Coronavirus continues to create chaos in the investment markets

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Stocks have dropped nearly 10% in the past week; bond yields have plunged to all-time lows and the investment world is still trying to assess the long-term impact of the coronavirus (formally known as COVID-19).

The virus has spread well beyond the borders of China and the Far East, with nearly 30 countries outside of China reporting confirmed cases of COVID-19—and the number continues to rise. The last weekend of February saw outbreaks in western Europe, including the Lombardy region of northern Italy. Iran has also confirmed multiple infections in the past week, and Brazil recently reported the first case in Latin America.

This strain of virus can be contagious for some period without an individual displaying any outward signs of the infection, which is why officials have made the decision to quarantine large numbers of people for at least a 14-day incubation period. In China, business facilities were ordered closed and other steps were taken to limit large concentrations of people in the hope of minimizing the risk of contamination.

These steps appear to be having the desired effect in China where the number of reported new cases may have peaked. That said, with the spread of infections moving beyond the Far East, there is growing concern that the stringent measures taken in China will have to be implemented much more broadly around the world.

Manufacturing firms feel the hurt

The economic impact of COVID-19 is now becoming evident well beyond the borders of China. Supply chain disruption is among the chief concerns. Many suppliers of goods for both end-products and components of production systems are based in China and the Far East. As a result, companies in the United States and abroad are finding it increasingly difficult to source inventory or parts necessary to manufacture their products. For instance:

- In recent corporate announcements, more than a third of S&P 500 companies mentioned the potential for some impact from the COVID-19 virus on the outlook for 2020, indicating that the specific impact is too difficult to quantify until greater clarity on the extent of the epidemic can be defined.

- Apple recently announced that production and supply of its products are being constrained and sales have fallen sharply, particularly in China.
- The China Passenger Car Association announced that retail auto sales in China in the first 16 days of February fell 92% on an annual basis. At this point, sales are expected to be down about 10% for the 1st quarter and 5% for the year.
- Other businesses in China are experiencing a similar impact—which could have a significant effect on the global economy. When the SARS epidemic hit back in the early 2000s, China made up just 4% of global GDP. Today, it accounts for 17%, so events there have a much greater impact on the global economy than they did in the past.

Short-term impact

The headlines on COVID-19 have been dramatic, and the short-term economic impact continues to be real. Global economic output will be negatively impacted by the virus and the actions taken to stem the spread. Until there is confirmation that the virus has been contained, it will be impossible to fully quantify that impact.

The reaction in the financial markets the past two weeks has been heightened by the recognition that the virus is not confined to Asia. As such, the total impact on global economic activity remains undefined but certainly worse than previously anticipated. Both the duration and magnitude of its impact before the issue is resolved appears to be ill-defined, contributing to the uncertainty—particularly in light of the rapid expansion of the epidemic beyond the Far East.

The growing crisis has had a significant impact on several areas of the economy:

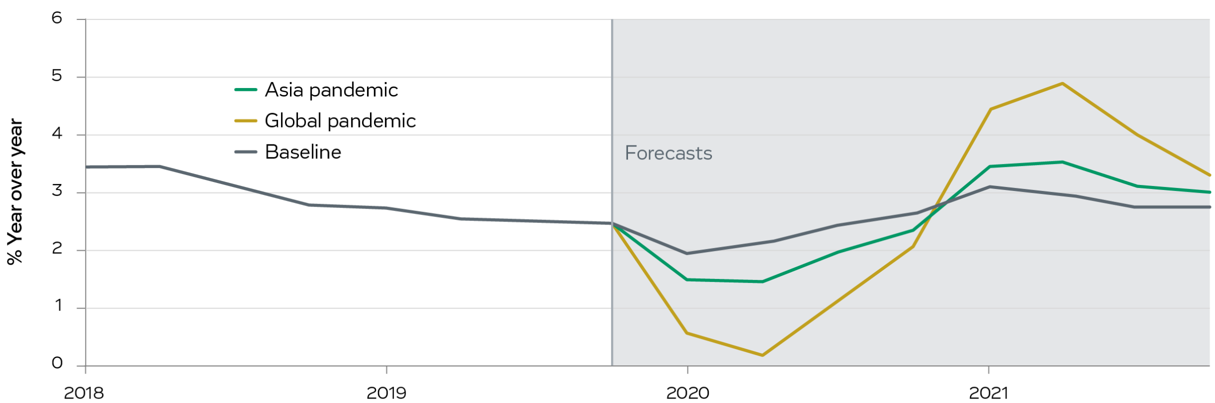
- Oil markets have come under severe selling pressure as global travel has slowed. The price of a barrel of West Texas Intermediate, a grade of crude oil used as a benchmark in oil pricing, has dropped by more than 20% since the outbreak began in January.
- Equity markets, which were already extended after a strong increase over the last 15 months, have been under severe pressure. While the recent advance in stock prices was created by the expectation of a resurgence in global growth and economic activity, those assumptions have been undermined by the spread of the epidemic.
- Safe haven assets, such as government bonds, have rallied sharply, pushing down yields. Yields on bonds, such as 10-year U.S. Treasuries, have dropped to record lows, and credit spreads have widened amidst growing concerns regarding the effect that a global economic slowdown would have on credit quality.
- Gold has also rallied. Like government bonds, gold is considered to be an asset that may offer protection or a hedge against unspecified financial risks and tends to perform well in heightened periods of market and economic uncertainty.

Long-term perspective

At some point, the spread of the virus will be contained, just as it was for other epidemics and pandemics. At that point, we believe it is highly likely that economic activity will rebound, perhaps sharply, as spending that was either delayed or deferred resumes, production recovers and inventories are restocked.

The graph below shows the likely path of slowdown and recovery under an epidemic/pandemic paradigm. We believe that equity markets and risk assets in general would follow a similar pattern.

World: GDP growth in pandemic scenarios
2018 – 2021



Source: Oxford Economics

In the immediate term, one must not be optimistic about the shift in the outlook related to these events. This is a new virus and, while one can hypothesize based on experience with prior events, such as the Swine Flu, SARS and others, there is still some degree of uncertainty until we more completely understand the pathology of COVID-19.

As such, financial markets will likely continue to be volatile and will continue to react to the incremental news headlines related to the expansion or containment of the disease. No doubt, risks to both the economic and equity market outlook have increased, but, in the absence of a recession, any equity market correction related to this event would likely be reversed with positive signs of progress in containing the virus.

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