Special report: Coronavirus

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What's an investor to make of the recent violent upheaval in the stock market? Does the spread of the new coronavirus outside of China signal a pandemic that will spark a global recession?

On February 19, the stock market as measured by the S&P 500® index hit an all-time high of 3386. Yet by month-end, as news about the coronavirus worsened, the index plunged 13%. Along with stock prices, oil, copper and other industrial commodity prices tumbled, while flight-to-safety assets like gold and Treasury bonds rallied. Surely all this must signal major economic troubles ahead.

The purpose of this report is to provide investors a perspective on the investment implications of the global medical crisis caused by the spread of the coronavirus and its associated disease, COVID-19. At this point in time there is much the world's medical experts still don't know about COVID-19, so any forecast or recommendation contains a high degree of uncertainty and risk.

In addition, it is difficult to discuss the economic and investment implications of a public health emergency without appearing to be unsympathetic. That is not my intent, as I recognize that the coronavirus will cause immense human suffering around the globe.

Anatomy of a stock market decline

In recent months, many market pundits, myself included, pointed out that the US stock market was selling at high price/earnings ratios relative to historical norms. In 2019, the S&P 500® index gained 29% while its earnings grew only about 2% due to a slump in global manufacturing. Last year, the market was driven up by an expanding P/E multiple thanks in part to three Federal Reserve interest-rate cuts. By year-end 2019, the US stock market was selling at 19.9 times trailing four quarter earnings: P/E ratios above 20 often spelled trouble in the past.

By mid-February, the index was up another 5% amid growing signs of a worldwide recovery in manufacturing. This recovery was expected to ignite better US earnings growth, maybe 5%-7% in 2020, and, thus, "justify" the lofty P/E on the US stock market.

Alas, when it became clear COVID-19 was not just a China story but a global story, the US stock market declined, as investors assumed, correctly in my view, that worldwide efforts to contain the virus would prevent any corporate earnings growth in 2020.

With the recent drop in prices, the S&P 500® index closed February at 2954. If operating earnings for the index in 2020 are indeed the same as last year, $164, then stocks now sell at a more reasonable 18 times earnings. That may not seem like a big improvement, but it is compared to the bond market. Since year-end, the 10-year Treasury yield dropped from 1.92% to close February at 1.15%, a new record low for yields on this security. The decline in stock prices has pushed the dividend yield on stocks from 1.8% at year-end to 2.0%, well above the current yield on the 10-year Treasury.

Unless the US is on the brink of a protracted recession, the US equity market has become much more attractively valued due to the recent market downturn.

What's the likely impact on the US economy?

The impact of the coronavirus on the US economy will be severe. The key question is: how long will it last?

I believe — assume is a better word — the economic impact of this medical crisis will most likely be limited to the first half of 2020, followed by a sharp recovery in the second half of the year. To illustrate my views, I've prepared Exhibit A which shows my estimates for key economic and market variables before and after the advent of the coronavirus.

How can you predict the future of the economy given the great unknowns surrounding the virus? There have been a number of pandemic scares over the past 20 years and all seem to follow a pattern: They start with alarming headlines about potential risks, they are followed by aggressive intervention measures by public health authorities, then they eventually either 1) blow over (flu tends to be a seasonal illness that dissipates with warmer weather), 2) get contained and controlled by public health authorities within several months or 3) turn out to affect only a relatively small and geographically confined population.

There was SARS or Severe Acute Respiratory Syndrome in 2003. It was deadly (10% fatality rate) but confined mostly to China and killed less than 10,000 worldwide. There was bird flu in 2006. It was extremely deadly, but also extremely difficult to spread from human to human, so it killed relatively few people.

There was swine flu in 2009. Now, this was a true pandemic. It's been estimated that 10% to 20% of the world population got the swine flu. It was the same H1N1 flu virus that caused the great Spanish Flu pandemic of 1918-1919. Thankfully, the swine flu of 2009 had a very low fatality rate — less than one-tenth of one percent — and dissipated in 2010. (Today we have antibiotics to treat respiratory infections. They didn't exist in 1918.)

Exhibit A

Forecasts of economic and market indicators before and after coronavirus

		2019 Actual	2020 Estimate	2021 Estimate
US GDP Growth	Before	2.3%	2.1%	2.0%
	After	2.3%	1.5%	2.3%
Consumer Prices (CPI)	Before	2.3%	2.4%	2.5%
	After	2.3%	1.7%	2.2%
S&P 500 Earnings	Before	$164	$175	$185
	After	$164	$164	$185
Fed Funds Rate	Before	1.6%	1.6%	1.8%
	After	1.6%	1.1%	1.3%
10-Year Treasury Note	Before	1.9%	2.2%	2.5%
	After	1.9%	1.5%	2.1%

Sources: Bloomberg, Atlanta Capital, Bureau of Economic Analysis, US Deptartment of Labor as of February 28, 2020.

In 2013, MERS, Middle East Respiratory Syndrome, popped up with an over 30% fatality rate. In the seven years since, only several thousand cases have been identified worldwide, mostly in the Mideast. In 2014, the deadly Ebola virus made the news when an American doctor contracted the disease treating patients in Africa. The death rate from Ebola is about 50%. The virus has been around for decades with most cases confined to West Africa. A vaccine for Ebola was approved last year.

Fortunately, in all the cases mentioned above, the stock market was higher a year following the first news of the crisis and the global economic impact from these medical crises was minimal.

