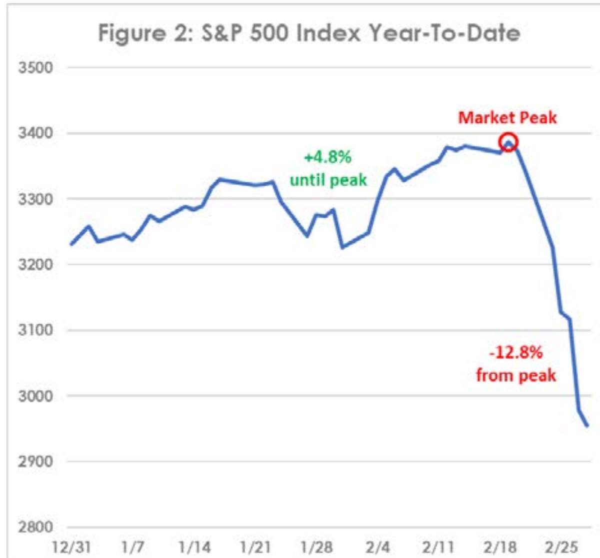
2020 CORONAVIRUS IMPACT ON MARKETS

SUMMARY

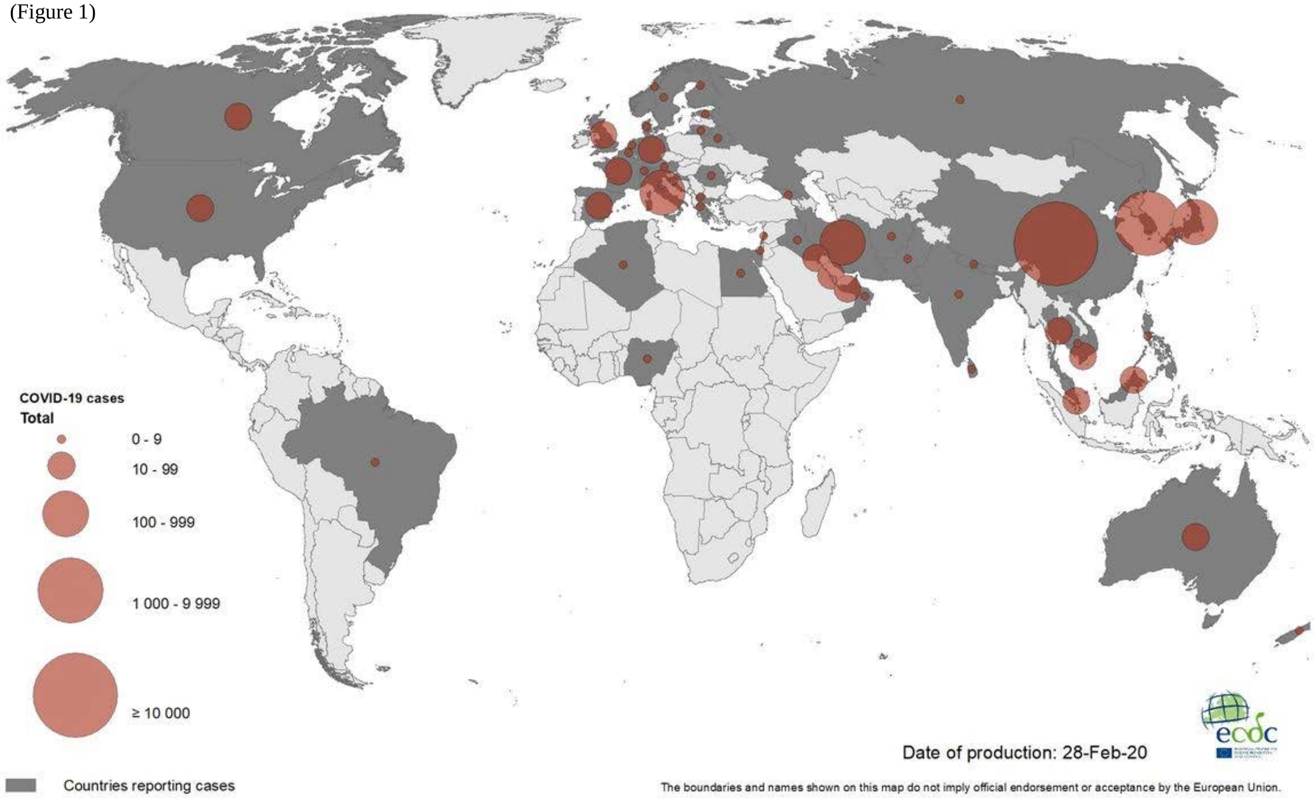
The year 2020 began with consensus expectation of synchronized stimulus and recovery in global growth despite some obvious risks, chief among them the outcome of the U.S. presidential election.

