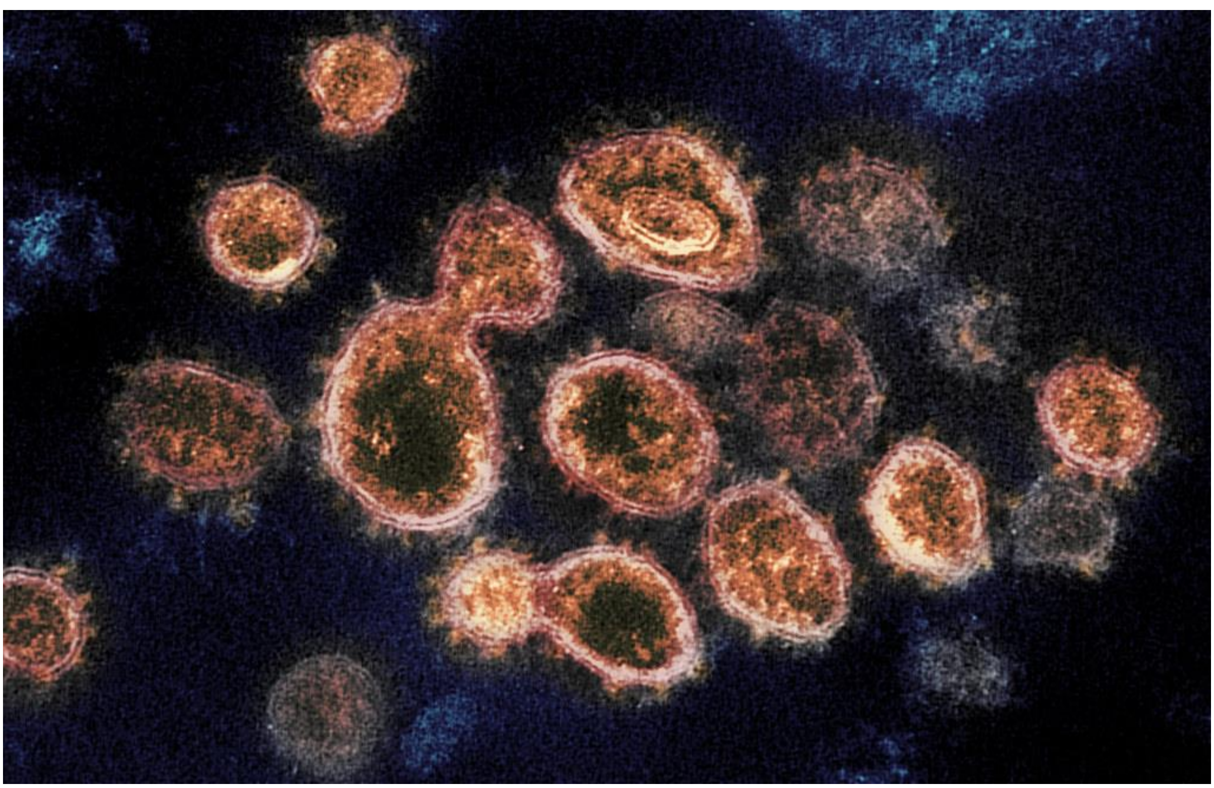
Assessing the impact of coronavirus on the markets: Our view

The recent surge of COVID-19 virus cases outside of China (Figure 5: Yellow), especially in Iran, Italy and Korea, has shocked the markets as investors flee to safety in fear of a global pandemic, we view this as a black swan event. However, our long-term view is that the correction is healthy for the markets and will be a speed bump on the road to the global economy recovery.

First, a look at the correction: the markets fell roughly 7% from their early-October peak within just three trading days; crude oil has plunged more than 20% since the start of the year. Safer assets have risen sharply as US 10-year bond yields hit an all-time low of 1.33% (Figure 2), while gold hit a 7-year high and is now sitting above the 1600 mark. The economic impacts of the virus are difficult to forecast, since the situation is dynamic. However, even if cases remain clustered predominantly in China, global GDP will likely slow.



Lessons from the past

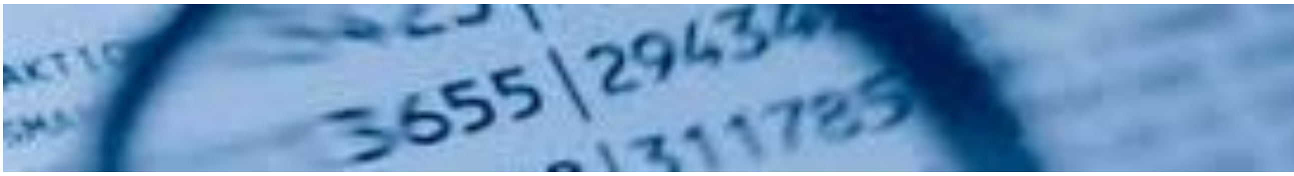
It is interesting to look back at the impact of SARS in 2003. The impact on China's GDP was about 1.5% for one quarter; it began to accelerate again the following quarter. Back then, China made up just over 5% of global GDP, so the net impact to global GDP was minimal. This time around, China was already facing a slowdown, so the impact to its economy is expected to be more significant. As well, China's contribution to global GDP is now about 20%, so a situation similar to SARS may have a bigger effect on the global economy. Impacts could include supply chain disruption, slowed demand as consumers spend less, and a plunge in tourism as consumers delay travel plans.

