

Coronavirus Blues

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*Doctor, doctor, give me the news,
I've got a bad case of Corona blues.*

Many investors have been echoing Robert Palmer's desperate plea, begging for information about the Covid-19 virus (also known as Coronavirus or SARS-CoV-2) and its likely impact on the world's economy. There's plenty of news, too, but the most important questions are still unanswerable. We can't yet know how many people ultimately will be infected, or for how long many of China's factories will be idled, or how deeply the response to the epidemic will cut into economic growth; but even so, we do need to think about whether and how to "vaccinate" our clients' portfolios from the virus and the response to it.

Markets have proved to be highly sensitive to news about Covid-19 and its epidemiology. In the first several weeks since the outbreak began last month, stock prices fell when it appeared that the outbreak was spreading more quickly, and then rallied when the number of new cases seemed to be diminishing. By mid-February, the number of new cases in China began a steady decline, but epidemiologists still worried that a surge may occur as soon as China lifts its lockdown. Outside China, the spread of the virus beyond China has continued unabated.

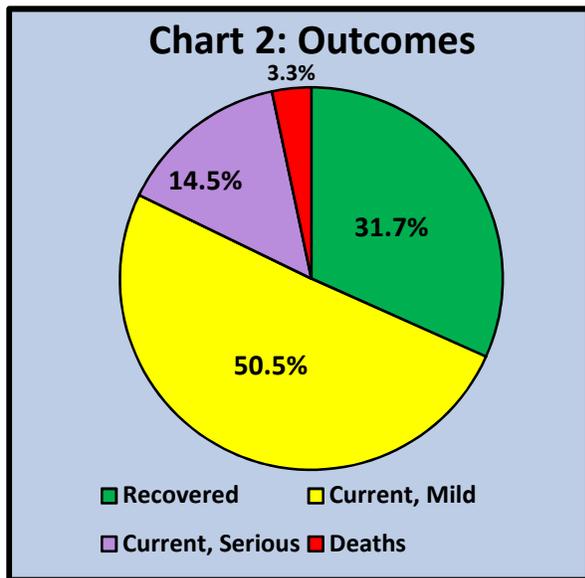
News of sharp increases in South Korea and other countries shocked markets over the weekend, resulting in steep global stock price declines yesterday; the S&P 500 index lost more than 3% on the day's trading. The biggest losses have been absorbed in the industries most directly affected by the virus's spread: Travel (cruise lines, airlines, and hotels), energy (as demand has contracted in China), and manufacturing (due to supply chain interruptions). Safe-haven assets like Treasury bonds and gold rallied.

Investors have sought guidance from history as they have tried to understand Covid-19's potential impact on markets and economies. Chart 1 shows some statistics for the current epidemic in comparison with previous similar episodes:

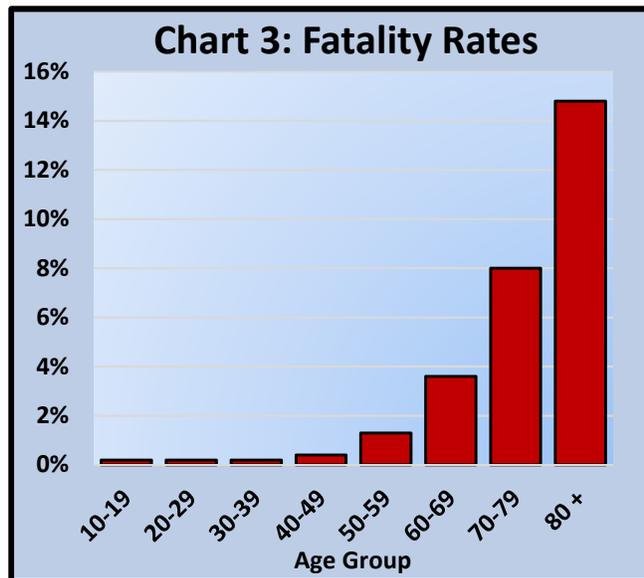
Chart 1: Historical Comparisons				
	SARS (2003)	MERS (2015)	H1N1 (2009)	Covid-19 (2020)
Total Cases	8,096	2,499	60,837,748	79,737
Deaths	774	861	12,469	2,628
Fatality Rate	9.6%	34.4%	0.02%	3.3%
Reproduction Rate	2 – 4	< 1	1.3	1.5 – 3.5
SARS: Severe Acute Respiratory Syndrome; MERS: Middle East Respiratory Syndrome				
Covid-19 statistics as of February 24, 2020				
Reproduction rate: Average number of people to whom each infected person will communicate the virus.				

