Monthly Update

February 2020

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At the start of the year, the impact of the Coronavirus was still an unknown, but as the virus increasingly spread in February, market action became dominated by fears of the virus. What began in China has now spread to South Korea, Italy, Iran, Japan, Germany, France, Spain, Singapore, Hong Kong, and importantly for us, the US[1]. The worry is not only the health impact, which we certainly don't want to downplay, but more crucially, the negative economic implications in terms of the change in business and consumer behavior to avoid contracting the virus. For example, China, a population of 1.4 billion people, where just 80k people (of 89k reported cases in total as of this writing) have gotten the virus and 34k have already recovered, they literally shut down about half of their economy via quarantine and factory closures[2]. Assuming we can believe their data, the pace of spread has slowed dramatically, and people are slowly going back to work.

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The fear now is the spread elsewhere, particularly to other parts of Asia, in Europe and now the US. In times like this, it's important to put the health impact into perspective. According to the World Health Organization, the flu results in 3-5 million people globally getting a severe case and 290k-650k die from it each year[3]. The US Center for Disease control estimated that the 2009 Swine Flu spread afflicted 61mm Americans with about 12k deaths[4]. Most people who get the coronavirus will just have a fever and a cough, while most children may see only modest symptoms. Those most at risk from something serious are those older and with already pre-existing conditions. The hope is that with the warmer weather the spring time brings, it will help end the virus spread, but the CDC does emphasize that "it is not yet known whether weather and temperature impact the spread of COVID-19…At this time, it is not known whether the spread of COVID-19 will decrease when weather becomes warmer.[5]"

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This will pass, but in the meantime, knowing when and to what the economic damage will be is impossible to predict. Instead, we just need to ride it out, make sure portfolios are structured to the needs of the clients and ensure clients liquidity needs are met for the next few years, for those that require it.

[1-2] John Hopkins
[3] World Health Organization
[4-5] Center of Disease Control

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The Stock Market

One of the issues for the stock market heading into the virus concerns was that valuations were extended. At the record high in the S&P 500 in mid-February, the index was trading at 20x trailing earnings and about 19x forward[6]. Thus, there was little room for error. The stock market was also very concentrated in terms of what was mostly driving the rally, which was big cap tech, where Facebook, Apple, Amazon, Microsoft and Alphabet consisted of about 18% of the S&P 500[7]. That compares with the top 5 names at the peak of the tech bubble 20 years ago, making up about 16% of this index[8]. What the recent selloff has done has taken the stock market back to where it was last October, just as the Fed was beginning to aggressively expand its balance sheet.

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The Economy

Also, of note, heading into the virus concerns, the global economy was only growing about 3% with the US economy at around a 2% run rate[9]. The slowdown in global trade and manufacturing in 2019 was the main reason for that slow in growth and while the US/China trade deal helped to deescalate the tensions, most of the tariffs are still with us.

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Thus, with the economic impact of the virus now upon us, the economic cushion was only modest. It is why we need to see this pass as quickly as possible and for economic activity in many places to come back online.

Interest Rates

In response to the economic concerns and drop in stocks, we saw a violent rally in US Treasuries in February, where the 10 yr. yield fell to 1.15% from 1.51% at the end of January, and vs 1.92% at the beginning of the year[10]. This has led to a sharp decline in mortgage rates and is providing a gift to those looking to refinance their mortgages and/or buy a home. On the other hand, we saw a rise in the cost of capital for businesses that have below investment grade credit ratings, otherwise known as high yield credits. The average yield for the Barclays high yield index jumped to 6.23% from 5.51% at the beginning of the month[11]. The yield started the year at just 5.19%, just above record lows[12]. However, yields for investment grade companies did fall in February, but there was very little corporate issuance to take advantage of that[13].

[6-13] Bloomberg

The Policy Reaction

As with other market hiccups and economic challenges of the past, everyone is looking to central bankers to save us with rate cuts, and this time is no different. While a stock market decline of 10% used to happen about once per year, that it is happening now in conjunction with the negative economic impact of the virus, has the US Treasury market pricing in two Fed rate cuts in coming months[14]. The first one of 25 basis points is widely expected in two weeks at their next meeting, and there is a growing possibility it would be 50 basis points[15]. We should also expect rate cuts from other central banks and the possibility of fiscal stimulus, too. On the latter, a few weeks ago, Hong Kong announced that they were literally sending each citizen a check of about $1400 US dollars to spend as they wish.

We are skeptical that rate cuts will help address the economic problems at hand, since it won't get people to travel or reopen factories, as long as the virus continues to spread. The hope is that it will at least help financial markets. After all, for better or worse, higher asset prices have become the unspoken 3rd mandate of the Federal Reserve along with maximum employment and price stability.

Conclusion

With huge uncertainty to the extent to which the coronavirus will spread, we are all flying blind in the short term in trying to gauge its impact, health wise, economically and with respect to markets. Though I do want to emphasize 'short term,' because this will pass and life will return to normal of course, hopefully by late spring/early summer. If it comes back next winter, expectantly we'll be extremely close to a workable vaccine.

Regardless of what comes in 2020, we try to construct portfolios for our clients that are well-diversified with a long-term time horizon in mind; an investor's two best friends. Of particular importance is making sure our clients have their liquidity needs met over the coming 24-36 month period, which then makes market gyrations less relevant during this time frame.

Please do not hesitate to reach out at any time with questions, or for any discussion on the economy and/or markets.

[14-15] Bloomberg

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