

MARKET REACTION TO THE CORONAVIRUS OUTBREAK

In recent days global markets have convulsed amid building concerns that the spread of the coronavirus (COVID-19) to areas outside mainland China could cause a sharper and deeper downturn in global economic growth than previously thought. From February 19 through today's close, the S&P 500 index declined 12.0%, while the Dow Jones Industrial Average lost 3,787 points for a decline of 12.8% over the same period. Yields on the benchmark U.S. 10-year Treasury bond plummeted to an all-time closing low of 1.27% today. The price of gold, traditionally viewed as a safe haven asset, has surged to its highest level since 2013. Meanwhile, crude oil prices, typically seen as a proxy for short-term global demand, have declined to their lowest levels since December 2018. Volatility also reemerged, as the CBOE Volatility Index (VIX) jumped from 13.7 on February 14 to above 35 in late trading today.

Two weeks ago, as part of our February *Market Review* publication, we focused on the potential economic and financial market impacts of the coronavirus outbreak. An updated version of that content appears on pages 3 through 6 of this publication.

The sudden and sharp movements throughout most asset classes this week have occurred largely in response to several significant changes to the market environment that had prevailed for the first seven weeks of the year. Most importantly, the discouraging developments of coronavirus outbreaks in Italy, South Korea, Iran and Israel have suggested to many market participants that efforts to contain the virus in several provinces in central China have been less successful than many observers had believed. Italy and South Korea, in particular, are large economies which play an integral role in global supply chains. This will likely compound the economic disruption caused by the containment efforts of the Chinese government in Hubei and nearby provinces. As such, a growing chorus of market commentators and economists has suggested that an increased probability exists of large supply-side shock which could push the global economy into recession.

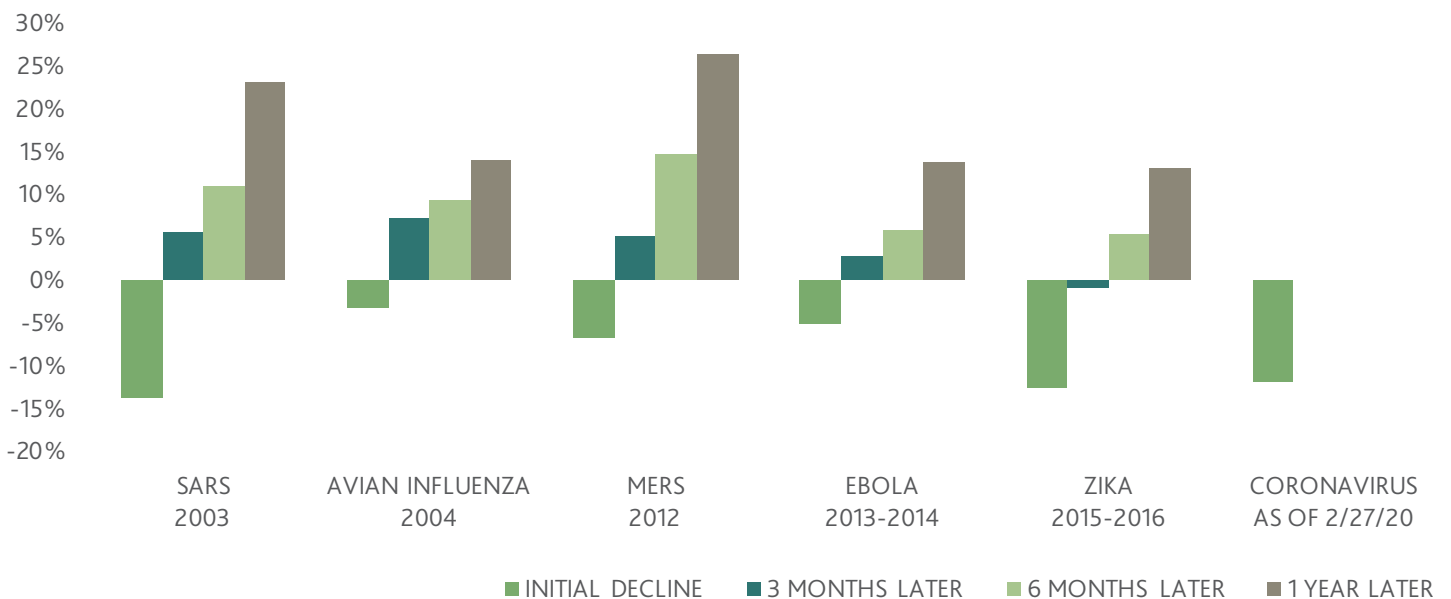
Outside of concerns directly related to the spread of the coronavirus, we would point to two additional factors that have likely played a part in the wave of negative sentiment sweeping markets. First, equity markets probably became somewhat overextended and complacent in the first half of February. Progress in resolving the U.S.-China trade war and a U.S. Federal Reserve that consistently communicated that it would not be tightening policy any time soon created an environment for some excessive optimism to build. Bernie Sanders' rise to front-runner status in the Democratic presidential primary contest, punctuated by his resounding victory in the Nevada caucuses on Saturday, February 22, most likely added to negative market sentiment. Many of the policy platforms advocated by Sanders would significantly increase the uncertainty surrounding several important sectors of the market including the health care industry.

