SLC Management

Investor sentiment evolving as virus spreads

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SLC MARKET INSIGHTS

February 2020 saw the spread of the coronavirus enter a new phase. South Korean and Italian hot spots emerged and countries around the world went on high alert. Almost 50 countries have now reported at least one infection within their borders.

Until recently, US equities and corporate bond spreads had ignored the scare – while Treasury rates quickly dropped on concerns. This reaction paralleled market dynamics during the SARS episode in 2003.

Those dynamics are now changing. China is struggling to get its production capacity back online – and infections have surged in other key manufacturing economics. These include economies that are key components of the global supply chain, such as South Korea and Italy.

World market worries have moved from the virus' potential impact to the actual impact that has now occurred. Manufacturing supply chains are being disrupted. And travel restrictions – with the resulting decimation of related leisure and other spending – has spread beyond China to Europe and other parts of Asia.

The economic hit ultimately depends on the intensity and duration of the outbreak, which right now is hard to handicap. If China doesn't make progress in getting most of its production capacity back online by the end of March, the economic fallout could potentially drag global growth down by 0.5-1.5% this year.

Equity markets

S&P 500 is down significantly from its peak

Equity markets, in particular, are growing concerned that economic weakness will extend into the second half of the year and delay any bounce back in the second quarter.

The S&P 500 is down from its peak. So far, this correction is a measured repricing of risk, bringing markets back to where they were in early November 2019. Sectors such as airlines, hotels and cruises are getting hit, as are large consumer companies with significant exposure to China such as Apple, Disney and McDonalds. With each day, more companies are flagging earnings concerns as they acknowledge supply chain interruptions.

This reaction seems appropriate based on the near-term effects of lost demand from travel and leisure sectors, as well as the expected future impact of companies grappling with reorganizing supply chains. While this will impact costs and profitability going forward, it shouldn't impact aggregate demand in a significant way. We believe the global economic expansion should resume once the current impacts of the coronavirus subside.

Interest rates

Markets surprised by Fed rate cut

In response to the virus the Fed surprised markets with a 50 basis point rate cut. In his accompanying press conference, Chairman Powell stressed that the Fed was reacting to elevated financial conditions and concerns that business and consumer sentiment could sour. He acknowledged that the Fed still lacks robust activity data to determine the extent of economic disruption, suggesting it is willing to do more if economic risks mount.

The news immediately sent equities lower and treasury yields dropped which implies that markets are concerned the Fed is seeing more storm clouds ahead. Powell stressed the economy and consumer are in good shape and the rate cut is for insurance. Markets will hear from Powell again at his scheduled press conference on March 18th, so he will have another opportunity to clarify the outlook.

A look ahead – central banks will be supportive and China will stimulate

China's central bank cuts rates, while early indicators suggest a coordinated global central bank response is under consideration

It is expected that other global central banks will also start to jump in with support. Powell assured that all G-7 central banks are communicating but that individual moves would reflect local country dynamics.

Meanwhile China's President has already made it clear they will do whatever is takes to deliver on its GDP growth targets. The central bank has already cut rates and the government has committed to ramping up infrastructure spending and supporting the purchase of homes and autos. This stimulus is likely to be on par with the program in 2015 and 2016 when global growth was at risk from prolonged energy weakness.

A lot is still unknown. However, as hard data emerges for February activity, we may start to see more clarity on what else central banks and governments need to do to help protect growth.

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