

# Market Volatility: Coronavirus

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Larry Adam, CFA, CIMA®, CFP®, Chief Investment Officer

## Contagion Concerns

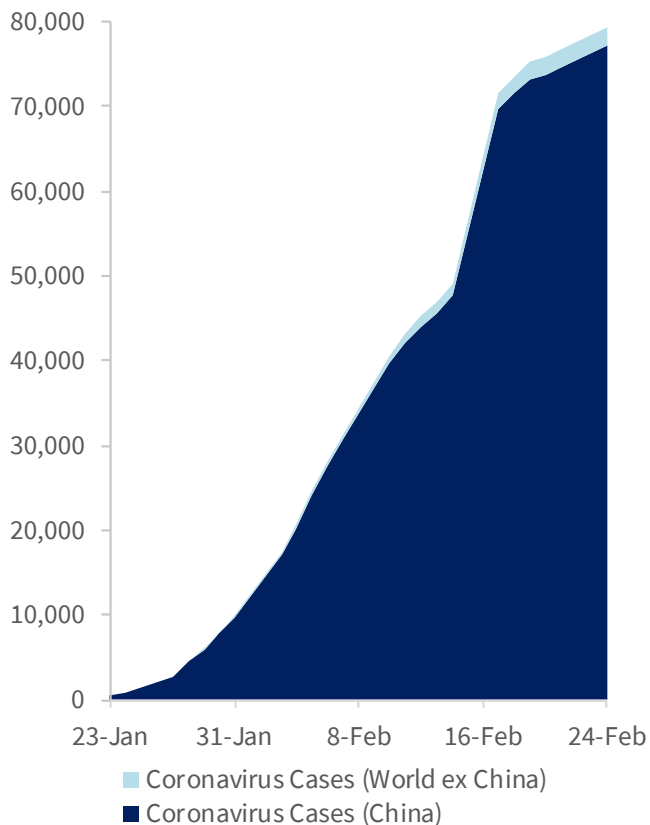
Unforeseen, immeasurable, and intensifying risk factors such as pandemics lead to market volatility. The truth is that no one really knows the impact the coronavirus will have, especially since information coming from China has been suspect. The financial markets had been complacent, hoping for a quick “V” shaped recovery following the initial decline, similar to that of previous viral outbreaks. But the ‘game changer’ over recent days has been the spread of the virus to other countries (e.g., Italy, South Korea, Japan) that are more transparent about the effects and this will likely reveal some ‘truths’ about the dynamics of the virus (e.g., how contagious, death rate, incubation period, recovery period, etc.). Thus far, while the number of cases outside of China has moved sharply higher over the past few days, the mortality rate remains muted relative to previous viral outbreaks.

## Market Impact

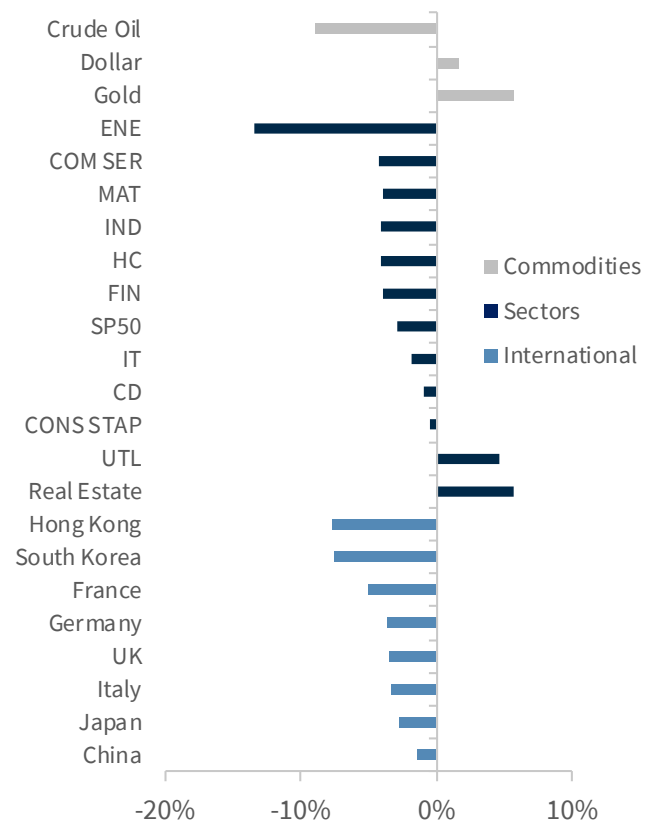
The market impact continues to display three dynamics in the midst of the coronavirus outbreak: a flight to quality, bias toward defensives over cyclicals, and a heightened negative impact based on proximity to the most impacted regions.

