BERMAN
CAPITAL ADVISORS

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Coronavirus Market Impact

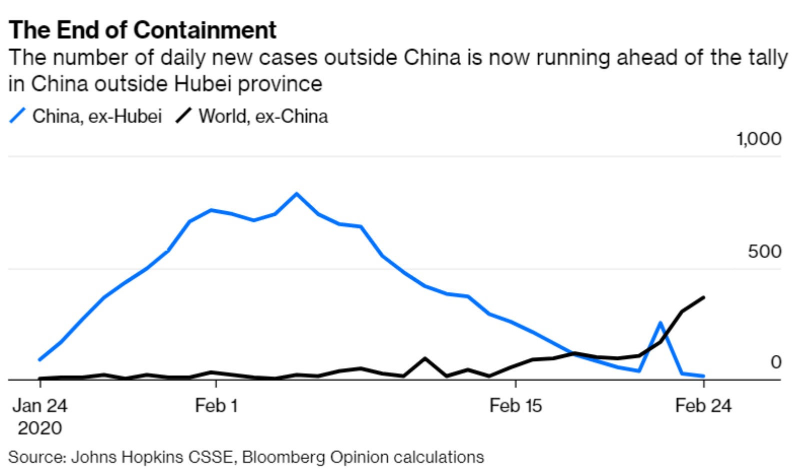
Key Takeaways

- The *economic* impact of the virus and the measures taken in response to it will likely be greater than initially expected. In the U.S., this could take about 1% off estimated GDP growth for this year. The impact in China will be significant in the first half of the year, and economists have cut their expectations for Chinese GDP from 6% to 3% for the first quarter. A strong recovery is expected in the back half of the year.
- The *market* impact will likely be blunted by monetary easing, a large fiscal response from China and the knowledge that the outbreak is ultimately be transitory. Near-term market predictions are a guess, but we would not be surprised if the selloff reached a high single digit percentage market decline. The situation remains very fluid, however, as uncertainty in the market is running high.
- While serious, COVID-19 won't be an existential crisis – containment measures, better understanding of the virus and the eventual arrival of Spring will ultimately stop the outbreak. If you have a long-term outlook and understand your risk tolerance, holding through this market volatility is likely the best strategy.

Background

On December 31 of last year, the Chinese authorities alerted the WHO to several odd cases of pneumonia in Wuhan, a city of 11 million in central China. The source of the infection was thought to be a live-animal market, which was closed. After an initially slow response, China implemented an aggressive quarantine of Wuhan on January 23. The same day, the WHO delayed declaring an emergency, citing no person to person spread outside of China. During this time, the markets viewed the novel coronavirus, now labeled COVID-19, as temporary and ultimately not that impactful to the world economy. Cases continued to climb, however, and on January 30 the WHO declared the outbreak a global public health emergency.

News from the past several days has significantly increased investors' concerns, as confirmed cases jumped notably **<u>outside</u>** of China (see chart below).



Fearing the failure of containment efforts, the markets sold off on Friday and dipped more significantly yesterday (-3.4% S&P decline). In turn, bond yields dropped again, with the 10-year Treasury bond reaching 1.37%.

Historically speaking, a decline of this magnitude is not all that notable. Yet given the very low volatility seen in recent years amidst a surprisingly resilient bull market, Monday's volatile trading stands out.

What Do We Know About the Disease?

Currently, there is still a lot we don't know about the virus. It is a respiratory ailment that spreads through fluids – typically droplets from infected people sneezing or coughing. The WHO has estimated the transmission rate (R_0, the average number of people to which a single infected person will transmit the virus) at 1.4 – 2.5, but this is highly uncertain at present. Compared to SARS, a previous respiratory outbreak, the virus is much more contagious but significantly less deadly, with an estimated (but highly uncertain) fatality rate of about 2%. The elderly, by far, are most at risk.

