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CAPITAL ADVISORS

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Coronavirus Market Impact Update

This past Tuesday, we wrote a piece on the Coronavirus's impact on the economy and financial markets. Events have moved so quickly that it makes sense to update you now. The bottom line of our last communication: Coronavirus is a potentially severe economic event, but it will be temporary. We stand by that concept, as nothing has changed regarding the nature of the crisis nor governments' likely response to it. The containment news is worse, the markets have dropped even more (the fastest drop from a market high to a -10% correction ever), and the U.S. government is under pressure to massively increase its efforts to combat the crisis. Coordinated rate cuts, which will not prevent a demand shock but will help calm the markets, are almost certainly in the works.

We believe it's critical to consider that, one way or another, the crisis phase will almost certainly have passed by late summer, and the market will start pricing that in before then. Broadly speaking, there are two possible scenarios. It's possible that governments will make significant progress in containing the virus, perhaps helped by summer weather. Unfortunately, it seems increasingly likely that containment measure won't be enough, which could cause more sentiment-driven selling. Longer term, a shift from containment to mitigation puts everyone in the same boat, meaning spot quarantines, social distancing and hand washing will be the main tools. Perversely, this will be better for the economy as supply chains catch up and travel resumes.

Over the last three days, the stock market has continued sliding amidst more signs the virus is spreading globally. The market has priced in a lot of bad news. Yet as no one really can predict how this will play out, as uncertainty about the course of the virus and how much demand will suffer are unknown. Investors are certainly frightened, as the VIX (a measure of volatility), has breached 44, indicating a high level of concern. The good news is the market is now far from complacent.

The table below shows the magnitude and rapidity of the decline, using the top 10 largest companies in the All-Country World Index. Former darlings Apple and Microsoft have sold off the most.

Percent Decline from Year-to-Date High: Top 10 ACWI Stocks by Market Cap

Company	% Decline from High	High Date	% of ACWI Market Cap
Apple	-16.4	2020-02-12	2.7
Microsoft	-16.2	2020-02-10	2.6
Facebook	-15.0	2020-01-29	1.0
JPMorgan Chase	-14.0	2020-01-02	0.8
Alphabet-Class A	-13.8	2020-02-19	0.9
Alphabet-Class C	-13.7	2020-02-19	1.0
Amazon	-13.2	2020-02-19	2.0
Alibaba	-11.0	2020-01-13	1.1
Johnson & Johnson	-9.7	2020-02-05	0.8
Tencent	-8.2	2020-01-13	1.0

Notes: % Decline from High= maximum drawdown % from 2019-12-31 to 2020-02-27. Based on price returns in local currency. Percentage of ACWI Market Cap calculated as of 2020-02-21 for ACWI Stocks. 2020-02-27 for all others. Source: MSCI

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These are significant moves for mega-cap stocks over such a short period.

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Economic Impact

Much of the short-term pain from the virus comes from government quarantine efforts (disrupting the workforce and shopping) and cancelled and delayed business. Uncertainty has real impacts: probably many people you know have or are considering cancelling travel plans. But, this does tend to pass relatively quickly. Historically speaking, pandemics (e.g. SARS, MERS, H1N1 virus) created sharp drops in economic activity which were followed by rapid bounce backs. This time may be a more severe version of that. When quarantines are being lifted, governments are very likely to spend what it takes to restart their economies. This is especially true in China, where the government fears social unrest, and in the U.S., where President Trump needs a good economy and market for his re-election prospects.

In our last letter, we talked about a "U" shaped recovery instead of a "V." Perhaps the bottom of the "U" is wider, but we still think that's the highly likely scenario. Coronavirus will hurt, but it won't be the end of the world. The economy and markets do recover from pandemics, especially in the context of an all-hands effort to get the economy moving again. China is already trying to restart its factories, and road traffic is rebounding outside the Hubei area. This makes it less likely that supply chains will be disrupted longer than a quarter or two.

A lot will depend on the U.S. economy, which is less trade dependent than emerging markets, Europe and Japan. Our economy is underpinned by consumer demand and business services. Again, the market move seems to reflect an expectation of notable weakness, perhaps even a brief dip into negative growth. Unless the virus is continually worsening in the Spring – unlikely given the arrival of warmer weather and likely a much greater Federal mitigation effort – consumption may return to close to normal. The fed funds futures market is pricing in a 25 basis-point cut by March, 60 basis points of easing by June, and nearly 90 basis points through year-end. With a lag, interest rate cuts will boost mortgage and consumer loan demand.

After Chairman Powell's comments on Friday, we expect an interest rate cut sooner than later, which could be eventually followed by a bipartisan fiscal package from Congress. Additional, extraordinary policy support is possible (bonus depreciation? temporary payroll tax cut?), which would also be helpful to recovery.

What We are Watching

Virus contagion: Most obviously, news regarding the virus itself will impact the economy and markets.

Unemployment Claims: The weekly data is among the best real-time indicators of the economy that we have. A sharp increase in layoffs could be a trigger for a more lasting (versus a quarter or two) recession and would change our outlook.

Company Profits: We expect most companies to either suspend providing earnings expectations or to guide lower now. Company comments around their supply chains and demand indications could be quite telling.

Credit Spreads: Widening spreads on high yield debt could indicate rising stress on corporate balance sheets, which could also have a snowball effect if large enough.

Conclusion

The situation remains quite fluid, but the market is now pricing in a lot of bad news. Actual bad news could be even worse, but that isn't our base case. The impact of Coronavirus is a serious issue, but ultimately a temporary one. We are open-minded to the possibility the course of events, and thus our response to it, will change. Yet we are hopeful that human ingenuity and the passage of time will eventually resolve the crisis.

Please contact your Berman Wealth Advisor if you have any comments or questions for us.

Thank you,

Berman Capital Advisors