- Flight to Quality.** Since the outbreak, we’ve seen a rally in Treasuries, gold, and the dollar. Overall, these less risky assets have seen strong inflows and strong outperformance. Longer duration bond yields have fallen sharply year-to-date (YTD) and are now nearing the lowest level (10-year Treasury yield: 1.38%) on record. This is consistent with the price action in gold, which is up 5.7% since the start of the year and is currently trading at the highest level since early 2013. Additionally, since the US economy has remained fairly contained from the virus thus far, the US dollar is up 3% YTD and is near the highest level in two years.

Number of Coronavirus Cases



Performance Since Coronavirus Outbreak (1/17/20)



- **Defensives Over Cyclical.** With growth concerns seeping into the market and interest rates continuing to fall, cyclical sectors have seen the worst performance while defensive sectors have outperformed. Utilities and real estate have been the two best performing sectors since the initial coronavirus outbreak, while those most exposed to both global and Chinese demand (e.g., energy and materials) have been the worst performing.
- **Virus Impact.** The countries with substantial upticks in cases with close proximity to China (e.g., Japan, South Korea), and those with more exposure to China's economy (Europe in general) have been amongst the hardest hit.

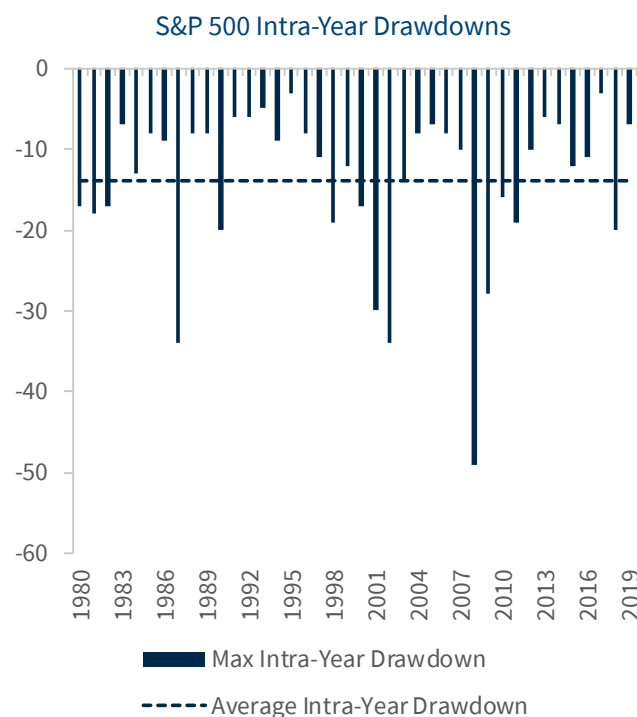
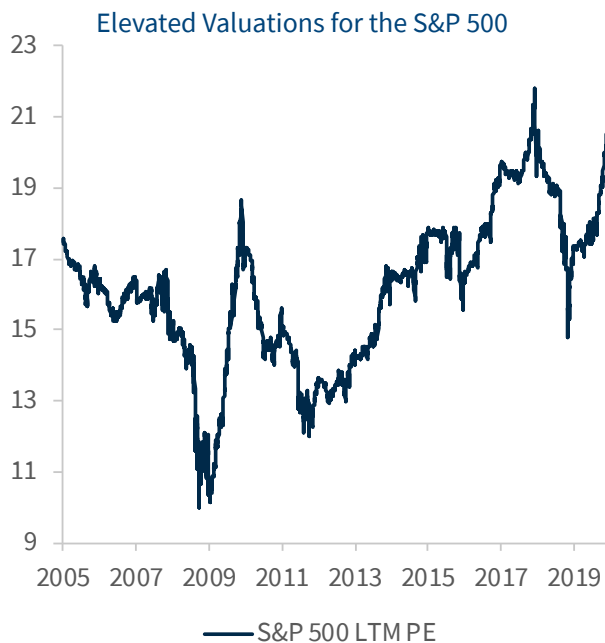
### Our Base Case

Our expectation, in consultation with our colleagues, has been that the situation was expected to worsen overseas, particularly in China, where our analysts believed the numbers had been substantially underestimated. However, they also believe that the impact in the US will not be nearly as severe, as the US is a leader in infectious disease and has an administration (with increased pressure due to an election year) that will proactively respond if the situation and number of cases escalates.