Source: World Health Organization, U.S. Centers for Disease Control and Prevention, Goldman Sachs

The data in Chart 1 show that Corona is already far more prevalent than SARS or MERS was, but it is also apparently far less lethal. Of the nearly 80,000 cases reported so far, approximately 25,000 patients have had a full recovery and another 40,000 current cases are reported as mild in nature, as shown in Chart 2. As with many similar illnesses, the virus is far more dangerous among the elderly than among the young, as shown in Chart 3.



Source: Worldometer



Source: China Center for Disease Control

The data in these charts are perhaps comforting: Although Covid-19 is widespread, it appears to be causing serious health problems only in a small percentage of the most vulnerable patients. For most people who are infected, the virus appears to have only a mild impact not unlike that of a typical flu.

Perhaps the biggest concern is that it is still spreading. In a globalized society, trying to contain a virus is nearly impossible, and Covid-19 took advantage of the unique conditions in which it arose. Wuhan is a major industrial city with extensive rail and air connections to all parts of China, giving Covid-19 many high-density vectors to escape the city and spread across China – especially during the Lunar New Year celebration when so many people traveled to and from Wuhan. It shouldn't be too surprising that hundreds of cases have now been reported worldwide: in the U.S., in Italy, in Iran, and across Asia. Public health officials in all of these countries will now have to make difficult decisions about how much collateral economic damage they are willing to sustain in combating the virus. To take two extreme and opposite examples, China has proved that it is willing to allow its economy to grind virtually to a halt, while the United States has taken almost no direct action so far.

Investors need to think about the economic impact of the virus and government attempts to control it. The sudden plunge in stock markets yesterday (and the equally sharp rise in Treasury bond markets) indicates that investors are beginning to recognize that the bigger potential threat to the global economy isn't from the virus itself, but from government and private-sector responses to the epidemic.

In this respect, it is relevant to note that the virus appears to be only slightly more dangerous than the common flu, and not nearly as lethal as polio, smallpox, SARS, Spanish flu, or many other diseases. Covid-19 apparently spreads very quickly, but the human immune system appears to have the upper hand – and our bodies will get help from rapid work by pharmaceutical research to develop treatments or vaccines. This suggests that economic activity will slow for a while, but ultimately resume with vigor.

Many corporate executives have used Covid-19 as an excuse to trim their revenue and profit forecasts for the coming year – and why not? Coming as it does right at the beginning of the year, Covid-19 enables companies to lower expectations without fearing the wrath of shareholders. The most prominent company to do so was Apple, which last week reported that it would fall short of its revenue target for the March quarter due to reduced economic activity in China – both lower production of parts for its products, and lower demand for iPhones. Disney likewise cut its forecast for the year because its theme parks in China will undoubtedly miss their occupancy and attendance targets. And Starbucks said it had temporarily closed about half of its stores in China. A Goldman Sachs research report¹ noted that about 37% of S&P 500 companies cited Covid-19 in their fourth-quarter conference calls.

Investors would be wise to see the differences among Apple, Disney, and Starbucks, because these differences can substantially affect how stock prices respond over time. A typical Starbucks customer, for example, won't order a second latte tomorrow because the store was closed today; that "lost" sale is gone forever. At Disney, a similar dynamic may apply only partially: The company can't sell yesterday's tickets today, but many vacationers may reschedule their visits to the company's theme parks for future dates; some of Disney's lost sales will likely return (subject to each park's capacity constraints, of course). In the case of Apple, product demand is so strong that a large proportion of lost sales will likely be recovered later this year if the supply chain can be relaunched in time to meet the company's inventory requirements.