The incubation period is a critical piece of information that is still unknown. Reported estimates center on 7-14 days, but Hubei Province has reported one patient's incubation period of over 21 days. The chart below, sourced from Goldman Sachs, shows information that puts the scope of the outbreak in historical context (it refers to the virus as "SARS-CoV-2"):

1. Total Infections, Deaths, and Fatality Rate

	SARS	MERS	SARS-CoV-2	H1N1 in US	Current Seasonal Flu in US*
Total cases	8,096	2,499	77,974	60,837,748	29mm – 41mm
Deaths	774	861	2,364	12,469	16k – 41k
Fatality rate	10%	34%	3.03%	0.02%	0.06-0.10%

*Preliminary Burden Estimate for the Seasonal Flu by US CDC from October 1, 2019, through February 15, 2020.

2. Reproduction Number

	SARS	MERS	SARS-CoV-2	H1N1	Seasonal Flu
R0 (reproduction number)*	2 - 4	<1**	1.5 - 3.5 (2.6)	1.33	0.9 to 2.1

*An epidemiologic metric used to describe the contagiousness or transmissibility of infectious agents

**Overall, the reproduction number (R0) of MERS-CoV was <1, with significant heterogeneity in specific contexts.

3. Incubation Period

	SARS	MERS	SARS-CoV-2	H1N1	Seasonal Flu
Incubation (in days)	2 – 7 (10)*	2 – 14	2 - 7 (24)**	1 - 4 (7)	1 - 4

Incubation period is the period between the infection of an individual by a pathogen and the manifestation of the illness or disease it causes

*WHO indicates that the incubation period of SARS is usually 2-7 days, but may be as long as 10 days.

**Current CDC estimate is 2-14; However, one Chinese study indicated it could be as long as 24 days

4. Contagious Period

Contagious Period*	SARS	MERS	SARS-CoV-2	H1N1	Seasonal Flu
Contagious beginning on day "X" of symptoms appearing	1	1	?	-1	-1
Contagious up to "X" days after becoming sick	14+	Varies	?	5 - 7	5 – 7

*The amount of time during which an infected person can give the disease to others.

Source: WHO, CDC, NIH, DOL; Chinese Ministry of Health, Lancet, NYT, Investment Strategy Group.

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Source: Goldman Sachs

The evolving understanding of the incubation period is relevant because it now seems that one could be contagious for some time before manifesting symptoms. For many patients, the COVID-19 virus will be indistinguishable from a bad case of the common flu. Another possibility is that some recovered and released patients could still be contagious. The longer the incubation period, the greater the danger of a global pandemic.

In any case, the disease is likely more widespread than currently documented. Reported cases depend on public health system capabilities, which may be far behind in some countries. Globally, we will likely see more public events cancelled and varying degrees of isolation enforced by governments.

Economic Impact

Most economists had been expecting a "V" shaped recovery, we think the new expectations will be for a "U." Rather than a one to two quarter impact, we expect growth will be reduced for the year, but with a recovery still evident in the back half of the year. Based on what we know now, we view the risk as being to the downside given the unknowns around the spread of the disease. The IMF, for example, initially trimmed only a little from its estimate of global GDP growth in response to the virus but is now considering "more dire scenarios."

Turning to U.S. corporate earnings, only 30% of S&P 500 companies' revenues come from international sources. A much smaller set of revenues, which Goldman Sachs estimates at 2%, are directly from China. However, disruption could be much more severe for some groups, such as technology hardware. U.S. semiconductor companies export almost 50% of revenues to China for assembly, for example. Retailer supply chains are also very China dependent. One silver lining to the recent trade war has been many companies' efforts to move some of their supply chains outside China. Thus, the impact of inventory disruption could be smaller than it otherwise would have been. Global travel is perhaps the most obviously impacted sector, and the stock prices of airline and hotel companies reflect this.

Market Impact

After last year's strong rally, many market strategists expected little progress from stocks this year, even before the coronavirus. We have modest expectations for the year as well and believe we could see more near-term downside. There just isn't a robust way to predict how much disruption will hit the global economy, but whether one quarter or three, it will be temporary.

Bonds have rallied smartly, with the 10-year reaching recent lows of under 1.4%. This stunning rally has the equity risk premium (the earnings yield of stocks over safe bonds) at about 4% over bonds, which is a good bit higher than the long-run average of 2.5%. Low rates truly do seem to be here to stay, but how much more upside can one expect from bonds? We remain focused on their role as a portfolio diversifier and seek returns elsewhere.

If you have any questions, please reach out to your Berman Capital Wealth Advisor. We would be happy to discuss further.