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# MACRO MUSINGS

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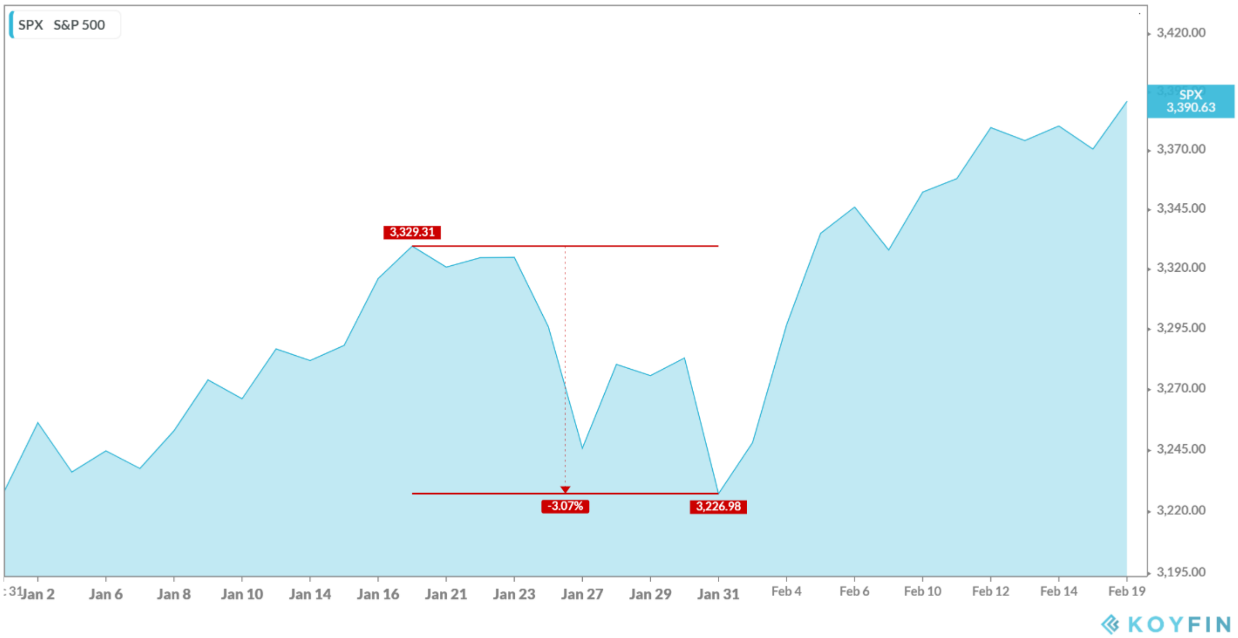
## MARKET SHRUGS OFF PANDEMIC

### SUMMARY

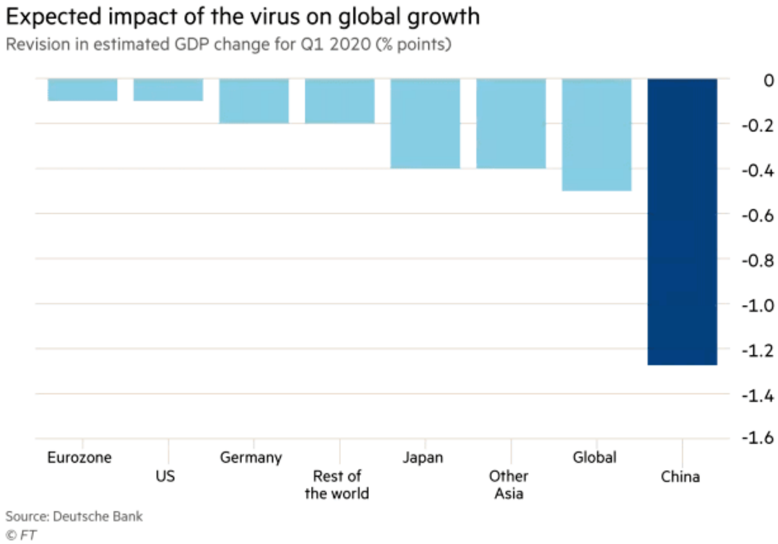
- **The market's resilience in the wake of the coronavirus outbreak may come as a surprise to many. But China's reaction in providing monetary stimulus, combined with the stock market's tendency to disregard previous outbreaks, suggests the response is not unusual at all.**
- **The US economy is holding firm. The latest data from the housing market shows housing starts and building permits accelerating, which should lend support to further economic gains for the rest of the year.**
- **There is a large gap between the money flowing into fixed income vs. money going into equities. Historically, when the difference is this wide, stocks saw better returns than bonds over the following twelve months.**

