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WEALTH MANAGEMENT

MARKET STRATEGY
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The Coronavirus Correction: Headwinds Will Pass, Stay Invested

Major Equity Indices (Price Returns)	2/19/2020 – 2/25/2020	2020 YTD (through 2/25/2020)
S&P 500	-7.62%	-3.17%
Dow Jones Industrial Average	-7.72%	-5.11%
NASDAQ Composite	-8.67%	-0.08%
Shanghai Stock Exchange Composite Index	1.27%	-1.22%
MSCI EAFE (USD)	-4.95%	-5.81%
MSCI Emerging Markets (USD)	-4.27%	-5.21%

Source: FactSet

The global equity rally came to an abrupt stop over the past several days as investors fear economic headwinds caused by the COVID-19 coronavirus. Since establishing 2020 highs in mid-February, U.S. equities declined rapidly with the S&P 500 index down 7.6% over four trading days from 2/19/20 to 2/25/20. We have received multiple inquiries regarding our position on the sell-off and what it means for client portfolios. While it is extremely difficult to predict the extent of economic disruption caused by the outbreak, which now appears to be spreading in countries outside of China, we believe that global GDP growth (especially in China, but the U.S. as well) will be negatively impacted and that the economic slowdown will weigh on corporate earnings in both the first quarter and second quarter of this year. While equities could suffer additional declines if negative coronavirus headlines accelerate, we also believe that economic and corporate fundamentals began 2020 with healthy trends and that those trends can resume as the epidemic subsides. While pessimism now dominates both investor sentiment and market headlines, we believe investors should stay invested. Our S&P 500 fair value estimate remains 3,350.

One piece of positive news is that according to the World Health Organization (WHO), the coronavirus outbreak in China peaked in early February, with the rate of new infections falling since then. China's Shanghai Composite equity index dropped 11.8% over three weeks following 1/13/20, but since 2/3/20 has rallied 8.8% as economic fears receded. As of 2/26/20, the Shanghai Composite was down 1.2% year-to-date (YTD). The Q&A below expands on our thoughts.

Why has the stock market sold off since last week? With a 2/19/20 closing price of 3,386, the S&P 500 had gained 4.8% in 2020, following positive investor reaction to solid early-2020 U.S. consumer spending trends, better than expected 4Q19 earnings reports, and a belief that the Phase 1 China trade deal would bolster business confidence and investment. Investors were optimistic that the coronavirus had peaked in China, factories were reopening, and economic activity would slowly return. Late last week, however, we learned of infected patients in South Korea and Japan, sparking new fear of economic disruption in those large economies. By Monday 2/24/20, the South Korea outbreak had expanded rapidly, and Italy and Iran were reporting new cases as well. The potential for a broadening pandemic led to a global "risk-off" sentiment with investors aggressively selling equities and buying government bonds, primarily U.S. Treasuries. On Tuesday 2/25/20, the U.S. Center for Disease Control and Prevention (CDC) cautioned the U.S. healthcare community (based on the pattern of infection outside the U.S.) to prepare for a potential pandemic and to expect a major outbreak in the U.S. This contributed to another wave of selling and a two-day decline of 6.3% (and down 7.6% since 2/19/20). We attribute rising investor fear to economic uncertainty caused by the spread of coronavirus; businesses and consumers will change behavior until the risk of contagion is diminished and economic activity will suffer for a period of time. The S&P 500 closed Tuesday at 3,128, back to early-December 2019 levels and down 3.2% in 2020.

When will the market bottom? We can't predict market bottoms and tops, nor do we believe that is the best way to achieve long-term success for our client's investment portfolios. Although we believe that equities could trade lower as volatility remains elevated and traders assess the potential for a longer than expected drag on GDP growth and earnings, we also do not see an extended decline and look for higher market levels this year. In the 11-year period of 2009 to 2019 (after the Global Financial Crisis), the S&P 500 gained an average 12.8% annually (excluding dividends). Over that same period, the average peak-to-trough decline each year was 12.6%. In other words, in an 11-year bull market the average annual intra-year decline was nearly 13%. A 13% correction this year would put the S&P 500 at 2,946, which is 6% below Tuesday's closing price. The S&P 500 last traded under 3,000 in mid-October last year – not that long ago. At 2,946, the S&P 500 price to earnings ratio (P/E) would be 16.8x the consensus 2020 earnings estimate, considerably cheaper than the forward P/E of 19.3x one week ago. We expect markets to recover from the recent decline, rewarding long-term investors in diversified portfolios. U.S. companies should benefit from a healthy jobs market and rising wages supporting consumer spending, a rebound in nationwide housing activity, and business investment in technology equipment and intellectual property. We expect earnings growth to resume, although it could be pushed out to late-2020, and low interest rates are good for economic stimulus and equity valuations.