In five previous instances of global virus outbreaks over the last twenty years, including the 2003 Severe Acute Respiratory Syndrome (SARS) and the 2012 Middle East Respiratory Syndrome (MERS), the average initial decline of the S&P 500 Index was 8.4% as seen in the chart on page 2. Six months following the beginning of the S&P 500's decline during each of these five periods, the benchmark, on average, was 9.2% higher. If we expand the time period to twelve months following the beginning of the S&P 500's decline in these five periods, the benchmark's average gain was 18.0%.



While the spread of the coronavirus from mainland China to key economies including South Korea and Italy clearly impairs the short-term global economic outlook, we believe there are several reasons why a U.S. or global recession is unlikely to occur at this point. First, most, if not all, major global central banks are in stimulus mode including the recent stimulus packages undertaken by the People’s Bank of China to offset some of the adverse impacts from the coronavirus containment measures. Secondly, the U.S. consumer, arguably the most important economic group in the world, remains on strong footing supported by a healthy labor market and muted inflation. Third, the domestic housing market is showing signs of strength amid historically low interest rates and pent-up demand. Any sustained boost in home prices across the U.S. could serve to further improve consumer confidence and broad economic activity. Finally, we would observe that the number of confirmed active cases of infection has appeared to peak according to data from Johns Hopkins University. The total number of cases currently numbering above 80,000 includes infected individuals, recovered individuals and deaths. Active cases are calculated by subtracting recovered individuals and deaths from the total number of cases. A peak in active cases could suggest that global containment measures are demonstrating some level of effectiveness. All of the above notwithstanding, we will be closely monitoring the markets for any signals that the global supply disruption underway begins to metastasize into something more troubling than a temporary event.

S&P 500 PERFORMANCE SINCE THE BEGINNING OF THE OUTBREAK



Source: Morningstar Inc., MainStreet Advisors Research

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MARKET BRIEF
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CORONAVIRUS: ECONOMIC AND FINANCIAL MARKETS IMPLICATIONS

The outbreak of the respiratory illness caused by coronavirus has put health authorities on high alert and unsettled financial markets. As of February 25, over 80,000 cases have been confirmed, and the number of deaths has surpassed 2,700. The virus is believed to have originated in late December in a large wildlife food market in Wuhan, China. The situation remains fluid with new cases being reported each day.

Measures are being taken globally in an attempt to halt the spread of the virus. Chinese authorities have suspended flights and public transportation in multiple cities, impacting over 50 million Chinese citizens. Other countries have instituted travel bans to and from mainland China. Some Chinese businesses and factories have remained closed since late January. Meanwhile, U.S. companies including Starbucks, Nike, Disney, McDonald's, and Apple have temporarily closed some or all of their operations in China. Concerns that these preventative measures will likely disrupt global supply chains have led to economists projecting a temporary slowdown in global economic growth.

ECONOMIC IMPLICATIONS

In an attempt to gauge coronavirus's potential economic impact, many economists have cited the 2002-2003 Severe Acute Respiratory Syndrome (SARS) outbreak as a historical comparison. Similar to coronavirus, SARS is believed to have originated in a wildlife food market in China and spread to over 20 countries. SARS affected around 8,100 people over the course of a few months and caused more than 770 deaths. The SARS fallout reduced China's economic growth to

an annualized rate of 9.1% in the second quarter of 2003 from 11.1% in the first quarter. With the SARS outbreak contained within a couple of months, China's economic growth quickly recovered to 10.0% in the third quarter of 2003.

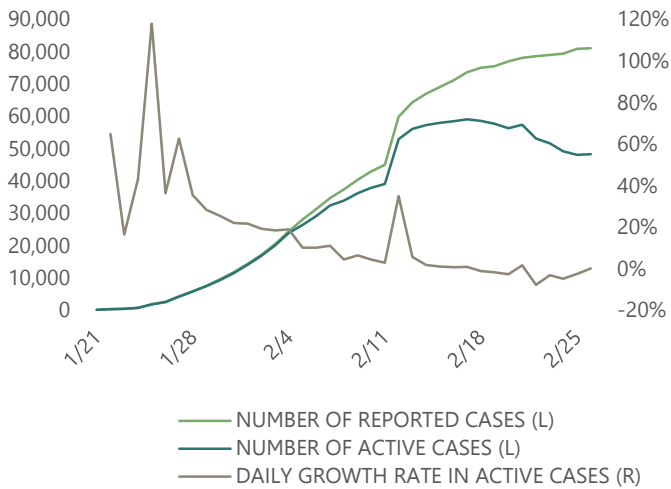
On February 22, the International Monetary Fund (IMF) reduced its 2020 global economic growth projection by 0.1% due to developments in the coronavirus outbreak. Prior to the outbreak, the IMF projected global economic growth would accelerate to 3.3% this year from 2.9% in 2019. If the IMF's estimate for the disease's economic drag is accurate, global growth may still be slightly better this year than in 2019. Economists forecast coronavirus will reduce China's economic growth to 4.6% in the first quarter, 1.3% lower than the pre-outbreak forecast of 5.9%. China's economy is expected to quickly recover and expand by 5.6% this year, down from 6.1% in 2019. The U.S. economy is projected to navigate the outbreak largely unscathed as economists reduced their first quarter growth forecast by a modest 0.2% and left their full-year growth forecast unchanged.

