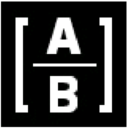

26 February 2020

MARKET UPDATE

Coronavirus Market Impact Update

WHAT HAS HAPPENED?

Equity markets have declined sharply over the past week, with losses accelerating over the last two days following news of an increase in the number of COVID-19 coronavirus cases in previously less affected countries such as South Korea, Italy and Iran.

Since hitting an all-time high on February 19th, the S&P 500 Index has dropped by 7.6%. Global equity markets are also down sharply with the MSCI All Country World Index (ACWI) off by 6.4%. In bond markets, investors rewarded duration while spread sectors were decidedly weaker.

Losses have been broad-based, with stocks in industries seen as most vulnerable, such as travel, luxury goods and energy, generally doing worst. More defensive industries such as REITs, telecom and utilities have held up better.

Investors have rushed to safe haven assets. Yields for 10- and 30-year US Treasuries reached all-time lows, while gold has fared relatively well.

WHY DID THIS HAPPEN NOW?

While the coronavirus crisis has been escalating for weeks, markets operated on the assumption that containment efforts would ultimately succeed at stemming the spread of the virus in China and elsewhere in Asia. In past virus outbreaks, such as SARS, H1N1 influenza, swine flu or Ebola, once a clear pattern emerged of declining new cases, markets recovered quickly, typically within three to six weeks.

The overall number of new cases has continued to decline. However, the sharp rise in reported cases outside China, including in Europe, suggests that containment has not been, and may not be, effective. The fact that some carriers are asymptomatic and that the incubation period is long and variable may be complicating containment efforts of national and international authorities.

WHAT ARE DIFFERENT SCENARIOS FOR MARKETS?

Markets reacted to increasing uncertainty about the potential for more economic damage if the coronavirus is not brought under control. Our China economist and equity team have recently reported on the potential impact of the coronavirus on China's economy and equity markets. (See *Will the Wuhan Coronavirus Infect China's Economy* and *Revisiting China's Equity Markets as Coronavirus Spreads*).

In a positive scenario, if heightened global vigilance and a global effort to avoid infection begins to work, we would see the number of new cases inside and outside China begin to decline. This would hopefully lead to the end of containment measures that in some cases have been draconian and severely economically disruptive, especially in China.

In a bear case scenario, the number of cases globally would accelerate and the economic impact would likely be deeper and more severe. However, in either scenario, we would expect a sharp V-shaped recovery in economic activity when the situation begins to improve.

HOW WILL CENTRAL BANKS RESPOND?

The disruptive impact of the virus globally will clearly have an impact on short-term economic growth. The timing of economic recovery, and therefore that of corporate earnings, will depend on the severity of the disruption to supply chains and the impact on consumer behavior worldwide. In any case, we expect central banks to continue to support capital markets with dovish policy and further quantitative easing.

Markets hate uncertainty, and a spreading virus with unknown but potentially significant global economic effects is highly uncertain. Given the strong equity rally over the last 14 months, a correction in response to this uncertainty is not surprising. Should markets continue to weaken, volatility remain high and, by extension, financial conditions tighten, we would expect the Fed to cut rates. That action will likely ease the markets' worries, but it will not be a panacea.

WHAT SHOULD INVESTORS DO?

While company earnings in the first quarter of 2020 will clearly be negatively affected by the crisis—especially in industries like leisure and airlines—recent earnings reports for the fourth quarter of 2019 have been broadly reassuring, and low interest rates continue to support equity valuations.

Our portfolio managers are assessing individual holdings and portfolio positioning for vulnerability to coronavirus-related issues. At the same time, our investment teams will look for opportunities that are being created by the current volatility. We recommend clients retain exposure to equities while maintaining balanced portfolios between different asset classes.

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Market Risk: The market values of the portfolio's holdings rise and fall from day to day, so investments may lose value. **Interest-Rate Risk:** As interest rates rise, bond prices fall and vice versa—long-term securities tend to rise and fall more than short-term securities. The values of mortgage-related and asset-backed securities are particularly sensitive to changes in interest rates due to prepayment risk. **Credit Risk:** A bond's credit rating reflects the issuer's ability to make timely payments of interest or principal—the lower the rating, the higher the risk of default. If the issuer's financial strength deteriorates, the issuer's rating may be lowered and the bond's value may decline. **Allocation Risk:** Allocating to different types of assets may have a large impact on returns if one of these asset classes significantly underperforms the others. **Foreign (Non-US) Risk:** Non-US securities may be more volatile because of political, regulatory, market and economic uncertainties associated with such securities. Fluctuations in currency exchange rates may negatively affect the value of the investment or reduce returns. These risks are magnified in emerging or developing markets. **Derivatives Risk:** Investments in derivative instruments such as options, futures, forwards or swaps can be riskier than traditional investments, and may be more volatile, especially in a down market. **Leverage Risk:** Trying to enhance investment returns by borrowing money or using other leverage tools may magnify both gains and losses, resulting in greater volatility. **Below-Investment-Grade Securities Risk:** Investments in fixed-income securities with lower ratings (commonly known as "junk bonds") tend to have a higher probability that an issuer will default or fail to meet its payment obligations.

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