Even with this understanding, the combination of elevated valuations (LTM P/E of 20.5x (the highest since early 2018)), the S&P 500 approaching our year-end target (3,400), the heightened levels of complacency (depressed VIX levels and a lack of a 5% pullback since August 2019), as well as increased political uncertainty warrant caution. We do not believe the current pullback will lead to a massive 20-30% correction because central banks and governments across the globe stand ready to respond with stimulus (this has already begun in Asia and at the G20 Finance Ministers' Communique) which will be supportive over the medium to longer term. However, we would not be surprised to see a 5%+ pullback or further weakness in the near term that would eliminate some of the recent market complacency. Overall, as long as the virus peaks during Q1/early Q2 (the ~100 days we have been referencing to substantiate a short-term disruption), we would continue to use pullbacks as potential buying opportunities, particularly within our favorite sectors as the overall fundamental backdrop remains supportive.

Keep in mind, periods of intra-year weakness are not unusual for the equity market as the S&P 500 historically experiences about four 5%+ pullbacks on an annual basis, with the average intra-year decline being ~14%. An increase in the number of cases reported outside of China and the

potential for a widespread outbreak in the US (a one in three chance estimated by our health care analyst) would likely be the causes for any further volatility, but still strong economic fundamentals continue to be supportive of the equity market. Our base case remains that the US economy will not enter a recession in 2020 as a strong labor market and elevated consumer confidence should continue to drive consumer spending (which comprises ~69% of the US economy) and an uptick in residential and government spending should support economic growth.



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## Dynamics to Consider

**The US economy is not the US equity market.** US economic fundamentals remain strong and echo our sentiment of a muted risk of recession over the next 12 months. The US economy may be able to avoid the worst of the virus given that exports make up only 5% of GDP, but keep in mind that ~40% of S&P 500 revenues come from overseas. With an increasing number of downward revisions to growth in Asia (especially China) and in Europe (Italy will likely enter recession) future US earnings expectations will be closely monitored. Further, increasing supply disruptions due to shut downs in China could be a detriment to revenues, costs, and margins.

**The equity market is a forward looking barometer.** The equity market tends to lead the economy by approximately six months, so if the market expects a solid rebound in economic activity in Q3, the expectation should filter through to the equity market over the upcoming months. It is important to remember that manufacturing indicators prior to the coronavirus outbreak had been signaling a turnaround once trade induced weakness and uncertainty had been placated by the phase one trade deal.

**Lower (negative globally) interest rates make equities more attractive.** With ~\$13.7 trillion in negative yielding debt globally and with the US 10-year Treasury yield at record lows, equities look particularly attractive relative to bonds as the S&P 500 dividend yield outpaces that of most other global developed market sovereign bond yields. Additionally, since the market is now pricing in at least one additional Fed rate cut and further easing from other global banks, looser monetary policy should further ease global financial conditions and support risk assets.

**Dollar Dominance.** One risk to monitor going forward is the recent strength of the dollar. While the dollar remains in a nearly ten-year up cycle, moderation in dollar strength had been less of a headwind in 2018 and 2019 relative to previous years. However, with the coronavirus leading the dollar to rise to multi-year highs, this will likely weigh on the earnings of multi-national earnings as a stronger USD historically has posed a headwind for the those companies with greater global exposure.

**Sanders Watch.** While the bulk of the sell-off is attributed to the virus, we need to continue to watch the upcoming election and its subsequent impact on volatility. Bernie Sanders' prospects to win the Democratic nomination have surged in recent weeks, and concerns about his policies posing a modest downside risk to the market are being realized, especially with the potential negative impact to future earnings growth that his proposal to roll back corporate tax rate cuts could have. While our political analyst believes a Bernie surge could help President Trump's re-election efforts, in politics anything can happen.

