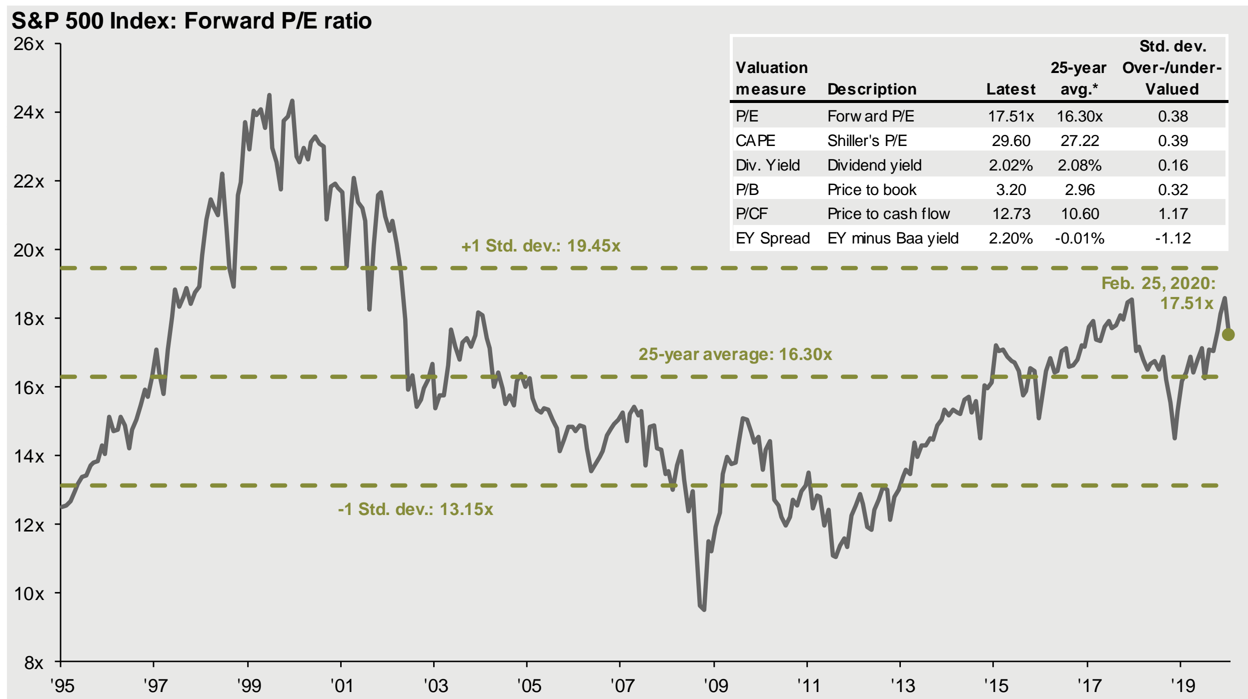
SPECIAL MARKET REPORT: CORONAVIRUS AND THE MARKETS – RESIST THE TEMPTATION TO SELL

Perennial Wisdom

In light of the recent market pullback following the continued spread of the coronavirus (COVID-19), we felt it worthwhile to remind investors that the medium and long-term impact of the virus will have little impact on the valuations of US and International businesses. Over the short-term, however, markets are fickle, and large fluctuations in valuations (volatility) can create opportunities for long-term investors to purchase assets at deep discounts to their intrinsic value. History suggests this may prove to be a better entry point than exit for investors. As Warren Buffet stated so succinctly, investors must ask themselves "'has the 10-year or 20-year outlook for American businesses changed in the last 24 hours or 48 hours?" The answer, of course, is no.

$1 Trillion of Value Destruction!?

The S&P 500, which represents 75% of the total market cap of US companies, is now down 3.1% for the year, following returns in excess of 31% in 2019. Prior to this week's news, the S&P 500 had been +3.3% year to date. That means that over $900 Billion in value has been destroyed since the end of last year. Is that rational? While valuations are by no means cheap in the United States, earnings multiples are certainly reasonable given that the 10-year US Treasury yield has fallen to 1.3%. Earnings are likely to suffer in the first half of 2020, but should recover in the second half, as the disease peaks.