In our view, the correction was not an extraordinary event, but rather a typical drawdown of the sort that can happen during a period of uncertainty and heightened fear. We do not believe it spells the beginning of a bear market. We are currently sitting around the 150-day moving average support (Figure 1) and are due for a rebound. That said, the situation could deteriorate further depending on how the virus story continues to unfold. We do not anticipate any more pullback, but believe we could see a further drawdown and short-term volatility if the virus continues to spread worldwide.

Highlights

- We view the recent correction as a **black swan event**: an unpredictable development with potentially significant consequences. Typical drawdowns for such events can range from 8% to 12%.
- Cases of COVID-19 in China are reportedly slowing, but growing clusters of cases elsewhere—in Iran, Italy and South Korea—triggered the correction.
- The spread of this new disease is disrupting global supply chains and hurting demand and consumption
- This is actually a healthy correction for the markets, lowering valuations and making investor's sentiment more realistic
- Markets are sitting at healthy support levels, though this could change if conditions deteriorate further.

Looking back at past corrections from all-time highs (Figure 4), markets tend to return to their previous highs within about a quarter (three months) of a pull-back. We expect more noise as virus updates continue to come out, but we do not see this situation as substantially different from previous similar ones. That said, we believe this recovery will be a longer, U-shaped recovery over the next few months—not dissimilar to what happened after SARS and the Japanese earthquake events, which also featured global supply chain disruptions—rather than the V-shaped recovery we saw in late 2018 (Figure 1).



Anticipating the recovery

A closer look at Chinese equity markets may offer clues about what direction the US equity markets are likely to take. The China Shenzhen CSI 300 fell 11.88% (Figure 4) when markets reopened after New Year's festivities. That fall was due to fears over the fast-spreading COVID19 virus and its effects on the domestic economy and daily life. After the multi-day drop, similar to what we saw in the US equity markets, the Chinese markets roared back, performing a V-shaped recovery within a month and nearing their previous highs. We are beginning to see positive signs coming out of China as the infection rate tapers (Figure 5: Orange) and recovery rates rise significantly (Figure 5: Green).

In short, the recent correction was the kind that often happens during black swan events. While nobody loves a correction, there is some good news in it: for one, it creates room for markets to run higher without fear of over-bought conditions. Investors now have a much-anticipated correction behind them; valuations have improved, with the price-to-earnings ratio falling from 19.1x to 17.6x; and investor sentiment is more realistic. As well, the economy remains strong: projections for 2020 GDP are robust, at 2.0% real, inflation-adjusted growth. Idle capacity in global resources will continue to mute inflation. We expect the US equity markets to recover over the next few months, but are prepared for COVID-19 to cause further volatility. We do not see a recession on the horizon for at least a few years.