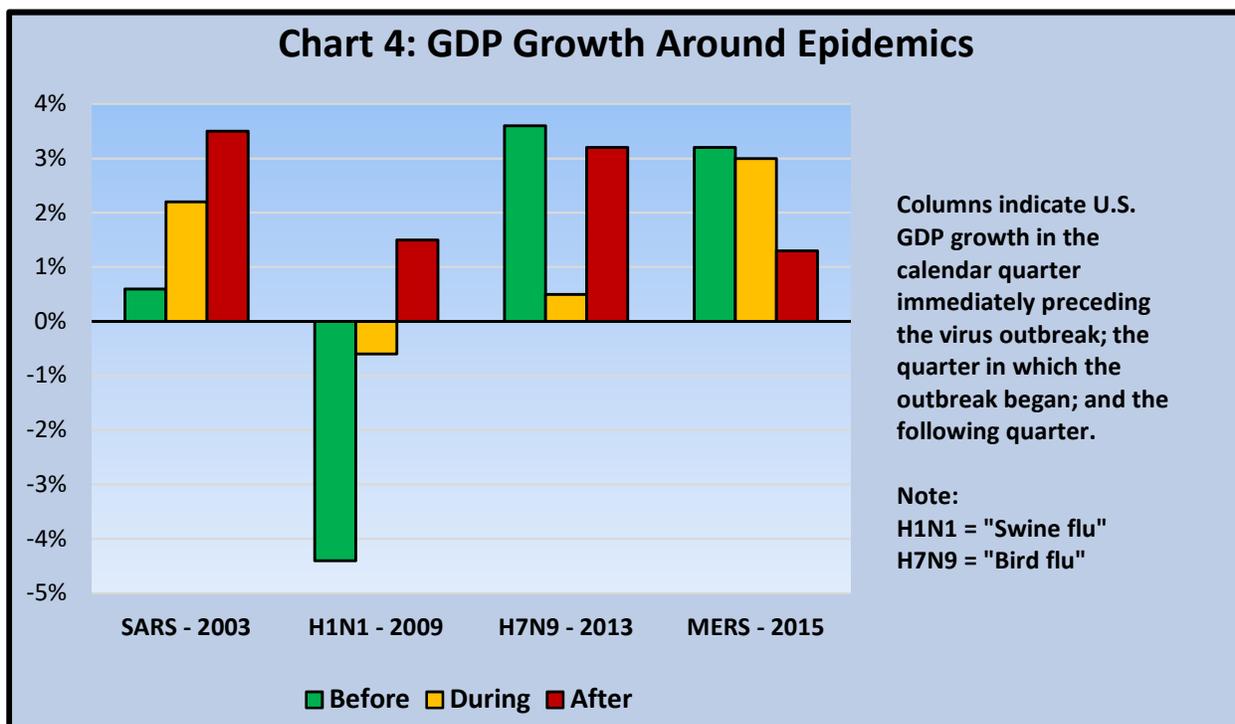
Taken as a whole, we expect that the dramatic curtailment of activity will almost certainly have a meaningful effect on China's overall economy in the March quarter, with some follow-through to the June and September quarters as well. The country had been cruising along with 6% GDP growth, which we think could be cut by at least a percentage point or two in the short term. As the number of new cases in China continues to diminish and as companies reopen their doors, we anticipate China's economy will rebound fairly quickly.

In the U.S., we expect a milder short-term impact. As of February 24, only 53 cases have been reported in the U.S., of which 14 were people removed from the Diamond Princess cruise ship in Yokohama. These 14 people may have encountered many other Americans on their return flight home, so it's entirely possible that we may discover a larger national outbreak here as well; so far, however, it hasn't happened. We think GDP growth may dip by a quarter-point to half-point in the March quarter, far less impact than Covid-2 has had on Asia or Japan. As with China, we think most of the slowdown will be reversed later this year.

¹ "Revisiting SARS-Coronavirus-2 (SARS-Co-V-2) and the Economic and Investment Implications," by Dr. Barry R. Bloom, Dr. Luciana Borio, Dr. Jan Hatzius, and David Kostin. Published by Goldman Sachs, February 24, 2020.

