The Coronavirus and Volatility

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Larry Adam, CFA, CIMA®, CFP®, Chief Investment Officer

Over the past 12 months, the equity market has been incredibly resilient as the S&P 500 posted its best annual (31.5%) and fourth quarter performance (9.1%) since 2013 despite headwinds such as slowing global economic growth, rising recessionary fears, elevated trade uncertainty (between the US and both China and Europe) and increasing noise in Washington (e.g., the 2020 election and impeachment proceedings). This positive price performance led valuation and technical indicators to become stretched by historical standards as evidenced by:

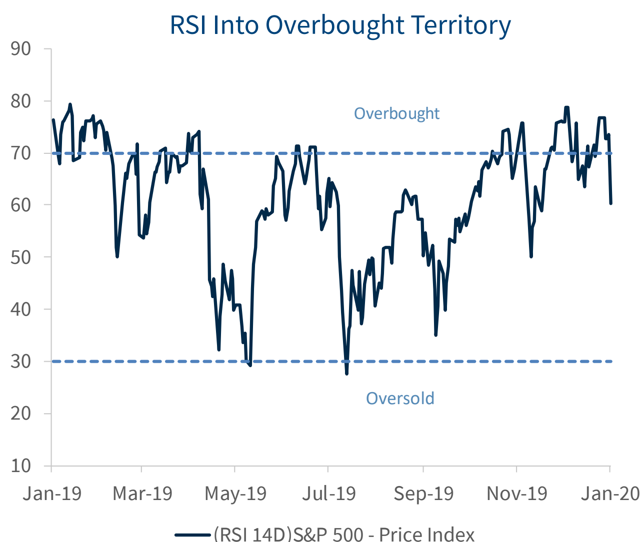
Valuations:

- Trailing 12-month S&P 500 P/E rising to 20.5x, the highest level since January 2018 and above our fair-value of

Technical Indicators:

- The 14-day RSI rising into overbought territory (a level above 70.
- The VIX falling to historically low levels (in January), it fell as low as 12 , well below the previous 20-year average of 19).
- S&P 500 Put/Call ratios declining to multi-year lows.
- The percentage of bullish readings in the AAII Bull/Bear survey rising to the highest level in two years.

RSI Into Overbought Territory



Given these stretched technicals, it is not surprising to see a modest pullback in the equity market. The S&P 500 had not seen a 1% daily decline since October (the longest stretch without a 1% daily decline since October 2018) and experienced only two 5% declines in 2019 (well below the 30-year historical average of four). While the catalyst of this current decline can be attributed to the spread of the coronavirus, we also note that it has coincided with increased uncertainty in the run-up to the 2020 election following Bernie Sanders' surge in both the Iowa and national polls over recent weeks (betting markets now see him as the front-runner) and rising geopolitical risk with the missile attacks on the US embassy in Iraq overnight.

While the extent and impact of this new strain of the coronavirus is uncertain now, there are a number of things to keep in mind.

- **Traceability.** Most of the people that have contracted the flu outside of China had recently visited the Wuhan region (the place of origin for this specific strand of coronavirus), so it is not yet rampantly spreading outside of the region.

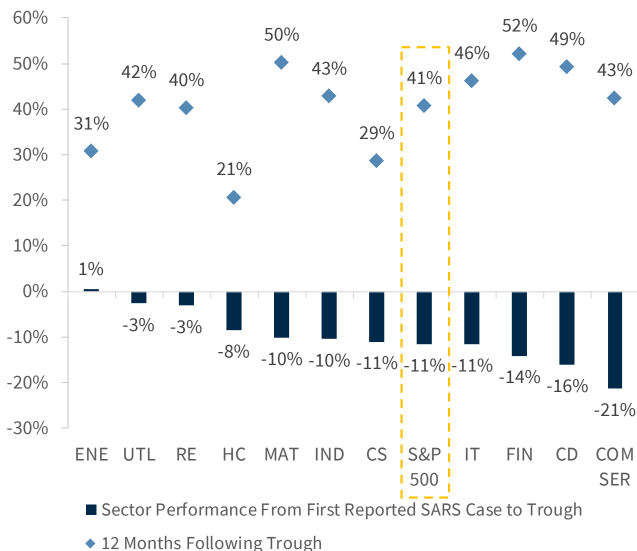
- **Severity.** While this disease is reportedly very contagious and easily transmittable, thus far it has a low mortality rate relative to other serious strands of the coronavirus (e.g., SARS, MERS).

- **Proactive Response.** China has taken significant steps to contain the virus by shutting down/restricting travel in impacted cities (encompassing around 30 million people) and extending the Chinese Lunar New Year holiday season.

Historical Market Performance. The eventual impact of the the coronavirus outbreak on financial markets is currently hard to quantify, but the outbreak of SARS in 2002 can provide a parallel. In the case of SARS, the VIX rose sharply, Treasury yields declined and the S&P 500 declined over 10% (led by more consumer-related sectors as consumer confidence declined in part due to uncertainty surrounding the virus). The US eventually escaped any SARS fatalities and the decline proved to be short-lived with the S&P 500 rallying 40% over the 12 months following

the SARS-related trough. A similar pattern of a short-lived decline followed by a rebound in the equity market was exhibited during the MERS and Ebola outbreaks.

Historical Sector Performance During SARS



Current Market Response. As expected, markets have reacted to the increasing uncertainty around growth:

- Treasury bonds rallied as yields have fallen; the 10-year Treasury yield is down to 1.61%.
- The yield curve flattened; the 10-year/2-year spread narrowed to 17 bps (vs. 35 bps at the end of 2019).
- Oil prices are down on demand concerns.
- Cyclical sectors are down the most (Energy, Materials, Technology and Industrial).
- EM and European equities are underperforming the US as they are more levered to EM growth.

