By Peter Boockvar
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Following a strong end to a solid year in 2019, the S&P 500 blew out of the gate in 2020 with the same kind of momentum. By the 3rd week of January, the S&P 500 was already up 3%, until a week later when we all began to hear news about the Wuhan coronavirus coming out of China. What followed was a fear-driven sell off, resulting in an unchanged month in this benchmark index[1]. I say 'fear-driven' because the health impact should be contained, but we can't discount the immediate economic impact, as parts of the Chinese economy, the 2nd largest in the world, shuts down in precaution. While I don't want to downplay the impact of the virus, it is important to have perspective. According to the Center for Disease Control, they estimate that from October 1st, 2019 through January 25th, 2020, 19-26mm got the flu with 180k-310k needing hospitalization and 10k-25k dying from it[2].

Global bond yields resumed their downward trend as concerns grew that the economic slowdown in China resulting from the coronavirus spread would also negatively impact other economic regions of the world. In particular, the US 10 yr yield started the year at 1.92% and finished January at 1.51%[3]. The yield curve also flattened, with the spread between the 3-month Treasury bill and 10 yr note yield inverting by 4 basis points, vs the steepening of 37 basis points by this past year-end[4]. While some of this is due to virus fears, it also reflects the lack of belief on the part of Treasury participants that the global economy will inflect higher with the signing of Phase One of US/China trade deal.

This Phase One trade deal was signed on January 15th, and while most of the tariffs between the US and China remain in place, this at least takes the chances of further escalation off the table for now. The key positive of the deal was the greater protection of intellectual property that China will hopefully take great pains to enforce. Phase Two of the deal will include Chinese state subsidies for state owned enterprises and the forced transfer of US technology to their Chinese joint venture partners. The timing of when this will likely occur, if at all, will be after the November presidential election.

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[1] Bloomberg
[2] Center for Disease Control
[3] Bloomberg
[4] Bloomberg

The other key to markets has been the influence of Federal Reserve policy. While they are now going to sit on their hands with regard to short term interest rates and their fed funds lever, eyes have now shifted to their balance sheet and the dramatic rise in its size since mid-September. The Fed's balance sheet has expanded by almost $400b since then to $4.15 Trillion[5]. This has happened as a result of the Fed's attempt to provide a higher level of bank liquidity into the financial system in order to better control short term interest rates. This has really mattered for the stock market because market participants have associated a larger Fed balance sheet with a form of quantitative easing, which in turn is meant to lift asset prices.

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The Coronavirus

I have to admit that I never heard of the term 'coronavirus' as of a few weeks ago, but tried to learn as much as I could immediately after. Outside of the characteristics of the virus itself, from a health, economic and market perspective, the first place to look for comparison was when SARS afflicted China and parts of the Asian region in late 2002 and early 2003. The coronavirus has a much lower death rate than SARS, but greater than the flu, so the real impact will be more economic than health related[6]. Back in 2003, the Chinese economy was only $1.4 Trillion in size versus $14 Trillion today[7]. In 2003, their economy accounted for about 4% of global GDP vs almost 18% today[8].

Thus, what happens in China doesn't always stay in China. The shutting down of major cities, factories, and travel can disrupt global travel and global supply chains. I do want to emphasize though, that once the warmer weather arrives this Spring, the virus should flame out as it did with SARS. Therefore, whatever the economic impact in the coming months, it should just be a short term phenomenon.

Stocks

The context in which the mid-January selloff began, induced by the spread of the coronavirus, as stated, was a market that got very one sided in terms of a bullish sentiment. At the same time, the valuation of the S&P 500 got to 20 times 2019 earnings estimates[9]. A variety of sentiment indicators, including Investors Intelligence, the American Association of Individual Investors, the Citi Panic/Euphoria index and the put/call ratio all pointed to an extreme level of positivity and complacency towards the stock market[10]. Viewed as a contrarian indicator, as when investors all lean in one direction a contra move typically takes place, all the stock market needed was a trigger for a reversal and the virus just happened to be it.

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[5,7-9] Bloomberg
[6] World Health Organization
[10] Investors Intelligence, American Association of Investor Intelligence, Barron's

Once we get past the impact of the virus, hopefully within a few months, the key will be the direction of earnings as the stock market needs to grow into the current high valuation. The two keys to this will be the pace of global growth and the direction of profit margins, which has been receding because of higher labor costs. That is good for employees, but does negatively impact the earnings of employers, if they can't manage that via higher productivity or price increases.

Interest Rates and the Fed

In January, the flattening of the US yield curve with the simultaneous decline of market driven interest rates overseas has, up until recently, been messaging a different viewpoint between the direction of global economic activity and that of the world's stock markets. The former seems to be expecting a more modest pace of growth, while the latter has been betting on a pick up. This should get reconciled this year, especially once we get past the impact of the virus.

We expect the Fed to scale back its asset purchases and balance sheet expansion sometime in April. This will be a good test for the stock market on whether it has been behaving in response to economic fundamental expectations, or just in response to the viewpoint that the Fed is printing money again, which historically has been good for risk assets.

The Global Economy

The US economy finished the fourth quarter of 2019 with a 2.1% year over year growth rate, which still might get revised a few more times[11]. Expectations for growth in 2020 is at a similar pace once we get past the Q1 influence of the coronavirus, which could cut Chinese GDP growth by up to 2 percentage points from its current 6% run rate[12]. We'll get no help from Europe, as their growth rate is estimated to be about 1% in 2020, a similar pace as seen in 2019[13].

The US economy continues to be buoyed by the consumer, as it has offset softness in manufacturing, trade, and capital spending. Thus, the state of the labor market this year will be key to watch with the current unemployment rate at a 50 yr low of 3.5%[14].

Conclusion

The coronavirus threw the markets for a loop in January, and it's likely that the impact remains with us for the next few months, until we hopefully see a slowing pace of infection. Once the warmer weather comes, it should peter out.

[11-13] Bloomberg
[14] Bureau of Labor Statistics

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Therefore, the focus should be on what the short term economic and health impacts are as things should improve in a few months. Perspective is important here; as of this writing, the S&P 500 is only slightly off its all-time record high[15].

As I stated in the last letter, it's important for Corporate America to grow its earnings into the current elevated valuation multiples. It is for this reason that we need to be realistic about returns in the coming twelve months. We also have to see the 2019 hope of an improving economy, via Fed rate cuts and a trade deal, be realized once we get past the Chinese health challenge.

Regardless of what comes in 2020, we try to construct portfolios for our clients that are well-diversified, and 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.

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[15] Bloomberg