As is often the case, a completely unexpected event took markets by surprise as a new virus threat (Coronavirus or COVID-19) emerged in China in January. Quarantine measures implemented by the Chinese government to contain the outbreak led to severe disruptions in local economic activity, straining global supply chains in an increasingly interconnected world.

After an initial sell-off in January, markets rallied in early February on optimism that containment measures in China were effective and the impact of COVID-19 would be limited in time. However, since February 24th, the appearance of new infection clusters in South Korea, Italy and Iran raised the specter of a global pandemic, with the potential to tip the global economy into a recession (figure 1). Equity markets responded to the threat by entering correction territory, down 12.8% since its peak on February 19th (figure 2).



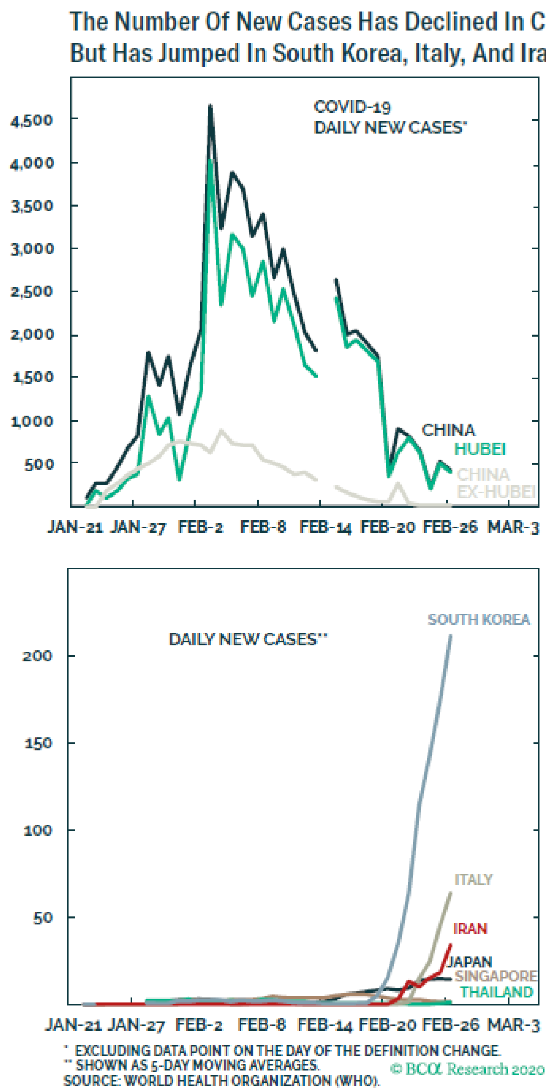
(Figure 1)



COVID-19 INFECTION

Since the beginning of the infection in Hubei province, China imposed unprecedented quarantine measures. The good news is that these policies appear to be effective in limiting the spread of the virus and the number of new cases has declined (figure 3). What spooked the market was the jump in new cases appearing outside of China, notably in South Korea.

(Figure 3)



Source: BCA Research.

What differentiates COVID-19 from earlier viruses such as SARS (Severe Acute Respiratory Syndrome, which affected 80,000 in 2003) include an extended incubation period and asymptomatic patients, contributing to high infection rates and unreliable case identification. The fear is that few countries outside China would be able or willing to impose similarly draconian measures to limit infections.

Mortality rates for the disease seem to be in a 2-3% range. However, it is believed that this rate would drop if more asymptomatic cases were diagnosed.

Within fatalities, COVID-19 disproportionately affects the elderly population (Figure 4).

COVID-19 Fatality Rates By Age (Figure 4)

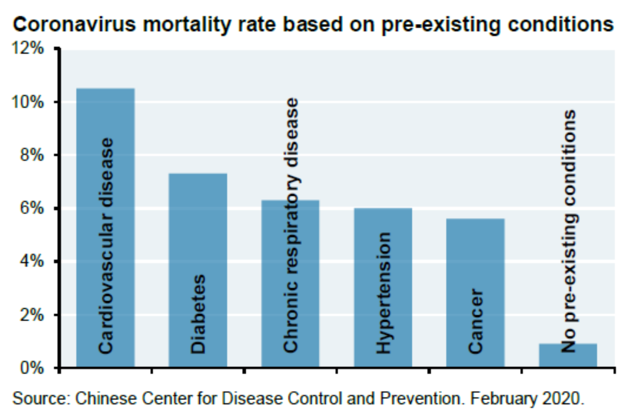
AGE	FATALITY RATE *(%)
80+ YEARS OLD	14.8
70-79 YEARS OLD	8.0
60-69 YEARS OLD	3.6
50-59 YEARS OLD	1.3
40-49 YEARS OLD	0.4
30-39 YEARS OLD	0.2
20-29 YEARS OLD	0.2
10-19 YEARS OLD	0.2
0-9 YEARS OLD	NO FATALITIES

* FATALITY RATE = (NUMBER OF DEATHS / NUMBER OF CASES) = PROBABILITY OF DYING IF INFECTED BY THE VIRUS (%). ANALYSIS BASED ON CASES DIAGNOSED AS OF FEBRUARY 11, 2020.
SOURCE: CHINA CDC.

