing and Non-Manufacturing Indices are in expansion territory, and mortgage rates near 3.25% have helped make the housing market robust. Perhaps the biggest risk to the US economy is social distancing, as consumer spending accounts for ~70% of US GDP. Our Chief Economist Scott Brown estimates that virus-impacted spending comprises ~7.7% of consumer spending and ~5% of total GDP. This spending includes subsectors such as restaurants, casino gambling, hotels, air transportation, and spectator events. If this virus-impacted spending component declines 10%, it will translate to a -0.5% impact on GDP. If the decline worsens to 20%, the downside risk to our 2020 GDP forecast (1.8%) would likely be 1.0%+.

...But Yields Are Already Pricing in Recession

The bond market is pricing in a recession over the next 12 months, but a review of the technicals reveals that the downside may be limited. Both the 10-year and 30-year Treasury yields have moved to historic lows, and the entire yield curve has fallen below 1% for the first time in history. From the most recent cyclical highs in November, yields have declined ~280 basis points, which is in line with the recession average of ~250 basis points. Focusing solely on the decline since the start of the coronavirus outbreak (~130 basis points) suggests we are not quite there yet. But switching from absolute terms to percentage terms confirms that whether we focus on the decline from November or the decline since the start of the outbreak the bond market is pricing in a recession, a significant one at that given that the decline in yields is the largest percentage decline dating back to 1960. Moving forward, technical indicators suggest that a further sharp decline may be limited in the near term. For example, the Relative Strength Index suggests that the 10-year Treasury is at its most overbought level in the last 20 years. Credit sectors also reflect the recent spike in volatility, as high-yield spreads, led in part by energy exposure, have widened to the highest level in four years over the last week.



Monetary Stimulus Now, Fiscal Stimulus Later

The Federal Reserve, the Bank of Canada, the People's Bank of China, and the Bank of Australia have already implemented interest rate cuts, and the Bank of England and the European Central Bank are expected to follow suit. Within the US, financial conditions have tightened to the lowest levels since 2011 and are now near the levels of the previous recession. Subsequently, the futures market is pricing in an additional 75 basis points of easing at the March FOMC meeting next week, with the expectation that rates will be cut to zero by April/June. Our Chief Economist Scott Brown has a slightly less aggressive stance, believing that the Fed will cut rates by at least 50 basis points next

week and that rates will be brought to zero by the end of the year. His belief is founded on previous Fed action, which has historically been proactive following an inter-meeting cut. He is also in agreement with our Chief Fixed Income Strategist, Kevin Giddis, with the thought that the Fed will seek non-traditional easing tactics (e.g., massive quantitative easing efforts, purchase of Treasury or mortgage-backed securities) in order to avoid negative interest rates.

As for any potential fiscal stimulus relief provided by the Trump Administration, our Washington Policy Analyst Ed Mills believes that current packages will be targeted efforts (e.g., tax holidays, special funding for impacted businesses such as travel-related industries). Until economic, health, and market conditions significantly deteriorate, policymakers in DC will allow the Fed to lead the way. Heightened pressure due to the election year combined with general responsibilities will lead the Trump Administration to propose a stimulus package, but current proposals remain at early stages until the magnitude and duration of the coronavirus situation within the US can signal specific needs. While the $8.3 billion supplemental package to meet the immediate health care response has been funded, it may be some time until large-scale stimulus measures are implemented.

