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MARKET MATTERS

SPECIAL UPDATE February 28, 2020

COVID-19 Market Impact Update

Earlier this week the Advisor Group Investment Research Team released a short notice on the market impact of the global coronavirus ("COVID-19") outbreak. This update seeks to provide some additional background. Between February 19 and February 27, the S&P 500 Index dropped 12% with declines greater than 3% in three of the last four days. The decline in the S&P 500 over the last six trading days is the quickest correction (defined as a decline from a peak of 10% or greater) in the S&P 500 on record. Meanwhile the yield for the 10-year Treasury note declined from 1.56% to an all-time low of 1.30% during the same timeframe, indicating a flight to safety and perhaps causing investors to rethink their portfolio allocations.

Prior to making any allocation decisions, it is important to place recent market volatility in a wider context. On the positive side, while the virus' spread is expected to continue across the globe, China was able to provide the world an early heads up, the World Health Organization ("WHO") is better prepared, the growth of new cases has slowed in China, and early indications are that COVID-19 is not as deadly as prior major health outbreaks. While it appears likely that global economic growth will be impacted in the short term, the intermediate- to long-term outlook is more positive. However, there are bound to be sudden increases in cases, including in the U.S. Additionally, if COVID-19 becomes a pandemic, then all current projections go out the window. In any case, such outbreaks eventually get contained, so it is important to keep a long-term investing approach and avoid selling low during the outbreak and buying high after containment. A major correction in U.S. equity markets was already probable during the longest bull market in history with or without a coronavirus outbreak.

The Virus was Already There

The sudden market declines earlier in the week were in part prompted by an increase in COVID-19 cases in Italy, Iran, and South Korea. However, the virus was already present in both Europe (including Italy) and South Korea since late January.[1] The surprise was not so much the location, but the number of new diagnoses. The fear is that COVID-19 will be more difficult to contain than expected. The developments in Iran were more recent, but this is an under-resourced country hurt by economic sanctions and the WHO has indicated that it will provide medical and testing supplies.

[1] HealthMap. https://www.healthmap.org/covid-19/. Visited February 27, 2020.

Mind Your Valuations

The 4.4% drop in the S&P 500 Index on Thursday, February 27, was partly driven by corporate earnings warnings. According to FactSet, the S&P 500 Index was trading at a forward 12-month P/E ratio of 18.8 as of February 19, compared to a five-year average of 16.7 and a 20-year average of 15.5.[2] If we update the calculation with the S&P 500 Index value as of February 24, we get a forward P/E ratio of 16.6, although that ratio could go up if expected earnings are revised down. We note that expected earnings were already declining before the COVID-19 outbreak. Data from Morningstar Direct indicates that most global equity markets were undervalued as of February 25. U.S. equities were considered fairly valued three months ago and overvalued five years ago, according to Morningstar.

China and WHO Responded Quickly

The WHO, which was heavily criticized for its response to the Ebola outbreak in 2014,[3] has been responding much more quickly to the COVID-19 outbreak. China has also been commended for its fast response.[4] The new virus strain was first reported to China's Center for Disease Control ("CDC") on December 26, 2019; reported to the WHO on December 31, 2019; identified on January 7, 2020; and sequenced by January 12, 2020; with testing kits available by January 13, 2020. That unprecedented speed allowed the rest of the world to prepare. However, China was criticized for its heavy-handed approach and it is unlikely that other countries will implement such extensive restrictions on movement.[5] Over 95% of global confirmed cases have been within mainland China and growth of new cases slowed significantly starting mid-February.[6]

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[2] "Earnings Insight," FactSet. https://www.factset.com/hubfs/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_022120.pdf. February 21, 2020.

[3] "Experts Criticize World Health Organization's 'Slow' Ebola Outbreak Response," *Wall Street Journal*. https://www.wsj.com/articles/experts-criticize-world-health-organizations-slow-ebola-outbreak-response-1431344306. May 12, 2015.

[4] "You're Likely to Get the Coronavirus," *The Atlantic*. https://www.theatlantic.com/health/archive/2020/02/covid-vaccine/607000/. February 24, 2020.

[5] "The World Health Organization Draws Flak for Coronavirus Response," *Wall Street Journal*. https://www.wsj.com/articles/the-world-health-organization-draws-flak-for-coronavirus-response-11581525207. February 12, 2020.

[6] John Hopkins University. https://gisanddata.maps.arcgis.com/apps/opsdashboard/index.html#/bda7594740fd40299423467b48e9ecf6. Visited February 27, 2020.

