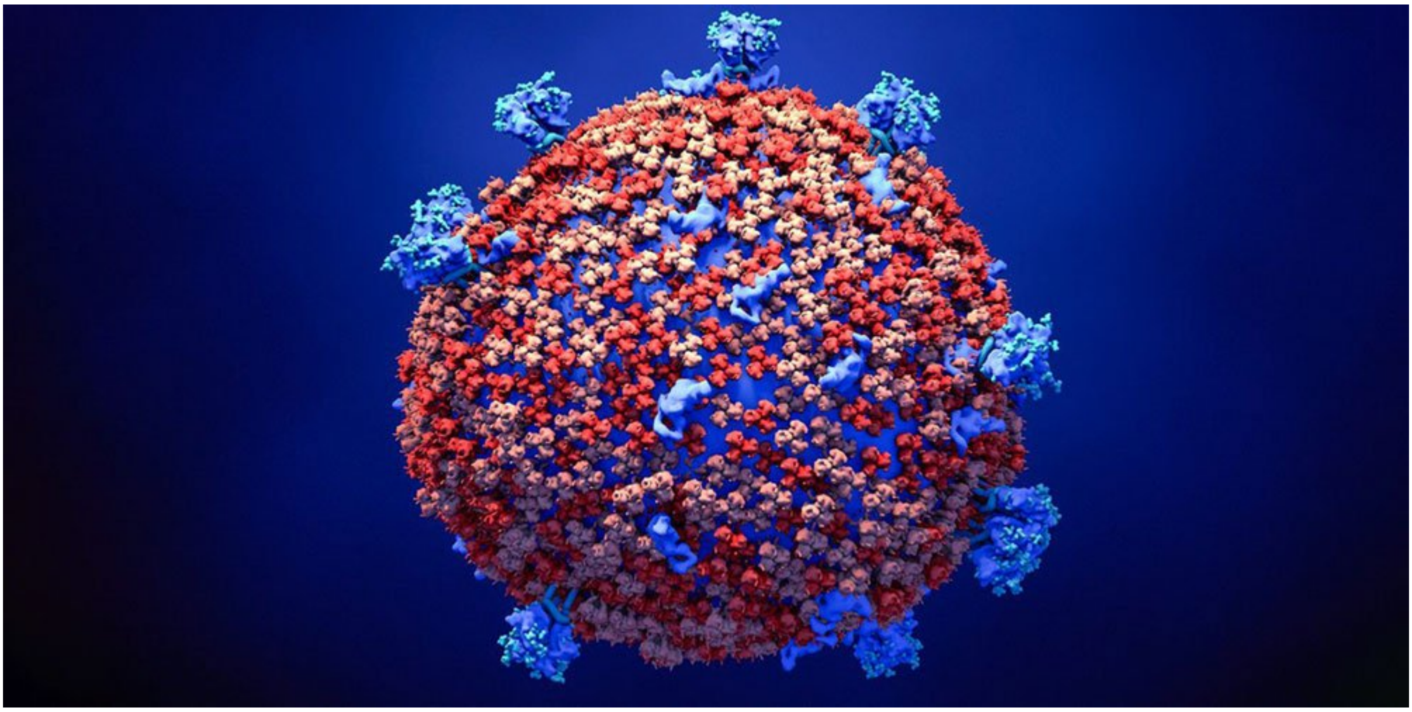


Coronavirus Shakes Markets—Likely Temporarily

March 2, 2020

Last week's change in the outlook for the spread of the coronavirus shook the markets, making it important for investment managers to provide clients with their analysis of the likely implications from a societal, market, and portfolio perspective.

In short, we do not expect the outbreak to lead to any long-term, structural, permanent change to either supply or demand. Governments are likely to stimulate, using both monetary and fiscal tools, as they have proven happy to do over the last decade.

We expect a resumption of economic growth and the forecasts predicted at the beginning of the year, albeit with low near-term visibility, and not likely until the second quarter or later.

Thus, our portfolio positioning is largely unchanged, and we are actively seeking buying opportunities during this period of dislocation.

Background

The new coronavirus, officially known as SARS-CoV-2, and the disease it causes, officially known as COVID-19, were first detected in Wuhan City, China, in December 2019. It has now spread to more than 50 locations around the globe, infecting more than 80,000 people and causing around 3,000 deaths.

While the majority of confirmed cases are in China, in recent days we have seen an increased spread in other countries, primarily in South Korea and Italy.

This caused the World Health Organization (WHO) to increase its risk assessment for the rest of the world from “high” to “very high.” Given this development, it is fair to assume that we will see the virus spread in the United States in the near-term.

