Thoughts on the New Coronavirus

March 2, 2020

During the past week, U.S. equity markets suffered the largest single-day point drop decline on record, the largest consecutive daily decline on record and the worst weekly decline since 2008. U.S. interest rates along most of the yield curve hit record lows. It would seem from movements in financial markets the world faces an imminent, deep and widespread recession. But, do we? Financial markets are reacting to the new coronavirus outbreak and its likely impact on global economic activity. There is still much uncertainty, but there is a lot we already know.

What Do We Know?

- According to Johns Hopkins University Center for Systems, Science and Engineering, through February 29, 2020, there were 85,994 cases confirmed globally with 79,251 emanating from Mainland China. There have been 2,941 deaths globally and 39,761 recoveries, implying a 3.4% death rate, and a nearly 50% recovery rate. In fact, news reports indicate 80% of those who have the virus have only minor symptoms. Furthermore, many healthcare professionals believe the number of infected patients is greater than those formally confirmed, suggesting the fatality rate is substantially lower.
- China was ground zero for the virus with news of the outbreak commencing around mid-January. The country initiated an ill-count around January 22. On approximately February 14, the authorities altered the count methodology, which led to a spike in that day's confirmed infections, but it also marked the peak in new cases. By February 27, China reported only 433 new cases, indicating the trend is stable at a relatively low number. In effect, China contained the virus in a period of about 40 days.
- China acted quickly and authoritatively by quarantining cities and provinces. The country also mobilized healthcare professionals, construction crews and civil servants to address the crisis. Through their actions they set examples for other countries to follow and enabled global healthcare professionals to learn about processes and treatment for containment. In addition, some of the characteristics of the infection and it's transmission were learned by the world's most prominent healthcare professionals.
- Cases away from China grew rapidly once they were diagnosed, but remain statistically modest relative to population sizes and contagion patterns associated with seasonal viruses, like the flu.

What We Do Not Know

- The new coronavirus (COVID-19) is a strain not yet epidemiologically understood. There is no medicine to treat it, and the forms of contagion are not yet fully identified. It appears infected individuals have a lengthy gestation period, yet become immediately contagious making it hard to diagnose and corral an outbreak.
- Chinese individuals live under an authoritarian regime that is able to forcibly restrict travel, congregation and human interaction. While individuals outside of China may willingly quarantine themselves for self-protection, it is unclear such measures can be enforced in many places. Should the virus spread in certain countries or regions, it is unclear isolation can be successfully implemented.
- COVID-19 appears to be fiercer than the seasonal flu, requiring more medical attention and even hospitalization. It is unclear whether most countries have the medical facilities and personnel to deal with large numbers of patients.

Economic Implications

The world ended 2019 on an optimistic economic note with expectations for growth recoveries in many underperforming regions, including China and Europe. There is no question that all 2020 forecasts are no longer valid, and the first quarter may well produce the worst quarterly global growth rate since the 2008/2009 recession. The key unknown is whether the health epidemic will have the depth and breadth to completely reverse the global economy's momentum in 2020? We believe, assessing the facts laid out above, that the virus will result in a severe hiccup, but not in a rolling global recession during 2020. An important element in that assessment is that the global economy was on an upswing and devoid of imminent stresses, as the virus hit.

Taking China's experience as an example for the world, affected countries should be able to contain outbreaks over periods of 30 to 40 days. As more countries are forced to deal with the virus, data on treatment, transmission, medical processes and immunology will be gathered by the world's medical community likely enabling countries to contain the problem quicker and more effectively. For this reason, we believe the peak of the global outbreaks will likely occur during March or April and the economic impact will begin to subside by the middle of the second quarter. Many companies cited disruptions in their supply chains as the most damaging impact of the virus. In this respect, China continues to restore production and will likely be operating near full capacity within a few weeks. Furthermore, we believe the global economy regains its earlier footing by the second half of the year. Unfortunately, given the severe economic effects of the quarantines, communal isolation and fear, growth losses from the first two quarters of the year will not likely be made up in the second half.

Implications for Financial Markets

The markets' severe correction during the last two weeks of February was probably caused by the realization that the global economy is inevitably altered for 2020. Investors had compartmentalized the epidemic in China because, although severe, the country has the resources to both address the health issues and stimulate a growth recovery. When the outbreaks moved forcefully to other countries, many assumptions on containment were dashed. In addition, we all realized the likely actions needed by communities in many countries to prevent the spread. Without reliable indicators the contagion has been arrested, investors began to price in a worst case scenario.

However, we do not believe the worst likely outcome and a global recession are imminent suggesting the magnitude of the markets' repricing has been excessive. We believe, for example, the decline in interest rates reflects an expectation that growth stalls warranting sizable intervention from monetary and fiscal authorities. We agree with the growing consensus that the U.S. Fed should allay the panic that appears to have overtaken U.S. markets, but disagree with the bond market's expectation for 3 to 4 cuts in the Fed Funds Rate. More likely, and appropriately, the Fed will lower rates in March, but hold subsequent stimulus to observe the magnitude and impact of an outbreak. Should the illness remain modest and regional, the Fed will likely hold back additional moves. In Europe, the Central Bank has limited ammunition so it has to continue purchasing securities. Elsewhere, monetary authorities have room to lower rates and will likely do so if the health crisis threatens their country.

Regarding global credit markets, they remained relatively well-behaved through the final two weeks in February. Investors capitulated during the final week by withdrawing over $4.2 billion from high yield mutual funds and selling securities of countries and industries most severely affected by the virus. Across credit the most visibly affected industries are travel, leisure, energy and commodities. We believe the selling presents opportunities because, in general, prior to the outbreaks, creditworthiness was solid and few companies were committed to now questionable capital expenditures. While fear will continue to play an important role in consumer behavior and investor decision-making, statistics around the outbreak do not seem to justify the magnitude of the market's reaction.

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