More Transmissible, but not as Deadly

COVID-19 is not as deadly as previous outbreaks, such as SARS (severe acute respiratory syndrome) and MERS (Middle East respiratory syndrome), which were also types of coronavirus, but is more transmissible. So far, COVID-19 has a mortality rate of 2.3%, compared to 9.6% for SARS and 34.4% for MERS. While SARS and MERS primarily spread through hospitals, COVID-19 has primarily spread through close contacts such as friends and family, although there is a new case in the U.S. that may have been contracted from general exposure in the community (and was another driver in Thursday's decline in the S&P 500 Index). About 81% of cases have been classified as mild. However, older patients are much more susceptible and have a mortality rate of up to 49%.[7]

Muted Economic Impact?

Based on the expectation of a continued, but managed, spread of the virus, the IMF,[8] IHS Markit,[9] and other commentators expect more than 5% annual GDP growth in China and a rather muted impact globally. GDP growth in China is expected to rebound in the second half of the year due to extensive fiscal and monetary measures implemented by the Chinese government, according to IHS Markit, and due to manufacturing having pent-up demand (unlike services, where the revenue is unlikely to be recovered). Companies with supply chains tied to China are more likely to be impacted, but companies across all sectors have cited negative impacts.[10] We find the IMF's and IHS Markit's growth expectations to be on the optimistic side, but we do believe that the long-term impact should be limited.

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[7] "Study of 72,000 COVID-19 patients finds 2.3% death rate," Center for Infectious Disease Research and Policy. http://www.cidrap.umn.edu/news-perspective/2020/02/study-72000-covid-19-patients-finds-23-death-rate. February 24, 2020.

[8] "Remarks by IMF Managing Director Kristalina Georgieva to G20 on Economic Impact of COVID-19," International Monetary Fund. https://www.imf.org/en/News/Articles/2020/02/22/pr2061-remarks-by-kristalina-georgieva-to-g20-on-economic-impact-of-covid-19. February 22, 2020.

[9] "Impact of COVID-19 on the Chinese and global economy," IHS Markit. https://ihsmarkit.com/research-analysis/impact-of-covid19-on-the-chinese-and-global-economy.html. February 18, 2020.

[10] "What Apple, Microsoft, Nike and other U.S. companies are saying about the coronavirus outbreak," *MarketWatch*. https://www.marketwatch.com/story/what-apple-walmart-and-other-us-companies-are-saying-about-the-coronavirus-2020-02-18. February 27, 2020.

The P-Word

While the spread of COVID-19 has slowed, we cannot predict the future. It is still possible that the trends reverse or that the virus becomes a pandemic,[11] in which case all current projections would be nullified and volatility in equity markets would likely surge until containment improves. With or without a coronavirus outbreak, though, there is always a risk of a major market correction due to a variety of unpredictable reasons. It is therefore important to keep a long-term investing approach. It is reasonable to update risk tolerances in light of recent developments, but also important to avoid selling low during a correction and buying high during a recovery. Note that we have already been in the longest U.S. equity bull market in history and the S&P 500 Index was last at its current level (2979 as of February 27, 2020) in October 2019. With valuations high even before the outbreak, as explained earlier, the risk of a correction was already elevated.

Market Reactions to Prior Outbreaks Not Instructive

The table below outlines how the S&P 500 Index has reacted in the six months and year following previous health outbreaks since the 1980s. It appears that factors other than the outbreak drove market returns. Additionally, the outbreaks did not occur during an extended bull market and therefore do not offer many lessons. The most useful insight is perhaps to reiterate the importance of maintaining a long-term investment approach.

Epidemic	Month End	6-month change in S&P 500	12-month change in S&P 500
HIV/AIDS	June 1981	-0.3%	-16.5%
Pneumonic plague	September 1994	8.2%	26.3%
SARS	April 2003	14.59%	20.76%
Avian flu	June 2006	11.66%	18.36%
Dengue Fever	September 2006	6.36%	14.29%
Swine flu	April 2009	18.72%	35.96%
Cholera	November 2010	13.95%	5.63%
MERS	May 2013	10.74%	17.96%
Ebola	March 2014	5.34%	10.44%
Measles/Rubeola	December 2014	0.20%	-0.73%
Zika	January 2016	12.03%	17.45%
Measles/Rubeola	June 2019	9.82%	N/A

Source: MarketWatch

[11] "H1N1 Was The Last Pandemic. Here's Why COVID-19 Isn't Yet In That Category," NPR. https://www.npr.org/sections/goatsandsoda/2020/02/24/808957041/h1n1-was-the-last-pandemic-heres-why-covid-19-isn-t-yet-in-that-category. February 24, 2020.

Advisor Group is closely monitoring market conditions and is here to assist you with reviewing developments. The current volatility serves as a reminder to your clients of the importance of maintaining diversified portfolios across multiple asset classes. Timing the market is a very difficult task as market conditions can change abruptly. It is prudent for clients to maintain a long-term investing approach.

If you have any questions about financial markets or investments that are offered at Advisor Group, please feel free to contact the Sales Desk at 800-558-7735 or you may reach Product Research by email at agr@advisorgroup.com.