Daniel Wildermuth's
MARKET COMMENTARY

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What Does Coronavirus Mean for Markets Longer Term?

Just over a week after various U.S. stock market indices set new all-time highs, the market entered correction territory defined by a loss of 10% or more. During the slide, the S&P 500 suffered its biggest two-day combined loss since August 2015 on February 24th and 25th, with losses again accelerating on February 27th after pausing on the 26th. Since the start of the year, commodity prices are down 10% and oil prices are down nearly 20% on concerns over global growth. Yields on 10-year Treasury notes, the most important risk-free asset in the world, have tumbled in recent weeks to historic lows because investors have flooded into them, driving up prices.

The speed and severity of the decline clearly reveals deepening concern over the prospects of a global pandemic, and markets normally overreact to conjecture or rumors before settling on actual facts. While fears of the coronavirus drove markets down in late January, equity markets originally recovered quickly as sentiment turned more positive, believing fears were overblown.

More recently, the surge of coronavirus cases outside China has dramatically heightened worries that the epidemic will more dramatically slow global growth given increasing business closings and increasing travel restrictions.

The impacts are potentially substantial. Some U.S. companies claim that they could lose as much as half their annual revenue from China if the coronavirus epidemic extends through the summer. Analysts report that U.S. businesses may generate no earnings growth in 2020 if the virus becomes widespread.

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Even if the virus is contained fairly rapidly, or dissipates in the spring, disruptions to global supply chains will likely take several months to fully reset. Business confidence in the U.S. has also turned decidedly more negative in recent weeks.

While markets were a bit rattled by cases in Italy and South Korea, markets reacted much more sharply to reports that cases were spreading beyond just a few countries, multiplying supply chain impacts. Germany, Europe's largest economy, is rushing to limit the spreading coronavirus impact which is hitting its already weak economy by further damaging supply chains heavily dependent on China and Italy. Within Germany, and other European nations as well, the number of confirmed infections is growing representing a direct internal threat. Increasing numbers of events have been cancelled and pressure to act more stringently is growing. Threats of quarantine combined with fears of the actual disease will increase the impact of the disease. In the U.S., the Centers for Disease Control (CDC) also warned that the spread to the U.S. was inevitable stating it's "When", not "If" it arrives. More recently, some concerns have arisen that the virus could potentially even push the U.S. into recession, although current projections as of February 27 predict only a slowdown in first quarter to a 1% annual growth rate.

Historically, the number of confirmed cases in epidemics typically rise sharply for eight to 10 weeks before peaking. Coronavirus is a bit more concerning because it is particularly contagious, and its long incubation period makes early detection difficult. As a result, infections spread more easily, and containment is more difficult, and it would seem wise to expect a somewhat longer and more widespread impact.

Still, while the impact on individual lives can and will be tragic, at a societal level, the longer-term impact should be minor. In Italy, through February 26th, of the 400 people with the coronavirus, all 12

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that died were elderly people with pre-existing health conditions. Overall, the mortality rate of the disease is estimated at about 2%, although rates are much lower outside of China. Not surprisingly, the majority of deaths are suffered by those that typically succumb to the flu, the old and very young. According to the CDC, about 36,000 people die from the regular flu every year, which has a typical mortality rate of 0.1%. By contrast, the Bubonic plague is estimated to have killed approximately half of the European population and Spanish Influenza inflicted its highest mortality rate on those aged 20-40 often within hours of contracting the disease. The coronavirus, as awful as it is, appears to represent nothing close to these events.

Economic growth may be stalled or delayed to some degree, but the planet should not suffer a global death rate that significantly alters societies or economies. As countries adjust and move forward, supply chains will revert mostly back to normal, and growth should resume, even it takes some time to ramp back up.

U.S. residents have further cause for optimism. The U.S. economy is best positioned among the 20 largest economies in the world to withstand the coronavirus shock. Corporate America remains strong, the lower tax environment continues to trickle down through the economy, and the very favorable monetary policy will likely continue at least through 2020. Profits for U.S. businesses are near cyclical highs and productivity has improved markedly in the past year. The U.S. unemployment rate remains at a 50-year low, and incomes are growing at the fastest rate in a generation, particularly at the lower end. Consumers are strong, and lower leverage combined with low interest rates result in less dollars applied to servicing consumer debt. Sales of new homes hit a 12 ½ year high in January. More recently, even trade policy has been turning more positive. Notably, the U.S. healthcare system is also better equipped than any other nation to combat a nationwide outbreak, and we have the geographical advantage of two oceans as neighbors.

Before coronavirus, U.S. stocks were already expensive carrying rich valuations while facing moderate economic growth prospects that many expected to slow, presenting a difficult market for U.S. equities in 2020. The stage was set for a market correction, and an unusually tragic cause has delivered one. Circumstances, however, also suggest that the pullback is "only" a correction that should not morph into a long-lasting full-fledged meltdown. The U.S. economy is strong and stable, and the global economy had been picking up speed. Damage should be temporary rather than permanent, and history suggests that a slowdown will be followed by a sharp rebound. Bolder investors may want to look for buying opportunities, but it's probably too early for assuming the worst for markets is behind us. As the disease increasingly impacts the U.S. and the globe, people will react unpredictably, and continued volatility in the markets seems very likely until a clearer direction for the disease and its impact emerges.