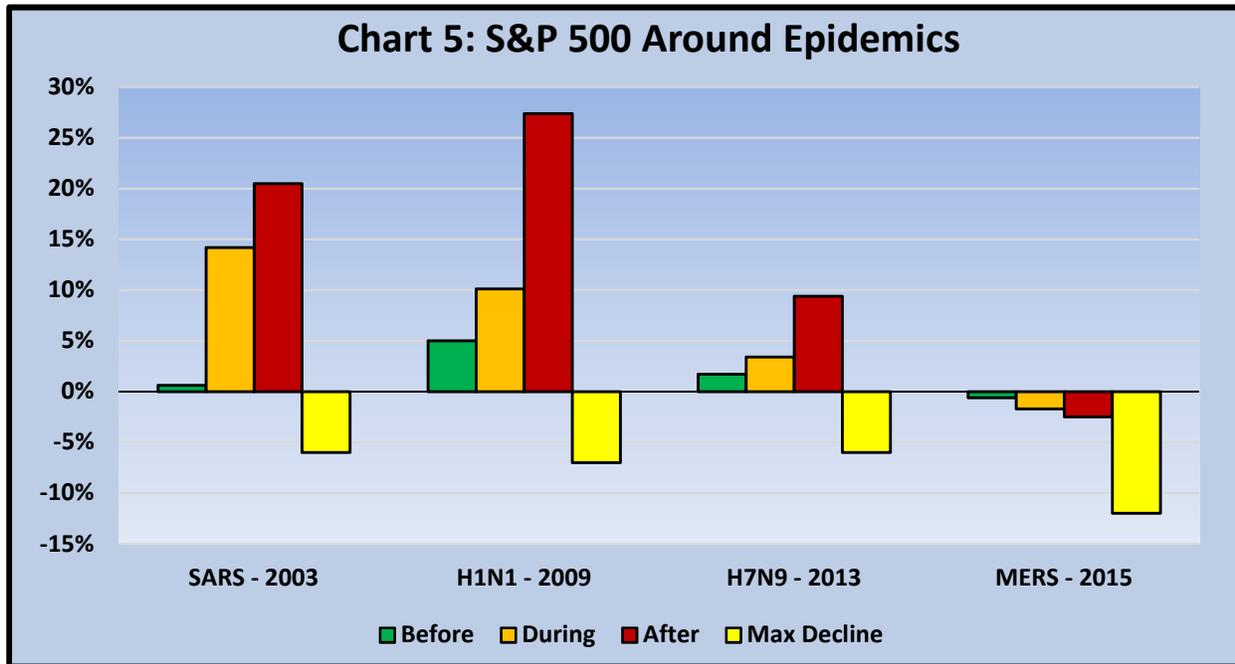
We are not short-term investors, however. We invest our clients' money based on long-term forecasts for economic growth and profitability, and we don't think that what we now know about Covid-2 would fundamentally change our view. We may see more volatility this year – a slowdown in the March quarter and a snappy recovery by the September quarter, for example – but our long-term view is unchanged.

This view is bolstered by the markets' history with SARS and other public health crises. Chart 4 shows how U.S. GDP growth rates changed immediately before and after several recent epidemics. Although each virus clearly had an impact, in most recent instances the impact was muted and subordinate to other macroeconomic trends: In 2003 and 2009, improving economic conditions following deep recessions continued to unfold, while in 2013 a strong uptrend was temporarily slowed before resuming its path. The GDP slowdown in 2015 was driven primarily by falling oil prices, and the small number of cases combined with low retransmission rates meant that the economy was largely unaffected by MERS.



Source: Goldman Sachs

While the impact on GDP growth (and corporate profits) of previous epidemics was muted, investors nonetheless took notice. The yellow columns in Chart 5 (next page) show that investors shaved between 6% and 12% off stock prices from the onset of the epidemic before regaining their equilibrium and bidding shares up again. In three of the four cases shown, stock prices accelerated a few months after the outbreak began, as investors came to realize that the extent of the epidemic's impact on corporate profits would be limited. We think the same will happen this year with Covid-19; the steep drop yesterday is part of that initial fear, but over the next several months we expect investors to regain their confidence as the economy bounces back from this health scare.



Source: Goldman Sachs

With that conclusion in mind, we have not made any meaningful changes to clients’ portfolios. We were aware at year-end that equity prices were elevated and we took some profits in January, before the outbreak began to worry Wall Street. Our clients’ equity portfolios are already tilted toward quality and slightly defensive in nature, and they have held up reasonably well against the market indexes in the past few days. The rallies in the bond market also served to offset some of the declines in the stock market for our clients. We see no reason to change our long-term discipline at this time.

What’s unknowable is how deeply equity markets will fall and how long they will take to recover; for that, we return to Robert Palmer: *Doctor, doctor, tell me the news!* The contours of the virus epidemiology will largely shape the contours of the stock market’s response.

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