**Chris Meekins**, Health Care Analyst, Equity Research

In our view, it is probably time to call this a pandemic. Cases are skyrocketing in South Korea, Italy, and Japan; as well as additional cases in Iran, Singapore, and 28 nations in total; it is pretty clear we are at or will be at in the days ahead pandemic levels. Pandemics are just epidemics that happen in multiple regions. Labeling it as a pandemic from an epidemic does not change much, but it will likely help lead to better public awareness of steps to take to avoid illness. Pandemic should not mean panic, it should however result in a closer look at what the potential impact of this virus spreading could be. With the developments of the last week, we are now increasing our likelihood of a widespread notable outbreak in the U.S. from 1 in 5 to 1 in 3.

**Nations to watch.** When we look at what nations are likely to see an epidemic next, we focus on:

- **South Korea.** South Korea went from a couple dozen cases a week ago to more than 600 today. The rapid spread will be difficult to contain despite raising alert level to red.
- **Italy.** Italy now has the third most cases of any nation. The Venice carnival is canceled and we anticipate further spread in Italy and across the EU.
- **Japan.** Japan has more than a hundred domestic cases, and we believe the number is higher as many cases are likely being underreported. Japan's handling of the cruise ship makes us question their capabilities to prevent spread.
- **Iran.** New cases abound though exact numbers remain murky.
- **Singapore.** Singapore has performed strong public health work thus far preventing transmission from getting out of hand.
- **United States.** We continue to believe cases are being unreported in the US and that questionable government decisions could contribute to more.

**Supply chain restrictions.** We now know China is limiting the export of N-95 masks (as is India) and that FDA has put together a list of drugs that may go into shortage. These are some of the many growing concerns over supply chain issues.

Click the link below to read the complete report:

[Fly Me to the Moon ... Probably Time to Call it a Pandemic](#)

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**Scott Brown, PhD.,** Chief Economist

For the last few weeks, financial market participants have shifted from fears of the coronavirus, to optimism that economic activity will rebound once the virus is contained, then back to fear that it will take more time to contain it. COVID-19 has spread to other countries, notably South Korea and Italy, with restrictions (mandatory and voluntarily) having an impact on those economies.

China accounted for nearly a third of global economic growth in the last two years. So this is a big deal. For US firms, there will be a loss of sales into China. China has accounted for an increasing share of global travel and tourism, which has been curtailed. Amid the trade war, supply chains have generally migrated away from China to places like Vietnam, Thailand, and Mexico over the last two years. However, much remains in China. Global supply chains are deep and complex. For US firms, you may not know exactly who is supplying your supplier. Supply chain disruptions have led to halts in motor vehicle production in Japan and South Korea.

Fears of the coronavirus have caused a flight to “safety” in the US bond market, pushing long-term yields lower, inverting the yield curve, and reigniting fears of a possible recession. Federal Reserve officials have continued to signal that the current stance of monetary policy is “appropriate.” However, the federal funds futures market is currently pricing in greater than a 50% chance that the central bank will lower short-term interest rates by late April.

Economic activity will recovery once the virus is contained, but it remains uncertain when that will be. Most likely, we are talking about months rather than weeks.

**Michael Gibbs,** Managing Director of Equity Portfolio & Technical Strategy, Equity Portfolio & Technical Strategy

In summary, the equity market became too overbought and was overdue for ‘something’ to interrupt the run. Coronavirus, along with weak PMI Services data on Friday, are the main culprits. We maintain the belief that the impact of the coronavirus will prove transitory and, by itself, will not end this bull run. We are also not worried about the US economy with the job market healthy. However, determining the degree of ‘give-back’ for equities is difficult, especially given the stretched nature (price and valuation) to the upside. Unless additional headwinds join the recent news (weaker macro or something else), we are comfortable assuming a 7-10% peak to trough decline is as bad as it gets.

The overriding positive theme for equities remains,

therefore the coronavirus is likely a disruptive noise item that halts upward momentum and causes a pullback as opposed to triggering a deep (beyond 10%) market swoon (as long as additional market headwinds do not develop). Supporting factors for this thesis include:

- The US economy should continue to grow (i.e., no recession means less likelihood of a lasting and significant decline).
- The job market is strong. The US economy is fueled by consumption.
- The Fed’s position is supportive of risk assets; they may also be pushed to lower rates if the virus negatively impacts commerce for an extended period.
- Global central banks’ actions (lower rates) are positive for risk assets; delayed effect should help global economies later in 2020.
- The PBOC will be aggressive in fighting the economic drag on economy.
- Earnings are recovering.
- Manufacturing is stabilizing and expected to improve throughout 2020.