However, we do not see evidence that the virus is spreading freely in the community, and the WHO has not defined it as a pandemic. If the WHO labels the COVID-19 outbreak a pandemic, efforts will automatically switch from prevention to focusing entirely on caring for sick people. We are not there yet.

Context

A new viral outbreak, such as COVID-19, naturally causes fear. In the early stages, the characteristics of the virus are unknown. We don’t know how it spreads or who it will infect, and we don’t know the social and economic impact.

But over the past few weeks, our understanding of the virus has increased tremendously. Now, more than two months after the virus first appeared in Wuhan, we have a large number of cases and studies from which to draw some conclusions.

While COVID-19 is a coronavirus genetically similar to SARS, which originated in China’s Guangdong province in 2002, or MERS, which originated in Saudi Arabia in 2012, the disease patterns are very different.

The infection rate of COVID-19, which is based on data from Chinese health officials, is relatively low, ranging from 0.9% to 4.8%. This is significantly higher than SARS and MERS (which only infected 8,000 and 2,500 people, respectively).

However, it is much lower than the swine flu (H1N1), which caused a pandemic in 2009-2010. The swine flu had an infection rate of 20% to 25% and caused more than 60 million cases and 12,469 deaths in the United States, according to the Centers for Disease Control (CDC).

To put that in context, the seasonal flu caused 61,000 deaths in the United States in 2017 and 2018 despite vaccination programs.

Once infection sets in, both SARS and MERS have a significantly higher mortality rate (9.6% and 34.4%, respectively) than COVID-19. According to the WHO, the mortality rate for COVID-19 is 2% to 4% in the Hubei province and 0.7% in other parts of China.

The increased rate in the Hubei region is likely the result of the local medical system being overloaded by the high number of cases in the province. It is therefore fair to believe that the overall mortality rate is around 1%.

We also know that 80% of people infected with COVID-19 experience only very mild symptoms. Of course, there are downsides to that—namely, it probably has increased the spread of the virus as infected people have not sought medical care.

Disease Outlook

While it is impossible to say exactly when COVID-19's spread will peak, it is fair to believe that it will follow a similar pattern as other respiratory viruses, including seasonal coronaviruses and flu viruses.

Seasonal coronavirus (of which there are four spreading in the United States right now) have a very distinct pattern; we usually see an active spread from November to April or May, followed by very low activity from June to November. The chart below illustrates. The seasonal flu follows a similar pattern.

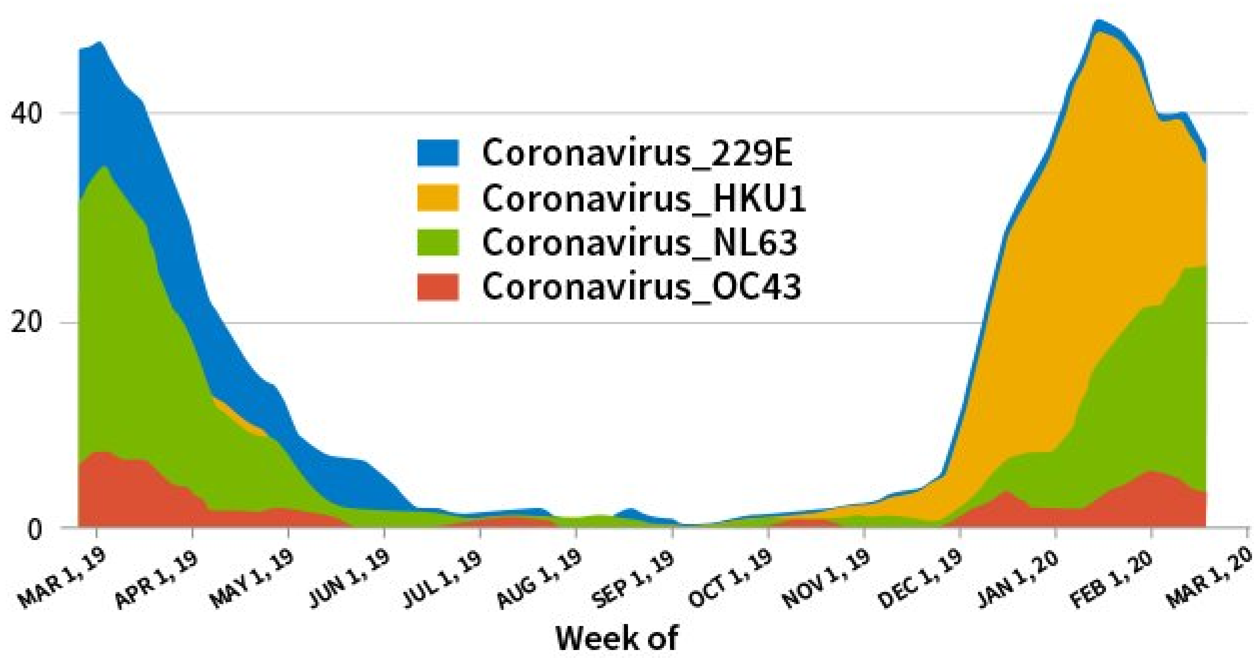
We therefore think it is reasonable to assume that the spread of COVID-19 will start to decrease in April or May. This should prompt a return to any normal societal activities that were curtailed by the virus.