FINANCIAL MARKETS IMPLICATIONS

History shows that diseases threatening to reach pandemic levels have produced volatile market reactions including panic driven sell-offs followed by quick V-shaped rebounds. For instance, during the SARS outbreak the S&P 500 declined 13.3% from January 14, 2003 through March 11, 2003. By May 5, 2003, the S&P 500 had recovered all of those losses. In response to coronavirus' recent spread outside China, the S&P 500 has declined 12.0% from February 19 through today's close. Shares of companies in the global airline, casino, hotel, cruise ship and travel agency businesses

CORONAVIRUS OUTBREAK

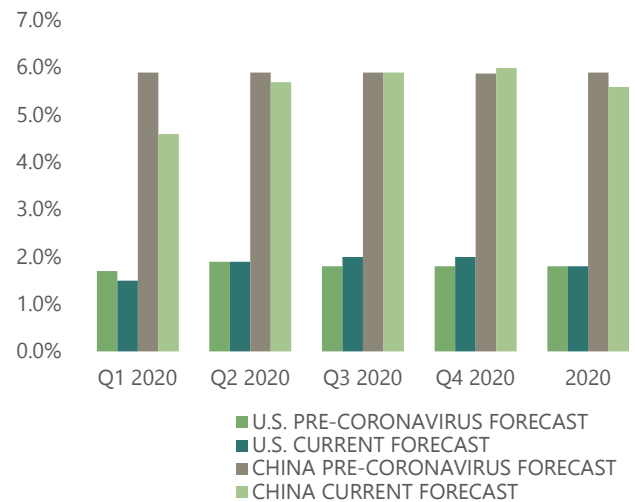
NUMBER OF CASES AND DAILY GROWTH RATE



Source: World Health Organization (WHO)

CORONAVIRUS IMPACT ON U.S. & CHINA

U.S. & CHINA'S GDP GROWTH FORECAST



Source: Bloomberg

Past performance does not guarantee future results.

have been hit the hardest and could remain under pressure for several months.

Other asset classes that are highly sensitive to China's economy, such as commodities, have also experienced steep losses. The prospect of a weaker global economy in the near term and associated weaker demand from China for oil and industrial metals led to sharp declines in commodity prices. The price of crude oil plunged over 20% to the lowest level in over a year around \$47 per barrel in late February from above \$60 per barrel in the first week of January. The travel ban in China is estimated to have reduced Chinese oil consumption by 20% and by 3% globally. China is the largest importer of crude oil from many of the world's largest producers including Saudi Arabia. Industrial metals also fell over 10% into correction territory. China's share of industrial metals' global demand has risen in the last couple of decades to 50%-60% today from 10%-20% in 2002.

Despite the pain in financial markets, we observe a few encouraging signs. The number of active coronavirus cases has been dropping as a growing number of people are released from the hospitals after making a full recovery. In addition, the daily growth rate in the number of confirmed cases has dramatically fallen from over 50% earlier in the outbreak to below 1% in late February. Fewer active cases and the slowing growth rate in confirmed cases could be signs that efforts to contain the virus are demonstrating some effectiveness. Although, the recent uptick in cases outside China increased concerns for a potential second wave of contagion likely due to infected people traveling for the Chinese Lunar New Year celebration in late January.

Another positive development is the stimulus response from China's central bank which may offset part of the virus'

economic drag. Throughout February, China's central bank lowered short-term interest rates and injected a few hundred billion dollars of liquidity into the economy via reverse repurchase agreements.

CONCLUSIONS AND INVESTMENT IMPLICATIONS

Deadly diseases including coronavirus and SARS are significant global health issues, yet their impact on the global economy and financial markets is typically brief. Often, the immediate market response overstates the long-term risks to the global economy. While it is too early to determine the full economic impact of the coronavirus, the recent decline in active cases and a significant liquidity injection from the People's Bank of China are encouraging developments. Given the extensive travel restrictions, quarantines and curfews throughout large parts of central China, most experts expect a moderate slowdown in Chinese GDP growth in the first half of 2020. We expect the broad U.S. equity market to continue navigating coronavirus concerns as the first quarter unfolds. Energy and industrial commodity prices and areas of the domestic equity market most closely tied to global travel could, however, remain under pressure for several months.

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