Long-term investors can nibble at favored names or strategies during periods of weakness (such as today). If only small amounts of excess cash are available, I would consider holding back given the elevated nature of price and valuation, which leave the market vulnerable to additional downside moves or at least a period of side-ways trading.

Traders, hold back new buying to see how the day closes, and how the next several days transpire.

**Kevin Giddis,** Chief Fixed Income Strategist

The fixed income market is the recipient of a new wave of crisis investing and I would ask you to tread with extreme caution. The reasons that we are closing in on all-time lows for the 10-year note have more to do with fear than they do with fundamentals, and that is a dangerous way to invest. Money is flowing into the US Treasury market right now because of the uncertainty of the containment and elimination of the coronavirus. The fact that this has spread into Europe is both alarming and consequential. An Asian virus contained in Asia is likely an Asian economic issue. When it spreads to other continents, it becomes more of a global pandemic that could affect the global supply chain and all economic growth.

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That is where we are today, at least as the investment community sees it right now. The concern is that this virus, if not controlled soon, could take down the economies around the world, and will eventually make its way to the US as well. This global slowing will likely force central banks, including the Fed, to be even more accommodative than they are now, which likely moves rates up and down the yield curve to even lower levels than we are seeing now.

That doesn't mean that all fixed income securities are worth investing in at these levels. Keep in mind that we are 'here' because of fear, and investors' desires to preserve their capital. The economic fundamentals in the US don't support this, but the bond market tends to be forward-looking, and the money flowing into the market today appears to be very concerned about the future of economic growth.

The current plan for fixed income investors should be to buy bonds to preserve capital, stay liquid, and get out of the way of the extreme volatility. While the 'experts' have missed the expected duration and impact of the coronavirus, it now has the world's attention, which means that, based on the current fundamentals, when this is contained, the reversal in rates could be severe.

**Chris Bailey**, European Strategist, Raymond James Investment Services Ltd.\*

Pan-European equity markets fell over four percent on Monday as coronavirus fears became more directly pertinent for the region, with these falls led by the Italian market which is at the centre of the most recent outbreak. Unsurprisingly pan-European fixed income instruments joined in broader global trends and sunk in many cases to even deeper negative yield levels. However the euro very mildly strengthened on Monday – although it still remains sharply down year-to-date versus the dollar.

Whilst the ultimate direct economic impact on the European economy from the coronavirus remains unclear - as efforts to control and limit the spread of the virus may or may not be as successful as currently perceived - regional financial markets have also become progressively unsettled by indirect supply chain exposures. Pan-European equity markets have approximately double the sales exposure to China compared with US equivalents, with the German stock market even more exposed due to high weightings in the automotive and other industrial sectors. This higher level of openness to the global economy makes Europe more leveraged to coronavirus news flow. Additionally it is also still worthwhile noting that European regional equity markets are typically already trading at a notable valuation discount (and dividend yield premium) to their American equivalents.

**Pavel Molchanov**, Energy Analyst, Equity Research

We estimate the coronavirus's peak oil demand impact of 2.0 million bpd globally, with 80% in China and 20% elsewhere in Asia-Pacific. This estimate is backed up by the reported reductions in China's refinery throughput. We assume this peak impact applies to February and March before gradually subsiding to zero by the end of June. Obviously, the situation remains fluid, especially as it relates to impact outside Asia. The warmer-than-normal winter is also a demand headwind, but on the flip side, there is a partial offset from the production disruption in Libya. Putting everything together, our global oil model currently points to a 2020 inventory build (increase) of 300,000 bpd, the mirror image of our pre-virus model. However, to prevent a massive inventory draw (decrease) in 2021, for reasons that include a fall-off in US production at current prices, we believe that prices will exhibit a back-end-weighted recovery. Starting from \$53/Bbl WTI and \$58/Bbl Brent in Q1 2020, we forecast oil exiting the year at \$70 WTI.

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\*An affiliate of Raymond James & Associates, Inc., and Raymond James Financial Services, Inc.

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Sector investments are companies engaged in business related to a specific sector. They are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification.

Fixed-income securities (or "bonds") are exposed to various risks including but not limited to credit (risk of default or principal and interest payments), market and liquidity, interest rate, reinvestment, legislative (changes to the tax code), and call risks. There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices generally rise. U.S. Treasury securities are guaranteed by the U.S. government and, if held to maturity, generally offer a fixed rate of return and guaranteed principal value.

Source for charts: FactSet

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