Which brings us to the current health crisis, COVID-19. As of this writing — noon on March 3 — there are 92,303 identified cases of the virus worldwide, which have resulted in 3,101 deaths. In the US so far, there have been 106 cases with six deaths. For comparison, the Centers for Disease Control and Prevention reports that this flu season in the US has afflicted 32 million people and resulted in at least 18,000 deaths.

About 90% of the cases and deaths from COVID-19 are from China. Other hard-hit countries include South Korea, Italy, Iran and Japan. Collectively, these countries account for about 28% of global GDP. Their economies will be hardest hit by the virus. It's also worth noting that China, Korea and Japan are important links in the global supply chain for many manufactured products, so factory shutdowns in these locations will have global ramifications.

The major fear, of course, is that the virus is spreading rapidly outside of China, so headlines about new cases and deaths are getting close attention. Getting less attention are people recovering from the disease.

According to the Johns Hopkins University coronavirus tracking map (probably the most reliable source of up-to-date data), recoveries from COVID-19 total 48,190, about half of the reported cases. In the US, there are eight reported recoveries.

Since February 18, the daily number of recoveries worldwide has exceeded new cases. Granted, most of these recoveries are occurring in China, which has experienced the virus longer than the rest of the world. But these recoveries do seem like good news that is being overlooked by the news media. Recent reports from Starbucks and Apple as well as the Chinese government suggest that business activity in China is beginning to pick up.

I suspect that the coronavirus health crisis will play itself out like most of the others have. It will eventually get contained and controlled by public health authorities. COVID-19's impact on the global economy, however, will be severe over the next three to six months as people and businesses "self-quarantine." If there is one economic rule of thumb about dealing with a global pandemic it is that "the cure is often worse than the disease," i.e, the economic cost of prevention and containment exceeds the economic loss from death and treatment.

The coronavirus threw sand in the gears of a world economy on the cusp of a manufacturing-led rebound. Until the public health authorities get the virus under control, the economy of Europe will decline and the Americas will stall. For the US, that probably means no GDP growth in the second quarter, with a rebound beginning in summer. Inflation and interest rates will be lower than they would have been without the virus. My forecasts in Exhibit A reflect the before and after impacts from the virus.

Exhibit B

Stock market decline has improved valuations, but credit markets are flashing warning signs

Indicator	Rationale	December 31, 2019	March 3, 2020
The yield curve: Short- vs. long-term interest rates	When short-term interest rates rise to meet or exceed long-term rates, monetary policy is usually tight enough to eventually cause a recession.	Curve has steepened as Fed cut rates three times in 2019. Curve still relatively flat	Recent Fed rate cut has kept yield curve flat
Widening spread between high- and low-quality bond yields	A widening spread between junk bond yields and Treasuries indicates deteriorating credit market conditions.	Credit Spreads are still narrow	Credit spreads have widened on fears of global recession
Rising wage inflation	When wages rise at a 4% annual rate, it is difficult for the Fed to keep core inflation near its 2% goal. So the Fed usually tightens policy aggressively.	Wage growth still well contained at about 3.1%	Wage growth still well contained at about 3.1%
S&P 500 P/E ratio over 20 times	Price/earnings ratios over 20 times trailing four quarter earnings makes stocks vulnerable to rising interest rates and inflation.	Rising stock prices and lackluster earnings push P/E up to 19.9x	Recent decline in stock prices has lowered the market P/E to 18.0x
Downturn in Leading Economic Index®	The Conference Board's LEI has peaked and turned down in advance of each recession since 1960. Average lead time is 13 months.	Still relatively flat over last six months	Last reading ticked up a bit, but still relatively flat

Sources: Bureau of Labor Statistics, The Conference Board, Bloomberg, Atlanta Capital.

What should investors do now?

No need to panic: The stock and bond market did that for you last week. The kinds of companies you would expect to be hurt in an economic slowdown brought on by a global pandemic are the ones that declined the most in late February — cruise lines, gambling casinos, hotels, airlines, oil companies and the like.

It's a little late to be making major adjustments in portfolio holdings based on the coronavirus, because much of the increasingly negative news has already been reflected in stock and bond prices. Sometimes doing nothing can be a good investment strategy. This is probably one of those times.

That said, here are some investment management issues to keep in mind over the next few months as the effects of COVID-19 play out on the world stage.

1. The worst US economic news is still ahead of us. Expect to start seeing bad economic news starting in March, and lasting until at least May.
2. Don't forget to adjust your stock/bond mix. The decline in stock prices and rally in bond prices increased the attractiveness of stocks relative to bonds. Most investors should maintain their target asset allocations.
3. While the Federal Reserve is likely to maintain an easy monetary policy over the balance of 2020 and may even cut interest rates further, the private credit markets are in the process of tightening credit conditions due to the virus-induced economic slowdown. Remain very quality-conscious in both your stock and bond selections.
4. Stock prices became deeply oversold in the late-February market debacle. From here, a normal pattern for stock prices would be a rally followed by a decline to test the lows as of February 28, 2020, about 2855 on the S&P 500. In other words, equity investors should not get overly optimistic if stocks rebound in the near term — prices are likely to back and fill over the next month or so.

Exhibit B shows the current reading on the five stock market indicators that I track. Collectively they indicate a reasonably favorable environment for equity investors. However, no set of leading indicators of stock market behavior are capable of accounting for the vagaries of a heretofore unknown pathogen capable of infecting millions of people worldwide. History suggests that medical science will again save us from our worst fears about the coronavirus. Let us hope that the coming months will at least rhyme with the history of the past two decades.