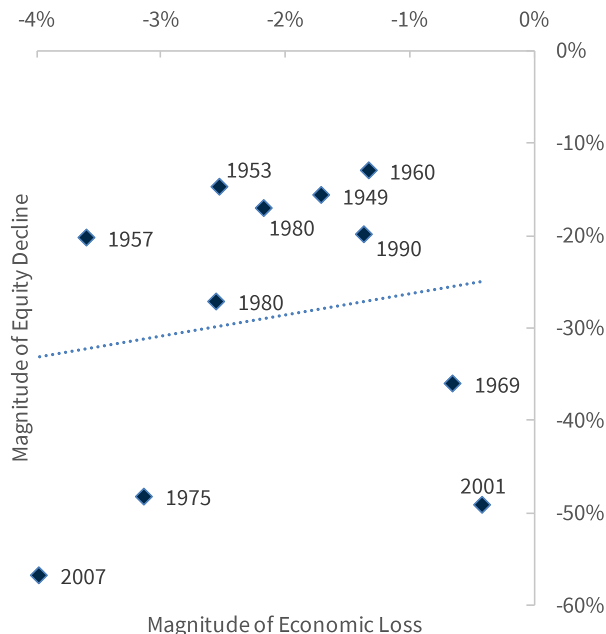
Base Case

Ironically, today's sharp sell-off is occurring on the 11th anniversary of the current bull market that had seen a total return of 453% and annualized performance of 16.8% before today. We have now experienced six 10%+ declines since March 9, 2009, and while the duration of the decline has varied substantially, the amount of recovery time has remained the same at ~103 trading days which equates to ~5-6 months. By extending our time frame and analyzing all recessions since 1948, there is an expected natural relationship between the degree of economic shock and the severity of the decline in equities. Given our prediction for a 0-1.0% decline in economic activity, should we enter a recession we expect it will be short and shallow, and that the total pullback will remain in the 15-25% range.

How Does The Current Pullback Stack Up

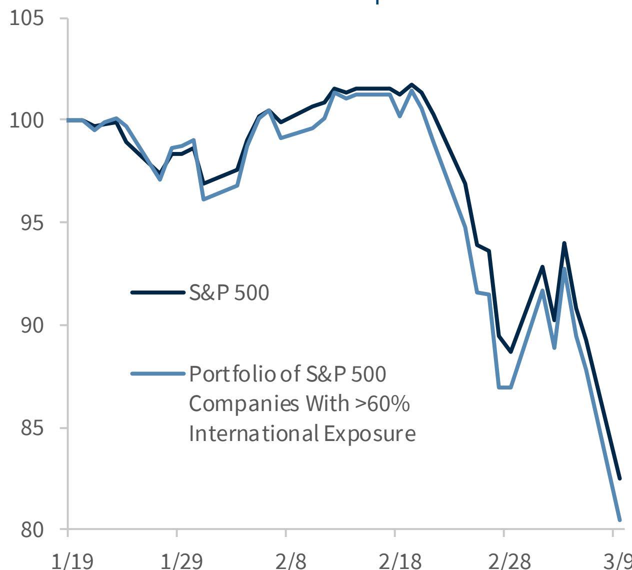
Timeframe	Decline (%)	Duration of Decline (Days)	Duration of Recovery (Days)
Apr 10 - Nov 10	-15.99%	50	88
Apr 11 - Oct 11	-19.39%	109	100
May 15 - Feb 16	-14.16%	184	104
Jan 18 - Feb 18	-10.16%	10	138
Sept 18 - Dec 18	-19.78%	66	82
Average	**-15.90%**	**84**	**103**
Current	*-18.40%*	*15*	-