Source: Cornerstone Macro and US Federal Reserve Board

Figure 1: S&P 500 Price Index (Log Scaled) & 150-Day Moving Average

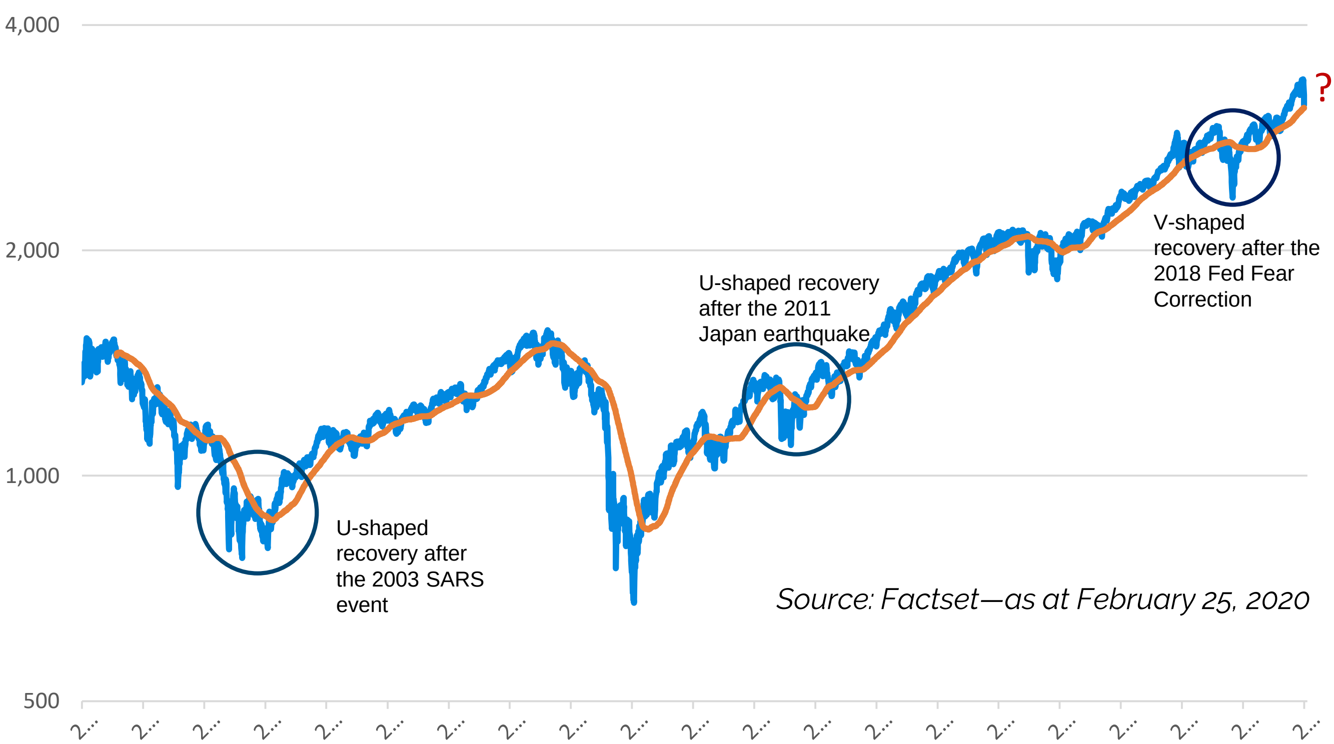
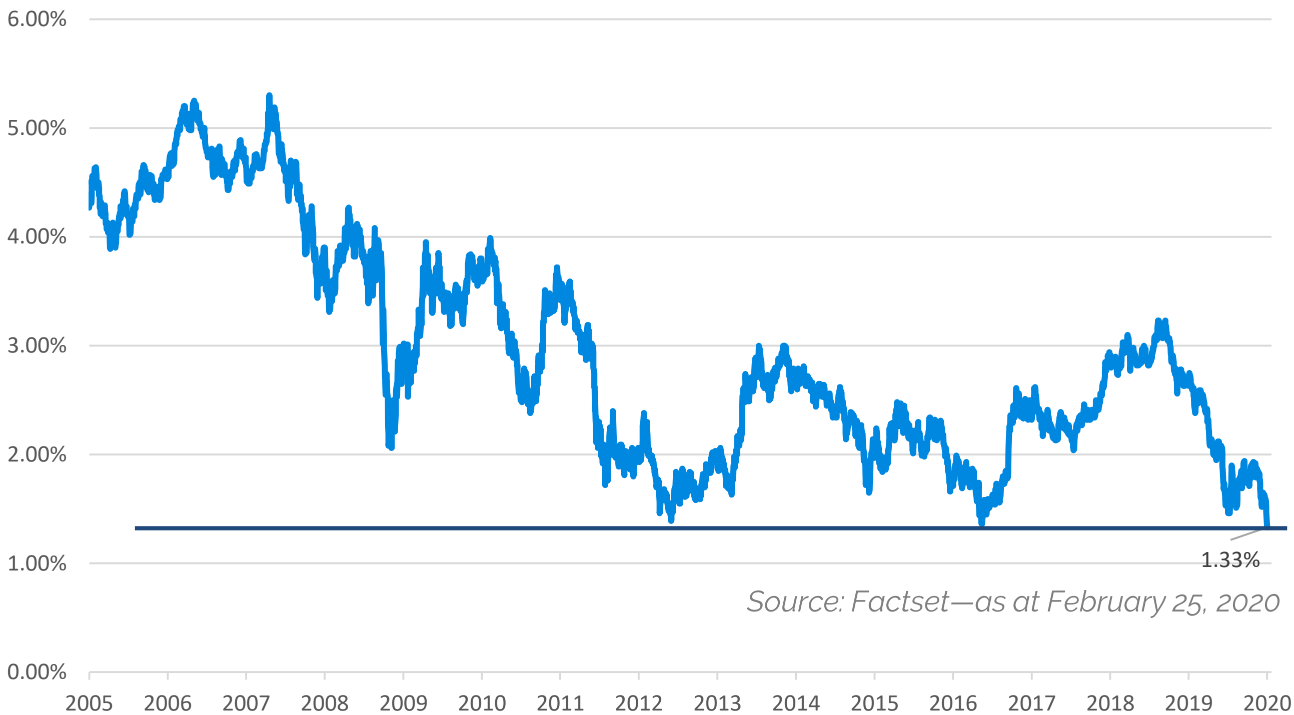