Why have U.S. interest rates moved dramatically lower? U.S. interest rates have fallen due to investor demand for U.S. Treasury securities, driving bond prices higher and yields lower. The 10-year U.S. Treasury yield was 1.33% on 2/25/20 (just two basis points (bp) from an all-time low), down from 1.92% on 12/31/19. A rapid drop in long-term rates is often driven by fears of an economic slowdown and expectations that the U.S. Federal Reserve (Fed) will reduce its short-term fed funds rate as a tool to stimulate the economy and avoid recession. We believe that bond investors are worried about coronavirus-caused economic headwinds building in the U.S. creating the need for the Fed to move its fed funds target at least 25bp from its existing 1.50% to 1.75% target. We see additional factors contributing to low U.S. interest rates, however. This includes a massive "flight to quality" as proceeds from the global equity market selloff are invested in the safety and security of U.S. Treasuries. In addition, U.S. interest rates, even after the large declines this year, remain among the highest in the developed world, and continue to attract strong demand from global institutional investors. U.S. 2-year Treasury yields have moved lower as well, to 1.20% from 1.57% at year-end, so the 10-year/2-year yield curve remains positively sloped; however, both the fed funds rate of 1.58% and 3-month yield of 1.51% provide further evidence that bond investors expect the Fed to cut short-term rates.

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What will be the global economic impact of the coronavirus outbreak? While it remains too early to gauge how deep and how long the economic impact will last, GDP growth will be disrupted country by country. At this point the most severe impact will be within China as manufacturing, travel, trade, and consumer activity have been substantially restricted. Prior to the outbreak consensus China 1Q20 GDP estimates were 6.0% at an annual rate. The GDP numbers could be well below that with many China forecasters predicting the reported number could be in the range of 4.0% to 5.0%, with some sectors of the economy in contraction. We expect continued weakness in Q2 as well, but the Chinese government has implemented monetary and fiscal stimulus, and if the virus outbreak has peaked in China, as the WHO suggests, growth could snap back strongly over the back half of 2020. As the virus spreads to other countries, including large economies of Japan, Italy and South Korea we expect ongoing concerns from global markets. According to the International Monetary Fund (IMF), these three countries, along with China, comprise 27% of global GDP output. Japan's downturn, which was evident in 4Q19, is likely to be extended through 2020, and an expected European GDP growth recovery could be delayed to later in the year.

The GDP impact in the U.S. is less certain at this time, as coronavirus infections have been minimal, but an increase in cases appears likely due to the global outbreak beyond China. The China slowdown and trade disruption so far could impact 1Q20 U.S. GDP by 0.2% or more, and a greater impact could be seen in 2Q20. U.S. economic data through January was better than expected, and the Atlanta Fed GDPNow estimate, which tracks quarterly GDP as data is reported was 2.6% as of 2/17/20, trending above the FactSet consensus estimate of 1.5%. The GDPNow estimate was bolstered by strong January contributions from consumer spending, residential construction, and government expenditures, each of which we believe will remain strong through the quarter. The estimate also reflects a positive contribution from business investment and inventories growth, but we believe those numbers could disappoint due to coronavirus uncertainty, with that headwind extending into the second quarter. The biggest risk to sustained GDP growth in the U.S. is a potential shock to consumer confidence if the coronavirus spreads in this country. At that point, containment would be critical to limit the duration of the outbreak, which we believe would be the likely outcome.

What has been the sector impact of equity market decline? From 2/19/20 to 2/25/20, the S&P 500 and the Russell 1000 index both declined 7.6%. All 11 S&P 500 sectors were substantially lower, but defensive sectors outperformed cyclical sectors and value stocks outperformed growth stocks. Among the leading sector decliners were Technology down 10.2% and Energy down 10.2%, while relative better performers were REITs down 2.4% and Utilities and Consumer Staples down 3.2% and 3.8%, respectively. The Russell 1000 Value index was down 6.5% during the selloff, while the Russell 1000 Growth index dropped 8.5%. For 2020 YTD, three sectors remain positive on a price basis: Utilities up 4.7%, REITs up 3.9%, and Technology up 0.4%. Continued market weakness would likely favor the defensive sectors vs. cyclicals, but we do not advocate for long-term investors to become overly defensive. In our view, as economic trends stabilize and visibility for GDP growth improves, cyclical sectors will outperform and drive market gains over the balance of the year.

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