Equity Decline Vs. Economic Impact

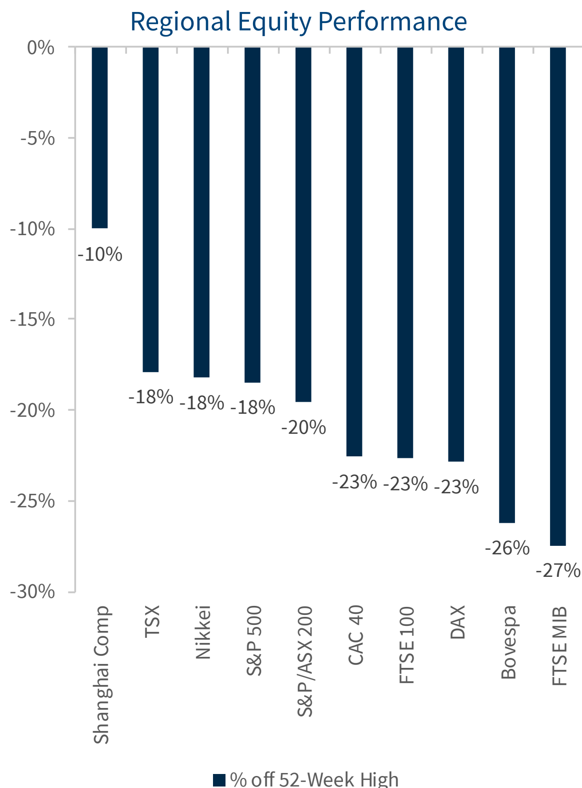


Despite the persistent uncertainty in the market, there are a number of factors that remain fundamentally supportive of domestic equities. First, with Treasury yields near record lows, equities have a more favorable relative yield. In fact, the S&P 500 yield is now ~125 basis points above that of the 10-year Treasury, and ~75% of companies have a dividend yield exceeding that of the 10-year. Second, valuations were at elevated levels prior to the escalation of the coronavirus situation and they have become increasingly attractive as the trailing 12-month PE is now below the previous 5-year average. Third, we have witnessed indiscriminate selling.

Performance of S&P 500 Companies With >60% International Exposure



To our surprise, the best performing equity region since the outbreak has been China, despite the fact that the region saw the largest negative economic and human impact. Other countries such as Germany and Italy are the ones that have entered bear market territory (a decline of 20%+). Additionally, one would reasonably expect that the S&P 500 companies with the largest international exposure would be underperforming the broad S&P 500 by a wide margin, but that has not been the case.



According to Joey Madere of Equity Portfolio & Technical Strategy, due to prolonged global supply chain disruptions, demand destruction around the globe as fears intensify, and given the fact that ~40% of S&P 500 revenues are derived overseas, the full-year 2020 earnings estimate has been lowered to $167 (from $174) with the reductions weighted specifically to first half 2020 results. Based on our belief that a recovery will occur in the latter half of the year, our 19.5x trailing multiple is unchanged, resulting in a revised 2020 S&P 500 price target of 3,256. Again, with the magnitude and duration of the virus still unknown, concerns may climb higher in the short term. However once fears subside, the easing from global central banks will be felt through the system, and low valuations will lead the market to start discounting in an eventual recovery.

Answers to Frequently Asked Questions

How does the coronavirus compare to the seasonal flu?

This season, it is estimated that the flu will infect 30 million people and cause 25,000-35,000 deaths. This correlates to a mortality rate of 0.1%. The mortality rate for the coronavirus has seen more variance, and is heavily dependent on government and health organization reactions within each country, testing capabilities, and the average age of the impacted population. For example, the mortality rate in South Korea is 0.5% (five times more deadly than the seasonal flu), in the US it is ~1.0% (ten times more deadly than the seasonal flu), and in Italy it is 3%+ (thirty times more deadly than the seasonal flu).

What will testing truly accomplish if some of the cases are mild or without symptoms at all?

The number of patients tested will determine some of the specifics surrounding the disease (e.g., mortality rate) but will also help hospitals prepare for the total anticipated need. Even in cases where no symptoms are experienced, the testing will provide a scientific baseline so that public health organizations and governments can respond in an appropriate way. While the government has implemented a number of positive measures (e.g., supplemental spending package, travel limitations), an error was made with testing capabilities and it is needed in order to see how widespread the virus will be and when the peak number of cases may be reached. We also each have our own social and moral obligations when it comes to limiting the outbreak (e.g., avoiding the elder population if experiencing cold or flu-like symptoms).

How much of the current headlines are currently priced into the markets?

Equity markets are pricing in a modest decline in economic data, therefore if the decline is not as bad as anticipated or if it is relatively short lived, we expect a rebound based on the monetary and fiscal stimulus measures currently enacted. The equity market is a forward looking barometer, typically leading the economy by 6-9 months on average. While fundamentals are not as constructive during times of panic, we believe the worst case scenario is currently priced in. The same is true on the fixed income side, with the bond market pricing in a more aggressive hit to the economy than what we experienced in 2007 on percentage terms.

If I use the current sell-off as a buying opportunity, which sectors do you favor?

We continue to favor technology-oriented stocks that have secular growth stories. Some of the consumer-related companies have taken the largest hit, and while their risk level remains high, they are likely to see the sharpest rebounds once fears subside. Ultimately, the risk-reward ratio in a portfolio is dependent on the risk tolerance and time horizon of the individual investor.

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Source for charts: FactSet

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