



## THE CORONAVIRUS AND FINANCIAL MARKETS

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### Summary and Major Conclusions:

*The economic impact of the coronavirus will be negative in the short term but the economic damage should be transitory. World equity and fixed-income markets have overreacted to the crisis, but emotion and momentum are moving the markets. Further equity price declines cannot be ruled out in coming days and weeks. The longer-term investment outlook is more favorable. US and world equity markets should generate decent returns over the next six to nine months, and massively outperform bonds. Economically sensitive stocks — and value stock managers — should outperform the overall domestic stock index.*

- ◆ The world economy is being held hostage by the virus. The epidemic has spread rapidly beyond China and into Asia and parts of Europe and the Middle East, with no end in sight.
- ◆ Above all else, financial markets detest uncertainty, and there are very few definitive answers at the moment. Markets prefer conclusive bad news rather than total uncertainty, which explains why investors have panicked, pursuing a massive flight from risk assets and stampede into safe-haven assets.
- ◆ COVID-19 has already dealt the world economy a severe blow, most notably in China and nearby Asia. The impact on the US economy has been mild to date.
- ◆ The primary economic impact is derived from public health countermeasures to contain the virus, rather than the sickness itself. Quarantine measures and other efforts to contain the spread of the virus have negatively affected all forms of business and economic activity.
- ◆ Chinese tourism and business travel are on hold; airlines have significantly curtailed flights to Asia; the closure of China's factories has disrupted global supply chains; and consumer spending has weakened because of quarantines and store closures.
- ◆ Financial markets will be at risk until the number of new cases outside of China reaches a peak, which is impossible to determine at this time. Asset prices tend to move to extreme levels during periods of panic, along with heightened volatility.
- ◆ The number of new cases outside of China is rising rapidly just as the number of cases inside China appears to be peaking. Chinese authorities are encouraging businesses to resume production and employees to return to work. Hopefully, these government directives will not reverse the decline in new cases within China.
- ◆ The US economy is more insulated than Asia and Europe but is not immune. I have revised first quarter US GDP growth from 2% to 1.5%. US exports of goods and services to China will decline, while local production could be temporarily disrupted.
- ◆ First quarter GDP forecasts for China and the world economy have been severely downgraded. Instead of 6%, I am now expecting less than 3% GDP growth for China. I have revised my forecast for Q1 world GDP from 3.3% to 2.5%.

- ◆ For the full year, my GDP estimates are only slightly lower than those prior to the outbreak. My 2020 forecast assumes GDP growth of 5.5%, 2.5%, and 3.3% for China, the US, and the world economies, respectively.
- ◆ Company earnings are vulnerable to negative surprises in Q1 and to a lesser degree in Q2. Profits of US multinationals are especially at risk. Under my base-case scenario, earnings should bounce back strongly in the second half of the year.
- ◆ Assuming a peak in new cases worldwide in the spring months — which is far from certain — world GDP will improve somewhat in Q2, with a more noticeable recovery in Q3 and Q4. The epidemic will be a short-term economic drag but is unlikely to derail the US expansion.
- ◆ World GDP should rebound strongly in the second half of this year and for much of 2021. Conversely, if the COVID-19 epidemic morphs into a pandemic, a world recession would become increasingly likely.
- ◆ Increased government stimulus from the major economies is likely to super-charge the world economic recovery later this year. In particular, Chinese policymakers have announced a new round of fiscal and monetary initiatives to support growth. In principle, policymakers always respond to economic shocks with increased government stimulus.
- ◆ World equity and fixed-income markets have overreacted to the crisis, but emotion and momentum are moving the market. Further equity price declines cannot be ruled out in coming days and weeks.
- ◆ I had warned in my weekly reports in January and early February that US equity market valuations were stretched. The recent plunge in the equity market suggests that US common stocks have returned to approximate fair value.
- ◆ World bond markets are extremely overvalued. The 1.28% yield on ten-year US Treasury bonds is at an all-time low. By way of perspective, the market yield on these bonds was roughly 2% in 1940, following the Fall of France. At 1.77%, the market yield on 30-year bonds is at an all-time low.
- ◆ Corporate bonds are also significantly overvalued. The current 2.38% market yield on US investment-grade corporate bonds is the lowest on record. Fixed-income investors should expect negative rates of return in all bond market sectors over the next six to nine months.
- ◆ US and world equity markets should generate decent returns over the next six to nine months, and massively outperform bonds. Economically sensitive stocks — and value stock managers — should outperform the overall domestic stock index.



**Robert F. DeLucia, CFA**, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.

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**Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index:** Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

**CBOE Volatility Index:** An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

**MSCI Emerging Market Index:** An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

**MSCI World Ex US Index:** Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

**Russell 2000 Small-Cap Index:** Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

**S&P 500<sup>®</sup> Index:** Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

**State Street Investor Confidence Index:** measures investor confidence or risk appetite quantitatively by compiling actual buying and selling patterns of institutional investors.

**US Trade-Weighted Dollar Index:** An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.

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