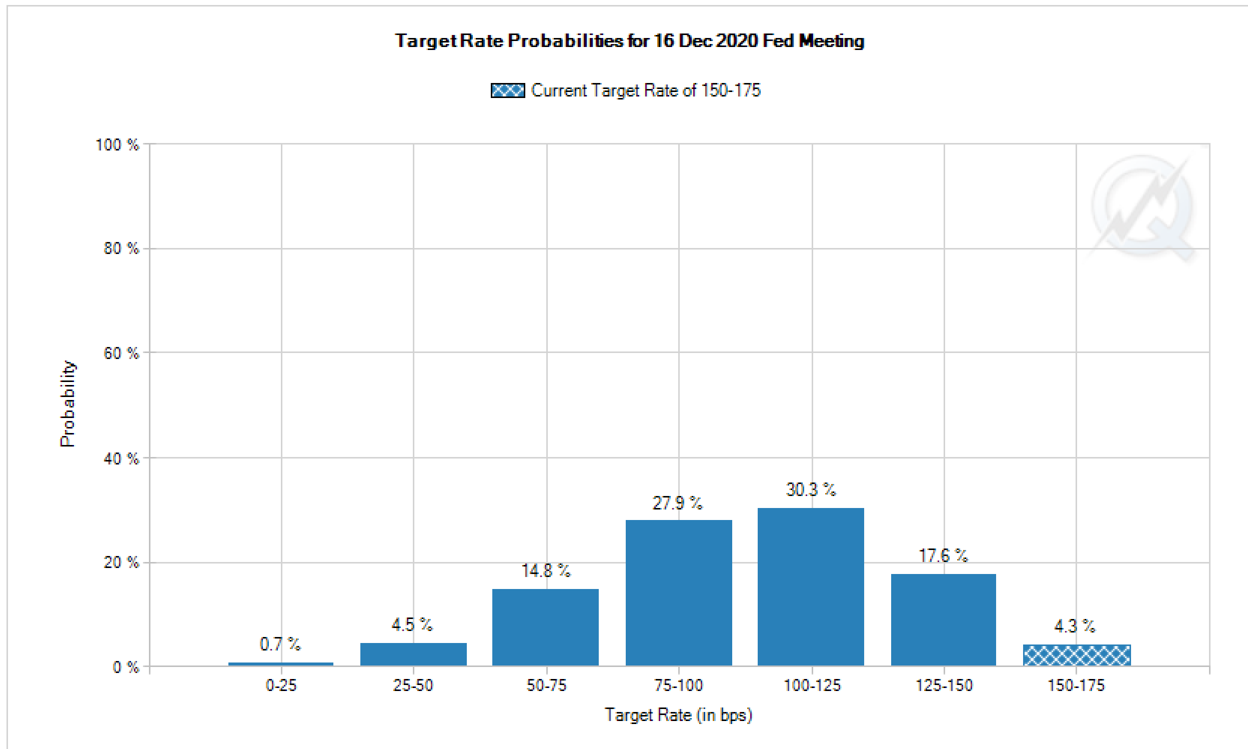


Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	17.51x	16.30x	0.38
CAPE	Shiller's P/E	29.60	27.22	0.39
Div. Yield	Dividend yield	2.02%	2.08%	0.16
P/B	Price to book	3.20	2.96	0.32
P/CF	Price to cash flow	12.73	10.60	1.17
EY Spread	EY minus Baa yield	2.20%	-0.01%	-1.12

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

The Economic Impact
In this week's *Barron's*, Oxford Economics warns that should coronavirus turn into a global pandemic, it could cut $1.1 trillion in revenues from the global economy in 2020 and cause global GDP to fall to 0% for the first half of the year. Under this scenario, the US and euro zone would both enter "technical recessions", and global GDP for 2020 would fall from 2.3% estimates to 1.0%. Lower discretionary spending and decreased travel and tourism would be accompanied by lower demand, declining capital investment, supply-chain disruptions, and financial contagion.

Central Banks will Respond
Yet, the world is not static. The Bank of China would likely continue to implement additional fiscal and monetary stimulus, as would the US Federal Reserve, the European Central Bank and the Bank of Japan, and the recovery would likely be swift, with GDP returning to 2.9% in 2021. In fact, the futures markets are already predicting two additional Federal Reserve interest rate cuts in 2020, bringing the interest rate target down to 1.00-1.25%, with odds approaching a 50% probability of a third cut to 0.75%-1.00%.



Source: CME FedWatch Tool

The Underlying Cause of the Economic Impact
It is important to understand that much of the immediate economic impact of a pandemic can be traced to the efforts to contain it, rather than from the effects from the disease itself. As we implement local, regional, and transnational quarantines, we shut down a lot of economic activity.

So far there have been ~79,000 cases of coronavirus reported, and ~2,600 deaths, putting the mortality rate at around 2%. This compares to the 2003 SARS outbreak, with a mortality rate of 8%. While we are yet to identify a vaccine, history tells us that economies and markets rebound as the epidemics subside and supply chains resume full capacity.

Other Factors Impacting the Markets
While it appears that Coronavirus has been the primary cause of the markets recent capitulation, it is also worth noting that Bernie Sanders recent rise as the likely democratic nominee - a candidate widely deemed anti-business and bad for the markets – may also be contributing to the recent volatility. We do not believe it is prudent to focus on the election outcomes at this time.

Portfolio Rebalancing into the Pullback
With US Treasury yields at their lowest levels in US history, this may prove an opportunistic time to accelerate your 2020 capital gains budget by realizing gains from the sale of a portion of your bond portfolio and redeploying the proceeds into equities at their current depressed prices in a hedged manner through the purchase of structured solutions, such as Buffered Enhanced Return Notes. More aggressive investors may consider a rotation from growth-oriented equities into value-oriented securities, which have underperformed over the past decade. Additionally, sector rotations into aerospace and defense, drug retailers, and energy – which has suffered from low oil prices – may present an attractive defensive repositioning.

As we stated in our client note earlier this month, from a financial perspective, the S&P 500 has traded higher 3 months after the World Health Organization (WHO) has announced a global health crisis 7 out of 11 times, and the mortality rate of this strain appears to be significantly lower than that of SARS. The financial impact is likely to revolve around continued manufacturing and supply chain disruptions, and a temporary decline in sales to affected markets. This may even manifest itself through short-term price inflation, like what occurred in the construction industry during the initial stages of the US-China trade dispute. But for long-term investors, such quarterly disruptions are unlikely to have long-standing impacts on the earnings of multinational companies, and even less so on domestic companies (60% of the S&P 500 market-weighted revenues are domestic).

If you and your family have any questions or concerns, or would simply like to discuss this or any other issues further, please do not hesitate to call us anytime.

Looking forward to speaking soon,

Brian Luster
Principal and Chief Investment Officer
Collective Family Office

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