Douglas Investments
Investment Environment

Its all about Coronavirus   February 2020

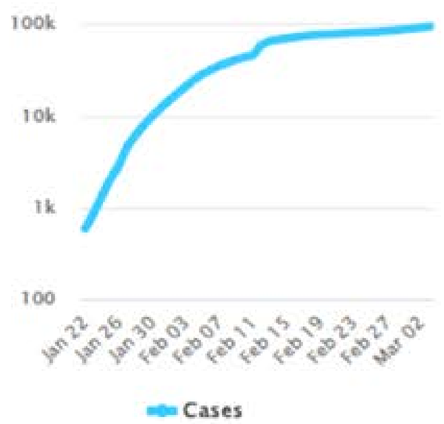
There is no doubt that the Coronavirus has caught equity markets off guard. If one looks at the graph of the S&P500 (arguably the leading index of the world) one can see that initially the US market recovered from the initial news of the Coronavirus on 22 January and even showed some growth after the breaking news. However, as the economic severity of the virus becomes apparent - largely due to the shutdown of the various provinces of China since the Lunar New Year – equities have begun to correct. China plays a major role in the global supply chain of goods. With China grinding to a halt the disruptions to this supply chain are likely to be severe causing a knock-on effect in company earnings. A number of multi-national companies (Apple, Microsoft, etc.) have already issued profit cautionaries which has caused markets to react negatively to the news.

The Coronavirus

The facts to date are that there have been 93,574 infections recorded and 3,204 deaths. 86% of infections have occurred in China with the balance spread across many other countries (source: worldometer). China has been effective in quarantining the city of Wuhan and surrounding areas where the virus seems to have originated, by isolating 50 million people and restricting them to stay in their homes.

The below two graphs provide some insight into total cases reported as well as active cases managed. The graph on the left shows the total cases reported since 22 January to 2 March. What is important to note is how the rate of infections is slowing and starting to "top out". The graph on the right shows the number of active cases (i.e. infected patients) being treated and those that are classified as serious or critical. The number of critical / serious cases is diminishing which is also a good sign. The economic impact of this virus will be determined by the rate and extent of infections as this causes countries to panic. The slowing rate of infections provides some evidence that the virus is being contained which could have a short economic impact.

Coronavirus - total cases



Source: Worldometer

Coronavirus - active cases

Source: Worldometer

The mortality rate is considerably less at 3.4% vs SARS 9.6%. The WHO estimate is that the fatality rate will be 2% which inversely means that 98% of people infected will actually recover in a period of 14 days.

Economically, the concerns are the effect on GDP and to date the estimates are that the Chinese GDP will decline by 2% to potentially less than 4% in 1Q2020. China is responsible for approximately 15% of the global oil demand which is a good proxy for its effect on world economic GDP. Notwithstanding this the current IMF forecast is that the virus will impact global GDP negatively by 0.1% from 3.3% to 3.2%. This is hard to believe but if it is the case it strengthens our investment stance of holding one's current investment positions.

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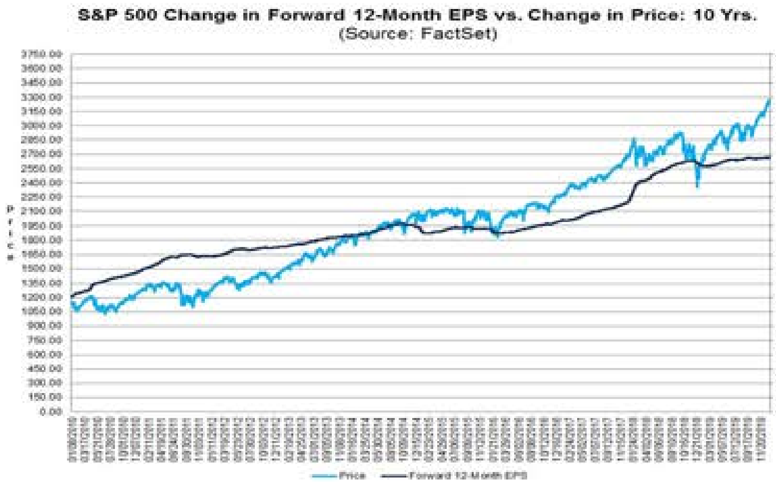
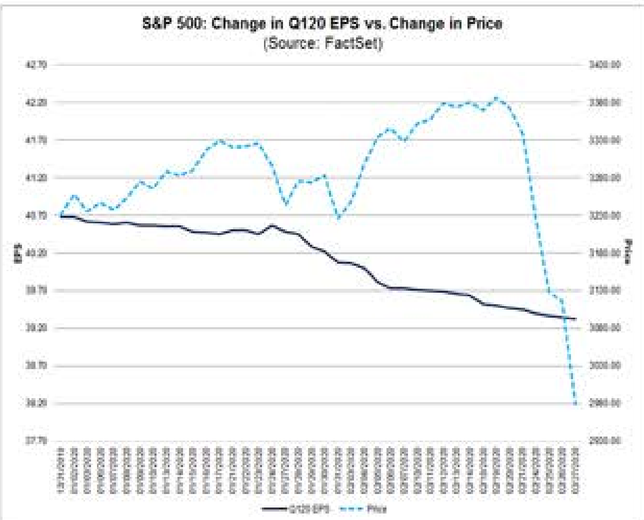
The S&P500 and Valuations

This graph shows the strong performance of the S&P500 since 2010 which accelerated in 2019 as the Fed reversed its interest rate policy. Equity prices outpaced earnings growth and as a result, valuation criteria tipped over to being expensive. The combination of a strong 2019 performance and equity markets being expensive, with a potential ongoing economic consequence of the Coronavirus, has been enough for markets to correct, being a drawdown in excess of 10% since the peak.



Analysts have lowered earnings estimates for the first 2 months of 2020 and the Q1 bottom-up EPS estimate has dropped by 3.3%. The question remains - have analysts been slow in reacting to the impact of the Coronavirus? On the other hand, could it be possible that analysts are simply not as pessimistic as the market? See the graph below which shows the percentage movement in EPS relative to the percentage movement in share prices. The correction in prices has been severe! This has brought the valuations more in line with their longer-term averages. Douglas Investments has been concerned about valuations for some months.



The hope and understanding is that the Coronavirus should be under control by April 2020. If this is the case, and the graph above showing infections effectively peaking out, it is possible that the equity market correction could be likened to the 9/11 Twin Tower disaster. That is, a massive extraneous event to equity markets that shocks investors and invokes their worst fears only to discover that the event has passed and, while extremely damaging at the time, it is also short lived.

Douglas Investments believes it is appropriate to hold onto investment positions as selling now would only compound the situation. It is also possible that this event could provide an investment opportunity to apply cash. Central banks, including the Fed, are generally taking an accommodative monetary stance to support economies which was emphasised by the following statement from the Fed Chair, Jerome Powell, on 28 February:

"The fundamentals of the U.S. economy remain strong. However, the coronavirus poses evolving risks to economic activity. The Federal Reserve is closely monitoring developments and their implications for the economic outlook. We will use our tools and act as appropriate to support the economy."

HSBC are now forecasting that the Fed will cut rates by 25 bps at the March, April and June meetings. This forecast was eclipsed on 3 March when the Fed cut the Fed Funds Rate by 0.5% independently of a scheduled meeting.

This is already reflected in the bond markets and should be supportive of equity prices – time will tell. The big assumption is that Coronavirus will not become a pandemic.