Bottom Line. Thus far, the decline in US equities has been fairly limited with the S&P 500 only 2.3% off of all-time highs, but volatility will likely remain elevated until the spread of the virus is under control. Emerging markets and cyclical sectors will likely remain under pressure, as the positive move to begin the year was driven by a turnaround in global economic growth that is now being questioned due to the coronavirus impact. However, the CDC maintains that the probability of a widespread outbreak of the coronavirus in the US is low. We would use any periods of weakness in US equities as a buying opportunity to add to our favorite sectors (Info Tech, Financials, Communication Services, Industrials and Health Care) as fundamentals (e.g., no recession over the next 12 months, an accommodative Fed and an acceleration in earnings growth) continue to support a move higher in equities in 2020. As a result, we reiterate our 3,350 year-end 2020 S&P 500 price target and continue to see upside for the S&P 500 over the next 12 months.

Scott Brown, PhD., Chief Economist

Pandemics, the rapid spread of an infectious disease across a wide area, have been a regular part of human history. We have better hygiene and healthcare these days, but the increase in global travel means that diseases can spread more rapidly and widely. Some pandemics have been moderate. Some have been severe. Containment is a high priority. The 1918 influenza pandemic (Spanish flu) infected half a billion people worldwide and killed 50-100 million. The Severe Acute Respiratory Syndrome (SARS) pandemic of 2002-03 killed 775 people (but had a big impact on the Southeast Asian economy). The Ebola virus killed over 11,000 people in 2013-16.

The Wuhan coronavirus has infected over 3,000 people, including five cases in the US, and has killed more than 80. It's believed that the virus has an incubation period of 10-14 days, meaning that a person could show no symptoms and pass the virus on to others. In China, the timing could not have been worse, coming days ahead of the Lunar New Year celebrations. Hundreds of millions of people travel during the holiday period, which lasts several days. The Chinese authorities have restricted travel to and from Wuhan (a city of over 10 million) and other cities, which will help to contain it. Schools have closed until mid-February. The US cases were directly traced to Wuhan, so the virus seems unlikely to spread here.

Pandemics can have a large impact on economic activity, reducing business activity and travel. The price of oil has declined on expectations of reduced demand. It's hard to tell when the virus will be contained. The long incubation period implies that it will be at least a few weeks, but perhaps a month or more. Financial markets should recover as the virus is contained, amid evidence that economic disruptions are subsiding.

Uncertainty is a negative factor for the stock market. That is what we are seeing now. US equity valuations were already pretty rich, so a moderate pullback is healthy. Slower global growth was a restraining factor for the US economy in 2019. World output has been widely expected to pick up in 2020, but the Wuhan virus should be a minor setback. Beyond the near-term impact of the Wuhan virus, the US economy appears set to achieve moderate growth in 2020.

Pavel Molchanov, Energy Analyst, Equity Research and **Chris Meekins,** Health Care Analyst, Equity Research

A few key points we want to discuss:

• The United States government is *very* prepared for this, and we doubt it will become a major issue in the US. We suspect more cases will show up in the US and death is possible though unlikely.

• The situation in China is significantly worse than what the government there is saying with likely 10x the publicly reported number of cases and deaths.

• The focus of product development is on diagnostics to identify disease quickly (currently specimens have to be sent to CDC) with a focus then on treatments and vaccines.

The United States government is the global leader in infectious disease response. HHS Secretary Azar was at the department during both the H1N1 pandemic, anthrax attack, and SARS outbreak. He is prepared to lead. Through the Strategic National Stockpile, the US has millions of masks and other critical items if the US needed to mount a response, something we doubt.

While the broader equity markets have thus far taken the Chinese coronavirus outbreak more or less in stride, the same cannot be said for oil. The spot price of Brent crude fell 6.5% last week as the headlines worsened, pushing the price below where it had been prior to December's US/China phase one agreement and the UK general election, not to mention the Iran war scare in early January.

Michael Gibbs, Managing Director of Equity Portfolio & Technical Strategy, and **Joey Madere, CFA,** Senior Portfolio Strategist, Equity Portfolio & Technical Strategy

The pullback in equities (-2.3% off the highs) on coronavirus concerns comes at a time when investor sentiment had gotten very complacent (i.e., low put/call ratio and VIX) and stocks had reached overbought levels (i.e., up 15% since October 2 and 11% above its 200 DMA). The market was in need of a pause or consolidation period to digest its recent strength, and the coronavirus is now acting as the catalyst. Looking back at prior epidemics, short-term volatility tends to increase (causing some near-term noise), but the economic and market impact ultimately has been short-lived. Moreover, the current S&P 500 pullback comes from a position of intermediate-term technical strength, contributing to our stance that this is creating a buying opportunity. Our overriding positive theme of sustainable US economic growth, a dovish Fed, recovering earnings per share growth, and a rebound in US manufacturing are all likely to remain tailwinds for US equities despite the unfortunate virus outbreak. Our favored area of potential support during this pullback is somewhere near the 50-day moving average of 3,199, followed by horizontal support at 3,074. If the selling carries beyond what we view as realistic, the upward trending 200 DMA of 3,005 is likely as bad as it gets. We would accumulate the weakness in under-invested portfolios.

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VIX is the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. The VIX is a widely used measure of market risk. The Relative Strength Index - RSI is a momentum indicator that measures the magnitude of recent price changes to analyze overbought or oversold conditions. It is primarily used to attempt to identify overbought or oversold conditions in the trading of an asset.

The 200-day moving average is a popular technical indicator which investors use to analyze price trends. It is simply a security's average closing price over the last 200 days. The 50-day moving average is one of the most commonly used indicators in stock trading.

Sector investments are companies engaged in business related to a specific sector. They are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification.

Source for charts: FactSet

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