## WHY DOESN'T THE MARKET SEEM TO CARE ABOUT CORONA?

Since the first reported death of the Coronavirus (since renamed COVID-19) on January 11th, the market has continued to rise. Concerns about the virus appear to have peaked at the end of January, but the decline was a modest 3% and the S&P 500 has rallied to new all-time highs since then:




It is difficult to say how significant the impact will be, but there must be at least *some* negative impact on the global economy. This chart from Deutsche Bank suggests that while China will see the biggest hit, every major economy will suffer in the short term:



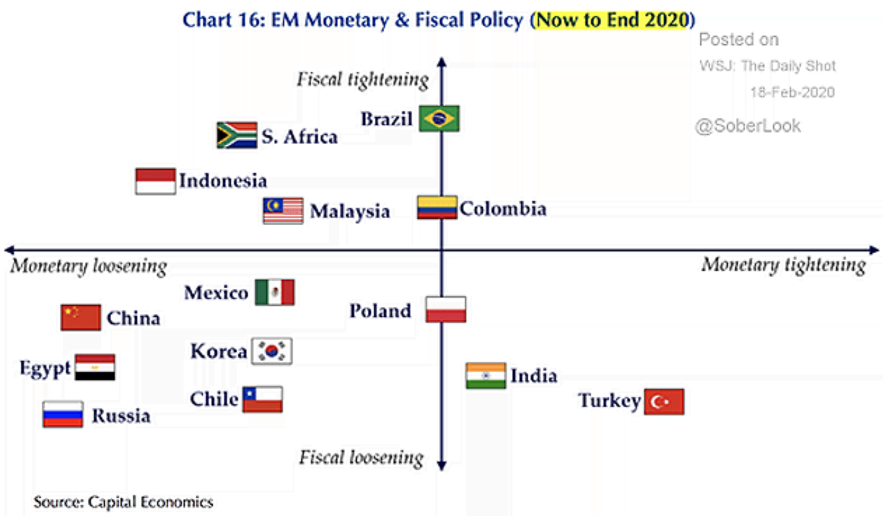
Although the impact on the US is projected to be minimal, even the strongest US corporations are warning that earnings will take a hit. Notably, Apple updated its sales guidance earlier this week. From their press release:

*Our quarterly guidance issued on January 28, 2020 reflected the best information available at the time as well as our best estimates about the pace of return to work following the end of the extended Chinese New Year holiday on February 10. Work is starting to resume around the country, but we are experiencing a slower return to normal conditions than we had anticipated. As a result,* ***we do not expect to meet the revenue guidance we provided for the March quarter due to two main factors.***

*The first is that worldwide iPhone® supply will be temporarily constrained…The second is that demand for our products within China has been affected.*

So why hasn't the market dropped more? The answer, in our opinion, is twofold. First, if the market believes the impact to global economic growth is temporary, it usually looks past the issue and expects the difference to be made up later in the cycle. Second, central banks often respond to such events by implementing rate cuts or injecting liquidity into their financial system, as the People's Bank of China did two weeks ago.

The most vulnerable emerging market economies are either loosening monetary policy, increasing government spending, or both. Currently, there are only two economies tightening monetary policy, as depicted in the graphic below:

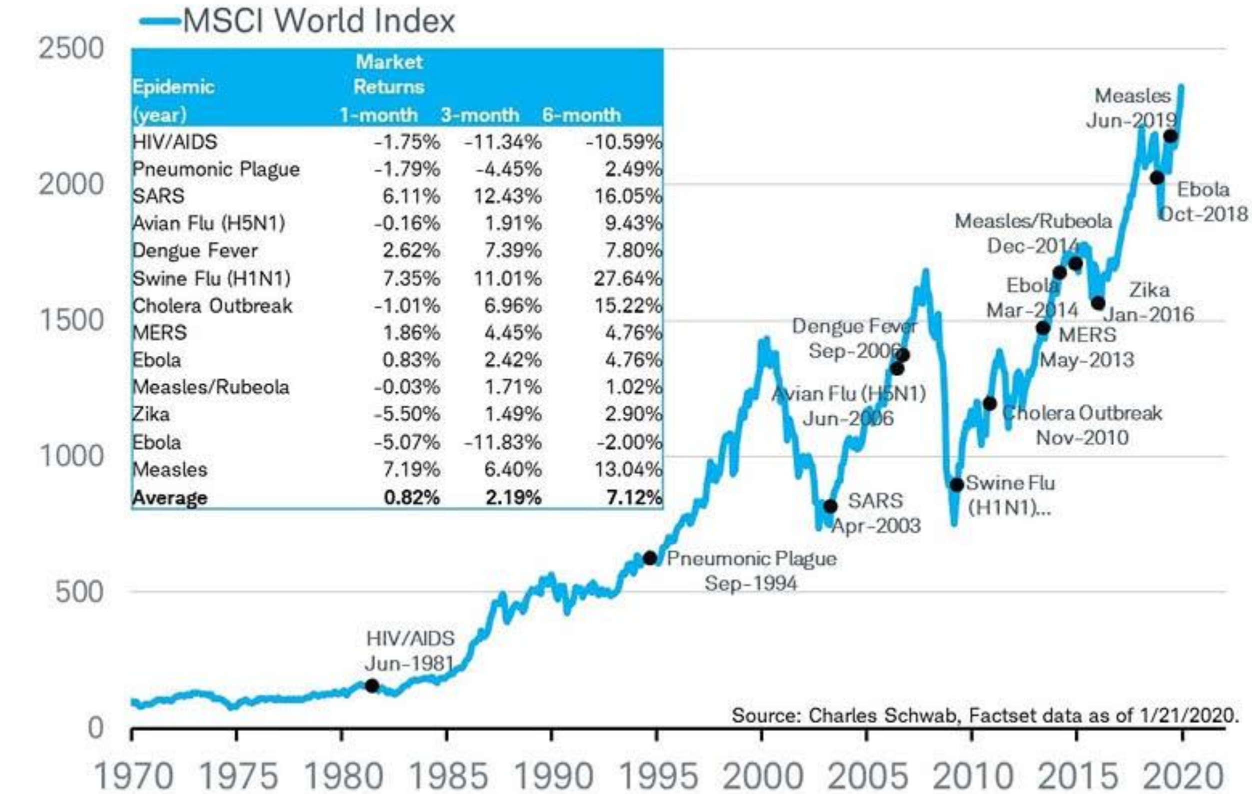



Although the Fed has taken no action, they are paying attention. Fed Chair Jay Powell recently gave congressional testimony where he stated that they are "monitoring" the impact of the virus and the potential disruptions to the global economy. Should growth turn down, the Fed will likely cut interest rates. It is also a good bet that if the situation worsens and spreads outside of China, the market may not be as forgiving.

## IF HISTORY REPEATS ITSELF, THIS OUTBREAK WILL NOT CAUSE MARKET PROBLEMS

History says the market looks past pandemics. The following table shows returns of the MSCI World Index during previous global epidemics. There does not appear to be any correlation between the outbreak of a new disease and the performance of the worldwide stock market (Chart from Schwab):

**Immune: world epidemics and global stock market performance**

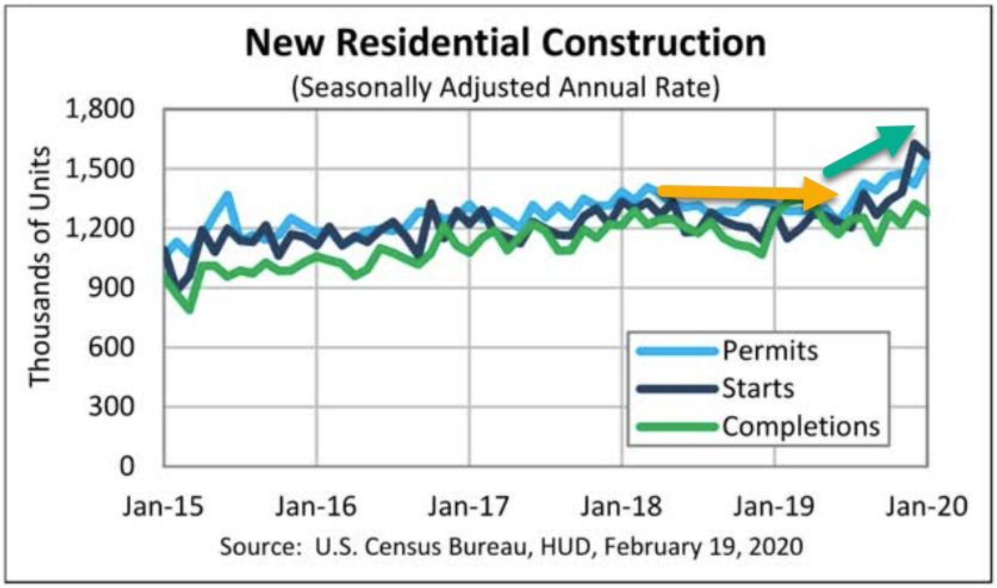



| Epidemic (year) | Market Returns 1-month | 3-month | 6-month |
|---|---|---|---|
| HIV/AIDS | -1.75% | -11.34% | -10.59% |
| Pneumonic Plague | -1.79% | -4.45% | 2.49% |
| SARS | 6.11% | 12.43% | 16.05% |
| Avian Flu (H5N1) | -0.16% | 1.91% | 9.43% |
| Dengue Fever | 2.62% | 7.39% | 7.80% |
| Swine Flu (H1N1) | 7.35% | 11.01% | 27.64% |
| Cholera Outbreak | -1.01% | 6.96% | 15.22% |
| MERS | 1.86% | 4.45% | 4.76% |
| Ebola | 0.83% | 2.42% | 4.76% |
| Measles/Rubeola | -0.03% | 1.71% | 1.02% |
| Zika | -5.50% | 1.49% | 2.90% |
| Ebola | -5.07% | -11.83% | -2.00% |
| Measles | 7.19% | 6.40% | 13.04% |
| **Average** | **0.82%** | **2.19%** | **7.12%** |

