Market Update

Our Thoughts on the Current Environment: COVID-19

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In the last several days, equities and other risk assets have fallen sharply amid increasing concerns about the spread and potential economic impact of the novel coronavirus. The spread of the virus (known as SARS-CoV-2) and the associated disease (COVID-19) beyond China (the epicenter of the outbreak) have gripped markets and caused volatility to meaningfully ratchet upward. The following is a synopsis of our thoughts regarding investment-related implications. First, some facts are in order.

As of February 26, the number of confirmed cases worldwide has increased to 81,000, the vast majority of which have occurred in China. However, infections have also been reported in over 30 other countries, and sadly, we note that the number of related deaths exceeds 2,500.

In response, public officials have adopted quarantine measures and imposed travel restrictions in affected areas. These actions have drastically disrupted economic activity, triggering fears that a healthcare contagion might lead to an economic contagion. As a result, economic forecasts for the first quarter and the calendar year of 2020 have been significantly lowered. To wit, consensus forecasts for first quarter Chinese GDP have been reduced from 6% growth to double-digit declines.

Forecasts for corporate earnings has also been lowered. Given the lack of clarity as to when supply chains might be fully operational again, companies have limited visibility into their earnings outlooks at this time.

Stocks have reacted accordingly and have entered correction territory with the S&P 500 Index down 12% from a record high it recorded just nine days ago. And bond yields have collapsed 60 basis points (0.60%) since the beginning of the year as investors have fled to safety. So where does this leave us?

As I write, I am between client meetings in Seattle and have observed that outright fear is not apparent, even though anxiety levels are understandably higher. Further, economic activity continues apace: roads are congested, buildings are rising, and airports, coffee shops and restaurants are bustling.

Still, we think investors should be contemplating two possible scenarios. In the first, infections slow by March/April. Chinese economic growth falls drastically, other regions of the world experience modest economic declines, and the US experiences a severe slowdown but does not officially register an outright decline in economic activity. By the second half of the year, global economic growth rebounds to its baseline trend as economic activity gradually normalizes.

The second scenario is far more dire. Infections continue to increase past April and extend well into the second quarter. Global growth declines for two or more quarters and remains challenged for the remainder of 2020.

A severe global recession ensues; and while the US would fare comparatively better than many other economies, a recession would likely be unavoidable.

Importantly, the first scenario is one that is now likely discounted by financial markets suggesting that much of the damage might already be done. Further, there are reports that the confirmed cases of SARS-CoV2 in China may be ebbing, although these announcements are being met with skepticism. And if the odds of scenario two increase appreciably, markets would likely suffer further.

In the meantime, policymakers are responding and taking measures to address health-related concerns as well as economic-related stresses. Risks involving the efficacy of lower interest rates when rates are already low and political infighting that could hinder the response are not immaterial and need to be considered.

That said, this episode will eventually pass. While no two global health crises are the same, history tells us that past global outbreaks have resulted in sharp stock market declines followed by substantial recoveries once fears have abated.

Timing recoveries is a near impossibility, and thus we believe investors need to be both disciplined and defensive during this time of elevated uncertainty. We are not bearish because the market is declining based on something that cannot be quantified. Nor are we bullish on anticipation that a "V-shaped" recovery will quickly unfold. We simply do not know how this will play out.

Accordingly, we intend to review relevant data and form an objective conclusion. We continue to advocate a balanced posture between stocks and bonds, believing that we will likely see large moves -– both up and down — in the weeks ahead.

We also continue to maintain a bias toward high-quality companies and stocks that possess low volatility characteristics, and we would de-emphasize businesses that are more cyclical in nature or carry levered balance sheets. We favor high-quality fixed income securities and would minimize exposure to high-yield issues as well.

We will keep you abreast of our thinking, and we invite your questions at any time.

For more information, please contact your Key Private Bank Advisor.