Figure 2: US 10-Year Bond Yields



Source: Factset—as at February 25, 2020

Figure 3: China Shenzhen SE / CSI 300 Index - Price Index

Source: Factset—as at February 26, 2020

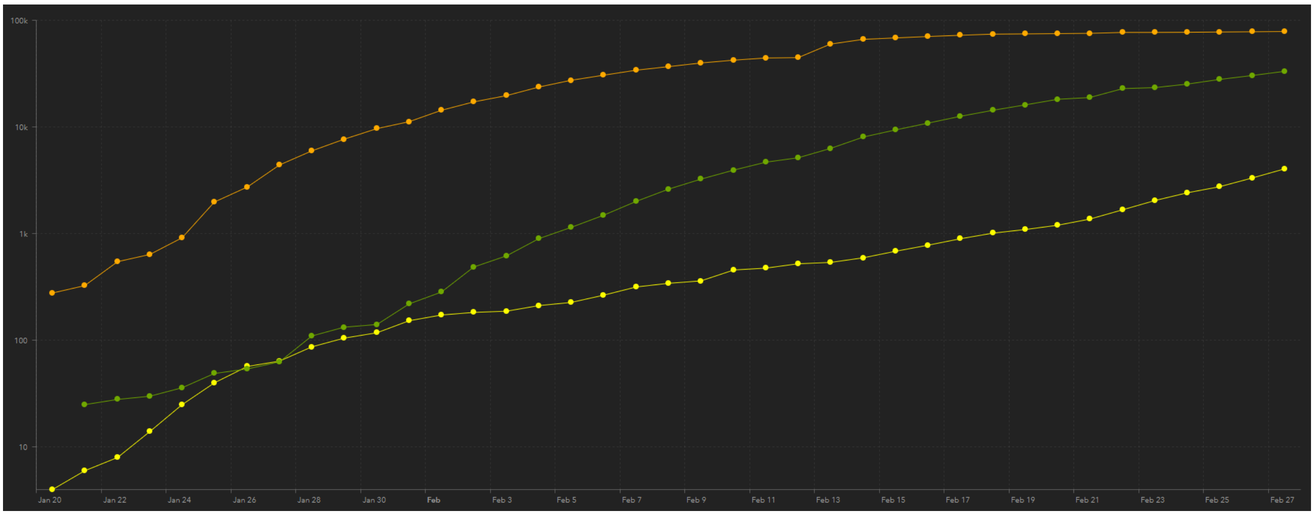
Figure 4: S&P 500 Corrections from All-Time Highs

S&P 500

Date of 4-Session Drop	% Change	1-Day Later	1-Week Later	1-Month Later	3-Months Later	6-Months Later
16-Oct-1989	-9.24%	-0.49%	0.58%	-0.66%	-0.61%	0.55%
25-Feb-2020	-8.10%	?	?	?	?	?
13-Oct-1989	-7.52%	2.77%	4.06%	1.78%	1.89%	3.21%
16-Nov-1982	-7.14%	1.85%	-1.84%	-0.09%	8.87%	20.66%
5-Jan-2000	-6.48%	0.10%	2.15%	1.59%	6.08%	3.15%
13-Apr-1987	-5.94%	-2.26%	0.16%	2.93%	7.71%	10.12%
19-Apr-1999	-5.71%	1.29%	5.47%	4.25%	9.16%	-2.18%
6-Dec-1928	-5.64%	-2.40%	-1.88%	8.47%	8.77%	11.92%
14-Jan-1999	-5.37%	2.56%	1.89%	1.48%	9.59%	15.34%
7-Jan-2000	-5.23%	1.12%	1.64%	-1.20%	5.19%	2.60%
	MEAN	**0.50%**	**1.36%**	**2.06%**	**6.30%**	**7.26%**
	MEDIAN	**1.12%**	**1.64%**	**1.59%**	**7.71%**	**3.21%**
	ODDS UP	**66.67%**	**77.78%**	**66.67%**	**88.89%**	**88.89%**

Source: Cornerstone Macro—as at February 25th, 2020

Figure 5: COVID-19 Map



Source: John Hopkins CSSE (https://www.arcgis.com/apps/opsdashboard/index.html#/bda7594740fd40299423467b48e9ecf6) —as at February 26, 2020

Figure 6: CNN Fear and Greed Index

Please feel free to contact your Portfolio Manager if you have any questions.

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