Source: BCA Research.

In addition, pre-existing conditions play a major role in mortality (Figure 5).

(Figure 5)



Source: JP Morgan.

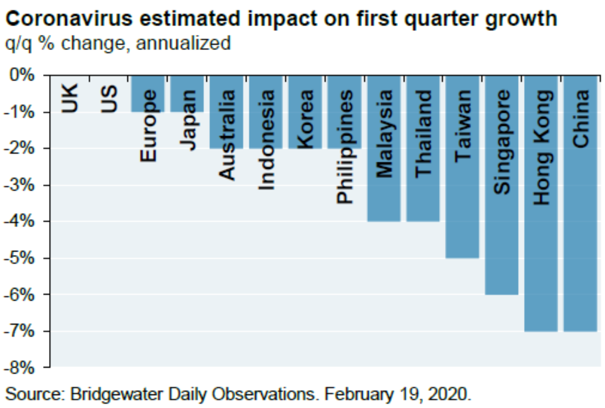
Finally, behavioral and environmental factors may also play a role. COVID-19 is particularly lethal for people with compromised lung capacity and China suffers from poor air quality and high smoking rates. If these factors contribute to mortality for COVID-19, mortality rates may be lower outside China.

MARKET IMPACT & OUTLOOK

Beyond the human cost of the infection, the initial economic impact was always going to be felt in and around China as quarantine measures curtailed activity and trade.

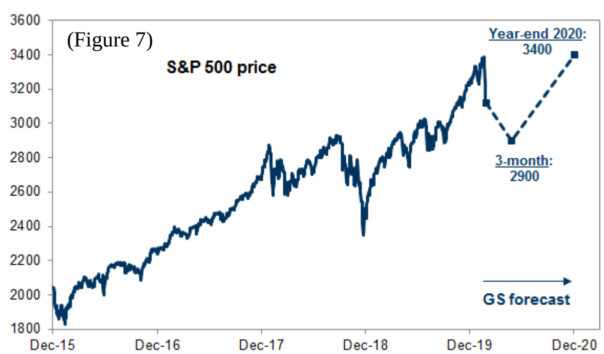
As shown below in figure 6, before news of infections spreading to other countries, the economic impact on U.S. GDP was estimated to be negligible compared to the cost to China and its nearby trading partners.

(Figure 6)



Source: JP Morgan

Concerns that COVID-19 would turn into a global pandemic caused financial markets to reprice the risk. As shown below (Figure 7), Goldman Sachs estimated on February 27th that a base case scenario of a widespread but short-lived pandemic could wipe out earnings growth for 2020 and lower equity multiples, resulting in a mid-year trough of 2900 on the S&P500 index. Last week's market action took the index down to 2954, implying that most of the downside is priced in, short of an outright recession.



Source: Goldman Sachs

Of course, the possibility of a recession has grown with negative headlines. However, so has the likelihood of a forceful policy response. Fed Chairman Jerome Powell indicated that much on February 28th, signaling that the central bank was prepared to cut interest rates if necessary, as COVID-19 "poses evolving risks" to the U.S. economy. While additional monetary stimulus would do little to contain short-term downside risk to GDP, it would certainly support a sharper recovery once the crisis is past.

While the eventual reach and severity of the infection is impossible to handicap, the important point remains that unlike 2008, which was a financial system crisis, COVID-19 is causing a temporary demand shock to the global economy. Thus, most of the lost demand in early 2020 is likely to materialize as pent-up demand once the crisis is over, leading to eventual retracement.

CONCLUSION

For our clients invested in a balanced portfolio, they can take solace in the fact that fixed income and defensive hedge fund strategies continue to offer a buffer to equity market volatility. Our active equity managers, on the other hand, are busy evaluating investment opportunities at now reduced valuations.

After the recent downturn in the equity markets, we believe there is an opportunity to rebalance and maintain a full, if not overweight, exposure to Market Directional Hedge Funds. Once markets bottom there will be an opportunity to overweight Global Equities in the recovery.

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