



MARKET UPDATE

Coronavirus Market Impact Update

OVERVIEW

Equity markets declined sharply last week, suffering their biggest weekly decline since October 2008. The selloff was largely driven by concern about the spread of the COVID-19 coronavirus and the resulting impact on the global economy and corporate earnings.

Since hitting an all-time high on February 19th, the S&P 500 Index has dropped by 12.7%, while the MSCI All Country World Index (ACWI) is off by 11.5% over the same period. Crude oil is down roughly 16%. All returns are in US dollar terms.

Investors have rushed to safe haven assets. Yields for 10- and 30-year US Treasuries reached all-time lows, ending the week at 1.13% and 1.65%, respectively. Within bond markets, investors rewarded duration while spread sectors were decidedly weaker.

In equity markets, losses were broad-based, with energy stocks leading the move lower as oil remained pressured by demand concerns. Financials also underperformed amid the lower rate backdrop, while other cyclical sectors such as materials and industrials also lagged. Defensive sectors didn't provide much protection as broad de-risking drove widespread declines.

By geography, non-US stocks fared better than US stocks. The S&P 500 Index dropped 11.4% last week, while the MSCI ACWI ex-US fell 9.0%. Valuation undoubtedly played a role here—US stocks came into the sell-off more expensive. Relatedly, US stocks were flat in January while other geographies were down a few percent—so, in a sense, the US had to catch up to the weakness elsewhere this year.

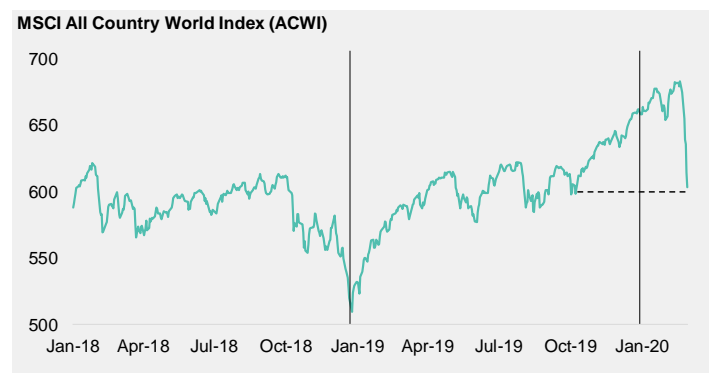
WHAT HAS CHANGED?

Whether a pandemic or an epidemic, the coronavirus has become the driving factor of market volatility. As cases outside of China expanded over the past week, investors began to price in a more meaningful impact on global economic activity and corporate earnings.

Prior to this week, much of the attention from financial participants was focused on China and the expected supply chain disruptions given China's importance as an intermediary in the production of goods. As greater demand-destruction, both within and outside of China became likely, investors began to reduce their growth expectations for 2020—ourselves included. Admittedly, no one knows the ultimate impact for certain—and that's the point. Markets hate uncertainty, and last week provided more uncertainty not less.

MARKET OUTLOOK

While the correction has been sharp, we believe it's important to view sell-off in stocks with some context. As the Display below illustrates, global stocks rallied 26.6% in 2019 after having fallen 9.4% in 2018.



While we had not characterized the market as overly expensive, there was a lot of optimism priced in and stocks had rallied sharply in the preceding months. Last week's decline takes us back to early October 2019 levels.

Coming into 2020, the MSCI ACWI was trading at 16.3x the consensus earnings estimate of 9.6% for 2020. That multiple was elevated versus history.

At the end of last week, the index was trading at 15.2x reduced expectations of 8.5% EPS growth for 2020. While earnings growth forecasts may be revised lower still, current valuations are closer to historical averages.

During past virus outbreaks such as SARS, H1N1 influenza, swine flu or Ebola, markets began to recover relatively quickly once a clear pattern emerged of a decline in new cases. While the ultimate impact of COVID-19 remains to be seen, we would expect a similar outcome in this case.

ECONOMIC IMPACT AND POLICY RESPONSE

The disruptive impact of the virus globally will clearly have an impact on short-term economic growth. The magnitude and duration of the impact will depend on the severity of the disruption to supply chains and the impact on consumer behavior worldwide.

We expect central banks to continue to support capital markets with dovish policy and further quantitative easing. We believe it's likely that central bank officials, including the US Federal Reserve, will begin to communicate a willingness to act as needed to help support the economy. In fact, Federal Reserve Chair Jerome Powell said on Friday the coronavirus poses "evolving risks" and pledged to "act as appropriate to support the economy."

In the US, we currently expect two rate cuts this year, but the risks are skewed in favor of near-term and more aggressive cuts, potentially as soon as the March meeting, if not earlier should financial market conditions continue to deteriorate.

We may also see governments implement fiscal stimulus measures in an attempt to help cushion the economic impact. Hong Kong, for example, recently proposed a package of economic stimulus measures which includes a cash payment of 10,000 Hong Kong dollars to all residents.

It is, however, important to keep in mind that government and central bank actions won't be a complete panacea – rate cuts won't directly help if schools are closed, flights cancelled and so on. What they can try to do is to prevent financial markets from being an accelerant—to keep markets from adding to the panic and to keep financial conditions from tightening further.

WHAT ARE WE DOING IN OUR PORTFOLIOS?

Broadly speaking, we are taking a cautious and deliberate approach to the management of our portfolios given the uncertainties. In some cases, we sold stocks that were the most exposed to any potential demand destruction from COVID-19. In other cases, we have identified new opportunities that have become more attractively valued. For the most part, however, we haven't felt the need to make meaningful changes to portfolios. Our investment teams will continue to monitor the evolving situation and its impact on client portfolios closely.

WHAT SHOULD INVESTORS DO?

While anxiety inducing, COVID-19 will recede and financial markets will price that eventuality in at some point. Though the period from here to there will be volatile, history suggests that the most damaging decision would be to meaningfully readjust portfolios at a time like this.

Trust in your diversification. During equity market declines, the negative correlation of bonds is an investor's best friend. The current sell-off is a great example of that—high grade bonds are up 2.0% this year while stocks have fallen 9.1% (as measured by the Bloomberg Barclays Global Aggregate Bond Index and MSCI ACWI, respectively). Other diversifiers, like alternatives, also tend to exhibit a low correlation to equities.

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A WORD ABOUT RISK

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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