About 14% of people who contract COVID-19 develop severe symptoms and 6% become critically ill. Patients who develop severe symptoms are generally elderly and/or have co-morbidities, such as cardiovascular and respiratory disorders. These patients are naturally at higher risk due to immune deficiencies and a higher disease burden.

This stands in contrast to MERS, which severely infected healthy people at their peaks of lives, when their immune systems were strongest. Fortunately, MERS had a very low rate of infection, and at the peak of the outbreak in 2012, only 2,500 people were infected.

We do not in any way want to diminish the individual suffering these diseases have caused, but want to stress that on a societal level, we believe the implications of COVID-19's spread are likely to be more in line with or less than what we experienced during the swine flu outbreak in 2009 and 2010.

Weekly Cases of Seasonal Coronavirus



Source: Intermountain Healthcare.

Economic Outlook

The sharp selloff in the global financial markets last week suggests that a sharp deceleration of economic activity is becoming the base case.

The expectation for monetary policy response also moved quickly. Fixed-income market participants are now expecting the U.S. Federal Reserve (Fed) to cut the federal funds rate by at least 75 basis points this year.

The financial markets have moved to price in a global recession as attempts to limit COVID-19's spread are likely to involve a severe curtailment of economic activity.

For now, we expect economic activity to remain depressed in March and April, with a sharp rebound beginning in the second half of the second quarter.

There will likely to be a permanent loss of output and corporate earnings relative to expectations at the beginning of this year. We expect losses to be concentrated in travel, daily consumables, and associated services, as these are most likely to be foregone.

At the same time, China is slowly returning to work. For example, in the automotive industry, major global original equipment manufacturers (OEMs) are reopening plants outside of Hubei province (according to J.P. Morgan, HIS Automobile, and newswires), and housing transactions are resuming.

Importantly, J.P. Morgan's Big Data Shipping Index (BIDSI) suggests that domestic shipping volumes have essentially recovered to pre-epidemic activity levels.

China's resumption of economic activity is crucial for global supply chains, and because many factories appear to have enough inventory to maintain production through the first quarter, disruption to global industrial production from China's shutdown may turn out better than feared.

Meanwhile, Chinese authorities have implemented measures to ensure adequate financial liquidity provisions and other support to minimize firms' financial hardship from the coronavirus quarantine. Economic policy makers around the world are also likely to support their domestic economies with additional liquidity provisions in the near term.

A sharp but transient decline in economic activity, together with additional liquidity provisions, leads us to focus on a sequential rebound in economic activity starting in early summer, if not sooner. Financial markets are likely to stabilize well before that.

Investment Implications

Before the outbreak, we expected the economy to continue on its pace of positive (albeit restrained) growth, supporting a continuation of our current positioning. We believed safe havens or crowded (and expensive) defensive trades would likely give way to more attractively valued cyclical industries and companies, as well as broader market participation.

We started to see this play out during the fourth quarter of 2019, where valuation as a factor was the dominant force driving investment returns, reversing course from the previous nine months. As we moved into 2020, optimism around a further cyclical expansion continued.

This led us to a strong preference for companies that demonstrated structural growth advantages, in contrast to the market, whose exuberance was evidenced by a sharp move higher in speculative shares and significant multiple expansion in software and semiconductors.

Thus, we were likely due for a pause, and the COVID-19 outbreak was just the event to tip market sentiment.

It has created meaningful uncertainty about the trajectory of global economic activity, impacting both aggregate demand and numerous supply chains.

Additionally, global crises (specifically those related to healthcare) and the unknown nature of the virus are particularly frightening. They play on our emotions.

All of this has combined for a major reversal of sentiment and a market correction—but given the transient nature of the situation, our outlook and portfolio positioning is largely unchanged, and we are actively looking for opportunities to add value during this period of dislocation.

Ken McAtamney, partner, is a portfolio manager on William Blair's Global Equity team. Olga Bitel, partner, global strategist, contributed to this post.

Disclosure:

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