Market Update- The Coronavirus

March 2, 2020

Dear MAM Client,

Even though our February 2020 Monthly Commentary included an article about the impact of the coronavirus, given the dramatic drop in stock prices last week, we thought clients would like to hear more about our thoughts regarding it.

Last week, the stock market experienced its worst week since 2008. After reaching a record high on February 14th, the S&P 500 Index declined 12.6% by February 28th. A market correction is defined as a drop of 10% or more in stock prices. Historically, corrections happen periodically, with an average decline of 13.8%. We've experienced 6 of them since the 2008-2009 financial crisis.

Was last week's market correction justified? Time will tell, but the market was reacting to the global spread of the coronavirus.

Origination of COVID-19: First a little background. As the World Health Organization (WHO) states, "Coronaviruses are a large family of viruses which may cause illness in animals or humans. In humans, several coronaviruses are known to cause respiratory infections ranging from the common cold to more severe diseases such as Middle East Respiratory Syndrome (MERS) and Severe Acute Respiratory Syndrome (SARS). The most recently discovered coronavirus causes coronavirus disease COVID-19".

The current coronavirus, COVID-19, originated in Wuhan, China sometime in the fourth quarter of 2019. It spread rapidly in China with over 80,000 peopled infected so far and over 2,400 deaths. During the last couple of weeks, there have been encouraging signs that the outbreak may be coming under control in China. The number of new cases continues to fall, as more than 20 provinces reported no new cases for the sixth consecutive day on February 27th.

Global Spread: What spooked the stock market last week was the news that COVID-19 is spreading around the world. There are now a significant number of those infected in South Korea, Japan, Italy and Iran, and a rising number in the U.S. Though Hollywood has done well making dramas featuring a virus leading to the demise of mankind, it is likely that COVID-19 will eventually run its course and/or therapeutics will be developed to combat the infection. So far, the virus appears to be associated with relatively low mortality rates, despite having a fairly high rate of contagion in affected areas.

Economic Impact: The virus poses a serious risk to global growth, and the situation will get worse before it gets better. The negative short-term economic impact results from quarantines, regional factory closures, and supply chain disruptions on production and global trade. Specific industries, such as travel and entertainment, will be hit particularly hard.

What we think is important is to distinguish between short-term tumult and long-term impact. It is unlikely that the outbreak will have a negative long-term economic impact. Historically, the economic impact of pandemics is typically a sharp V-shape, where activity drops hard and fast for a quarter or two, and then bounces back to recover most, but not all, of the lost output. As new clusters of infection occur outside China, the V-shaped recovery might look more like a Ushaped recovery, with the recovery to the economy taking a little longer. In terms of equity markets, a review of previous significant epidemic/pandemics shows that stocks performed quite well after a short downturn.

Government Economic Stimulation: Chinese authorities have already taken initial steps to stimulate its economy to offset the impact of COVID-19. The U.S. may not be far behind. Federal Reserve Chair Jerome H. Powell recently said, "We'll be watching this (coronavirus) carefully. The question for us really is what will be the effects on the U.S. economy? Will they be persistent? Will they be material? That's really the question…There's no way to be confident about anyone's assessment, and there are a range of assessments…Of course, policy is not on a preset course. If developments emerge that cause a material reassessment of our outlook, we will respond accordingly…I think you can expect the Chinese government to do lots of things to support economic activity, and they've said they're open to cushioning the economic effects."

The next Federal Reserve meeting is scheduled for March 18th. It is likely that the Fed will announce an interest rate cut at the conclusion of its meeting. If the economic outlook deteriorates much further, we would expect more coordinated policy easing globally. This would likely include central bank rate cuts and more fiscal spending.

MAM Comments: Sharp market downturns that we experienced last week serve as a great reminder for having a bond allocation to provide downside protection for portfolios. This bond exposure helped MAM portfolios to drop significantly less than the S&P 500. On average, MAM portfolios have a 30% allocation to bonds.

An interesting aspect of a stock/bond allocation, is that a portfolio with an allocation to bonds automatically becomes more conservatively allocated when stock prices drop. For instance, for a portfolio with a 70% equity/30% bond allocation, if stock prices drop 10% and bond prices stay flat, the bond allocation increases to 33% and the stock allocation falls to 67%.

As mentioned in the February Monthly Commentary, in early February we fully sold the position in Matthews Asia Dividend (MAPIX) in all portfolios. We reinvested the proceeds in the exchange-traded fund, Schwab U.S. Broad Market (SCHB), which invests in large-cap U.S. stocks. At this point, we are not planning to take any additional actions in response to the COVID-19. Our position on this would change if we feel that the outbreak is likely to have a more long-term economic impact. Fortunately, for accounts taking regular withdrawals, we replenished the three-year "safety bucket" when we repositioned portfolios last November.

Please let us know if you would like to have a conversation to discuss your portfolio(s).

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