The MSCI World Index captures large and mid cap representation across 23 Developed Markets countries. With 1,646 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. **Past performance is no guarantee of future results.**

## HOUSING READY TO SUPPORT U.S. ECONOMY

After struggling for most of 2018 and 2019, housing market activity is accelerating and should help support GDP growth in the coming quarters:




Housing is a critical industry because it involves so many parts of the economy. That is one reason a downturn in housing almost always leads to recession (from Bespoke Investment Group):

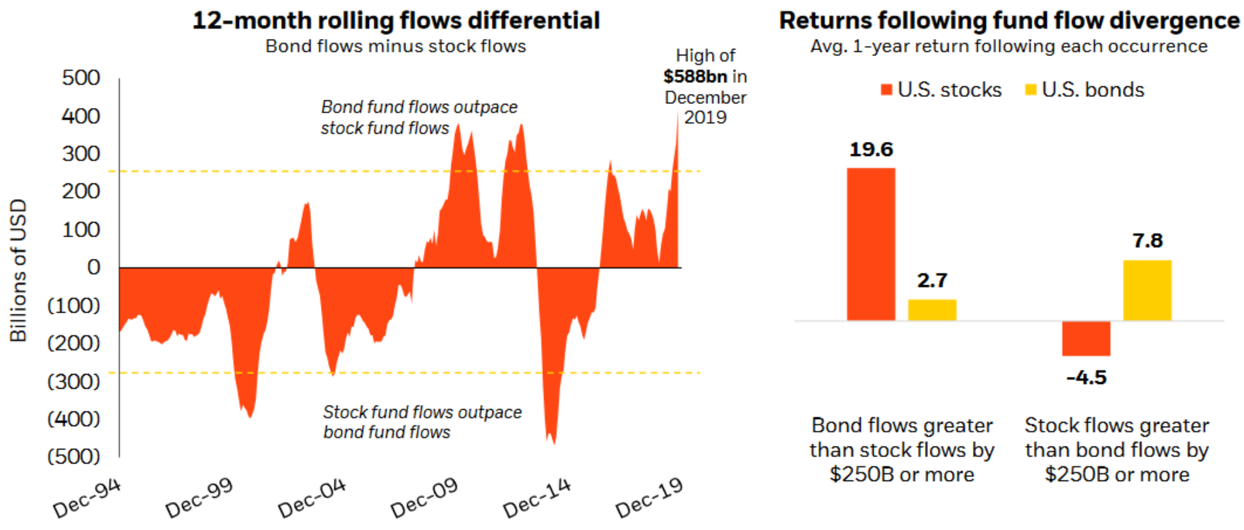
Lower mortgage rates, which are approaching an all-time low, are helping boost housing activity:


Combined with robust employment growth, steady retail sales, and a supportive Fed, there are no significant obstacles to economic growth over the next year.

## FUND FLOWS ARE SUPPORTIVE OF FURTHER MARKET GAINS

While a correction can occur *anytime*, the amount of money going to bond funds instead of stocks has historically supported good equity returns.

The chart on the left below shows the 12-month cumulative flows into bond funds minus the amount going to equities. You can see the ratio of bonds to stocks was at a record dollar amount in December. On the right, it shows that when the spread between flows into bonds and stocks becomes this stretched, equity performance has been excellent, while bond returns were much more modest (but still positive, on average).




Source: Morningstar as of 12/31/19. Stock mutual funds and ETFs are represented by the Morningstar Broad Equity Category. Bond mutual funds and ETFs are represented by the Morningstar Taxable and Municipal Bond Categories. U.S. Stocks are represented by the S&P 500 Index and U.S. Bonds are represented by the BbgBarc US Agg Bond Index. **Past performance is no guarantee of future results.** Index performance is shown for illustrative purposes only. You cannot invest directly in an index.

Source: BlackRock Investment Institute

## WE ARE FOCUSED ON MACROCAST, NOT THE LATEST HEADLINE RISK

If COVID-19 hurts corporate profits and economic growth beyond a brief timeframe, it should flow through to MACROCAST™, and we will follow our process and take defensive measures if necessary. In the meantime, we think the US economy is in good shape. As we mentioned earlier, corrections can happen at any time and for any reason, but we expect any decline to be temporary.

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