SPECIAL REPORT: THE EVOLUTION OF A FINANCIAL MARKET PANIC

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It is striking that the high-grade corporate bond market has been resilient despite the plunge in equity markets. Market yields have declined to an all-time low of 2.31%, seemingly oblivious to the potential for a spike in defaults that always accompanies recessions. This fact alone suggests that the ultimate economic damage will be transitory rather than protracted. It also reinforces my forecast that containment efforts may result in a severe hit to both first quarter GDP and company profits, but that the impact will be confined to the short term and be followed by a sustained recovery in subsequent quarters.

Last week's equity market decline was the worst since the 2008 financial crisis, while government bond yields plunged to all-time lows. This *Special Report* provides an update of health conditions around the world and the likely impact of the virus on the world economy, along with the likely implications for world financial markets in 2020.

- Stock prices and bond yields declined with lightning speed last week as the coronavirus epidemic threatens to evolve into a pandemic. The cumulative decline in the S&P 500 is nearly 13%, while bond yields have plunged to all-time record lows. Last week's equity market decline was the worst since the 2008 financial crisis.

- While the number of new infections in China has allegedly peaked, new cases outside of China remain in a steep uptrend. Although far from assured, there are increasing odds that Europe and North America will face similar economic dynamics that have unfolded in China and parts of Asia.

- The primary economic impact stems from public health efforts to contain the virus, rather than the illness itself. Quarantine measures to contain the spread of the virus within China have undermined confidence and negatively affected exports, services, consumption, freight, travel, and manufacturing.

- Additional containment efforts outside of China could result in significant short-term economic weakness, but should not derail the 11-year old business expansion. Following a disastrous February, business activity in China appears to be in recovery mode, but the damage to global supply chains will continue to cripple manufacturing and trade worldwide.

- History reveals that epidemics and other natural disasters tend to halt economic growth in the short term, but unleash sufficient pent-up demand to boost aggregate spending, output, and capital investment in subsequent quarters.

- It is impossible to develop a credible economic forecast until there is evidence of a peak in new cases worldwide, which could be weeks away. The most likely outcome is a sharp decline in economic activity in the first half, followed by a strong rebound in growth during the second half of this year.

- The worst-case scenario is that the current epidemic morphs into a global pandemic. In this case, the odds of a global recession would exceed 50%. However, a recession would be steep but brief, and a strong economic recovery would likely soon follow.

- The best-case scenario would involve only a moderate increase in the number of cases in the US and Europe, while China continues to re-start its economy. My base case is that both Europe and the US experience an epidemic, but one that is far less severe than that within China. A sustained economic recovery should follow in Q3.

- As always, equity markets will discount the economic rebound well in advance of the news, and ultimately rise to new highs. However, the timing of the recovery in stock prices is predicated upon the severity and duration of the epidemic.

- A useful signal for adopting a more pro-growth investment strategy will be a sustained unwinding of the mass quarantines, business shutdowns, school closings, and travel bans outside China, in response to a decline in new cases.

- In the best-case scenario, world equity prices would return to their old highs before mid-year; in the worst-case scenario, a return to new highs would likely be deferred until the second half of this year. My base-case scenario assumes a return to the old market highs within six months.

- In relative economic terms, it is instructive to understand that the spreading virus is less of a sustained economic threat relative to last year's trade war. Moreover, the epidemic will likely be a transitory one-time event, whereas trade protectionism could be an ongoing threat to the global economy for many years.

- It is also important to step back and assess underlying conditions within the US economy and financial system. Compared with those just prior to the 2001 and 2008 recessions, economic fundamentals are far healthier.

- While recessions can and do occur in response to exogenous supply-side shocks, low inflation, highly favorable financial conditions, a solid banking system, healthy housing market trends, and a vibrant labor market should mitigate the downturn.

- The strong likelihood of a massive monetary and fiscal policy response worldwide also reinforces my forecast of a severe but brief economic fallout from the virus. Policymakers worldwide — most aggressively in China — are easing monetary conditions and implementing tax cuts and public spending programs.

- The Federal Reserve is likely to cut its policy rate several times this year. Prior to the coronavirus outbreak, my assumption was that the Fed would hold policy rates steady for all of this year.

- 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 market panics, accompanied by massive volatility. The yield on ten-year US treasuries has declined to 1.08%.

- The high-grade (HG) corporate bond market has been resilient, despite the plunge in equity markets. Market yields have declined to an all-time low of 2.31%, seemingly oblivious to the potential for a spike in bond defaults that always accompanies recessions. Corporate bonds and common stocks are both classic risk assets.

- The US corporate bond market is at an all-time high. The calmness of corporate bond investors suggests that the economic damage will be brief and transitory rather than protracted, and that the equity market has perhaps overreacted to the unfolding news.

- Compared with a year-to-date loss of nearly 9% for US equities, HG corporate bonds have gained nearly 4%. The total return on US treasury securities this year is 5%.

- Equity valuations have improved significantly from the market's all-time peak during February. The price-to-earnings (P/E) ratio for the S&P 500 has declined from a multi-year high of 19.5x to 16.5x, slightly below the average of the past five years.

- Investors should expect further stock price declines until there are clear signs of an end to the health crisis and the economic fallout. History shows that markets tend to overshoot on the downside during periods of investor panic. Nonetheless, my belief is that stock prices will be significantly higher both six months and one year from now, assuming an economic recovery in the second half of the year.

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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® 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 quantitively 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.