BRIEF MARKET COMMENTARY – THOUGHTS ON THE CORONAVIRUS OUTBREAK

February 2020

First, we must acknowledge that no one knows with certainty how the coronavirus outbreak will play out or how bad it will eventually get. Our thoughts are with the families of victims, those infected, and those battling the spread of the disease. The World Health Organization has declared the new coronavirus a global health emergency, while in the United States it has been declared a public health emergency. We are hopeful the global health authorities can contain this outbreak. China has taken extraordinary efforts, including shutting down travel and quarantining an entire province. Its response has been much faster than in past epidemics emanating from its shores. Our confidence is bolstered by the prospect of global cooperation and the news that researchers are already racing to develop a vaccine not more than a month after the virus emerged.

Still, it's clear that the coronavirus—and the Chinese government's aggressive efforts to contain its spread—will at least have a large negative shorter-term impact on China's economy and spillover effects on other countries with closer economic and trade ties to China. But assuming this doesn't turn into a severe pandemic, the economic impact still seems likely to be somewhat short-lived—maybe a couple of quarters, followed by a make-up period of above-normal growth. We believe it is unlikely to have a lasting, long-term effect on the global economy, but it will likely cause a delay in the current nascent economic recovery. Prior to the coronavirus outbreak, there had been signs of a bottoming in global economic activity as accommodative monetary policy and easier financial conditions started filtering through.

Historically, economic growth and financial markets have responded with a "V-shaped" pattern to temporary disruptions caused by past epidemics. The recovery in economic activity is often fueled by the pent-up demand in retail and a restart of the manufacturing sector.[1] Looking back at the SARS and MERS viruses, history suggests equity markets will start to rebound once the incidence of new coronavirus cases peaks and starts to turn down. Yet, this outbreak could be more disruptive than past ones because it could be more severe, and because of a greater reliance on global supply chains. As Jason Trennert at Strategas Research Partners points out, we have no historical precedent for an economy the size of China quarantining 50+ million people.[2]

As investors, we're challenged with assessing the odds of whether recent volatility is creating opportunities or whether it is the start of a more significant threat to equity markets. We assume that there will be a material negative impact on corporate profits in the near-term as businesses deal with supply and demand disruptions resulting from this health scare. Yet, we believe this is likely a one-time impact over the next couple of quarters and should not have a permanent effect on future earnings potential. In addition, trade tensions are behind us for now and global policymakers are easing. The timing is uncertain, but the effect of the coronavirus will, at some point, end. Therefore, as long-term investors, we are inclined to look beyond the next few months.

Over the intermediate term (next 3-5 years), our expectation has been for lower-than-average positive returns from most asset categories along with higher volatility. Based on what we think are the most likely outcomes—while acknowledging that there is still a great deal of uncertainty—we do not believe recent events change the key underlying assumptions for our intermediate term return assumptions for stocks and bonds. Therefore, at this time, we continue to maintain a slight defensive posture and aren't recommending any changes to portfolio strategy in response to the coronavirus. We continue to follow daily reporting on the trajectory and spread of the virus and other developments. If the facts and circumstances change, our analysis and views on the economic and portfolio impact may change as well.

From a strategic standpoint, we aim to construct portfolios to be resilient across a range of economic and market scenarios by emphasizing thoughtful portfolio diversification and manager selection. The recent coronavirus scare is an example of a "flight-to-safety" type environment that reinforces the need for a balanced approach—and the role of high-quality bonds as a source of stability and diversification of equity market risk. For this reason, we've maintained allocations to "defensive" assets in the form of investment grade bonds, despite historically low yields.

In terms of tactical portfolio positioning, we continue to advocate a slight defensive tilt with an elevated cash/short-term fixed income position as "dry powder." We maintain a slight underweight to global equities overall, with a modest tilt towards more reasonably priced international and emerging markets stocks. We also recommend an overweight position to certain flexible/alternative strategies that can provide valuable diversification benefits versus traditional stocks and bonds.

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[1] *BlackRock, "Testing Our Global Outlook," February 17, 2020.*
[2] *Jason Trennert, Strategas Research Partners, "Investment Strategy Report," February 24, 2020.*